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Seychelles and the IMF

Press Release:
IMF Completes the Third Review Under the Extended Arrangement for Seychelles
June 3, 2011

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

May 18, 2011

SEYCHELLES: LETTER OF INTENT

May 18, 2011

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund

Dear Mr. Strauss-Kahn:

1. The attached Supplementary Memorandum of Economic and Financial Policies (MEFP) describes Seychelles' performance through December 2010, and updates the policies that were laid up in the MEFPs dated 1st December 2009, 1st June 2010 and 3rd December 2010 for the remainder of 2011 and for 2012.

2. **We request completion of the third review under our Extended Arrangement (EFF) and the release of the sixth tranche of SDR 3.52 million (40 percent of quota)**. We have made significant progress in our reforms and the program remains on track. All quantitative performance criteria (PCs) at end-December 2010 were met with margins, including a primary surplus exceeding the target by 1.6 percent of GDP, and monetary developments remain favorable. The structural benchmark scheduled for end-December was observed; we expect that the Cabinet will approve the amendments to the Financial Institutions Act (a structural benchmark for end-April 2011) with a two month delay. Overall, our reforms have delivered a stable, growing economy and a sustainable debt profile.

3. **The EFF continues to accompany a comprehensive medium-term structural reform strategy** aimed at consolidating macroeconomic stability and securing growth; and to **guide our macroeconomic policies** over the current year. Despite our good progress, developments in food and fuel prices and unanticipated financial support for the national airline require some adjustments in our program targets that do not jeopardize our hard-earned macroeconomic stability. Specifically, we request a change in net international reserves, and reserve money targets for end-June and end-December 2011, as well as in the fiscal primary balance target for end-December 2011.

4. **We believe that the economic and financial policies set forth in the MEFP are sufficient to ensure that the objectives of the program will continue to be met**. We stand ready to take any further measures that may prove necessary to meet our objectives. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. We remain committed to full implementation of the recommendations of the Fund's latest safeguards assessment of the Central Bank of Seychelles (CBS).

5. **It is expected that the fourth review of the arrangement will be completed by end-September 2011 and that the fifth review be completed by end-March 2012.** Financing assurance reviews will continue as long as public debt arrears to external private creditors remain outstanding.

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

Sincerely yours,

/s/

Danny Faure
Vice President and Minister of Finance
Republic of Seychelles

/s/

Pierre Laporte
Governor
Central Bank of Seychelles

Attachments: MEFP and TMU

SEYCHELLES: SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2011

A. Introduction

1. This document tracks progress during the first year of our macroeconomic and financial policies and structural reforms under the three-year program supported by an Extended Fund Facility (EFF) arrangement. It updates the MEFP of December 3, 2010, and details our policy commitments through the remainder of 2011, to support completion of the fourth EFF review.

B. Macroeconomic and Financial Performance in 2010

2. **In 2010, the Seychellois economy started to reap the benefits of its stabilization efforts, and economic activity recovered strongly.** Tourist arrivals increased by 11 percent and foreign direct investment (including a large private residential complex) boosted activity, in particular in construction, beverage manufacturing, electricity, and transportation and telecommunication services. Overall, real GDP growth is estimated to have exceeded 6 percent.

3. **The economic recovery took place in a low inflation and stable exchange rate environment.** Inflation was almost nil year-on-year. The Seychelles rupee was broadly stable against all currencies, with a slight depreciation against the dollar at the beginning of the year being offset by an appreciation towards the end of the year. Gross international reserves reached 2.2 months of prospective imports at year-end.

4. **Our macroeconomic policy objectives for 2010 have been met.** The larger-than-anticipated government revenue performance for the year as a whole (4 percentage points of GDP) translated into a fiscal primary balance in excess of the initial budget by 1.6 percent of GDP. Part of the revenue margin was used to release the pressure on our highly compressed expenditure, including a contingency for capital expenditure of about 1 percent, set aside at the beginning of the year. The fiscal surplus (2. 8 percentage points of GDP) and the successful restructuring of our external debt facilitated a rapid decline in our public debt, to 82 percent of GDP at year-end, from 128.6 percent a year earlier.

5. **Monetary developments remain broadly favourable.** Broad money expansion was contained at 13.7 percent year-on year, slightly higher than initially projected despite reserve money growth in line with program targets. Private sector credit (excluding the impact of a loan reclassification) started to recover from a substantial contraction the year before, while net credit to the government declined, sustained by the rapid domestic debt repayment. This resulted in a significant liquidity overhang which in turn pushed interest rates on treasury bills and CBS intervention rates to low levels: short-term interest rates on 3-month treasury bills went below ½ percent while retail lending and deposit rates also edged down.

C. Program Implementation

6. **The program remains on track and the program of structural reforms is being implemented broadly as scheduled.** All quantitative performance criteria were met at end-2010. The VAT bill was submitted to the National Assembly and adopted on December 21, 2010, ahead of schedule for this structural benchmark.

D. Macroeconomic Outlook in 2011

7. The outlook for the economy is a continued, albeit slower, recovery in 2011 with increased downside risks. Global growth prospects are not significantly different from those prevailing at the 2011 budget preparation. In particular, European economies (the main markets for our exports) are projected to grow at a modest pace. In view of several large resorts commencing operations, we project nonetheless a strong increase in tourism receipts this year. However, prospects for canned tuna (our second largest export) are less encouraging in part due to the worsening impact of piracy on the supply of tuna to the domestic processing factory and no significant growth is expected in this industry over the medium term. More significantly, our small, highly open economy is confronted with substantial external shocks stemming from international food and fuel prices.

8. **These international factors are expected to translate into a slowdown in real GDP growth in 2011** to 4 percent, a rise of consumer price inflation to about 5½ percent by year-end, and a negative impact on the trade balance of about 5 percentage points of GDP compared to last year's projections. Lower FDI-related inflows from the exceptionally high level registered in 2010 will nonetheless reduce the current account to 32.7 percentage points of GDP in 2011, from more than 50 percentage points in 2010.

E. Policies for 2011

9. **We intend to make several policy adjustments to help the economy absorb the global price shocks.** Our first line of defence against such shocks will continue to be our flexible exchange rate regime. We are also tightening monetary policy and offsetting the negative impact of the shocks on the budget to mitigate second-round inflation effects, limit balance of payments pressures and stay the course towards debt sustainability.

10. **We have designed measures to help households adjust to the price shocks.** The rise in domestic prices is expected to be gradual because Seychelles' state-owned suppliers of fuel and basic commodities have adopted cautious purchase and stock strategies that will smooth price increases throughout part of the year. While a full pass-through is being implemented for most fuel prices, measures have been adopted to smooth the price of a few sensitive products. A Stabilization Fund has been set up for this purpose to help the relevant state-owned enterprises absorb the associated costs through reimbursable funds.

F. Fiscal Policy

11. **We remain committed to a sustainable fiscal policy, in line with our strategy to bring public debt below 50 percent of GDP by 2018.** Our budgetary performance was consistent with forecasts for the first two months of the year and we plan to offset the fiscal cost of the Stabilization Fund by reducing non-priority capital spending by an equivalent

amount. Revenue performance is expected to be slightly higher than in the budget, mainly reflecting upward revisions in dividends from public enterprises. However, support to the national airline, which faces serious but temporary financial difficulties and whose bankruptcy would disrupt tourism activity, requires a relaxation of our primary surplus target by 0.5 percentage points of GDP in 2011, to 4.5 percent. This will not significantly affect the prospect of fiscal sustainability.

12. **Net disbursements of the Stabilization Fund are capped at SR 50 million (the equivalent of 0.4 percentage points of GDP) in 2011.** Its objective is to enable eligible state-owned companies to smooth out price increases for cooking gas prices, as well as electricity and public transportation tariffs. It is expected that any disbursed funds will be reimbursed to government once the pass-through is complete. The use of the Stabilization Fund will be monitored closely on a monthly basis to ensure that disbursements are consistent with the 2011 cap.

13. **Progress continues in the implementation of our key capital projects.** Two new electricity generators are currently being commissioned by PUC, over 150 housing units have been delivered on Perseverance Island, and the rehabilitation of the Victoria Hospital continues. To make up for envisaged disbursements of the Stabilization Fund, the capital budget for the year will be reduced by SR 50 million by delaying non-priority projects, including. In addition, we are maintaining capital projects amounting to SR 50 million under contingency upon revenue targets for end-June 2011.

14. **Air Seychelles is implementing a strategic action plan to eliminate operational losses by year-end, limiting the need for budget support.** The financial losses it faced at the end of 2010 were caused by a variety of factors, including the Government’s policy of encouraging competition through access to landing rights, higher fuel prices, one-off maintenance charges and currency movements (most costs are in USD whilst revenues are in Euros). In support of the plan, detailed in ¶52-56, budget funds of up to SR83 million (0.7% of GDP) will be provided in 2011 to help cover expected operational losses and debt servicing costs of government-guaranteed emergency loans contracted with Nouvobanq.

G. Tax and Customs Reform

15. **Replacing Good and Services Tax (GST) by a single rate Value Added Tax (VAT) remains a cornerstone of our comprehensive tax policy reform.** Over the course last year, we have completed several preparatory steps, including by:

- introducing a new Revenue Administrations Act (Jan 2010);
- eliminating business tax threshold for companies and lowering that of non-companies (January 2010);
- introducing the Income and Non-Monetary Benefits Tax (July 2010);
- increasing the rate of GST on tourism from 10% to 12% (November 2010); a last increase of the GST rate to 15 % on tourism is scheduled for November 2011.
- shifting from a system of administrative assessment of Business Tax to one of self-assessment; and
- harmonizing the income tax rate so that *all* (national and expatriate) employees pay a flat rate of 15 percent (January 2011).

Combined, these reforms have broadened the tax base, simplified the system and made it fairer and more equitable. Further modernization of the Seychelles Revenue Commission (SRC) will now be undertaken, with a focus on customs administration.

VAT Introduction

16. **A number of policy decisions were taken in preparation for the implementation of VAT in July 2012**, including the approval of VAT legislation in December 2010. Based on stakeholders' feedback ,advice from the IMF February 2011 tax mission and basic underlying principles of tax collection predictability, we have made the following decisions:

i. Petroleum will continue to be subject to the same excise taxes per litre, but will be exempt from VAT to keep the taxation system simple. Petroleum taxes yield over a tenth of total tax revenue, with low compliance and administration costs.

ii. Businesses shall be liable for VAT if their turnover is above a threshold or if they opt for voluntary registration.

iii. The threshold level will be set with the aim of obtaining approximately 1,000 registered taxpayers in the first year. Once the SRC masters the administration of these taxpayers, the threshold will be gradually lowered to cover more businesses.

iv. To limit cash-flow issues, VAT-registered businesses will be allowed to offset the VAT liability on imported capital goods against the input VAT credit to which they are entitled when filing the next return.

v. Rental income which is currently subject to GST will be brought under the Business Tax Act.

Cabinet will approve VAT regulations including rates, exemptions and thresholds by end-June 2011.

17. **Administrative preparations are also underway.** A resident IMF VAT expert – funded by an EU grant – will assist the SRC for a period of 18 months starting in June 2011 and covering the first 6 months of VAT implementation. This expert will assist the SRC in developing skills, procedures, manuals necessary to secure a successful transition to VAT.

Tax and Customs Administration reforms

18. **General administrative reforms in the SRC continue** – they are aimed at improving self compliance whilst reducing overall collection costs. To facilitate collaboration between the Tax and Customs departments, the SRC will merge the prevailing three sets of identification numbers into one. The single Tax Identification Number will require the repeal of the Seychelles Business Number Act and amendments in the Revenue Administration Act 2009 and the Seychelles Revenue Commission Act by end-July 2011. Additionally, the SRC is carrying out the following measures to improve overall administration of taxes:

a. Further to a function-based restructuring of the Domestic Tax Division, the Audit Section now consists of two units which segment the taxpayer population by size and similar characteristics. Thus, the SRC will be able to better understand and mitigate compliance risks, improving revenue collection. Filing requirements differ by size of business to decrease processing workload of the Tax Division and reduce compliance costs; small business will only be required to file and pay taxes on a quarterly basis.

b. In addition to public disclosure through its website and printed brochures, the SRC prepares a weekly section in the national daily newspaper explaining a different tax each week. Staff is sent on short attachments with other tax administrations to better understand and develop tax payer education programmes. The first of these will be to the South African Revenue Service in the first half of 2011.

c. Extra staff is being recruited to facilitate implementation of VAT: 10 by July 2011 and an additional 10 in the first quarter of 2012. It is envisaged that 21 new staff members will join Customs, the first 9 in 2011 and a further 12 in 2012.

d. The SRC is enhancing the role of its IT department to ensure tax administration efficiency and further develop its Client Management System, in close coordination with the Government's IT Department through fortnightly meetings.

19. **The Customs Management Act is expected to be approved by the National Assembly by end-June 2011.** The bill was submitted to the National Assembly in December 2010, but the latter requested a number of amendments which are currently being finalized by an ad-hoc commission. The Act will become operational in February 2012, giving sufficient time for the development of supporting regulations, staff training and outreach for importers, agents and the general public.

20. **A reform team will be appointed by April 2011 to ensure successful implementation of the Customs reform program**. This includes the development of a capacity building plan; the implementation of risk management and post clearance audit procedures; the review and development of standard operating procedures; and overall improvements in ASYCUDA (Customs' IT system) effectiveness.

H. Public Financial Management

21. **Public Financial Management was further strengthened, as reflected in the recently completed EU assessment.** The Public Expenditure and Financial Accountability (PEFA) assessment concluded by the EU in March 2011 noted remaining weaknesses, notably in the area of medium-term budgeting and legislative scrutiny of the budget law. These are being addressed through the formulation of an action plan. In addition, recommendations of the Auditor-General (AG)'s report for budget year 2009 to improve ministries and departments' procedures are followed up by the Audit Committee (created in April 2010). To strengthen expenditure management, the Public Budget Management Section of the Ministry of Finance has started monitoring line ministries' creditor lists on a monthly basis. The Comptroller General will promptly clear any related payments outstanding to

continue to ensure the non-accumulation of domestic payment arrears. The Ministry of Finance and PUC are currently engaged in an extensive exercise to verify the utility consumption of line ministries for 2010 and settle any final bills within 30 days of their submission.

22. We will adopt a new Public Finance Act (PFA) to incorporate our reformed budget practices. This law will reflect recent operational improvements in public financial management, most notably in the area of budget formulation, execution, reporting and auditing, in line with Fund recommendations. The law will also extend the coverage of the National Assembly's budgetary oversight to capital expenditure. Given the complexity of this reform we have sought Fund advice on drafting the Bill, which we expect to submit to Cabinet's approval by end September 2011.

23. The revision of the Financial Instructions and the Accounting Manual will be completed by June 2011. The new PFA will also provide the basis for revising the Accounting Standards of Financial Statements, aligning them with the International Public Sector Accounting Standards (IPSAS). By September 2012 we will have the necessary framework in place to ensure accounting practices are in line with international best practice.

24. We plan to introduce a new chart of accounts that incorporates a functional classification in the 2012 budget. A special committee, spearheaded by the Financial Planning and Control Division of the Ministry of Finance, and including representatives of the Treasury and the Government's Department of Information, Communications and Technology has submitted a proposal and an action plan to Cabinet.

25. We are introducing medium-term policy-based budgeting, to further improve fiscal planning and accountability. For the 2012 Budget, we will undertake a pilot program comprised of the two largest ministries – health and education. Subject to the results of the pilot, we will extend policy-based budgeting to all agencies' budget preparations from 2013. Implementation of the new system is supported by a training program for government officials responsible for budget implementation, which started in late 2010 with courses on asset management and strategic budgeting.

26. Further progress is being made in treasury management and in the rationalization of public entities. The new budget dependent agencies' re-classification policy has been fully implemented, resulting in a sharp reduction in the number of suspense accounts. As a result, strategic assessments of our public entities are being carried out with the objective of addressing duplication and elaborating a plan for privatization.

27. **We will launch a strategic plan to establish a well-targeted and sustainable social security system covering the Social Security Fund (SSF) and the Social Pension Fund (SPF).** As part of this plan, we are reforming SSF investment objectives. SSF assets were built from collections under the previous system of Social Security Contributions. By April 2011, we will submit an amendment to the Social Security Act to the National Assembly to formalize our current policy whereby no SSF funds may be used for government expenditure. By end-September 2011 we will submit to Cabinet a strategic plan for the investment of SSF assets, which will outline objectives and modalities of investments and permissible uses for related income. This plan will be formulated by the SSF Board of Trustees, which is also entrusted with oversight of the plan's implementation. Meanwhile, part of SSF deposits at commercial banks will be gradually transferred to the central bank.

I. Monetary and Exchange Rate Policies

28. **The Central Bank of Seychelles (CBS) will continue to rely on reserve money targeting as its monetary policy framework.** It will maintain Repos as the main instrument to guide short-term interest rates while the Deposit Auction Arrangement (DAA) and the Credit Auction Arrangement (CAA) will be used for fine tuning. The CBS is increasing its range of monetary instruments, such as the recently approved foreign exchange SWAPs, to achieve greater flexibility in market interventions.

29. **To absorb excess liquidity and prevent the risk of inflationary pressures from the recent increases in global food and fuel prices, the CBS has tightened monetary policy by raising minimum reserve requirements (MRR) on commercial banks' deposits.** MRR on domestic and foreign currency deposits were raised from 10% to 13%, the former effective April 1, the latter effective June 1 (following three monthly steps). Liquidity tightening, compounded by the gradual transfer of SSF deposits to the CBS, is expected to lead to an increase in T-bill rates that could limit the risks of capital outflows.

30. **The CBS and the Ministry of Finance are coordinating their efforts to improve liquidity management.** A calendar of weekly Treasury bill issuances is communicated four weeks in advance so as to inform the market on the quantity of paper to be issued. This has helped improve the predictability of the securities market and facilitate banks' liquidity management. Closer collaboration with the SRC and Ministry of Finance on daily government expenditure and revenue collection has also been beneficial in terms of liquidity management.

31. **We have decided to reintroduce longer terms government bonds in the domestic market as a first step towards the establishment of a benchmark yield curve**. The absence of a yield curve is a barrier to financial sector development. We are requesting TA from the IMF to assist us in developing domestic securities markets, including the re-introduction of the secondary market and a primary dealership system.

32. **We remain committed to the floating exchange rate regime.** This regime continues to function well and the Seychelles rupee has remained resilient in the face of global currency volatility. The CBS will only intervene in the foreign exchange market to smooth out excessive volatility, to ensure orderly market conditions, and, if needed, to build up international reserves in line with program objectives. We stand ready to consider additional recommendations from the IMF to further improve the functioning of the foreign exchange market, in particular the inter-bank market. We will introduce a code of conduct for foreign exchange and money market participants in late 2011.

33. **The CBS continues to target a gross external reserve target of 3-month import coverage.** It considers this threshold as a cushion against Seychelles' relative openness to the world economy and vulnerability to external shocks. At end-2010, we reached 2.2 months of import cover and remain on track to meet this target in a reasonably short period. To help absorb global price shocks, however, the reserve accumulation objectives for 2011 have been slightly adjusted down.

34. **Given its internal capacity constraints, the CBS will maintain a prudent approach to its reserve management program**, limiting the use of external parties to manage its reserve asset to the World Bank (RAMP program) and the Bank for International Settlement. The CBS Investment and Risk Implementation Committee will finalize proposals

and enter into formal arrangements with preferred institutions during the second quarter of 2011. Besides their more favorable terms for investing a portion of external reserves, these institutions will also provide technical assistance on reserve management to the CBS.

J. CBS Operations and Governance

35. **The first phase in the implementation of an integrated (core) banking system went live on December 01, 2010 as planned.** The CBS can now provide all banking services on a single IT platform, which has greatly enhanced the efficiency of its operations and significantly reduced operational risks stemming from different types of software. We have now started a second phase to integrate other CBS operations, including payroll, HR management and inventory management.

36. **The modernization of the national payment system is gathering momentum.** Several major steps were taken in 2010, including the formalization of new clearing house rules and the adoption of the National Clearing and Settlement system Act. The successful implementation of the new core banking system, which provides straight-through-processing of interbank and Government transaction on a real time basis, will bring additional benefits to the payment system in 2011. This new system provides the platform for implementing an Electronic Clearing House and introducing a local Switching System to facilitate the settlement of rupee ATM/POS transactions. The CBS will continue to promote electronic funds transfer and cards. A real time gross settlement system will be introduced by end-2012.

37. The capital of the CBS will be increased in 2011, in line with the CBS Act. The recapitalization of the CBS through t-bill issuance on December 15, 2010 brought the capital of the central bank to 10 percent of end-2009 monetary liabilities, enhancing its portfolio of tradable securities for open market operations. A transfer of SR 13.4 million from 2010 distributable profits will bring capitalization of the CBS to 9.21 percent of end-2010 monetary liabilities.

38. **The CBS legal framework has been further strengthened, addressing vulnerabilities and enhancing independence.** In line with the 2010 IMF Safeguards Assessment a set of amendments to the CBS Act 2004 will be submitted for Parliament's approval by end-June 2011. Among the key amendments are provisions which clarify the terms of lending to Government: any such lending above the stipulated limit will be subject to punitive terms (form of higher above-market interest rates and shorter repayment periods) except in cases of force majeure. Other provisions include (i) a strict prohibition on receiving or seeking outside instructions for CBS employees and board members; (ii) an explicit reference to Governor and Deputy Governor terms of office of six years; and (iii) due process in the event of dismissal, including for the Governor, Deputy Governor and Board members.

39. **CBS governance is being improved through further strengthening of internal control and audit mechanisms.** In February 2011, the CBS Board approved a risk policy and a framework for risk management and established a Risk Implementation Committee. This committee has since merged with the Investment Committee to enhance efficiency and stimulate synergies. In the coming months the CBS will put in place a new structure that will provide clear segregation of duties relating to reserve management activities of front, middle and back office functions. Internal audit has been established as a fully fledged CBS division.

K. Financial Sector Reforms

40. **We are initiating several measures to enhance competition and promote the deepening of the underdeveloped financial sector. According to the 2010 Article IV consultation report, Seychelles banks appear to have a higher return on equity than their peers, which could imply a lack of competition.** A recent study by the CBS identified several impediments to the development of commercial bank credit to the private sector including (i) high switching costs by banks; (ii) inadequate disclosure by financial institutions; (iii) absence of a credit rating system; (iv) excessive costs and lengthy procedures for registration of loan and other bank-related documents; and (v) lengthy procedures for resolution of financial disputes. To address these shortcomings, the Ministry of Finance has reduced the charges and timeframe for document registration; it will work with the Judiciary to put in place a faster system for resolution of financial disputes; and it will propose some amendments to the Financial Institutions Act (FIA) (see ¶41 below). In addition, the CBS will introduce measures to minimize switching costs, and will implement a financial literacy campaign to enhance public awareness and encourage informed decisions to reinforce competitive pressures on banks.

41. **The proposed amendments to the FIA, to be approved by Cabinet by June 2011, will also strengthen the regulatory framework and enhance competition**. They will allow for (i) the introduction of new financial products (e.g., leasing, hire purchase) and Islamic banking (to be licensed and regulated by the CBS); and (ii) the establishment of a Credit Reference Bureau to allow information sharing on potential lenders between banks. The proposed amendments will also give the CBS extra regulatory powers, including to: (i) enhance disclosure of banks' terms and conditions (to ensure greater transparency toward the public); (ii) impose fines; and (iii) regulate certain categories of fees/charges, especially where these are deemed to inhibit competition in the financial sector.

42. **Our endeavor to further develop the financial sector will be boosted by the establishment of a stock exchange in Seychelles**. Whilst the Seychelles market may not solely justify the existence of a stock exchange we are confident that the latter could attract sufficient offshore business, including from the Indian Ocean, South Asia, the Middle East and Africa. Government has decided to tender out the process for establishing the exchange and proposals will be invited in the coming months. A national committee will be established with the task of selecting the most suitable candidate based on technical and financial criteria to ensure utmost transparency in process.

43. **The CBS continues to work towards developing a risk-based supervision framework which was initiated with IMF technical assistance**. Negotiations are underway with IT companies to develop a Bank Supervision Application forming the basis for conducting offsite supervision under the CAELS approach. On-site supervision of institutions under the purview of CBS will continue as per the scheduled timeframe, in line with the CAMELS banks rating system. In the context of this risk-based approach the CBS will require banks to submit business plans on an annual basis by end-2011, enhancing macro-prudential supervision of financial institutions.

44. **Supervision of the Housing Finance Company (HFC) and the Development Bank of Seychelles (DBS) is progressing well.** The CBS has started the on-site examination of DBS and a final report is expected to be ready by end of May 2011. Offsite supervision of DBS is currently underway. The on-site examination of HFC is expected to start in August 2011, meanwhile training is being provided to HFC to support the submission of prudential reports to the CBS on a regular basis.

45. **The CBS has advanced considerably in developing the appropriate safeguards for financial sector stability.** A first draft of the crisis preparedness binder has been completed and circulated to key stakeholders for comments, addressing identified gaps. The draft has been sent to Toronto Centre for its review in April 2011.

46. **Seychelles will continue its efforts to promote transparency and stability of the offshore financial sector**. Work is under way to address several legal and regulatory weaknesses in the area of exchange of information that had been identified by a recent peer review of the Global Forum on Transparency and Exchange of Information for Tax Purposes (¶48). In addition, the CBS will seek to start negotiations for its membership within the Offshore Group of Banking Supervisors.

47. **Substantial legislative changes are being prepared to improve the tax transparency of our offshore sector:**

- A new Companies Act will unify the existing "dual" system of the Companies Act 1972 and International Business Companies Act 1994, and provide a stronger regulatory framework, including for international business companies.
- A Revenue Administration Regulation under the Revenue Administration Act will cater for Seychelles obligations to exchange information with third countries.
- Additional Tax Information Exchange Agreements are being finalized, including with the Netherlands and six Nordic countries.
- A new International Corporate Service Providers law will clarify the authorities' ability to request documents and information (ensuring that all relevant information required is available on offshore entities).
- A Financial Services Commission will be legally established to reflect the increased responsibility of SIBA in enforcing transparency of the offshore sector.

48. **We have made important strides in implementing recommendations of the 2006 Mutual Evaluation of Seychelles the Anti-Money Laundering (AML) and Counter Financing of Terrorism (CFT) regime by the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG).** In particular, in 2008, the Financial Intelligence and Assets Recovery Unit (FIU) was established and attributed investigative powers and duties. Staffing in FIU has been recently increased, enabling the FIU to ensure that reporting entities comply with the requirements of the AML Act and the Prevention of Terrorism Act 2004 by means of on-site inspections. The FIU has also applied to become a member of the Egmont Group and has assisted law enforcement agencies from seventeen countries to date.

49. **The CBS is committed to encouraging a sound and efficient insurance sector that promotes policyholder confidence**. To this end, various capacity building initiatives are underway. A workshop on insurance supervision, facilitated by Commonwealth, was held in March 2011. In addition, the FIRST Initiative has agreed to provide TA to the CBS to strengthen insurance supervision, including by reviewing the regulatory framework and preparing manuals for conducting examination of insurance and insurance-related companies.

Table 1: Schedule of Actions for 2011

Submit first Draft of Crisis Binder to Toronto Centre	Apr-11
Submit FIA amendments to Cabinet of Ministers	Jun-11
Start negotiations for membership within the Offshore Group of Banking Supervisors	Jul-11
Implementation of Bank Supervision Application	Dec-11
Require banks to submit business plans	Dec-11
Review regulatory framework of insurance sector, preparation of manuals for insurance supervision	Dec-11
Conduct onsite examinations of DBS and HFC	Dec-11

L. Public Enterprises

50. **In view of recently increased quasi-fiscal risks, public enterprise monitoring will be reinforced.** In April 2011, a revised policy to formalize the selection criteria of Board members was submitted to Cabinet; a second policy revision is expected to be approved by Cabinet in July to align Board remuneration with the level of responsibility and work entailed. A privatization plan for non-strategic enterprises which do not serve policy goals is on track for September 2011.

Air Seychelles

51. **Air Seychelles' operations have been crucial to the tourism industry, which is the mainstay of the economy.** Although its share of the market has been declining, Air Seychelles still transports more than half of all tourist visitors to the country. In contrast to many countries in the OECD and the Indian Ocean, Seychelles has allowed Gulf-based carriers to increase flight frequencies in 2010 and 2011, an action driven by Government's desire to encourage the growth of tourist arrivals and its commitment to openness and competition. The Government is thus committed to ensure any shocks affecting the airline do not disrupt the continuous flow of visitors to the country.

52. **The financial position of the national airline deteriorated in 2010 due to a number of pricing and contractual issues. It was also affected by greater competition, fuel price increases, one-off maintenance charges and adverse currency movements.** In December and January the Government provided a guarantee on loans of SR 225 million (2% of GDP) to re-finance the airline's debt, which are to be repaid over a five-year period.

53. **Bold steps have been taken to eliminate the company's losses and limit the drain on the Government's current budget.** The Government replaced the company's management and Board in February 2011 and charged it with eliminating losses whilst focusing on the core business (i.e. providing direct air access for visitors to the Seychelles). The new management team has prepared a strategic action plan and is taking immediate remedial action.

54. The central elements of the plan are eliminating loss-making routes, streamlining and modernizing the fleet, improving the terms of Air Seychelles' code-share arrangement with Air France on the critical Seychelles-Paris route, and passing on fuel-price increases. Although the airline enjoys a high load factor (number of seats sold per flight) on most of its routes, its cost base is high due in part to an ageing fleet with high maintenance and lease costs. Low overall utilization of the long-haul fleet is also a problem.

55. **The government is confident that a restructured Air Seychelles can be placed on a sound financial footing so as to minimize the cost of its recapitalization, within one year.** Internal reforms undertaken in the next few months will be crucial and the Ministry of Finance is closely monitoring the situation and will report to the IMF on a quarterly basis.

PUC

56. **Our commitment to improving our capacity to invest in public infrastructure has not abated, particularly regarding urgent needs in the utilities sector.** BADEA will finance expert, who would carry out the study on PUC tariffs and mapping out the latter in consistency with full cost recovery and meeting future investment needs. This is on course for completion by end-July 2011. Additionally we will reinstate tariff adjustments to fuel price variations by end-September 2011, with a view to eliminating PUC's operational losses and any further recourse to the Stabilization Fund.

Public Financial Institutions

57. **We have taken major steps toward our review of the privatization of the two State-owned banks, Nouvobanq and Seychelles Savings Bank (SSB).** The Seychelles Government has met the International Finance Corporation's advisory services with a view to bring the review process of the Government's shares in Nouvobanq to completion before end-2011. The IFC is also considering subscribing to a capital augmentation of 20 percent as a way to facilitate its privatization.

58. **Government has offered 40 percent of SSB's shares to the private sector beginning April 2011.** The shares will be tradable. This initial sale of shares was offered to the general public, with a priority given to the bank's account holders and employees.

59. **Measures are being implemented to enhance the DBS's lending capacity and governance procedures.** In recent months, DBS offered more affordable rates (8.5 percent) and more flexible terms, which increased demand for its loans. This in turn has put excessive strain on the financial position of the bank, which currently has insufficient funds to satisfy its portfolio of approved loans despite the issuance of government-guaranteed bonds on the domestic financial market at 6% (a rate which provides enough spread to cover the bank's operating costs despite the lower lending rates). In March 2011, the DBS Board stopped the refinancing of existing loans, limited the size of loans to SR6 million (with additional lending to be done on a pari passu basis with commercial banks) to curb demand. Several other actions will be implemented in the second half of 2011 such as establishing minimum liquidity buffers and enhancing governance procedures.

60. **A new law governing DBS to reflect its new mandate will be introduced in early 2012.** The emphasis will be on small and medium-sized enterprises (SMEs) in targeted, development-oriented sectors, with high risk projects that commercial banks would generally not be willing to finance. Given the high risk nature of such projects interest rates could at times exceed those offered by commercial banks.

61. **As part of the action plan we plan to adopt by end-June 2010 for house financing policy, we are also working on a strategy to modernize HFC.** The action plan will in particular limit the role of the public sector within the constraints of the significant pent-up demand for housing and limited commercial bank financing for lower income applicants. The strategy will be informed by the recommendations of the FIRST initiative's strategic review. It was drawn up and presented to the management and the HFC Board in April 2011prior to Government approval.

M. Total and External Public Debt

62. Our revised public debt management strategy policy, which was adopted together with the current budget, entails a gradual reduction of our total public indebtedness to 50 percentage points of GDP by 2018. Despite the recent issuance of government guarantees in relation to the domestic loans extended to Air Seychelles and the bonds issued locally by DBS, and a less favorable macroeconomic context, total public debt is projected to decline to 76.2 percent at end-2011, from 82.3 percent at end-2010. Unless force majeure, we do not plan to issue additional government guarantees on domestic loans in 2011.

63. Our external debt restructuring is close to completion. Seychelles remains in discussions with two official bilateral non-Paris creditors (Abu Dhabi and India) on the restructuring of outstanding claims and expects to conclude shortly bilateral agreements with two remaining commercial creditors. In addition, we are seeking the finalization of the two remaining bilateral agreements with Paris Club creditors. We are committed to meet the program limits on contracting new government or government-guaranteed external loans as set out during the last program review.

N. Statistics

64. We have adopted a strategic plan to achieve compliance with SDDS and BPM6, based on the recommendations of the IMF and other external advisors. In September 2011 we will commence publication of quarterly and annual GDP statistics under the SDDS framework, as well as improve labor market statistics. By December 2012 we will compile the production index on a quarterly basis using the quarterly GDP indicators. In 2012 we will redevelop data sources and estimation methods in response to the introduction of the VAT. The new chart of accounts will facilitate the reporting of fiscal data in compliance with the Government Finance Statistics Manual 2001 (GFSM 2001).

65. Other initiatives include our participation, for the first time, in the International Comparison Program being coordinated by the African Development Bank and efforts to improve our data sources by drawing on a wider range of taxation and survey data. We are also enhancing our institutional capacity through increased staffing, training, and information dissemination, including through participation in IMF training courses.

O. Program Monitoring

66. The program will continue to be monitored by semi-annual reviews, with semi-annual quantitative performance criteria and disbursements, in line with the MEFP of May 16, 2010. The quantitative performance criteria for 2011 are shown in Table 2. The structural benchmarks are shown in Table 3. The attached revised Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria, indicative targets, and adjusters under the program.

67. Seychelles will avoid introducing new exchange restrictions, multiple currency practices, or bilateral payment agreements in contradiction with Article VIII of the IMF's Articles of Agreement and imposing any import restrictions for balance of payments reasons.

68. We stand ready to adopt any additional measures, in consultation with IMF staff, which may become necessary to ensure program success.

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

	2010			2011								
	December			March			June		September		December	
	Program	Adjusted	Actual	Indicative target	Adjusted	Prel.	Performance Criteria	Revised	Indicative target	Revised	Performance Criteria	Revised
Performance criteria												
Net international reserves of the CBS, millions of U.S. dollars (floor) [1]	168	148	204	189	191	210	192	204	202	203	213	199
Reserve money (ceiling)	1,753	…	1,746	1,804	…	1,772	1,824	1,755	1,844	1,757	1,862	1,765
Primary balance of the consolidated government (cumulative floor) [2]	823	…	1,031	142	…	419	240	240	515	462	602	536
The contracting or guaranteeing of new external debt by the public sector (Millions of U.S. dollars; cumulative ceiling) [2]	37	…	7	4	…	0	33	33	46	46	47	47
The contracting or guaranteeing of new short-term external debt by the public sector (Millions of U.S. dollars; cumulative ceiling) [2]	0.0	…	0.0	0.0	…	0.0	0.0	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 government (ceiling)	0.0	…	0.0	0.0	…	0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:												
Net external non project financing (millions of U.S. dollars; cumulative) [2]	31.8	…	11.4	-1.4	…	0.7	0.0	-0.6	2.1	6.8	5.5	1.6
Program accounting exchange rates												
SR/US$ (end-of-quarter)	11.75	…	…	11.75	…	…	12.30	12.15	12.30	12.15	12.30	12.15
US$/Euro (end-of-quarter)	1.27	…	…	1.27	…	…	1.36	1.34	1.36	1.34	1.36	1.34
US$/UK pound (end-of-quarter)	1.48	…	…	1.48	…	…	1.57	1.56	1.57	1.56	1.57	1.56
US$/SDR (end-of-quarter)	1.49	…	…	1.49	…	…	1.56	1.49	1.56	1.49	1.56	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 net flows from the beginning of the calendar year; includes external non-project loans and grants net of external debt service payments.

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

Table 3: Structural Benchmarks, 2010–11

Measure	**Target Date**	**Macroeconomic Rationale**	**Note**
Cabinet approval of the amendments to Financial Institutions Act as described in MEFP, ¶41	End-April 2011	To strengthen competition in the banking sector and improve risk management.	Not met. Moved to end-June2011.
Adopt an action plan for house financing policy that limits the role of the public sector (MEFP, ¶61)	End-June 2011	To reduce fiscal risks, strengthen competition, and promote development of the banking system.	
Launch a strategic plan for the reform of the social security system (MEFP, ¶27)	End-June 2011	To establish well-targeted and sustainable social security system.	
Cabinet approval of VAT regulations, including rates, exemptions, and thresholds (MEFP, ¶16)	End-June 2011	To modernize the tax system and remove tax distortions.	
Commission and complete a study on optimal tariffs for utilities (MEFP, ¶56)	End-July 2011	To ensure cost recovery and long-term sustainability of utilities.	
Develop a privatization plan for nonstrategic public enterprises, which do not serve public policy goals (MEFP, ¶50)	End-September 2011	To reduce the role of the state in the economy, improve corporate governance and minimize fiscal risks.	
Cabinet approval of a new Public Finance Bill extending the National Assembly's oversight on capital expenditure budget (MEFP, ¶22)	End-September 2011	To strengthen public finance management.	
Reinstate the electricity tariff adjustment for fuel price variation (MEFP, ¶56)	End-September 2011	To reduce losses of the public utility company.	

SEYCHELLES: TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This technical memorandum of understanding presents the definitions of variables included in the quantitative performance criteria and indicative targets set out in the memorandum of economic and financial policies (MEFP), the key assumptions, and the reporting requirements of the Government and the Central Bank of Seychelles (CBS) needed to adequately monitor economic and financial developments. The quantitative performance criteria and indicative targets, and the benchmarks for 2011 are listed in Tables 2 and 3 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 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.

II. MONITORING AND REPORTING

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

Adjusters

5. The floor on the CBS's NIR will be adjusted upward (downward) by the amount by which the external non-project loans and cash grants exceeds (falls short of) the amounts assumed in the program (MEFP Table 2). The floors will also be adjusted upwards (downwards) by the amount that external debt service payments fall short (exceed) the amounts assumed in the program.

B. Reserve Money (Ceiling)

Definition

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

Monitoring and reporting

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

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

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

D. Public External Debt (Ceiling)

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

10. For the purposes of this performance criterion, the definition of debt is set out in Executive Board Decision No.6230-(79/140), Point 9, as revised on August 31, 2009 (Decision No. 14416-(09/91)).. Debt is understood to mean a current, non contingent liability,

created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future points in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. The ceiling on contracting official and officially guaranteed external debt includes all form of debt, including:

a. loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

b. suppliers credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and,

c. leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the 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.

d. Arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt.

E. External Arrears of the Public Sector

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

F. Domestic Arrears of Government

12. The nonaccumulation of budget expenditure arrears will be a performance criterion under the program and will be measured on net basis from the beginning of a calendar year. 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; (3) debt service payment on domestic debt of the government or guaranteed by the government that has not been made within the contractually agreed period.

II. Data and Information

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

The CBS will report

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

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

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

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

The Ministry of Finance will report

Monthly (within 2 weeks from the end of the month):

- Consolidated government operations on a commitment basis and cash basis in the IMF-supported program format.
- The detailed revenues and expenditures of the central government and social security fund.
- Accounts of the public nonbank financial institutions.
- Import and export data from the customs department.
- Public debt report.
- Statements of Stabilization Fund operations
- Consolidated creditors schedule on domestic expenditure arrears of the government.

Quarterly (within a month from the end of the quarter):

- Financial statements of Air Seychelles

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.