EXECUTIVE BOARD MEETING

EBS/19/44
Correction 1

June 12, 2019

To: Members of the Executive Board

From: The Secretary

Subject: **Seychelles—Staff Report for the 2019 Article IV Consultation and Third Review Under the Policy Coordination Instrument and Request for Modification of Targets and Monetary Consultation Clause**

Board Action:	The attached corrections to EBS/19/44 (6/3/19) have been provided by the staff:
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 6, 7, 15, 17, 19, 61, 65, 69**
Questions:	Mr. Sy, AFR (ext. 38651) Mr. Konuki, AFR (ext. 38085) Mr. Dhungana, AFR (ext. 35421)

Box 1. Seychelles: Main Recommendations of the 2017 Article IV Consultation

Recommendations	Status
Fiscal Policy and Public Financial Management	
1. Target primary surplus of 3 percent of GDP from 2018 onwards to buttress the medium-term debt reduction target of bringing public-debt-to-GDP ratio below 50 percent by 2020.	1. The authorities revised down the primary surplus target to 2.5 percent of GDP from 2018 onwards to address investment needs. The medium-term target of bringing public debt-to-GDP ratio below 50 percent has been postponed by one year to 2021.
2. Create further fiscal space to accommodate investments aimed at enhancing resilience to climate change.	2. The authorities have been seeking financing sources for the climate change related projects, including external grants and PPPs to minimize fiscal impact. The government has introduced measures to limit the nominal growth of current spending, including procurement reforms and measures to remove duplication of services provided by different agencies.
3.Continue the progress to strengthen the SOE sector	3. The authorities made significant progress under the PCI, including publishing significant fiscal risks arising from SOEs and amending Code of Governance for SOEs in line with OECD Guideline.
Monetary and foreign exchange policy	
4. Maintain an appropriately tight monetary policy stance.	4. The CBS has kept an appropriately tight monetary policy stance, which has contributed to contain inflation at a low level.
5. Continue the progress toward a stronger monetary policy framework in which interest rates play a prominent role.	5. The CBS made significant progress with the help of Fund TA. It has ~~introduced~~ operationalized an interest rate corridor in ~~June~~ July 2017 and announced a policy rate in December 2018.
6. Maintain the flexible exchange rate policy.	6. The CBS has maintained flexible exchange rate policy while keeping international reserves buffer at an adequate level.
Financial sector policy and structural reform	
7. Continue efforts to address risks of further potential loss of correspondent banking relationships (CBRs).	7. Seychelles has made significant progress towards protecting CBRs, including amendments to strengthen the AML/CFT framework as envisaged under the PCI and improve CBR compliance by local banks.
8. Improve the business environment, including by reducing cross-subsidization in electricity prices.	8. Progress has been limited in improving business environment. Adjustment in electricity tariffs to reduce cross subsidization have resumed starting September 2018.
9. Deepen, diversify and upgrade the tourism and fisheries industries	9. Certain efforts on diversifying tourism markets and providing more local content through guesthouses have borne fruit. More efforts are needed to value upgrade the fisheries industry.

Source: IMF Staff

3.5 percent in December 2018 from 7.1 percent in December 2017 (following the resolution of a large legacy NPL) and that banks are adequately capitalized and liquid. The CBS raised the lower and upper bounds of the interest rate corridor by 50 basis points in ~~late December 2018~~ January 2019, citing concerns over potential demand pressures arising from public-sector wage adjustments in the 2019 budget and the still brisk pace of private credit growth. Headline year-on-year CPI inflation rate declined to 2 percent in March 2019, down from over 4½ percent earlier in 2018 due to declining international fuel prices in the later months of 2018 and a tight monetary policy stance since ~~March~~ April 2018. Staff's newly constructed financial conditions index indicates a general improvement in financial conditions relative to 2016, prior to the start of the strong credit growth cycle 4.

6. **Economic conditions continue to be favorable** (Tables 1-5, Figures 1 and 2). Tourist receipts grew by 16¾ percent in 2018 with strong growth from the major European markets, according to the CBS survey. The robust performance of the tourism sector coupled with strong canned tuna production resulted in a real GDP growth of 4.1 percent in 2018. The nominal exchange rate has been stable in recent months while gross international reserves (GIR), supported by strong tourism, have outperformed staff's projection at the time of the 2nd review under the PCI. Private sector credit growth decelerated since March 2018 but remained high at 13.6 percent at end-March 2019. Financial soundness indicators indicate that the ratio of non-performing loans (NPLs) to gross loans declined to 3.5 percent in December 2018 from 7.1 percent in December 2017 (following the resolution of a large legacy NPL) and that banks are adequately capitalized and liquid. The CBS raised the lower and upper bounds of the interest rate corridor by 50 basis points in late December 2018, citing concerns over potential demand pressures arising from public-sector wage adjustments in the 2019 budget and the still brisk pace of private credit growth.[3] Headline year-on-year CPI inflation rate declined to 2 percent in March 2019, down from over 4½ percent earlier in 2018 due to declining international fuel prices in the later months of 2018 and a tight monetary policy stance since March 2018. Staff's newly constructed financial conditions index indicates a general improvement in financial conditions relative to 2016, prior to the start of the strong credit growth cycle.[4]

7. **The economic outlook remains benign in the near- and medium-term provided that the authorities maintain their prudent policies envisaged under the PCI**. Growth is expected to moderate to around 3½ percent during 2019–20, around the potential rate, on the back of a tightening of monetary policy, moderating performance in the tourism and fishery sectors, and a moratorium on large hotel construction projects until 2020.[5] While the increase in some excise rates in the 2019 budget and an electricity tariff rebalancing scheduled for later 2019 could create inflationary pressures, the tight monetary policy stance should help contain inflation. Foreign direct investment (FDI) and growth should pick up after the lifting of the moratorium on large hotel construction at

[3] A 5 percent increase on the salary table for public services was implemented in April 1, 2019. This salary scale revision is done every five years as stipulated in the Salary Act. Increases in salary have contributed to consumer credit growth as borrowers' income has increased. As Seychelles imports most of its consumption, higher demand translates into higher current account deficits and a depreciating local currency. As exchange rate pass-through to inflation was estimated by staff to be significant, demand-pull inflationary pressures remain a concern for monetary policy and macroeconomic stability.

[4] See accompanying Selected Issues Paper "Estimating a Financial Conditions Index for Seychelles."

[5] The large hotel moratorium introduced in late 2015 prohibits construction of new large hotels until end-2020.

2017 with a new monetary policy framework which uses an interest rate corridor.[15] The new framework aims at enhancing monetary policy transmission by reducing short-term volatility and providing more guidance to short-term interest rates. The mid-point of the interest rate corridor serves as the policy rate. After building up an adequate level of reserve buffers by 2014, the CBS' foreign exchange interventions have been mostly confined to limiting excessive volatility.

22. While inflation has been falling recently, the CBS should stay vigilant to any sign of inflationary pressures. After raising the policy rate by 50 basis points in ~~late December~~ January 201~~8~~9, the CBS kept it unchanged in March 2019. Staff found the CBS's monetary policy tightening at ~~end-2018~~ January 2019 appropriate, considering the faster credit growth at the time as well as an increase in public wages announced in the 2019 budget. Although inflation has been falling since early 2018, thanks to the decline in international fuel prices during late 2018 and early 2019 and the tight monetary policy stance; and staff's credit cycle analysis indicates that the credit gap is nearly closed (Box 3), inflationary pressures are expected from increased private consumption on the back of higher public wages and sustained credit to the private sector, as well as the rising international fuel prices in recent months. In this context, staff supports the CBS' recent monetary policy decision to keep the policy rate unchanged and to stay vigilant to any sign of inflationary pressures. Given that consumption-driven loans continue to drive credit growth, staff recommended accelerating the amendment of the Financial Stability Act, which will enable the authorities to adopt macroprudential measures to address risks from a potential build-up in consumer credit. Seychelles' economy has been characterized by structural excess liquidity in the banking system for many years, partly due to unsterilized purchases of foreign exchange by the CBS during 2009–10, in the aftermath of the crisis. Starting in 2014, the CBS conducted a sterilization program to mop up excess liquidity using Treasury bonds specifically issued by the Ministry of Finance.[16] Staff also encouraged a close coordination between the Ministry of Finance and the CBS on the unwinding of the monetary debt so that the government's debt reduction strategy and the CBS' inflation objectives would be balanced.

23. Staff welcomed the progress made toward strengthening the new interest rate-based monetary policy framework. Under the new framework, the focus of monetary policy is to guide short-term interest rates through the introduction of a Monetary Policy Rate (MPR), which serves as the key policy rate signaling the prevailing monetary policy stance. The MPR is expected to lie at the center of interest rate corridor. To strengthen the new framework, considerable progress has been made in inflation forecasting and liquidity management capacity, including progress in

[15] The floor on the corridor sets the rate at which the CBS pays banks when they place their excess funds in an overnight deposit at the CBS while the ceiling sets the rates at which the CBS charges banks when it provides them with overnight collateralized liquidity. In the transition to the new framework, the CBS still closely monitor~~ed~~s reserve money~~ until mid-2018~~.

[16] This "monetary debt" is fully backed by blocked deposits at the CBS. See Appendix III of Country Report No. 17/401.

implementing the CBS 6-phase plan (PS¶35).[17] Staff encouraged the CBS to continue adapting its communication policy and work with relevant stakeholders to develop the interbank market with the help of Fund TA. Staff concurred with the CBS's views that adopting a formal inflation targeting framework at this current juncture would be premature. As the basic infrastructure for a well-functioning interest-rate-based monetary policy framework is being developed, it appears too early to consider a move to a formal inflation targeting framework. Nonetheless, announcing a medium-term inflation objective could help anchor inflation expectations, thereby promoting economic and financial stability, and increasing the traction of monetary policy. In that regards, staff encouraged the CBS to formalize and expand the survey of inflation expectations. Closer coordination between the CBS and the Ministry of Finance would also help improve liquidity forecasting which would benefit the implementation of monetary policy.

24. The flexible exchange rate policy has served Seychelles well and reserve coverage is at an adequate level. Staff's external sector assessment indicates a modest level of overvaluation of the real effective exchange rate and an external position moderately weaker than implied by fundamentals and (Annex II). Meanwhile, GIR currently stand at around 125 percent of the ARA metric. Given Seychelles' perennial vulnerability to external shocks as a typical tourism-dependent small island economy, staff views the current level of reserve coverage as adequate. Large foreign exchange purchases would lead to increased excess liquidity in the system or to further issuance of monetary debt to mop it up, which would be detrimental to both the inflation and the debt reduction objectives. Thus, staff advised the CBS to maintain its flexible exchange rate policy and limit foreign exchange purchases to the extent necessary to preserve reserve coverage ratios at around the current level.

Authorities' Views

25. The authorities concurred with staff's assessment and policy recommendations. They appreciated the Fund's ongoing TA activities supporting their efforts to ensure a successful transition to the new monetary policy framework. Although the CBS recognizes the importance to promptly ~~amend~~ draft the Financial Stability Act and drafting of amendments had already started, it noted that the involvement of other agencies and capacity constraints are slowing down the process.[18] In this context, it requested to delay the submission of the ~~amendment~~ new Financial Stability Act to the Cabinet to end-September 2020 (PS¶36, 6th review RT) from end-May 2019 pledged at the time of the 2nd PCI review.

D. Supporting Financial Stability

26. Seychelles is making progress in reducing the jurisdictional risk associated with its offshore financial sector. Tax legislation has been amended to meet the obligations under the

[17] The CBS developed an action plan, consisting of six phases, aimed at facilitating the transition to the new monetary policy framework in late 2017 (see Annex II of Country Report No. 18/48).

[18] Demands on the Attorney General's Office are particularly high and have increased with the new regulatory and legal reform agenda. In Seychelles, the Attorney General plays the role of a principal legal advisor to the government and initiates all criminal prosecutions for criminal offences following investigations by the police, the Financial Intelligence Unit, and the Anti-Corruption Commission. Furthermore, in a tight labor market, there is intense competition from the private sector for high-skilled nationals which leads to a staffing turnover in public institutions.

Corruption Commission of Seychelles (ACCS), have identified TA needs for capacity enhancement and contacted the external experts to request TA. The authorities are encouraged to make prompt progress in capacity enhancement in these institutions in preparation for the next ESAAMLG evaluation scheduled for September 2019.[19] Staff expressed its concerns about new provisions in the recent amendments to the International Business Corporations (IBC) Act that would prohibit the disclosure or availability of the list of directors of Seychelles IBCs (except under specific circumstances).[20] Staff urged the authorities to articulate a new offshore sector strategy focusing on measures to move to a more transparent business model in compliance with international best practices and prevent the misuse of legal persons and arrangements for money laundering activities. Staff also encouraged the authorities to accelerate the progress toward an implementation of a risk-based approach to supervising AML/CFT risks of banks and trusts and company service providers in line with the MER recommendations. Staff welcomed efforts by the CBS to improve financial institutions' compliance with the requirements needed to obtain new and maintain existing CBRs with the help of an intermediary bank, which include the provision of backup CBRs. The factors leading to global banks' withdrawals from CBRs being multiple and interrelated, the authorities are encouraged to continue efforts at the regional/international level to address current challenges to the maintenance of CBRs.

28. Staff welcomed the progress toward improving financial stability and encouraged the CBS to accelerate the implementation of remaining reforms. Progress in completing a full transition to Basel II and adoption of Basel III capital definition is in line with the original plan (PS¶39, 5th review RT). This would support on-going efforts to reduce the risk of loss of CBRs, especially through international capital adequacy assessment process requirements and the adoption of a more risk-based supervisory approach. The Cabinet already approved the policy framework to strengthen crisis management, bank resolution, and the safety net (PS¶36). However, submission of draft legislation to strengthen the legal framework on these fronts will be delayed to end-March 2020 (5th review RT) from end-June 2019 envisaged at the time of the 2nd PCI review due to staffing constraints of relevant institutions other than the CBS, including the Attorney General's office.

Authorities' Views

29. While the authorities agreed with staff's policy advice, they pointed out that it would take more time than originally planned to implement some reform measures. A ~~first draft of~~ policy paper to repeal the existing AML Bill and replace it with a new legislation was submitted to Cabinet (absent measures to strengthen entity transparency, particularly on IBCs) and the authorities are drafting the new AML legislation with the assistance of an international consultant. A

[19] Seychelles is under the "enhanced Follow-Up Process" and will continue to report bi-annually to ESAAMLG on its progress in implementing the MER recommendations.

[20] Under the FATF standards, the list of directors of a company should be considered by countries as basic ownership information that should be made publicly available (see Recommendation 24 on pages 66-69, particularly, paras. 24.3 on basic ownership information of companies that needs to be publicly available).

budget (3rd review RT). This follows several technical assistances received from the AFRITAC South mission. The government has calculated the cost of social obligations of SOEs and provides that information in the budget document for the 2019 budget, in line with the 3rd review RT.

23. Going forward Government will be paying close attention to the non-profitable SOEs: namely Petro Seychelles, Seychelles Public Transport Corporation and Air Seychelles. Out of the non-profitable SOE's Air Seychelles is the only one with significant losses, having recorded a $43.5 million provisional loss for the year 2018. The latter has submitted a transformation plan whereby they have requested Governments' assistance of a guarantee of $12.5 million for a working capital loan and $6 million transfers to the company in 2019, which will be financed by a grant, and $6 million financial support each year during 2020–23. Government has assessed their request and does not currently have the fiscal space to accommodate for the request for the years during 2020–23. However, different options are being considered, such as extension of guarantees to Air Seychelles. During the second PCI review and the preparation of the 2019 budget, Air Seychelles did not advise the Government of all the losses in their operations. As such, Government has requested that Air Seychelles prepared an operational restructuring plan. One of the components is that Etihad, another shareholder, will convert US$ 30 million current liabilities into preference shares which Air Seychelles will only start repayment of US$ 5 million per year from 2022. To ensure that Air Seychelles delivers on its mandate, as part of its network efficiency development plan, the airline will consolidate its regional network by suspending its Abu Dhabi service effective 11 May 2019, in addition to the services to Paris and Dusseldolf which have been already closed. Those international routes were loss making for the airline. As part of its network adjustments the airline will concentrate on developing its operations in the region. Effective 12 May 2019, Air Seychelles will add a new Sunday service on its Mumbai route, increasing its frequency to six flights per week. As from 3 June 2019 the airline will commence daily services to Johannesburg with a new flight to be operated on Mondays. Both routes to Mumbai and Johannesburg have been profitable to date.

24. PEMC will undertake a governance and operational audit of Air Seychelles from the 23rd of April 2019. This will allow Government to have an independent assessment of all their Governance framework and ensure that Air Seychelles is undertaking cost saving measures exercise on all its operations. Air Seychelles will start to report to PEMC on a segmenting accounting framework on a monthly basis to ensure that Government monitor its profit or loss in its three lines of businesses (domestic, international and ground handling). Until now, Air Seychelles has been reporting such information only internally.

25. During 2019 the PEMC will be conducting operational and governance assessment on three SOE's: namely Air Seychelles (5th review RT), STC and PUC. In addition, as part of the risk assessment, PEMC will do a thorough assessment of the project box bond totaling to US$ 71.5 million that Air Seychelles has with Etihad. There is a risk that Air Seychelles will need to roll over the bond when it matures in September 2020 and June 2021.

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sector. Nonetheless, work on the development of tools to assess the impact of IFRS9 is still in progress.

38. The CBS remains committed to ensure its prudential regulatory framework remains in line with international best practice and is effective in safeguarding the safety and soundness of the financial sector. Based on this, work is ongoing with Deloitte to prepare the Risk Based Framework for the prudential supervision ~~of AML risk~~ of banks ~~and trusts and company service providers~~. It is expected that the framework will be completed by end-June 2020. With regards to the risk-based framework for AML/CFT supervision, a 2-year program will start implementation by June 2019. A risk-based approach to AML/CFT supervision, consistent with FATF standards, will be implemented by December 2020 in line with the RAS agreed with the World Bank for capacity building on AML/CFT. This will be later than the original target of end-March 2019 as there is a lack of internal capacity to undertake this task, hence the need to seek assistance from the World Bank. In addition, in order to further ensure the legislative framework remains on par with international standards, a comprehensive exercise to review the Financial Institutions Act is ongoing and a draft policy paper is expected to be completed by end of 3rd quarter 2019. Once finalised it is expected that the IMF will assist will peer reviewing the work done. It is anticipated that the amendments to the legal framework to allow for the implementation of risk-based AML/CFT supervision, consistent with FATF standards, will be presented to Cabinet by end-March 2020 (5th review RT).

39. The adoption of the Basel II framework is on track to be implemented by end-December 2019 (5th review RT). To this end, Pillar 1 will be operational by June 2019. Work with Deloitte is ongoing to implement Pillar 2 by December 2019. Lastly work to implement Pillar 3 is anticipated to be completed by end-December 2019 (5th review RT).

40. The authorities remain committed to improving the jurisdiction's AML/CFT framework. In October 2018 Cabinet approved the policy paper for the new AML Act which addresses some of the legislative deficiencies which had been identified under during the MER. Further to that a legal expert has been contracted to assist the AG's office in drafting the Act. It is expected that the Bill will be presented to National Assembly by June 2019. Moreover, a National AML/CFT Committee has been appointed in order to improve national coordination and ensure that the deficiencies as noted in the MER are addressed in a timely manner. Additionally, a Technical Committee has also been appointed to assist the National Committee. The Cabinet of Ministers has also approved for a Reimbursable Advisory Services agreement with the World Bank to provide technical assistance in reviewing and drafting legislative amendments to laws relevant to preventing money laundering and terrorist financing as well as National Strategy. In addition, this agreement will provide for capacity building of relevant AML supervisors (in formulating a Risk Based approach), law enforcement agencies as well as the prosecution office and judiciary.

41. Development of the oversight framework of the national payment system is continuing. A Principles for Financial Market Infrastructures (PFMI) Assessment was completed in March 2019. The CBS is committed to address the deficiencies noted in the assessment. In addition to the PFMI Assessment, a review of the National Payments Systems Act (NPSA) 2014, is underway.

Table 1a. Quantitative Targets (QT) Under the Policy Coordination Instrument, December 2017 - December 2019 [1]

	2017		2018					2019			
	December		June		December			June		December	
	QT		QT		QT			QT		QT	
	Act.	Status	Act.	Status	2nd Review	Act.	Status	2nd Review	roposed	2nd Review	Proposed
Quantitative Targets											
Net international reserves of the CBS, millions of U.S. dollars (floor) [2]	424	Met	430	Met	375	407	Met	403	403	412	412
Reserve money target (ceiling on daily average during the quarter) [3]	3,559	Met	3,632	Not met	...	...			...		...
Primary balance of the consolidated government (cumulative floor)	622	Met	469	Met	538	646	Met	302	265	589	589
Accumulation of external payments arrears by the public sector (ceiling) [4]	0.0	Met	0.0	Met	0.0	0.0	Met	0.0	0.0	0.0	0.0
Monetary Policy Consultation Clause [5]											
Inflation (mid-point, percent) [6]	...		...		3.9	3.7		4.1	2.8	4.4	2.6
Inflation (upper bound, percent) [6]	...		...		5.9			6.1	4.8	6.4	4.6
Inflation (lower bound, percent) [6]	...		...		1.9			2.1	0.8	2.4	0.6
Inflation (upper inner-bound, percent) [6]					5.4			5.6	4.3	5.9	4.1
Inflation (lower inner-bound, percent) [6]					2.4			2.6	1.3	2.9	1.1
Memorandum items:											
Nominal public debt (millions of Seychelles Rupees) [2]	13,337	Met	13,653	Met	13,698	12,854	Met	13,728	13,301	13,757	13,342
Program accounting exchange rates [7]											
SR/US$ (end-of-quarter)	13.67		13.84			13.94			14.02		14.02
US$/Euro (end-of-quarter)	1.19		1.20			1.16			1.14		1.14
US$/UK pound (end-of-quarter)	1.29		1.35			1.30			1.33		1.33
US$/AUD (end-of-quarter)	0.79		0.78			0.72			0.71		0.71
US$/CAD (end-of-quarter)	0.80		0.80			0.77			0.76		0.76
US$/CNY (end-of-quarter)	0.15		0.15			0.15			0.15		0.15
US$/SDR (end-of-quarter)	1.41		1.45			1.40			1.40		1.40

Sources: Seychelles authorities; and IMF staff estimates and projections.

[1] March and September 2018 indicators are not QTs and do not form part of program conditionality.

[2] Measured at program accounting exchange rate. The NIR floor is adjusted as defined in the TMU.

[3] The ceiling is the upper bound of a symmetrical band of six percent in both directions around the reserve money target. Until June 2018, this is a QT.

[4] The nonaccumulation of new external payment arrears constitutes a standard continuous target. Excludes arrears for which a rescheduling agreement is sought.

[5] When the end of period annual average headline inflation is above/below the upper/lower bound, a formal consultation with the Executive Board would be triggered.

[6] Average of year-on-year headline inflation for the past 12 months.

[7] Program exchange rates have been set according to prevailing market rates at the latest available update.