Central Bank of Seychelles

Monetary Policy Framework

Foreword

As per the Central Bank of Seychelles Act 2004, as amended, the primary objective of the Central Bank of Seychelles (hereafter referred to as the Bank) is to promote domestic price stability. Safeguarding price stability facilitates the efficient allocation of resources among various economic sectors and contributes towards a sound long run economy. The other objectives of the Bank include promoting a sound financial system and advise the government on banking, monetary and financial matters, including the monetary implications of proposed fiscal, credit policies or operations of the government.

Monetary policy is a critical tool that affects government expenditure, consumer spending, investment and net exports which in turn affects the price and output levels in the economy. With the change from a fixed to a floating exchange rate regime in late 2008, managing money supply has shifted from interventions in the foreign exchange market to other market-based monetary policy instruments. While such instruments, along with functioning money markets, are important for managing money supply under any type of exchange rate regime, their importance is of a greater magnitude under a floating exchange rate regime. Subsequently, the Bank is tasked with managing money supply through formulating monetary policy in accordance with the current and foreseen economic activity.

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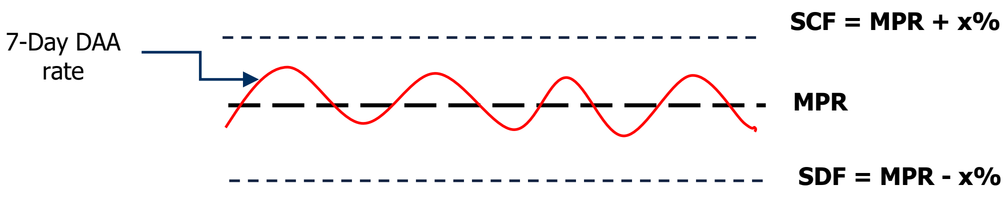
1. Background

As part of the economic reform programme adopted by the authorities in November 2008, monetary policy transitioned to a monetary targeting framework as part of the decision to move from a fixed to a floating exchange rate regime. Under this framework, the final target - price stability – was to be achieved by influencing changes in the money supply (or total liquidity in the economy) through the use of reserve money[1] as the operational target. In April 2014, the Bank switched from meeting end-quarter reserve money targets to quarterly average reserve money targets, in a bid to provide more operational flexibility.

Despite the changes, the transmission of monetary policy through the interest rate channel remained a challenge. To further enhance the monetary policy framework, a more transparent and forward-looking approach was adopted in the Bank's monetary policy formulation and implementation through the operationalisation of the overnight interest rate corridor[2] in July 2017. The corridor, which aimed to provide clearer guidance for short-term market interest rates, complemented reserve money as the existing operating target. Whilst price stability remained the primary objective of monetary policy, the conduct of monetary policy was adjusted to place more emphasis on interest rate formation.

2. Monetary Policy Framework

In January 2019, the monetary policy framework transitioned from reserve money targeting to an interest rate-based framework. The focus of monetary policy has shifted from indirectly influencing the intermediate target of money supply growth to guiding short term interest rates through the introduction of a Monetary Policy Rate (MPR). With the discontinuation of reserve money as the operating target, the MPR serves as the key policy rate signalling the monetary policy stance henceforth. This is complemented by the interest rate corridor which adjusts accordingly to changes in the MPR. In addition, the MRR remains as a supporting policy indicator.



In principle, the MPR lies at the centre of the interest rate corridor. This rate is set at a level which is consistent with the desirable general price level deemed stable for the Seychelles economy in the medium term. It is formulated based on analyses and

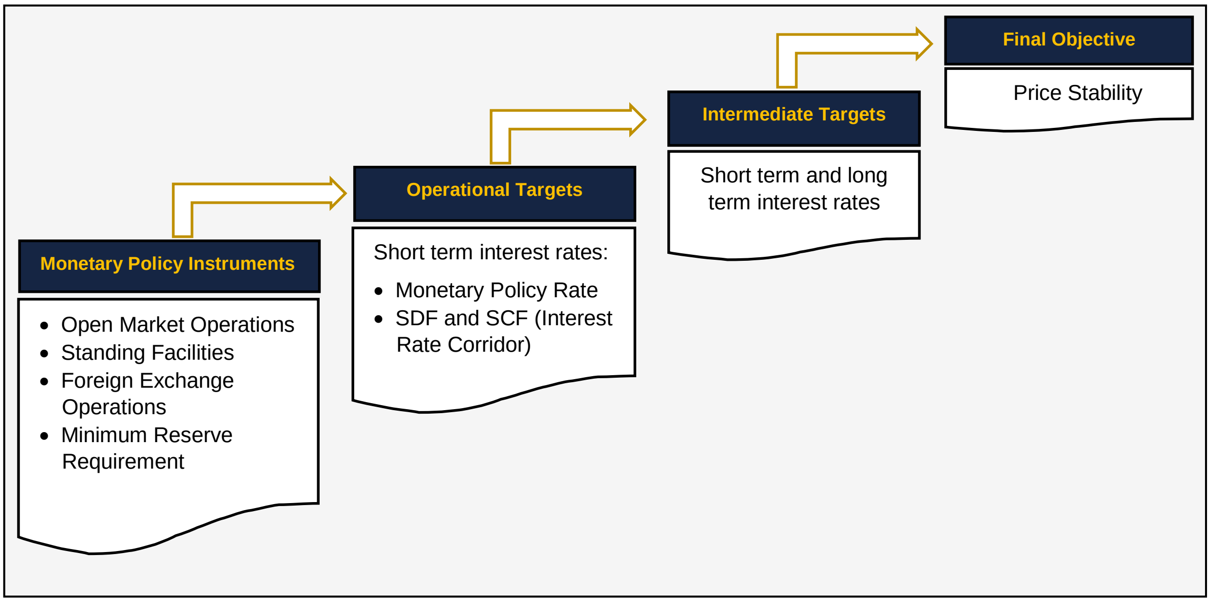
[1] Reserve money is also referred to as base money or high-powered money and comprises of currency issued by the Central Bank and deposits of Other Depository Corporations (ODCs) held with the Bank.
[2] The interest rate corridor is defined by the existing overnight facilities, that is, the Standing Credit Facility (SCF) as the ceiling, and the Standing Deposit Facility (SDF) as the floor.

projections of inflation and other key macroeconomic variables, determined by the Bank's macroeconomic modelling and forecasting framework which applies the fundamental principles of economic theory. The MPR is reviewed and published on a quarterly basis following Board approval.

As part of its efforts to enhance the quality of communication on monetary policy, the Bank aims to improve its dialogue with all relevant stakeholders. This is done mainly through quarterly press communiqués and press conferences subsequent to the Board's decision on monetary policy.

Through the revised framework the Bank aims to enhance the transparency of monetary policy and better guide financial institutions in setting their interest rates as well as assist economic agents in making better informed financial decisions. It is expected that short-term interest rates will be more sensitive to monetary policy signals, and better reflect market expectations. The overall effectiveness of monetary policy will increase when interest rates over a wide spectrum of the yield curve can be allowed to respond to changing monetary impulses. This objective has to be viewed as a long-term desirable development which must pass through various stages of market development.

Monetary Policy Framework



3. Decision-making process for monetary policy implementation

The Board of Directors is responsible for monetary policy, which is discussed at pre-set quarterly meetings, whilst the responsibility to oversee its operational implementation has been delegated to the Monetary Policy Technical Committee (MPTC) within the general guidelines determined by the Board and directions given by the Governor.

The MPTC reports on its activities to the Board and makes recommendations on appropriate future implementation of monetary policy.

4. Terms of Reference of the Monetary Policy Technical Committee (MPTC)

4.1 Mandate

The MPTC is established by the Bank's Board of Directors with the responsibility to:

i) consider matters pertaining to the formulation and implementation of monetary policy,

ii) advise on the operational aspect,

iii) recommend policy proposals for the Board's consideration, consistent with the Bank's objectives, and

iv) decide on parameters relating to the implementation of monetary policy.

The MPTC shall report on its activities to the Board of Directors at least on a quarterly basis.

4.2 Composition

The Chairperson shall be the First Deputy Governor and other representatives of the Committee shall be the Second Deputy Governor and the Head or a designated representative from the following Divisions:

- Banking Services Division (BSD)
- Financial Inclusion and Market Conduct Division (FIMCD)
- Financial Markets Division (FMD)
- Financial Surveillance Division (FSD)
- Research and Statistics Division (RSD)

FMD shall act as Secretariat to the MPTC.

4.3 Functions

The primary functions of the MPTC shall be to:

- provide a forum for the exchange of information on, and analysis of,
  - overall macroeconomic developments in the country and abroad**;**

    - current developments in key financial indicators.
- provide a forum for the consideration of research and analysis that are relevant to the formulation and implementation of monetary policy before submission to the Board.
- evaluate developments and trends in overall liquidity of the financial system.
- approve the use of instruments under the control of the Bank in line with decisions adopted by the Board pertaining to the implementation of monetary policy.

The decisions will be guided by the analysis and policy recommendations of FMD and RSD as well as any other proposal brought forth by an MPTC member.

4.4 Meetings

As the Secretariat of the committee, FMD is responsible for setting up the meetings, subject to the approval of the Chairperson. Any other member may also request to have a non-scheduled MPTC meeting if approved by the Chairperson.

The MPTC shall have a main meeting at least once a month to coincide with the start of a new Minimum Reserve Requirement (MRR) maintenance period. In the event that the main monthly meeting cannot be conducted on the planned date the meeting should be rescheduled within the next 48 hours.

Minutes of all MPTC meetings, which record all formal decisions, and the views of all members shall be taken and forwarded via email to all members within 10 working days following the meeting.

If the First Deputy Governor is not present or acting as Chief Executive Officer of the Bank, as prescribed by the CBS Act 2004, as amended, the Second Deputy Governor shall chair the meeting.

In the event that the Second Deputy Governor is unable to chair the meeting, a designated Head of Division, in the order listed below, shall act as Chairperson.

i. Research and Statistics Division (RSD)
ii. Financial Surveillance Division (FSD)
iii. Banking Services Division (BSD)
iv. Financial Inclusion and Market Conduct Division (FIMCD)

Under all circumstances, the Head of FMD shall not be nominated as Chairperson of the Committee.

4.5 Decision Making

4.5.1 Deliberations

During a sitting of the Committee, a quorum of majority of members in office[3] shall be required. Each member shall express his/her views based on the submitted information or proposal, as the case may be. Decisions shall be reached by majority vote.

A quorum shall also be required where in place of a meeting, members' views are sought via email. Similarly, decisions shall be reached by majority vote.

The Committee shall consider each view in turn, and the view preferred by a majority of the members shall prevail and be adopted as the decision of the Committee.

In the event of an equality of votes, the Chairperson shall have a casting vote in addition to his/her deliberative vote. Where the Chairperson takes a decision in accordance with this provision, he/she shall as soon as possible inform the Board of Directors of the exercise of his/her authority under that section and his/her reasons for doing so.

4.5.2 Governor's approval

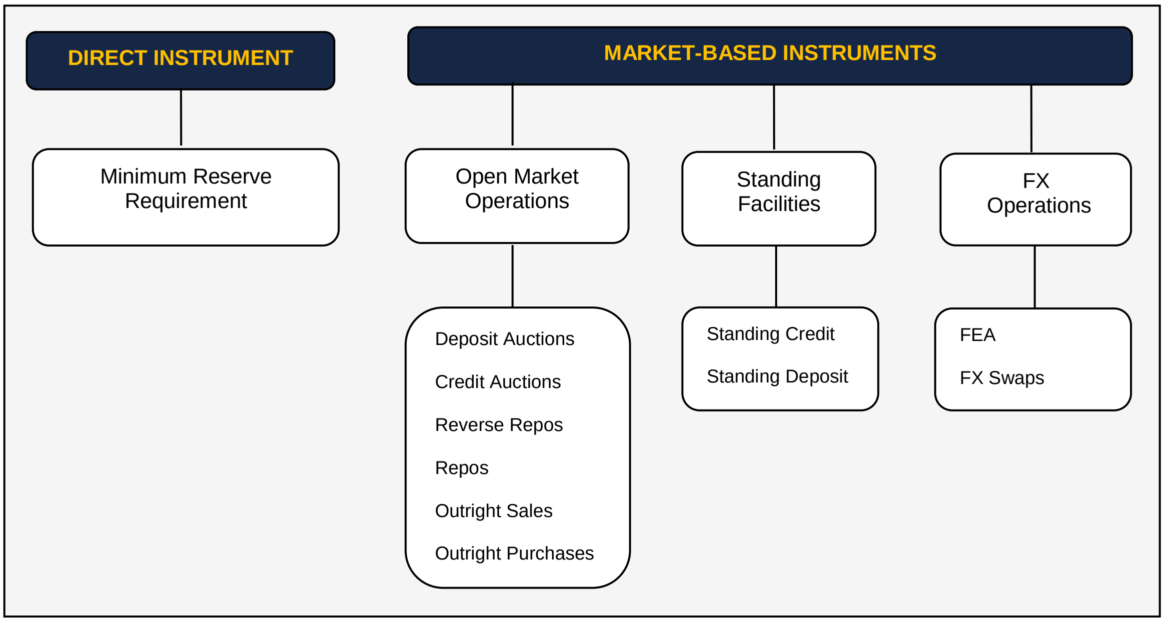
The decisions of MPTC shall be communicated to the Governor, for his/her views.

All policy recommendations that are to be submitted to the Board for approval, shall be supported by the Governor.

[3] Members in office include all members who are on duty or not on leave.

5. Monetary Policy Instruments

The Bank uses available monetary policy tools for the conduct of open market operations and foreign exchange operations, so as to ensure an effective market-based implementation of monetary policy.



A. Minimum Reserve Requirement

The Minimum Reserve Requirement (MRR) system provides a simple and effective mechanism to alter the supply of total liquidity in a country like Seychelles where the development of market-based indirect instruments is at an early stage.

As stipulated under Part VII, Article 31 of the CBS Act 2004, as amended, the Bank may require the maintenance of minimum required reserves against deposits or other similar liabilities. However, funds held in the form of trust or custodian accounts for specific projects shall not be subject to the MRR.

The Bank acknowledges reserve requirements as a very powerful instrument and seeks to avoid large and frequent changes in the ratio. As the Bank aims to make use of the multiplier link between reserve money and money supply, a change in the reserve ratio will directly affect the money multiplier. High reserve requirements may also influence the development of the rest of the financial sector and they tend to increase the interest rate spread. The long term objective is therefore to gradually reduce the requirements as monetary conditions improve and the use of market-oriented instruments has become more effective.

B. Open Market Operations

The Bank transacts in the primary market (called open market operations) to send signals about the stance of monetary policy and to guide interest rate formation by managing the level of liquidity in the banking system.

These transactions are conducted through an auction mechanism. The choice between fixed price and variable price auctions are dependent on the market situation and the evolution of short term interest rates domestically. In variable price auctions, namely Uniform Price and Multiple Price, the overall quantity is set by the Bank and the participants bid on the price, although allotment procedures differ for each type of auction. Variable price auctions allow the Bank to determine the quantity it wants to sell or buy at a market determined rate.

Fixed price auctions are only used in extraordinary circumstances when there is uncertainty in the market and a need for the Bank to send a clear signal. In this type of auction, the interest rate is set by the Bank and participants bid for only the amount they wish to obtain at that rate.

The types of available instruments are summarised below. The details are included in the **Operational Guidelines for Policy Tools**.

i. Deposit Auction Arrangement (DAA)

The DAA was introduced by the Bank as an instrument to manage liquidity. It is a convenient means for ODCs to invest their excess liquidity with the Bank and earn a return on idle funds, as opposed to placing these funds in riskier investments. It is currently being used as the main monetary policy instrument to absorb excess liquidity levels within the banking system for a specified length of time.

The Bank determines the various parameters, such as the frequency, type of auction, maturities and the number of bids to be submitted, depending on the needs in the market and monetary policy objectives.

ii. Credit Auction Arrangement (CAA)

The CAA is an open market tool used to supply liquidity in the system. It is used as and when the need to inject liquidity in the system arises and serves a similar purpose to the overnight lending facility. However, the use of the CAA is initiated by the Bank and not the participants. The Bank may offer CAA, based on current monetary and liquidity stance and the interest rate is generated from the auction process.

iii. Securitization of Government Debt

The marketable securities, which resulted from the conversion of a 20-year Government Restructuring Bond into smaller tranches, can be used by the Bank for temporary and/or permanent adjustments in liquidity. The conversion and subsequent extensions upon maturity is governed by a Memorandum of Understanding (MOU) between the Bank and the Ministry responsible for finance.

iv. Outright sales and Purchases

The Bank may also use the securities it holds for outright sales to the market in situations where there is a need for a more permanent sterilisation of liquidity. These sales can be conducted on an auction basis or on a bilateral basis. In the latter case, without a well-functioning secondary market, it will be important to determine a fair and appropriate market price. The Bank may buy securities from the secondary market in the situation where there is a need to supply liquidity on a permanent basis. The purchases may be conducted on an auction or bilateral basis.

v. Repurchase Agreements

The Bank may use repurchase agreements (repos) to inject liquidity and reverse repurchase agreements (reverse repos) to withdraw liquidity on a temporary basis. A repo transaction involves injection of liquidity whereby the Bank buys government securities as underlying collateral (with an appropriate haircut to reflect current market value) from the ODCs at a particular price, with an understanding to sell back the same securities to its original owner at the original buying price at a specified future date, under a formal legal agreement.

A reverse repo transaction, on the other hand, involves the withdrawal of liquidity whereby the Bank sells securities to ODCs at a specific price, with an understanding to repurchase the same securities at the original selling price at a particular future date, under a formal legal agreement.

The repo and reverse repo rates are determined through the auction system and interest payments are computed on the basis of the duration of the agreements and the principal amounts involved.

C. Standing Facilities

Standing Facilities refer to the Standing Credit and Deposit Facilities, offered by the Bank to ODCs for management of their short-term liquidity position. The Standing Deposit Facility (SDF) allows these institutions to place reserves overnight at the Bank whilst the Standing Credit Facility (SCF) is an overnight collateralised lending facility. In view of providing clearer guidance to the financial market with regards to appropriate evolution of short term interest rates, the SCF and SDF will serve as the ceiling and the floor of the short-term interest rate corridor, correspondingly.

The primary aim of the credit facility is to ensure that ODCs can meet their payment obligations at end-of-day settlement. This is a necessary precondition for a smooth functioning payment system. A standing credit facility has an important monetary policy function in that it induces participants to manage their liquidity more actively, tends to reduce the level of excess liquidity in the system and contributes to stabilising market interest rates. The rates applicable on both facilities are determined by the Bank. Subject to the availability of eligible collateral for the SCF, the Bank is providing open access to the SCF and SDF daily.

D. Foreign Exchange Operations

The Bank intervenes in the foreign exchange market for external reserves management purposes or to smooth out excessive volatility in the domestic exchange rate and ensure orderly market conditions. Purchases from the market add liquidity whilst also increasing the official reserves; a sale has the opposite effect.

i. Foreign Exchange Auctions (FEA)

This instrument allows for the purchase and sale of foreign exchange (denominated in reserve currencies[4]) by the Bank as part of its foreign exchange and monetary operations. Auctions are carried out as and when necessary in the context of the current foreign exchange and monetary policies as well as the reserves management and investment guidelines.

ii. Foreign Exchange Swaps

In terms of liquidity management by the Bank, an FX swap involves the exchange of a given amount of foreign currency (denominated in reserve currencies) against the domestic currency (the rupee) at an agreed exchange rate on an agreed date (spot date), and then a re-exchange of these two currencies on a later date (forward date), also at an agreed exchange rate. The exchange rates for both transactions are agreed at the time the swap is entered into, that is, on the deal date, thereby removing any exposure to exchange rate movements during its duration.

An FX swap transaction has two separate legs with two different settlement or value dates: a spot leg and a forward leg. These can be done through two types of transactions, the **Buy-and-sell** and **Sell-and-buy.**

FX swap transactions shall be backed by a Foreign Exchange Swap Agreement, with provisions for both legs of the transaction. FX Swap transactions are to be managed and initiated by the Bank.

Over time, this may also help to develop the domestic foreign exchange market. FX Swap may also be used by the Bank to temporarily change the composition of international reserves, as determined by the Reserves Management and Investment Guidelines.

[4] Reserve currencies as detailed in the Operational Guidelines

iii. Central Bank Foreign Exchange Transactions

All foreign exchange transactions conducted by the Bank must be in line with Article VIII of the IMF Articles of Agreement. The Article refers to the spread allowed for spot exchange transactions between the currencies of member countries of the IMF. It stipulates that the rate used for spot transactions shall not differ from prevailing mid-rate by more than ±1%.

When conducting FEAs, the Bank must ensure the MCP rule, which defines the margin between the spot transaction and the prevailing mid-rate, is not breached, as stipulated under the Article VIII.

For transactions undertaken on behalf of government and government-related agencies, the Bank shall use the previous day's mid-rate based on the average traded exchange rates of authorised dealers. As per the Article VIII, any day's transaction rate shall not be in breach of the MCP rule.

6. Eligibility Criteria

Eligibility criteria for participation in the Bank's open market operations and foreign exchange operations are limited to:

- Any participant liable to reserve requirements;
- Participants must be in a 'generally sound financial condition' and must not have any existing arrangement under the Emergency Loan Facility (ELF);
- Any additional criteria as set out in the relevant sections of the instruments as per the **Operational Guidelines for Policy Tools**;
- Participation is entirely on a voluntary basis.

7. Clause on Penalties

This section provides for events of default in transactions relating to monetary policy instruments, denominated in both rupee and foreign currencies. It shall be applicable to all instruments used for foreign exchange operations, standing facilities and open market operations.

Participants who do not comply with the obligations laid out in the operational guidelines for specific policy instruments[5] shall be subject to:

[5] Excluding the MRR, which is covered under the CBS Act, 2004, as amended.

(i) Financial Penalties

7.1 In the event of late payment in the specified foreign currency and/or insufficient funds in the rupee account with Bank, the defaulting party shall pay to the aggrieved party for each day that payment is delayed such amounts to be calculated as per 7.1.1, 7.1.2 and 7.2:

7.1.1 **For the foreign exchange component**, a penalty interest equivalent to the overnight SOFR[6] plus 500 basis points (i.e. plus 5.0 per cent p.a.), in addition to a fixed minimum amount of 1,000 units of the currency of auction, is applicable on the amount that is not settled. Should the total amount exceed 10,000 units of the currency of auction, then a maximum penalty fee of 10,000 units is applicable.

7.1.2 **For rupees**, a penalty interest equivalent to the latest MPR plus 500 basis points (i.e. 5.0 per cent p.a.), in addition to a fixed minimum penalty of R10,000, is applicable on the amount that is not settled. Should the total penalty exceed R100,000 then a maximum penalty fee of R100,000 is applicable.

7.2 For the first breach, penalties as defined in 7.1.1 and 7.1.2 shall apply. In the event of a second and successive infringement that occurs within a 12-month period from the date of the first breach, the penalty interest rate shall be 750 basis points (i.e. 7.5 per cent p.a.).

7.3 In the event of a third and successive breaches within a 12-month period from the date of the first breach, the party shall be liable to a financial penalty as specified in 7.2, in addition to suspension from subsequent operations (as per ***Section (ii)*** below) - of the same type and executed under the same procedures.

(ii) Non-Financial Penalties

7.4 The duration of suspension shall be for:

7.4.1 One month if the infringement amounts to less than 40 per cent of the total accepted bids;

7.4.2 Two months if the infringement amounts to between 40 – 80 per cent of the total accepted bids;

[6] Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralised by treasury securities. SOFR is intended to have more or less the same uses as LIBOR, however, it is more robust as it is linked to a market that is considered to be able to withstand any potential "rigging" due to the deep rootedness of the US Treasury Repo market, as well as its compliance to the IOSCO principles for benchmark rates.

7.4.3 Three months if the infringement amounts to between 80 – 100 per cent of the total accepted bids.

7.5 The parties shall not be liable for damages for any delay or failure to comply arising out of causes beyond their reasonable control and without their fault or negligence, including but not limited to, Acts of God, fires, riots and wars.

8. Eligible Collaterals

When the Bank lends in its operations, it does so against securities to protect itself from credit risk. The securities considered as eligible collaterals against the Bank's lending consist of instruments issued by the Bank and government as detailed below.

Eligible Collateral	Denomination
DAA	Seychelles rupees
Treasury Bills	Seychelles rupees
Treasury Bonds	Seychelles rupees

The term-to-maturity of the collateral should not be less than the term of the credit facility. A haircut shall be applicable to the value of these collaterals in a bid to protect the Bank from the risks associated with holding them; notably market risk. In all circumstances, the value of the collateral including the applicable haircut as calculated under the **Operational Guidelines for Policy Tools** shall be equal to or greater than the credit being sought.