International Monetary Fund

Bolivia and the IMF

Press Release:
IMF Executive Board Completes Sixth Review Under Stand-By Arrangement for Bolivia
October 31, 2005

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

October 7, 2005

The following item is a Letter of Intent of the government of Bolivia, which describes the policies that Bolivia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Bolivia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

La Paz, October 7, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato:

1. Since the completion last April of the fifth review of our program supported by the Stand-By Arrangement (SBA), Bolivia has experienced far-reaching political developments, including the resignation of former President Mesa, the changeover to the current government led by President Rodríguez, congressional approval of a constitutional amendment enabling general elections next December, and a political agreement on a constitutional assembly and a referendum on regional autonomy to be held in mid-2006. Despite the complex social and regional factors involved, these developments unfolded strictly within the established political and institutional framework and economic stability has been maintained.

2. The government attaches paramount importance to the SBA-supported economic program. As detailed in the attached Memorandum on Economic and Financial Policies (MEFP), we have fully adhered to the agreed macroeconomic policies—having observed, with margins, all the end-June quantitative performance criteria. We also have met, or expect to have met, all end-September quantitative performance criteria. However, as of today, we have no final information on the combined public sector deficit and domestic financing outturns relative to their end-September 2005 quantitative performance criteria. We are therefore requesting waivers of applicability for those two performance criteria. We have also taken, as described in the MEFP, important structural reform actions in the fiscal and financial sector areas—including approval by Congress of the procedural requirements for appeals before the tax superintendency, an end-June 2005 performance criterion.

3. The revised 2005 budget law that was submitted to Congress as a prior action for the fifth review became inconsistent with the fiscal situation following approval, last May, of the new hydrocarbons law, which has substantially enhanced revenue. This, together with the emergence of the urgent political issues noted above, prevented Congress from approving a revised 2005 budget law by end-June, which constituted a performance criterion. However, we have recently submitted to Congress an updated law and are also strengthening the fiscal target beyond what would have been called for by the original program, with a corresponding modification in monetary targets. We are therefore requesting a waiver for the nonobservance of the end-June performance criterion.

4. The interim nature of the current government requires, as detailed in the MEFP, some scaling down and rephasing of certain structural reforms. In this context, we will refrain from submitting to Congress a comprehensive tax reform, an end-September structural benchmark,

although we will prepare a draft tax reform proposal for consideration by the next government. With respect to hydrocarbons policy, any potential review in light of developments under Law 3058 of May 17, 2005, would have to be undertaken by the next government.

5. On the basis of the policy developments, outlook, and proposed prior actions described in the MEFP, we hereby request completion of the sixth review under the SBA, contingent on observance of the quantitative performance criteria for end-September specified in Table 1 of the MEFP, but in respect of which we are requesting waivers of applicability of the performance criteria on the fiscal deficit and domestic financing of the combined public sector. At the same time, taking into account the stronger than anticipated balance of payments in 2005, and the above-noted reprofiling of structural policies, we propose that total access under the SBA be reduced by SDR 25.72 million (15 percent of quota), corresponding to the last purchase, as currently scheduled. We propose that the remaining amount of SDR 17.14 million (10 percent of quota), that would remain available under the SBA after the purchase associated with this sixth review, be rephased and linked to the next and final review, completion of which would be contingent on observance of the performance criteria for end-December 2005 specified in Tables 1 and 2 of the MEFP. Moreover, we intend to treat the arrangement as precautionary. The discussions for the final review would provide an opportunity for the next government to outline its medium-term economic policies and poverty reduction strategy, including its intentions regarding relations with the Fund, as well as the potential implications for Bolivia of the G-8 debt cancellation initiative.

6. We are confident that the policies set forth in the MEFP are adequate to achieve the objectives of the program, and will take any further measures that may become necessary for this purpose. We would consult with the Fund on the adoption of these measures in accordance with the Fund's policies on such consultations.

Sincerely yours,

/s/
Waldo Gutiérrez
Minister of Finance

/s/
Juan Antonio Morales
President, Central Bank of Bolivia

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

MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES

October 7, 2005

1. **The government of Bolivia has held discussions with the Fund staff in the context of the sixth program review under the stand-by arrangement**. The discussions covered: (i) developments under the economic program for 2005 specified in our Memorandum of March 24, 2005; (ii) the macroeconomic outlook for the remainder of the year; (iii) an outline of the macroeconomic framework for 2006; (iv) structural policies; and (v) the medium term outlook

I. DEVELOPMENTS UNDER THE 2005 PROGRAM

2. **Despite the major political developments, macroeconomic stability has been maintained and overall performance in 2005 has been positive**. Buoyed by the hydrocarbons sector, economic growth remained strong during the first half of the year. Temporary supply disruptions associated with road blockades led to an increase in inflation in May-June, which has since been partially reversed. The trade surplus in the first semester of 2005 was broadly in line with program projections. All end-June quantitative performance criteria were observed (Table 1). In particular, the fiscal deficit was smaller than programmed and the NIR target was met with a large margin. While we do not yet have final information on fiscal deficit and domestic financing outturns for end-September, we have met, or expect to have met, all end-September 2005 quantitative performance criteria with margins.

3. **The combined public sector recorded an overall surplus of 0.4 percent of GDP during the first seven months, reflecting both higher hydrocarbon revenues and lower spending**. There has been a large increase in revenue, related to strong gas exports and the changed regime for the hydrocarbons sector, including the introduction of a new tax—the Impuesto Directo a los Hidrocarburos (IDH). The revenue increase, which also reflected improvements in tax administration, more than compensated for a decline in external grants. Spending, on the other hand, has been significantly constrained thus far, in large measure reflecting slower-than-projected execution of capital projects. The events leading up to the changeover to the current government contributed to the low implementation rate, with corresponding delays in loan disbursements.

4. **We have taken monetary and exchange rate policy actions consistent with achieving low inflation and accumulating foreign exchange reserves**. In May/June, we were faced with pressures on the reserve position associated with deposit withdrawals triggered by the political crisis. In response, the central bank raised repo rates (the rates at which it provides liquidity) by over 100 basis points. Following the assumption of the interim government and the agreement on general elections, there has been a marked shift in sentiment. Financial system deposits have recovered from the sharp drop in June and the related liquidity assistance provided to banks has been fully repaid. The net liquid foreign assets of the financial system have increased significantly, including a substantial strengthening of central bank reserves, which are now much higher than programmed. The related monetary impact has been matched, to a large extent, by renewed demand for local currency, as evidenced by significant sales of foreign currency to the central bank.

Nonetheless, in order to forestall possible inflationary pressures, the central bank has placed increasing amounts of local currency paper—which, given the increased preference for local currency, has been achieved with declining interest rates.

5. **On the exchange rate front, we have maintained the bilateral rate virtually unchanged against the U.S. dollar**. This has implied a highly competitive real effective exchange rate, given the appreciation of major regional currencies. In mid-July, we marginally appreciated the Boliviano against the U.S. dollar under the crawling peg, and widened the buy-sell spread, which has been reflected in increased activity in the interbank foreign exchange market. A small additional appreciation was implemented in mid-September.

6. **With respect to debt management, we have taken advantage of the favorable market conditions to improve the currency composition and lengthen the maturity of domestic debt**. Specifically, in our open market operations, we have increased the share of local currency treasury paper by over 20 percentage points since end-2004. Moreover, despite the bunching of maturing treasury bills in the third quarter, we also managed to meet our placement targets and tripled the average maturity of newly issued treasury paper to over three years. The infrastructure of our debt management has been enhanced by the introduction of a new electronic auction system that has improved market transparency and information sharing.

7. **The balance of payments has been substantially stronger than programmed**. With exports benefiting from high energy and metals prices, the current account surplus has been broadly in line with the program, despite supply disruptions in the first half of the year. The capital and financial account has recorded a higher-than-projected surplus, despite a shortfall in disbursements of external loans for public investment projects. This was associated in part with increased demand for Bolivianos and direct foreign investment in the mining sector. Overall, as noted above, these trends have resulted in a higher-than-programmed level of international reserves.

II. Updated Macroeconomic Policy Framework for 2005

8. **We now project, for the year as a whole, somewhat lower growth and higher inflation, and a substantially stronger balance of payments, relative to the program**. Despite reduced economic activity in the second quarter, we still expect growth to increase from 3.6 percent in 2004 to about 4 percent in 2005, underpinned by a still considerable growth in hydrocarbons output. Twelve-month inflation is projected at 4.2 percent, compared with the June peak of 6.4 percent. The overrun vis-à-vis the program inflation target of 3.8 percent is associated, in part, with the depreciation of the Boliviano vis-à-vis regional currencies. The new hydrocarbons taxation regime will bring in higher fiscal revenues in 2005, savings from which will contribute to a lower-than-programmed fiscal deficit. In the financial system, deposits and NIR are expected to maintain the gains recorded thus far.

A. Fiscal Policy

9. **We expect that the fiscal deficit will continue its declining trend from the peak of nearly 9 percent of GDP in 2002 to 3.5 percent of GDP in 2005**. While we expect a recovery in the execution rate of investment projects in the remainder of the year, the fiscal deficit should remain well within the limit established at the time of the fifth review of the program. We have sent a revised budget to Congress, which will allow us to increase the implementation rate of infrastructure and social projects, thereby using a share of the new hydrocarbons tax revenue and promoting a recovery in the disbursement of external project loans, with particular attention to pro-poor initiatives. In addition, current spending will also increase due to higher fuel subsidies and transfers to a low-income housing program. Nevertheless, in light of the surplus recorded in the first seven months, hydrocarbons revenues not contemplated in the program, and lower-than-programmed pension payments, we expect that the fiscal deficit in 2005 will amount to at most Bs 2,728 million (3.5 percent of GDP, i.e., 2 percent of GDP lower-than-programmed before grants), compared with the original program target of Bs 3,763 million (4.8 percent of GDP).[1] Thus, we propose a corresponding downward adjustment to the end-December 2005 ceiling on the deficit of the combined public sector (Table 1).

B. Monetary and Exchange Rate Policy

10. **The gains made thus far in strengthening international reserves have positioned us better to handle vulnerabilities, including those associated with political uncertainties**. Accordingly, in the period ahead, monetary and exchange rate policy will be geared towards maintaining those gains while further reducing inflation. In this context, we will take action as needed to reduce the 12-month growth in currency issue from the high of over 30 percent in June to 26 percent by December 2005, and will maintain the exchange rate under review. Given developments thus far, we are now projecting a US$230 million increase in NIR during 2005, compared with the programmed increase of US$40 million. This would be consistent with an increase in financial system liquid foreign asset coverage of deposits to around 54 percent. Taking into account the revised projection, but also the potential need for a margin (given the experience with deposit withdrawals around the time of previous elections), we propose to raise the end-December program floor on the increase in NIR only partially—to US$135 million, the mid-point between the original target and the current projection (Table 1). Finally, we intend to make further progress in improving the currency composition and maturity structure of domestic debt.

III. Preliminary Macroeconomic Framework for 2006

11. **We envisage for 2006 real GDP growth in the range of 4–4½ percent, lower inflation, and a further reduction of financial sector vulnerabilities**. Achievement of

[1] These ratios are based on a revised GDP. In relation to the programmed GDP, the corresponding ratios are 3.7 and 5.2 percent, respectively.

the growth objective is predicated on an acceleration of growth in the mining and construction sectors, reflecting large ongoing mining investments, and higher capacity utilization in the hydrocarbons sector. Lower inflation will be facilitated by prudent management of the revenue windfall from the hydrocarbons sector, some of which will again be saved to reduce the fiscal deficit and avoid creating expenditure rigidities for the medium term. The proposed fiscal stance and competitive exchange rate, together with strong prices for hydrocarbons products and metals, will help maintain external current account and overall balance of payments surpluses. Thus, we expect a further increase in the reserve coverage of financial sector deposits.

12. **We intend to submit to Congress, prior to the Executive Board meeting, a 2006 budget that will raise infrastructure and social capital spending while providing for a further reduction in the fiscal deficit**. The main elements of the budget proposal will be:

- ***Tax revenue***. An increase in public sector revenue by 0.3 percent of GDP, including 1 percent of GDP in hydrocarbon revenues. The revenue projection includes the elimination of the financial transactions tax (FTT) on local currency sight deposits. The FTT on foreign currency sight and savings deposits will be maintained at the current rate as part of our efforts to promote de-dollarization.

- ***Expenditure***. The budget proposal incorporates a 1½ percent of GDP increase in public investment relative to the projected 2005 level. We will continue to contain current spending in relation to GDP, including the wage bill, and expect a further reduction in pension costs.

- ***Deficit***. The limit on the deficit of the combined public sector authorized in the government's proposal will be equivalent to 3.7 percent of GDP. This is consistent—based on the Fund staff's revenue projection and assuming an implementation rate of 93 percent[2] of the investment budget—with a projected fiscal deficit of 3 percent of GDP. We expect that the 2006 budget will be approved by Congress or on a lapse-of-time basis by end-December 2005, and we request that such approval be converted into a structural benchmark (currently an end-December PC).

IV. Structural Policies

13. **Despite the unexpected political changeover, and the interim nature of the current administration, we have made significant progress in implementing the structural actions envisaged in the program**. In the fiscal area, Congress elevated to law the new tax code procedures. In the financial sector, provisioning and reserve requirements were tightened and Congress approved a law setting up the Financial

[2] The average of the last six years, excluding the highest and lowest observations.

Restructuring Fund (FRF) and enhancing the autonomy of the banking superintendency and the central bank.

14. **With respect to hydrocarbons policy, Congress enacted a new law in May, which the current administration has moved on to implement and regulate as mandated, including as regards the tax-related provisions**. Given the far-reaching changes introduced, the altered energy price outlook, and the ongoing contacts with oil companies on the implementing regulations, the impact of the new law still needs to be fully assessed. Hence, no further legislative adjustments are contemplated at this stage and any potential review of hydrocarbons policy would need to be conducted by the next government.

15. **Looking ahead, we intend to make significant additional progress within our mandate**. As detailed in Table 2, some scaling down and rephasing of structural actions relative to the original program is proposed under the circumstances. In sum, we are in a position to advance as follows:

Fiscal reforms

- ***Budget framework***. Prior to the Executive Board meeting, we will submit to Congress a draft Budget Framework Law aimed at enhancing the budget process at all levels of government. The enhancements are all of a technical nature and consistent with any degree of fiscal decentralization or regional autonomy.

- ***Expenditure and debt management***. In the context of our broader program to register all public sector employees and pensioners, we expect to complete, by end-December 2005, 50 percent of the registry on health and education sector employment, as well as the implementation of a registry system on subnational debt for nine regional governments (prefecturas) and 17 municipalities (benchmark).

- ***Tax reform***. Submission/approval of a broad tax reform package (currently with corresponding end-September/end-October benchmarks) is not advisable during the current administration in view of the need for such a reform to be fully owned by the next government. Nonetheless, with a view to expediting the process, we will prepare a draft tax reform bill for consideration by the new government, taking into account technical assistance recommendations received from the Fund's Fiscal Affairs Department. The proposal will include, inter alia, the introduction of a personal income tax that would exempt about 80 percent of the population, and will be at least revenue neutral and anchored on the objectives of equity and efficiency. We plan to finalize our draft proposal by end-December (benchmark).

Financial sector reforms

- ***Deposit insurance***. Prior to the Executive Board meeting, we will submit to Congress a draft law introducing a partial coverage deposit insurance scheme with adequate contributions by financial institutions, to strengthen depositor protection in the context of bank liquidation and resolution procedures.

- ***Corporate restructuring and bankruptcy***. The lack of an appropriate corporate restructuring and bankruptcy framework compounds the vulnerabilities in Bolivia's financial system. By end-December, we plan to submit to Congress draft legislation to improve the corporate restructuring and bankruptcy framework (benchmark).

- ***Privatization***. By end-year, we plan to sell the remainder of the state's assets in banks where the public sector holds a majority ownership (performance criterion).

V. Medium-Term Outlook

16. **We believe our medium-term fiscal prospects have improved since the discussions with the Fund staff for the fifth program review in early 2005**. The combination of higher hydrocarbons taxation, stronger international commodity prices, and the tax reform to be proposed, would boost fiscal revenue over the medium-term, despite the current uncertainties regarding investment in the hydrocarbons sector. The enlarged revenue envelope will allow a further reduction in the fiscal deficit, and hence a more rapid reduction in the debt ratio than previously projected, without undermining Bolivia's poverty-reduction and growth-enhancing efforts. To facilitate the formulation of a poverty-reduction strategy by the next government, we are coordinating with the international community with a view to consolidating the conclusions of the National Dialogue completed in December 2004, which we intend to publish. Finally, we look forward to the implementation of the G-8 debt relief initiative, which should further enhance Bolivia's medium-term economic outlook.

Table 1. Bolivia: Quantitative Performance Criteria Under the SBA, 2005 1/

			December	
	Jun.	Sep.	Prog. 2/	Proposed
(Cumulative flows from December 31, 2004, in millions of bolivianos)				
Deficit of the combined public sector 3/				
Unadjusted limit	1,351	2,123	3,763	2,728
Adjusted limit	1,241			
Actual--projected	436			
Margin	805			
Net domestic financing of the combined public sector 4/				
Unadjusted limit	122	347	1,174	1,174
Adjusted limit	622			
Actual--projected	-64			
Margin	686			
Central Bank net credit to the NPFS				
Unadjusted limit	-391	-298	137	-30
Adjusted limit	-391	-298		
Actual--projected	-608	-1,206		
Margin	217	908		
Net domestic assets of the central bank 5/				
Unadjusted limit	-168	-106	102	10
Adjusted limit	-209	51		
Actual--projected 4/	-451	-1,498		
Margin	242	1,549		
(Cumulative flows from December 31, 2004, in millions of US dollars)				
Net international reserves of the central bank 6/				
Target	-43	-21	40	135
Adjusted target	-38	-40		
Actual--projected 4/	26	220		
Margin	64	260		
Net nonconcessional external debt 7/				
Limit	13	23	14	14
Adjusted limit	13	17		
Actual--projected	8	-13		
Margin	5	29		
External debt with maturities up to one year				
Limit	25	25	25	25
Actual--projected	24	0		
Margin	1	25		

Table 1. Bolivia: Quantitative Performance Criteria Under the SBA, 2005 1/

	Jun.	Sept.	December Prog. 2/	December Proposed
(Cumulative flows from December 31, 2004, in millions of US dollars)				
Adjuster to the nonconcessional external debt limit for financial and corporate restructuring				
WB and CAF nonconcessional financing for financial and corporate restructuring				
Program baseline	1	8	10	6
Actual	1	1		
Adjuster to the net domestic financing of the NFPS				
Net external financing of the NFPS 8/				
Program baseline	128	188	273	180
Actual	42			
Adjuster for the deficit of the CPS				
Financing through HIPC and beyond-HIPC debt relief (program) 9/				
Program baseline	23	30	45	40
Actual	20			
External financing for social spending				
Program baseline	0	0	0	0
Actual	0			
Projected program grants				
Program baseline	4	4	45	45
Actual	3			
Projected concessional program loans				
Program baseline	34	34	54	54
Actual	1			
Tax Revenues				
Program baseline	966	1,459	1,948	n.a.
Actual	999			
Adjuster for NDA of the BCB				
Overdue obligations to foreign official creditors				
Program baseline	0	0	0	0
Actual	0			
Adjuster for NIR of the BCB				
Increase in foreign currency financial system deposits in the BCB	5	-19		
(Cumulative flows from December 31, 2004, in millions bolivianos)				
Adjustment to limit on domestic financing of combined public sector				
Maximum adjustment in the program	500	500	500	500
Actual shortfall	707			
Adjustor for NDA of the BCB				
Decrease in foreign currency financial system deposits in the BCB	-41	157		
Adjuster for NIR on currency issue				
Currency issue (program)	-518	-277	428	1,110
Maximum adjustment to NIR target	25	50	75	75

Source: Data provided by the Bolivian authorities.

1/ Definitions of the targets and adjusters as in the TMU attached.
2/ as in EBS/05/53
3/ The limits on the deficit of the combined public sector will be adjusted downward by the difference between actual and projected program grants. They will be adjusted downward (upward) by the amount of the shortfall (excess) between actual and projected HIPC debt relief.
4/ The limits on the net domestic financing of the NFPS will be adjusted upward by the difference between projected and actual net external financing to the NFPS (measured cumulatively over the same period as net domestic financing), excluding HIPC debt relief, up to the designated ceiling; it will be adjusted downward by the amount of any overdue obligations to foreign official creditors.
5/ The limits on the NDA of the BCB will be adjusted downward by the amount of any overdue obligations to foreign official creditors. The ceiling will be adjusted for the flow of the Central Bank financial system foreign currency deposits.
6/ The ceiling on NIR will be adjusted upwards by the amount of any overdue obligations to foreign official creditors and adjusted downward by shortfalls relative to the projected currency issue, up to the designated ceiling. The ceiling will be adjusted for the flow of the Central Bank financial system foreign currency deposits.
7/ The limit is reduced by shortfalls between actual and projected disbursements of loans for financial and corporate restructuring.
8/ Does not include the HIPC debt relief through rescheduling or the amortization component of stock of debt reduction operations.
9/ Comprises refinancing and the amortization component of stock of total public debt reduction operations under HIPC.

Table 2. Bolivia: Structural Conditionality for the Sixth and Seventh Reviews Under the Stand-By Arrangement

Condition	Measure	Date	Status/Proposal
	Fiscal Area		
Benchmark	Approval by Congress of a Hydrocarbons Law and its regulations, which should provide an appropriate framework for developing the large hydrocarbon reserves.	June 30, 2005	Not observed. *No further legislative adjustments contemplated at this stage.*
Performance Criterion	Passage of a revised budget law for 2005 with spending levels consistent with staff's revenue projections and the program deficit target after grants of the combined public sector of 5.2 percent of GDP.	June 30, 2005	Breached. *Grant waiver.*
Performance Criterion	Approval by Congress of the law regulating the procedural requirements of the recursos de alzada and jerárquico before the Tax Superintendency.	June 30, 2005	Observed.
Benchmark	With Fund technical assistance, submit to Congress an Organic Budget Law that sets hard budget constraints on all levels of government guided by the principles of budget unity, transparency, comprehensiveness, and appropriations determined by Congress.	June 30, 2005	Not observed. *Modify and convert into prior action for sixth review.*
Proposed prior action for sixth review	*Submission to Congress of a Budget Framework Law that sets hard budget constraints on all levels of government guided by the principles of budget unity, transparency, comprehensiveness, and appropriations determined by Congress.*	--	
Benchmark	Submission to Congress of a comprehensive tax reform, including the introduction of a personal income tax, which will exempt 80 percent of the population.	September 30, 2005.	*Modify benchmark.*
Benchmark	Approval by Congress of a comprehensive tax reform including the introduction of a personal income tax, which will exempt 80 percent of the population.	October 31, 2005	*Modify benchmark.*
Proposed modified benchmark	*Preparation of draft bill for consideration by the next government on a tax reform that is at least revenue neutral, including the introduction of a personal income tax, which would exempt about 80 percent of the population.*	*December 31, 2005*	

Condition	Measure	Date	Status/Proposal
Benchmark	Complete a comprehensive survey and setup a registry on health and education sector employment, as well as an audit on sub-national debt, including floating debt, based on FAD TA.	September 30, 2005	Progress made on setting-up a registry. *Modify and reschedule to December 31, 2005.*
Proposed modified benchmark	*Complete 50 percent of the registry on health and education sector employment, as well as the implementation of a registry system on subnational debt for nine regional governments (prefecturas) and 17 municipalities.*	*December 31, 2005*	
Benchmark	Submission to Congress of a 2006 budget with spending levels consistent with staff's revenue projections and a deficit target after grants for the combined public sector of 4.1 percent of GDP.	October 31, 2005	*Modify and convert into prior action for sixth review.*
Proposed prior action for sixth review	*Submission to Congress of a budget law for 2006 with a deficit after grants of 3.7 percent of GDP. The budget proposal will be consistent with a projected deficit after grants of the combined public sector equivalent to 3 percent of GDP, based on Fund staff revenue projections and assuming a 93 percent implementation rate of the investment budget.*	--	
Benchmark	Approval by Congress of an Organic Budget Law that sets hard budget constraints on all levels of government guided by the principles of budget unity, transparency, comprehensiveness, and appropriations determined by Congress.	October 31, 2005	*Modify benchmark.*
Proposed modified benchmark.	*Approval by Congress of a Budget Framework Law that sets hard budget constraints on all levels of government guided by the principles of budget unity, transparency, comprehensiveness, and appropriations determined by Congress.*	*December 31, 2005*	
Performance Criterion	Passage of the 2006 budget law with spending levels consistent with staff's revenue projections and a deficit target after grants for the combined public sector of 4.1 percent of GDP.	December 31, 2005	*Modify and convert into benchmark.*
Proposed benchmark	*Congressional approval, or enactment on a lapse-of-time basis, of a budget law for 2006 with a deficit after grants of 3.7 percent of GDP. The budget will be consistent with a projected deficit after grants of the combined public sector equivalent to 3 percent of GDP, based on Fund staff revenue projections and assuming a 93 percent implementation rate of the investment budget.*	*December 31, 2005*	

Condition	Measure	Date	Status/Proposal
	Financial and Corporate Sectors		
Benchmark	Submit a draft law creating a deposit insurance scheme with partial deposit coverage and establishing its proper functioning.	September 30, 2005	*Convert into prior action for sixth review.*
Benchmark	Submit to Congress draft legislation to improve the corporate restructuring and bankruptcy framework, including through enhanced protection of creditor rights.	September 30, 2005	*Reschedule to December 31, 2005.*
Performance Criterion	Sale and transfer on final basis of the ownership of the state's participation in banks majority-owned by Nafibo.	December 31, 2005	*Maintain PC.*

BOLIVIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

September 16, 2005

1. **This memorandum consolidates the original (March 2003) Technical Memorandum of Understanding (TMU) under the Stand-By Arrangement with the various changes introduced in the context of the five previous reviews**. It presents the definitions of the macroeconomic variables subject to quantitative performance criteria under the SBA-supported program, the related adjusters, and reporting requirements. No changes are being introduced in the context of the sixth review, except for a re-specification of quantitative performance criteria for end-December 2005 (Table 1 of the MEFP), minor clarifications and updates, and the suppression of previous requirements that are no longer applicable.

I. QUANTITATIVE PERFORMANCE CRITERIA

2. **Quantitative performance criteria are set with respect to**: (a) the deficit of the combined public sector (CPS); (b) net domestic financing of the CPS; (c) Central Bank of Bolivia (BCB) net credit to the nonfinancial public sector (NFPS); (d) net nonconcessional external debt of the public sector; (e) external debt of the public sector with maturities up to one year; (f) the change in the net international reserves (NIR) of the BCB; and (g) the change in the net domestic assets (NDA) of the BCB.

a. **The deficit of the CPS** is the sum of the net external financing of the NFPS and the net domestic financing of the CPS, where the CPS is defined to include the operations of the NFPS and the proceeds from the operating balance of the BCB.

- **The NFPS** comprises: (i) the general government (central administration, public sector social security, prefectures, municipalities, and other decentralized agencies); and (ii) the nonfinancial public enterprises.

- **The net external financing** of the NFPS comprises: (i) external disbursements to the NFPS; (ii) total HIPC debt relief from refinancing operations; (iii) net disbursements of funds for the NFPS administered by the BCB as trust funds; and (iv) unpaid current interest obligations; <u>less</u> (v) amortization due by the NFPS after HIPC debt relief for the amortization component of the stock of debt reduction operations; (vi) net payments in settlement of the external arrears of the NFPS; and (vii) shareholder contributions to the Corporación Andina de Fomento (CAF).

- **HIPC debt relief** includes that provided under the original and enhanced initiatives from the reduction in amortization arising from stock of debt reduction operations and rescheduling. It also includes beyond HIPC relief, i.e. debt relief granted by HIPC creditors beyond that agreed within the enhanced HIPC framework.

b. **The net domestic financing of the CPS** is the sum of: (i) the increase in the net claims of the domestic financial system on the NFPS (excluding deposits in the

BCB related to foreign loans administered as trust funds); (ii) the cash operating results of the BCB (before distribution to the treasury's account, with negative sign); (iii) the change in the NFPS liabilities to the private sector in the form of fiscal certificates; (iv) the increase in the domestic floating debt of the NFPS; and (v) all domestic borrowing by the NFPS, including net disbursements to the NFPS related to any new domestic debt instruments issued by the government and held outside the NFPS. Valuation changes (due to changes in inflation) in the stock of domestic debt denominated in inflation-indexed units (UFVs) are excluded from the computation of net domestic financing of the CPS.

- **The cash operating result of the BCB** is calculated as the sum of (i) interest on deposits abroad; (ii) earnings on the BCB portfolio with the NFPS and the financial system; (iii) interest payments by the treasury on government paper held by the BCB; (iv) interest on LAIA accounts; (v) commissions and realized foreign exchange gains; and (vi) other current receipts, excluding any sale of fixed assets, including gold; minus current payments to: (i) the IMF, excluding repurchases and SAF, ESAF and PRGF loan repayments; (ii) other international organizations, excluding amortization and interest on loans administered by the BCB as trust funds for the NFPS; (iii) the domestic financial institutions on account of reserve requirements; (iv) interest on certificates of deposit and treasury bills B and D; and (v) administrative and other current expenditures. In consolidating the BCB cash operating result with the NFPS accounts, transfers to the treasury out of operating profits will be excluded from expenditure.

- **The domestic floating debt of the NFPS** comprises the liabilities incurred for goods and services received but not yet paid for, excluding claims on and liabilities to other entities within the NFPS. The floating debt with respect to public sector wages at the end of each month includes: (i) unpaid wage increases; and (ii) wages for work performed in a previous month but not yet paid. Floating debt includes the floating debt of the departmental capitals, El Alto, and those municipalities having subscribed an adjustment program (PRF) with the government as of December 31, 2002.

c. **BCB net credit to the NFPS** is defined as the BCB's gross credit to the Treasury (including emergency and liquidity assistance, and any holdings of treasury bills and bonds by the BCB) minus the deposits of all NFPS entities with the BCB. It excludes net disbursements of foreign loans administered by the BCB as trust funds for the NFPS.

d. **The nonconcessional external debt of the public sector** is defined as the outstanding external debt of the public sector, excluding: (i) concessional loans with a grant element—based on the interest rate and repayment schedule of each loan and any grants or other external concessional loans in connection to the loan in question—of at least 35 percent using the OECD commercial interest reference rates as of August 15, 2005; (ii) changes in BCB liabilities included in the definition of NIR; (iii) debt reprogrammed with official creditors; (iv) the use of Fund resources; and (v) the effect of any stock-of-debt operations under the enhanced HIPC Initiative or beyond-HIPC relief.

- **The public sector** is defined to include: (i) the NFPS; and (ii) the Central Bank of Bolivia (BCB) and other financial public sector entities, including NAFIBO and FONDESIF.
- **External debt** has the meaning set forth in point No. 9 of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt, adopted on August 24, 2000, and will include any public debt instruments held by foreign official institutions.
- **External debt** will be valued at the end–2004 U.S. dollar exchange rates of 0.73351 Euro = US$1,104.12 Japanese yen = US$1, and for other currencies according to the corresponding end–2004 exchange rates published in the IMF's International Financial Statistics.

e. **The external debt of the public sector with maturities up to one year** excludes: (i) normal import credits; (ii) reserve liabilities of the central bank; and (iii) the use of Fund resources.

f. **NIR of the BCB is defined as:** (i) BCB liquid foreign assets; <u>less</u>: (ii) BCB liabilities to nonresidents (including swaps and the net position under the Latin American Integration Association, LAIA, clearing mechanism) with an original maturity of at most one year; (iii) outstanding purchases and disbursements from the Fund (excluding disbursements from the trust fund); and (iv) BCB net liabilities to the Latin American Reserve Fund (FLAR), including bridging loans (even those obtained by the NFPS) and those obtained by pledging gold. **The change in NIR of the BCB** will be measured by differences in stocks.

- **The NIR definition excludes**: (i) gains resulting from the conversion of monetary gold into foreign exchange; (ii) gains resulting from the acquisition of domestically produced gold; and (iii) any of the financial institutions' liquid asset requirement holdings (RAL), whether or not included in the BCB balance sheet.

- **The BCB's assets and liabilities denominated in foreign currencies other than the U.S. dollar** will be converted to U.S. dollars at the market exchange rates for the respective currencies in effect at the date of the NIR measurement, except for: (i) gold, to be valued at the accounting rate of US$375 per troy ounce; and (ii) SDR holdings and the net Fund position which will be converted into US$1.55301 = SDR1.

- **NIR will be valued at the accounting exchange rate** of Bs 8.15 = US$1 in 2005.

g. **The NDA of the BCB** is defined as currency issue less the NIR of the BCB.

II. ADJUSTERS

3. **The limits on the deficit of the CPS** will be adjusted downward by the difference between actual and projected program grants (i.e., grants not earmarked for projects or "transferencias de libre disponibilidad") if actual grants exceed projected program grants.[1] The adjustment will be limited to the shortfall in actual concessional program loans from projected concessional program loans.

4. **The limits on the deficit of the CPS** shall be reduced (increased) by the shortfall (excess) between actual and projected HIPC debt relief.

5. **The limits on the deficit of the CPS for June 30 and September 30, 2005** will be reduced by 33 percent of any excess of actual tax revenue over the programmed levels specified in Table 1 of the MEFP.

6. **The limits on the net domestic financing of the CPS** will be adjusted upward by the shortfall in cumulative net external financing to the NFPS, excluding any medium- and long-term liabilities transferred from the BCB to the treasury and from other financial public sector institutions, and also excluding HIPC debt relief, up to the designated ceiling.

7. **The limits on the net domestic financing of the CPS** will be adjusted downward by (1) any medium- and long-term liabilities transferred from the BCB to the treasury; and (2) any liabilities transferred from other financial public sector institutions to the treasury.

8. **The limits on the net domestic financing of the CPS and on the change in the NDA of the BCB** will be adjusted downward, and the target for NIR of the BCB will be adjusted upward, by the amount of any overdue obligations to foreign official creditors.

- **Foreign official creditors include, but are not limited to:** (i) multilateral organizations; (ii) bilateral official creditors excluding debts covered under Paris Club or other bilateral rescheduling or debts under negotiation including service on rescheduling but excluding old debts to countries in the region; (iii) supplier's creditors without official guarantee excluding already rescheduled debt service; and (iv) holders of private bonds excluding zero-coupon bonds used in debt conversion schemes.

9. **The limits on the central bank net credit to the NFPS** will be adjusted downward by any transfer of cash from the BCB to the treasury associated with the transfer of any medium- and long-term liabilities.

10. **The limits on net nonconcessional external debt** will be reduced by the amount of the shortfall between actual and projected external financing for financial and

[1] The EU grant for water and sanitation is classified as a program grant as corresponding spending had already been in the budget.

corporate restructuring, up to the ceiling indicated in Table 1 of the MEFP.

- **Loans** for financial and corporate restructuring comprise CAF credits of US$10 million for 2005 and would be guided by the following principles: (i) all parties agreed on guidelines for the Corporate Restructuring Fund(s) to be structured in accordance to market based principles, consistent with those governing the creation of the fund for supporting the financial system (FASF); (ii) only viable companies (based on financial fundamentals and future business plans and prospects) with strong restructuring plans are eligible to participate; (iii) the Funds' Boards reaching these decisions must be safeguarded from political influences; (iv) government to provide safeguards from claims, in case a company ultimately fails; (v) the operation of the funds must be well coordinated with the regulations governing the voluntary workout law; (vi) the provision of funds should not constitute subsidies in the long run; and (vii) the funds are to be managed by international managers with demonstrated expertise.

11. **The floors on the change in the NIR of the BCB** will be adjusted downward for shortfalls relative to the projected currency issue, up to the designated ceiling indicated in Table 1 of the MEFP.

12. **The floors on the change in the NIR of the BCB** will be adjusted upward/downward by the net increase/decrease in the legally required and excess reserves denominated in foreign currency by financial institutions held with the BCB. **Conversely, the limits on the change in the NDA of the BCB** will be adjusted downward/upward by the net increase/decrease of the legally required and excess reserves denominated in foreign currency by financial institutions held with the BCB.

III. Selected Reporting Requirements

13. **Monthly updates for fiscal and monetary information** will be provided at most 25 calendar days after the end of each month. The quantitative targets and limits will be measured as cumulative flows from December 31, 2004.

14. **The treasury will remit to the BCB, on a weekly basis**, information on all **placements of treasury bonds other than open market operations**, necessary to monitor the deficit and net domestic financing of the CPS.

15. **Floating debt of the departmental capitals**, El Alto, and those municipalities having subscribed a PRF with the government as of December 31, 2002 will be reported semiannually, with at most a 90–day lag; and will be included in the floating debt figures as soon as available.

16. **A quarterly estimate of pro-poor spending and pro-poor spending excluding wages** of the NFPS will be provided at most 90 calendar days after the end of each quarter (reporting agency: Fiscal Programming Unit of the Ministry of Finance (UPF)).

- **The pro-poor spending of the SPNF** includes current and capital spending on health (excluding payments to “beneméritos”) and education (excluding universities); and capital spending on basic sanitation, urban development and rural development (including spending on PLANE). It excludes pension outlays.