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Uruguay and the IMF

Press Release:
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January 18, 2006

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

December 27, 2005

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Dear Mr. de Rato:

Since the last program review in September, the Uruguayan economy continued to perform strongly, with robust growth, low inflation and good fiscal indicators—underpinned by sound macroeconomic policies. All end-September quantitative PCs and targets have been met with solid margins, and we anticipate that all end-December quantitative PCs will also be met. The 2005–09 budget adopted in December reflects our priorities on social and infrastructure spending geared toward achieving lasting growth, social progress, and debt sustainability.

We have also made important progress in advancing our structural reform agenda, with a view to entrenching financial stability and boosting growth prospects. The end-December benchmark on tax administration has been observed. In addition, we are preparing comprehensive reforms for the tax and financial system, with relevant draft legislation soon to be submitted to Congress. While the reform proposal for the police pension system has been submitted to Congress, we now expected it to be approved by end-May 2006. We are also advancing well with developing an agenda of growth-supporting structural reforms, a key pillar of our program.

The attached supplement to the memorandum of economic policies of May 24 outlines our economic and financial program for 2006, consistent with our medium-term strategy and the policy framework being supported by the current SBA. In this connection, we request: (i) completion of the second review under the SBA; (ii) a waiver of nonobservance of the end-November PC on reform of the police pension system and establishment of a PC in the same terms for end-May 2006; (iii) a waiver of nonobservance of the December PC on financial sector reform and modification of the corresponding June PC related to its implementation, reflecting the decision to keep the supervisory authority within the central bank, in line with Fund advice; and (iv) the establishment of quantitative and structural performance criteria and indicative targets for 2006, as specified in Tables 1 and 2. Moreover, due to lack of availability of final data by the time of this review, we request waivers of applicability for the end-December 2005 performance criteria on the combined public sector primary balance, general government noninterest expenditure, net domestic assets of the BCU, net international reserves of the BCU, and nonfinancial public sector gross debt.

We request the extension of repurchase expectations for February–December 2006, consistent with established IMF policy. Should the external position turn out significantly stronger than we currently anticipate, we will consider reducing the net use of Fund resources by treating the arrangement as precautionary in the future or making advanced repurchases.

As usual, we will maintain a close policy dialogue with the Fund and stand ready to take additional measures as appropriate to ensure the achievement of the program's objectives.

Sincerely,

/s/	/s/
Walter Cancela	Danilo Astori
President	Minister of Economy and Finance
Central Bank of Uruguay	Oriental Republic of Uruguay

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

SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. This memorandum supplements the Memorandum of Economic and Financial Policies (MEFP) of May 24 and its supplement of September 14, 2005.

A. Performance under the 2005 Program

2. Performance under the program has continued to be strong. Economic growth has remained robust, and the 6 percent objective for 2005 is well within reach. Inflation is still below the central bank's (BCU) target range for end-2005 (5½–7½ percent), aided by a significant strengthening of the peso against the dollar. Fiscal performance through the third quarter has remained in line with the program, reflecting continued strong tax revenues offsetting weaker performance by public enterprises, and prudent expenditure management. The Social Emergency Program is now operational, assisting those in greatest need, including through direct income transfers, free preventive health care, and a temporary employment program.

3. Vulnerabilities have further decreased, including through a significant strengthening of the international reserves position. This was aided by higher-than-programmed international bond placements and renewed foreign exchange purchases by the BCU in light of strong money demand and sustained capital inflows.

B. Macroeconomic Outlook and Policies

4. We remain committed to the medium-term fiscal framework set out in our letters of May 24, 2005 and September 14, 2005, aimed at achieving a primary surplus of 4 percent of GDP from 2007 onward. The 2005 primary surplus target of 3½ percent of GDP is well in hand, and we are confident that our policies are adequate to achieve the 2006 primary surplus target of 3.7 percent of GDP. The five-year budget, consistent with this medium term-framework, has been adopted.

5. Our fiscal strategy targets increases in revenues of about one percent of GDP in 2006 and of 1½ percent of GDP during 2006-08 to ensure meeting the primary surplus targets and finance higher spending in priority areas. To achieve these objectives, we are pressing ahead with revenue administration reforms and are finalizing a comprehensive tax reform. In the case of public enterprises, we are targeting an improvement in the current primary surplus as a result of the recovery from the drought in 2005, lower transfers to the central government, and adjusting tariffs to maintain appropriate margins and reflect cost developments. These policies will create the necessary fiscal space for our planned spending increases in infrastructure, social and other priority programs, within the envelope of the program's fiscal targets.

6. We will monitor closely both revenue and expenditure developments, and are prepared to take measures as needed to ensure meeting the program targets. To this end, the budget law allows for semi-annual revenue performance assessments and authorizes the

executive to lower spending should revenues be lower than budgeted. In addition, should revenue turn out stronger than envisaged in the program, we reiterate our commitment to save any overperformance to achieve a primary surplus of 4 percent of GDP.

7. We will maintain the current monetary framework of base money targeting within a flexible exchange rate regime. We have set an indicative inflation target range for end-December 2006 at 4½ -6½ percent and we will continue with our policy of reducing the inflation rate consistent with the program's gradual disinflation objective. We will set base money target ranges for consistency with the inflation target, will monitor inflation developments very closely and stand ready to adjust policies to ensure meeting the inflation objective.

8. We expect NIR to exceed the original program objectives for end-2005 by about US$640 million, of which some US$400 million represent pre-financing operations for 2006. For next year, we anticipate continued strength in the external accounts, with underlying NIR (excluding the unwinding of the pre-financing operations) targeted to increase by US$230 million. If market conditions allow, we intend to continue to conduct pre-financing operations for 2007. The BCU has started to participate in the forward foreign exchange market to jump-start it, while hedging the exchange rate and interest rate risks of its forward position, which will remain of limited size. We also plan to develop a futures foreign exchange market and will request Fund TA for this, with a view to phasing out BCU's participation in the foreign exchange derivative markets.

C. Structural Reforms

Fiscal reforms

9. **Tax reform.** We are preparing draft legislation on a comprehensive tax reform for submission to Congress by end-February, and implementation by end-June 2006. The key objectives of the reform are to improve equity and growth prospects, and ensure attainment of the revenue targets of our fiscal program. While we will only finalize the draft legislation after completing the ongoing consultation process with the Uruguayan society, the reform is envisaged to include: (i) introducing a personal income tax; (ii) revamping the corporate income tax; (iii) lowering the VAT rates, while expanding its base to broadly maintain its yield; (iv) eliminating sectoral exemptions to employers' social security contributions and unifying the rates for the non-rural private sector, excluding education; and (v) eliminating several low-yield taxes. The tax rates will be set consistent with our revenue objectives. Also, we will be careful not to reduce the burden of indirect taxation until the revenue gains from the reform are well in hand.

10. **Revenue administration.** We are taking strong steps in this area, building on the recent recommendations of Fund and World Bank technical assistance missions. We have signed a memorandum of understanding between the MEF and the DGI to ensure meeting our goals for improvements in tax collection, and have made appropriate allocations in the proposed budget to support the DGI. We have also recently established a committee in

charge of designing a reform plan for the customs authority (benchmark for end-August 2006). To ensure successful implementation of the tax reform, and in particular of the personal income tax, we intend to: (i) formulate a plan to strengthen the auditing and enforced collection functions of the BPS (new benchmark for June 2006) and have requested technical assistance from the Fund for this purpose; (ii) continue improving the coordination between the DGI, the BPS and the customs authority; and (iii) establish quarterly minimum collection targets for 2006 for the BPS.

11. **Public Investment.** Beyond increases in public investment, our agenda for sustained rapid growth aims at improving the quality of investment by strengthening procedures for planning, selection, and implementation; and seeking private sector participation in infrastructure projects. As a pilot case, we are currently exploring public investment in railroad infrastructure, complemented with privately-managed joint public-private investment on freight transportation services, to satisfy the increased demand derived from the large forestry projects. We are currently evaluating financing modalities for this investment, while minimizing its contingent fiscal costs.

12. **Pension reform.** We have submitted to Congress a reform proposal for the police pension fund, aiming to enhance fairness and to improve its financial viability, and expect its passage by end-May. Preparations for the reforms of the pension funds of the military and the banking sector are proceeding, with the goal of ensuring their financial sustainability. We will submit our reform proposal for the military pension fund and for the banking pension fund to Congress by end-November 2006, with implementation slated for end-May 2007 (new PCs). Moreover, we have established a committee to study reforms to improve the actuarial fairness and ensure long-term fiscal sustainability of the general pension plan. This group will be working closely with the World Bank to adopt a reform agenda by end-2006 for implementation beginning in 2007.

13. **Budget process.** By end-March 2006 we will establish a committee to steer reforms to improve the budgetary process in line with best international practices. We will also request Fund TA to assist the committee, which will prepare recommendations with a timetable to improve legislation, coverage, classification, formulation, controls, and transparency of the budget process, consistent with our constitution) by August 2006 (new benchmark). Among the possible measures, we are considering creating a budget office at the MEF to coordinate the formulation of the budget and to strengthen the monitoring of its execution. Once the tax reform has been implemented we plan to complete as part of the annual budget execution assessment a tax expenditure analysis to make transparent the costs of any remaining exemptions. At the same time we are working with the World Bank on improving government procurement. We have made significant progress in improving our records of floating debt, with a view to include them as part of our fiscal targets. As an initial step, we propose to monitor the fiscal primary balance, including floating debt, as an indicative target. We intend to make this a PC as soon as we are confident of the proper recording and internal control systems working of our systems and no later than end-2006.

14. **Debt management.** We have made preparations for a debt management unit at the MEF, including by allocating resources in the budget. The unit will be established by end-December 2005, with the adoption of its terms of reference and the appointment of its head. The unit will work on the design of a debt management strategy aimed at lengthening average maturity, smoothing the amortization profile, and reducing the share of foreign currency-denominated debt by issuing peso or inflation-indexed domestic and international bonds. In addition, we have submitted to congress a draft law to modify the statutory debt ceilings, which would facilitate debt management operations by expanding the coverage of debt instruments and applying the ceilings on net (rather than gross) debt.

Monetary and financial system reforms

15. The draft legislation to improve the operational framework of the financial system is about to be completed, for submission to Congress by end-December as planned. The broad outline of the reform of the central bank includes establishing its operational independence to conduct monetary policy, including by staggering the appointments of board members, and delinking them from the political cycle. The new legislation would also strengthen financial sector supervision and improve the bank resolution framework by providing alternatives to outright liquidation and strengthening the deposit insurance scheme. While the deposit insurance and bank liquidation functions will be placed in a separate institution, we are now keeping the supervisory authority within the central bank (to protect its institutional strength), but will put a governance structure in place that ensures its independence. We will also adopt a plan to strengthen the BCU's financial position by end-September 2006 (new benchmark), and have included adequate provisions for this in its proposed new charter.

16. Regarding the public bank BROU, credit granting policies and controls continue to be strengthened, in line with lending at commercial terms. While the trust managing BROU's nonperforming loans has continued to service its debt to BROU, new steps are needed to ensure that this continues. We have therefore recently changed the governance structure of the trust fund, appointing a Board member to represent the Ministry of Economy and providing it with greater independence from BROU; we will abstain from any interference in the collection efforts; and will transfer the effective management of fideicomiso II and III to the asset management company that manages fideicomiso I by December 2005. Moreover, we continue to honor the government's guarantee of the notes issued by the trust to BROU should the trust be unable to service the debt according to the agreed schedule.

17. To address the difficult situation in the housing bank BHU, we have prepared an action plan that aims to minimize contingent fiscal costs, while recognizing the need for a mortgage lending market in Uruguay. The plan foresees the removal of BHU's low quality assets into a fiduciary trust, a refocus of BHU's activities, and the implementation of an automated loan system. Under the plan, BHU will only be allowed to receive saving deposits for mortgage down payments and shall only resume its lending once the Superintendent concludes that sufficient progress has been made in implementing its restructuring that such lending does not pose a risk to the safety and soundness of the institution. The action plan will be adopted formally by Ministers of Economy and Housing and the Board of BHU soon

and will be followed by a detailed implementation plan by end-February (new benchmark). BHU will service the note to BROU on schedule, and if necessary, the government will honor its guarantee.

18. We expect the sale of NBC (the bank formed with the consolidated good assets from three failed banks) to be completed no later than the end of the first quarter of 2006. While we will maintain preferred shares, they have no voting rights and will be sold to the future owner of NBC over the next five years. Collection efforts by the asset manager for the liquidation funds for the bad assets of the failed private banks is proceeding on schedule and semi-annual financial statements are being published and audited annually. The transfer of information on non-performing borrowers of the liquidation funds into the credit registry will be completed by December 2005.

Boosting growth

19. Recognizing the importance of business environment to achieve sustained growth, reforms in this area are a priority for us. Once the private sector commission has published its results (expected by March 2006), we will incorporate some of its key recommendations into our program. Key areas under consideration by the commission for possible recommendations include: (i) public enterprise reforms; (ii) private sector participation in infrastructure projects; (iii) business start-up costs; (iv) the bankruptcy framework; (v) labor market issues; and (vi) international trade integration beyond Mercosur.

D. Program Financing and Safeguards

20. With a significant part of the financing needed in 2006 already secured in 2005, next year's program financing is well in hand. Nevertheless, we plan to continue to enhance our access to both domestic and international capital markets in anticipation of medium-term financing needs. We also expect significant flows from the World Bank and IDB (about US$430 million) next year, broadly in line with amortizations, and are strongly committed to firmly implement associated donor conditionality to ensure timely disbursements.

21. A new on-site safeguards assessment of the BCU was completed in September 2005, and we are fully committed to implementing its recommendations. As first steps, we have included all the Fund liabilities in our balance sheet, and have amended the criteria for selection and appointment of the external audit firm.

Table 1. Uruguay: Proposed Structural Conditionality for 2005-07

Area	Structural Conditionality	Date	Status
A. Structural performance criteria			
a) EBS/05/136			
Fiscal	Have in place a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	February 28, 2006	Observed.
Pensions	Begin to implement reform of the pension fund for the police.	November 30, 2005	Not observed.
Tax reform	Submit to congress a comprehensive tax reform as described in paragraph 7 of the MEFP.	February 28, 2006	
Tax reform	Begin to implement the comprehensive tax reform.	June 30, 2006	
Central Bank	Submit simultaneously three laws to congress to: (i) give appropriate autonomy to the central bank (as described in paragraph 12 of the MEFP); (ii) strengthen the regulation of the financial system (as described in paragraph 13 of the MEFP); and (iii) provide a suitable bank resolution framework (as described in paragraph 14 of the MEFP).	December 31, 2005	Not observed. 1/
Central Bank	Begin to implement these laws. 2/	June 30, 2006	
BROU & BHU	Government to ensure timely service of BHU note and BROU fiduciary notes to BROU in accordance with the current payment schedules.	Continuous	Observed.
BHU	Adopt action plan to address the financial situation of BHU consistent with minimizing systemic risks and contingent fiscal costs.	December 31, 2005	Observed.
b) Proposed new PCs			
Pensions	Begin to implement reform of the pension fund for the police.	May 31, 2006	
Pensions	Submit to Congress reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP.	November 30, 2006	
Pensions	Begin to implement the reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP.	May 31, 2007	
B. Structural benchmarks			
a) EBS/05/136			
Tax administration	Sign a memorandum of understanding between the Ministry of Finance and the DGI agreeing on quantitative targets and indicators for 2006 on tax collections, audit coverage, tax services, and information systems.	December 31, 2005	Observed.
Tax administration	Finalize the design of a comprehensive reform plan for the customs agency (including establishing collection targets consistent with the program).	August 31, 2006	
Debt management	Create a debt management unit at the Ministry of Finance.	December 31, 2005	
Growth	Publish agenda of growth-enhancing reforms (including timetable for implementation) prepared by the business environment commission.	March 31, 2006	
Growth	Submit to Congress bankruptcy law (to include Chapter-11 type corporate restructuring).	June 30, 2006	
Financial sector	Sell shares of NBC in amounts that yield managerial control to the private sector.	June 30, 2006	
b) Proposed new benchmarks			
Financial sector	Adopt a detailed schedule for the implementation of the BHU action plan.	Februrary 28, 2006	
Tax administration	Formulate a plan to strengthen the auditing and enforced collection functions of the BPS.	June 30, 2006	
Budget	Prepare recommendations, with a timetable, to improve legislation, coverage, classification, formulation, controls, and transparency of the budget process.	August 30, 2006	
Central Bank	Adopt plan to strengthen the central bank finances (outright capitalization or interest payment on government paper).	September 30, 2006	

Sources: Ministry of Economy and Finance; and Central Bank of Uruguay.

1/ Nonobservance due to the decision to keep the financial sector supervisory authority within the BCU. Fund staff supports this decision.
2/ Proposed modification (see paragraph 3 of the LOI).

Table 2: Quantitative Performance Criteria and Indicative Targets of the 2005-08 Program 1/

	2004 Stock	2005								
		June 30				Sept. 30				Dec. 31
	Dec. 31	PC	PC (adjusted)	Actual	Margin (+)	PC	PC (adjusted)	Actual	Margin (+)	PC
A. Quantitative performance criteria										
		(In millions of Uruguayan pesos)								
1. Combined public sector primary balance (floor) 2/	...	5,471	5,372	6,394	**1,022**	9,687	9,490	10,351	**861**	14,647
2. General government noninterest expenditure (ceiling) 2/	...	23,561	23,539	22,080	**1,459**	34,643	34,665	32,996	**1,670**	46,561
3. Net domestic assets of the BCU (ceiling) 2/	74,079	3,983	3,983	-302	**4,284**	4,572	4,572	-16,424	**20,995**	-3,910
		(In millions of U.S. dollars)								
4. Net international reserves of the BCU (floor) 2/	-2,218	-130	-130	18	**148**	-110	-110	592	**702**	280
5. Nonfinancial public sector gross debt (ceiling) 4/	12,189	12,510	12,495	12,239	**255**	12,575	12,566	12,490	**76**	12,550
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	**0**	0	0	0	**0**	0
B. Indicative targets										
		(In millions of Uruguayan pesos)								
7. Combined public sector overall balance (floor) 2/	...	-5,086	-5,186	-2,794	**2,391**	-7,459	-7,656	-4,597	**3,059**	-7,072
8. Monetary base (ceiling) 2/	15,648	557	557	1,070	**-513**	1,673	1,673	498	**1,175**	3,468
9. Floating debt of the central government (ceiling)	3,081	3,081	3,081	2,567	**514**	3,081	3,081	2,298	**783**	3,081

Table 2: Quantitative Performance Criteria and Indicative Targets for the 2005-08 program (concluded)

	2005 Stock	2006 Targets				2007 IT	2008 IT
	Sept. 30	Mar. 31	Jun. 30	Sept. 30	Dec. 31	Dec. 31	Dec. 31
A. Quantitative performance criteria							
(In millions of Uruguayan pesos)							
1. Combined public sector primary balance (floor) 2/	n.a.	2,651	5,196	10,434	16,473	19,311	20,748
2. General government noninterest expenditure (ceiling) 2/	n.a.	13,409	27,050	39,870	53,558	57,735	63,095
3. Net domestic assets of the BCU (ceiling) 2/ 3/	51,525	-3,136	-4,195	-8,003	-7,130	-16,203	-9,522
(In millions of U.S. dollars)							
4. Net international reserves of the BCU (floor) 2/ 3/	-1,546	250	333	414 5/	554 5/	544	395
5. Nonfinancial public sector gross debt (ceiling) 4/	12,309	12,882	13,074	13,082	12,995	13,150	13,286
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	0	0	0
B. Indicative targets							
(In millions of Uruguayan pesos)							
7. Combined public sector overall balance (floor) 2/	n.a.	-3,076	-5,528	-6,255	-4,983	-2,966	-2,537
8. Combined public sector primary balance (extended) (floor) 2/	n.a.	2,651	5,196	10,434	16,473	19,311	20,748
9. Monetary base (ceiling) 2/ 3/	16,146	3,140	3,261	2,105	4,882	1,803	1,720

PC= Performance Criterion; IT=Indicative Target.

Sources: Ministry of Economy and Finance; and Central Bank of Uruguay.

1/ As defined in the Supplementary Technical Memorandum of Understanding.
2/ Cumulative changes from the previous calendar year.
3/ 2006 targets are cumulative from end-September 2005.
4/ All maturities.
5/ Indicative targets.

SUPPLEMENTARY TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum supplements the technical memorandum of Sept. 14, 2005. It presents the definitions of the variables included in the performance criteria and indicative targets for the year 2006 annexed to the Memorandum of Economic and Financial Policies. Definitions for the targets for the remainder of 2005 will be monitored in accordance with the TMU of September 14, 2005.

1. **Cumulative floor on the overall balance of the combined public sector (indicative target).** The combined public sector comprises the non-financial public sector (NFPS) and the Central Bank (BCU). The NFPS comprises the central government,[1] the social security system (*Banco de Previsión Social, Caja Militar,* and *Caja Policial*), the local governments (*Intendencias*), the public enterprises (AFE, ANCAP, ANCO, ANP, ANTEL, INC, OSE, and UTE (including Salto Grande)). The below-the-line overall balance will be measured as the negative of the *sum* of: (a) the net financing of the NFPS[2] minus (b) the operating balance of the BCU.

   (a) The net financing of the NFPS would include the *sum* of: (i) increase in net claims of the domestic financial system on the NFPS (excluding government bonds and treasury bills); (ii) the increase in the net amount of NFPS bonds and treasury bills held outside the NFPS (excluding any debt issued for the capitalization of BCU and debt issued to finance the capitalization of the deposit insurance scheme up to a limit of US$20 million); plus (iii) external bank loans and external[3] supplier credits to the NFPS; plus (iv) the net increase in liabilities arising from the forward sale of NFPS assets; plus (v) the increase in net non-bank loans;[4] *minus* (vi) the net increase

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[1] This includes the funds managed directly in the ministries (*Fondos de Libre Disponibilidad*).

[2] Excluding any cash outlays related to government guarantees (principal plus interest) on the BHU and BROU's fiduciary trusts notes; change in net debt associated with the assumption of financial liabilities of BHU and its recapitalization as part of its restructuring, and any cash inflows related to loan recoveries and sale of assets which were transferred from BHU to the government as the beneficiary in the restructuring; and the change in the net debt associated with the final outcome of the litigation/arbitration with the former shareholders of Banco Comercial.

[3] Based on the residency principle.

[4] Nonbank loans are defined in accordance with point No. 9 (a) (i) of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 6230-(79/140, August 3, 1979), as amended in 2000, but exclude those instruments listed in paragraph 1 (a)

(continued)

of NFPS financial assets held by the NFPS outside the domestic financial system (including the loan component of the deposit insurance scheme); plus (vii) gross revenues from the sale of public assets (net of associated fees and commissions); plus (viii) all upfront payments related to future concessions (including the sale of mobile phone licenses); plus (ix) recoveries of financial assistance provided to the banking system.

(b) The operating balance of the BCU is defined as interest earnings on gross international reserves, as defined below, and other earnings including those on other foreign and domestic assets minus operating expenses, commissions paid, and interest paid on domestic and foreign debt administered by the BCU.

2. **Cumulative floor on the primary balance of the combined public sector.** The combined public sector primary balance will be calculated as the overall balance measured from below the line plus interest payments. Interest payments are defined to exclude commissions and fees.

3. **Cumulative floor on the extended primary balance of the combined public sector.** The combined public sector extended primary balance will be calculated as the primary balance of the combined public sector defined in paragraph 2 minus the change in the stock of floating debt of the central government. Floating debt of the central government is defined as expenditures from**:** the general treasury account ("Rentas Generales"), "Rentas de Afectación Específica", payment obligations with domestic suppliers for which external and domestic debt has been earmarked, investment funds of the Ministry of Transportation and Public Works, and own funds from agencies outside the budget (Casinos). It includes debt registered in the integrated information system (SIIF), and that has been authorized for execution and confirmed by the respective central accountants, and for which no checks for payment have yet been issued. Excluded are obligations for utilities, obligations related to subsidies (except for the forestry fund), judiciary debt and obligations falling under "*Inciso 24"* of the accounting plan of the *"Contaduria General de la Nacion"* (excluding debt with international organizations), domestic suppliers' credits of the Ministry of Housing, and overdue payments for wages and salaries (including all related labor benefits) of public sector contractual and permanent employees, provided such overdue payments do not exceed 10 days following the date on which payments are due.

4. **Cumulative ceiling on general government expenditure** applies to total (current and capital) non-interest expenditure of the central administration and the social security system (BPS) as recorded in the accounting system at the time that checks are delivered, a bank transfer is made, or the BCU notifies the receipt of a payment order.[5] The non-interest

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(i), (ii), (iii) and (iv) of this memorandum, and cover loans of the central government and public enterprises only.

[5] Expenditures by local governments are not included.

expenditure of BPS excludes benefit payments. The non-interest expenditure of the central administration includes *Fondos de Libre Disponibilidad* but excludes transfers to the social security system, automatic transfers to the private pension funds (AFAPs), and earmarked revenue as of December 31, 2004.

- The ceiling on general government expenditure will be adjusted downward for any expenses arising from pension adjustments, which exceed the increase in the legal minimum adjustment.

5. **Cumulative ceiling on the monetary base (indicative target).** Money base is defined as the sum of (i) currency issue; (ii) nonremunerated and remunerated peso sight deposits of BROU, BHU, private banks, and other institutions defined below at the BCU; and (iii) call peso deposits of BROU, BHU, private banks, and other institutions at the BCU. Other institutions include pension funds (AFAPs), local governments, public enterprises, trust funds of the liquidated banks (FRPB), investment funds, offshore institutions (IFEs), insurance companies, exchange houses, stock brokers, and the nonfinancial private sector. The monetary base excludes central government and BPS peso deposits held at BROU subject to a 100 percent reserve requirement. The indicative target is defined as the cumulative change calculated using the monthly averages relative to the base month average.

6. **Cumulative floor on the net international reserves (NIR) of the BCU.** NIR is defined as the difference between the gross international reserves and BCU reserve liabilities. Gross international reserves include all foreign exchange assets that are claims on non-residents and that are in the direct effective control of the BCU and are readily available for such purposes of the BCU as intervention or direct financing of payment imbalances. Such assets may be in any of the following forms, provided that they meet the test of effective control and ready availability for use: currency, bank deposits in nonresident institutions and government securities and other bonds and notes issued by nonresidents (with a rating not below "A" in the classification of Fitch and IBCA and Standard and Poor's or "A2" in the classification of Moody's). In addition, holdings of SDRs or of monetary gold would be included under gross international reserves (provided they meet the test of effective control and ready availability of use) as would the reserve position in the IMF, and liquid foreign assets set aside for the use of the government.

(a) Excluded from gross international reserves are all foreign currency claims arising from off-balance sheet transactions (such as derivatives instruments), capital subscriptions to international financial institutions, any assets in nonconvertible currencies, claims on any nonresident Uruguay-owned institutions, or any amounts (in all components of assets, including gold) that have been pledged in a direct or contingent way.

(b) BCU reserve liabilities include (i) all foreign currency-denominated liabilities of the BCU with original maturity of one year or less to residents and nonresidents (excluding government deposits); (ii) all certificates of deposit used to constitute reserve requirements against bank deposits; (iii) the total use of Fund credit by Uruguay; and (iv) any net position on foreign exchange derivatives vis-à-vis the peso with either residents or nonresidents undertaken directly by the BCU or by other financial institutions on behalf of the BCU, as measured in items II.2 and III.4 of the IMF's Data Template on International Reserves and Foreign Currency Liquidity.

(c) For the purpose of the NIR calculation, (i) the gold holdings of the BCU will be valued at the accounting rate of US$42 per troy ounce; (ii) liabilities to the IMF will be valued at the rate of US$1.44946 per SDR; (iii) gains or losses from gold swaps and other operations will be excluded; and (iv) non-U.S. dollar denominated foreign assets and liabilities will be converted into U.S. dollars at the market exchange rates of the respective currencies as of September 30, 2005.

- The NIR floor will be adjusted upward (downward) by any excess (shortfalls in) net financing of the NFPS defined as the difference between the stock of debt of the NFPS, as defined in para. 8 but excluding central government foreign currency deposits in domestic commercial banks and excluding any liabilities to the Fund, and schedule A below, and which is not explained by the adjustments specified in para. 8, bullet 1 (i-vii). The downward adjustment of the NIR floor will be limited to US$400 million.

Schedule A
(In millions of U.S. dollars)

	Sept.-05	Mar.-06	Jun.-06	Sept. 06	Dec.-06
Stock of debt of the NFPS, excl. CG FX deposits in domestic commercial banks and Fund liabilities	10,136	10,530	10,706	10,828	10,884

7. **Cumulative ceiling on net domestic assets (NDA) of the BCU.** NDA is defined as the difference between end-of-period monetary base and net international reserves (NIR) of the BCU as defined in paragraphs 5 and 6. The flow of NIR will be valued at the accounting exchange rate of Ur$23.9 per US$1.

- The NDA ceiling will be adjusted downward (upward) by the Ur$ equivalent of any upward (downward) adjustment in the NIR target of the BCU.

8. **The overall nonfinancial public sector debt ceiling** refers to the outstanding stock of external debt[6] and domestic debt[7] measured on a *gross* basis[8] in domestic and foreign

[6] For the definition of external debt the term "debt" has the meaning set forth in point No. 9 of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 6230-(79/140, August 3, 1979), as amended in 2000), and the term "external" is defined

(continued)

currency *owed or guaranteed by the NFPS*, valued in U.S. dollars at the accounting rates of Ur$23.9 per U.S. dollar, U.S. dollar 1.2026 per Euro, Yen113.46 per U.S. dollar, U.S. dollar 1.44946 per SDR, and Ur$1.4882 per UI. If the Ur$ to UI rate exceeds 1.5916 the UI debt will be valued at Ur$ 1.4882 plus the difference between the actual rate and Ur$1.5916. The debt ceiling will exclude (i) the government guaranteed note of BHU to BROU (with outstanding obligations estimated at US$500.8 million at end-September 2005) and the government guaranteed notes issued by the fiduciary trusts associated with the transfer of BROU's nonperforming loans (with outstanding obligations estimated at US$400 million at end-September 2005); and (ii) net debt of the NFPS with the BCU. It will include the total stock of Fund credit outstanding to Uruguay.

- The NFPS debt ceiling will be adjusted (i) upward (downward) by revisions made to the actual nonfinancial public sector gross debt stock at end-September 2005; (ii) upward by a maximum of US$500 million for the amount of debt issued to recapitalize the BCU; (iii) upward by a maximum of US$133 million (downward) for the cumulative reduction (increase) in the net credit position of public enterprises with the BCU; (iv) upward by a maximum of US$150 million for the costs associated with the final outcome of the arbitration/litigation to the former shareholders of Banco Comercial; (v) upward by a maximum of US$82 million for debt issued to finance below-the-line operations of public enterprises (such as recapitalization of ANCAP's subsidiary abroad); (vi) upward by BHU restructuring costs related to the assumption of financial liabilities or capitalization up to a limit of US$1 billion; (vii) upward by a maximum of US$40 million for the amount of debt issued to onlend to the deposit insurance scheme; and (viii) upward (downward) by the amount that the unadjusted NIR floor is exceeded (falls short) with the upward adjustment limited to the amount of the upward revision of the NIR target, up to a limit of US$500 million.

9. **External payments arrears of the public sector** are defined on the residency principle and relate to public sector debt with foreign creditors. This performance criterion is monitored on a continuous basis.

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on the residency principle. The suppliers' contracts of ANTEL with equipment providers Ericsson and NEC are expensed under goods and services as rental outlays and, therefore, excluded from the definition of nonfinancial public sector gross debt for program purposes.

[7] Domestic debt covers net claims of the domestic financial system on the NFPS; NFPS bonds and treasury bills held outside the NFPS and the domestic financial system; non-bank loans as defined in footnote 4; and lease arrangements of the central government and public enterprises, as defined in point No. 9 (a) (iii) of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 6230-(79/140, August 3, 1979), as amended in 2000.

[8] Debt outstanding with the domestic financial system (excluding BCU) will be measured net of gross deposits.

10. **Continuous performance criterion on the timely service of bank restructuring debt to BROU in accordance with the current payment schedule**. The bank restructuring debt to BROU includes the notes to BROU guaranteed by the government and issued by theBHU and the fiduciary trusts that own and manage the nonperforming loans formerly on the books of BROU. Timely service is defined as the payment of agreed principal and interest by the BHU, the trusts, or the government in accordance with the timetable (and no later than the 10th of the subsequent month) and terms presented in Schedule B.

Schedule B. Scheduled Service of Bank Restructuring Debt to BROU
(In millions of U.S. dollars)

	BHU Note				Fiduciary Trusts 1/			
	Service			Balance 2/	I	II	III	Balance 2/
	Principal	Interest 3/	Total		Service			
2005 M 09	0.8	0.9	1.7	500.8				
2005 M 10	0.8	0.9	1.7	499.9				
2005 M 11	0.8	0.9	1.7	499.1				
2005 M 12	0.8	0.9	1.7	498.2	82.2	5.3	8.9	254.2
2006 M 01	1.3	0.9	2.2	497.0				
2006 M 02	1.3	0.9	2.2	495.7				
2006 M 03	1.3	0.9	2.2	494.4				
2006 M 04	1.3	0.9	2.2	493.1				
2006 M 05	1.3	0.9	2.1	491.9				
2006 M 06	1.3	0.9	2.1	490.6	81.6	5.3	8.9	158.4
2006 M 07	1.3	0.9	2.1	489.3				
2006 M 08	1.3	0.9	2.1	488.1				
2006 M 09	1.3	0.9	2.1	486.8				
2006 M 10	1.3	0.9	2.1	485.5				
2006 M 11	1.3	0.9	2.1	484.3				
2006 M 12	1.3	0.9	2.1	483.0	81.0	5.3	8.8	63.4
2007 M 01	1.7	0.9	2.6	481.3				
2007 M 02	1.7	0.9	2.6	479.6				
2007 M 03	1.7	0.9	2.5	477.9				
2007 M 04	1.7	0.9	2.5	476.2				
2007 M 05	1.7	0.8	2.5	474.5				
2007 M 06	1.7	0.8	2.5	472.8	40.4	2.5	6.3	14.2
2007 M 07	1.7	0.8	2.5	471.1				
2007 M 08	1.7	0.8	2.5	469.4				
2007 M 09	1.7	0.8	2.5	467.7				
2007 M 10	1.7	0.8	2.5	466.0				
2007 M 11	1.7	0.8	2.5	464.3				
2007 M 12	1.7	0.8	2.5	462.6	8.1	0.3	5.8	0.0
2008 M 01	2.1	0.8	2.9	460.5				
2008 M 02	2.1	0.8	2.9	458.4				
2008 M 03	2.1	0.8	2.9	456.3				
2008 M 04	2.1	0.8	2.9	454.2				
2008 M 05	2.1	0.8	2.9	452.1				
2008 M 06	2.1	0.8	2.9	449.9				

1/ Fiduciary trusts that own and manage the debt formerly on the books of BROU.
2/ Estimated balance of outstanding principal and interest obligations.
3/ Estimate. The contractual interest rate is the 60-day U.S. dollar-denominated time deposit rate of BROU plus 50 basis points, and is revised on June 30 and December 31 every year based on the rate prevailing on that date.