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Uruguay: Letter of Intent and Technical Memorandum of Understanding

June 13, 2006

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

June 13, 2006

Dear Mr. de Rato:

1. **Progress.** Performance under our program continues to exceed expectations. While we are raising our 2006 growth projection from 4 to 4½ percent, we continue to expect that inflation this year will remain within our target range of 4½–6½ percent. Policy implementation is going well, with solid revenue and prudent expenditure policy resulting in a strong fiscal outturn for the first quarter; buoyant exports and capital inflows allowing the central bank to strengthen its foreign exchange reserves beyond program targets; and strong capital market access further improving the public debt structure. In March, we advanced payments of all 2006 repurchases to the Fund.

Performance. Preliminary data suggest that all continuous and end-March 2006 quantitative performance criteria were met, some with wide margins; final data will be available prior to the Board meeting. We have also made significant progress in the implementation of our ambitious structural reform agenda, including with the recent sale of Nuevo Banco Comercial and the preparation of a new bankruptcy law, which is about to be submitted to Congress (both benchmarks for end-June). Also, the timetable for the implementation of the recommendations of the growth commission has recently been published (end-March benchmark). Contrary to our earlier expectations, Congress decided to consider the tax reform prior to the police pension and financial sector reforms. Thus, we now expect its approval earlier than previously programmed, while the approval of the police pension reform (end-May performance criterion) and financial sector reform (end-June performance criterion) will be delayed to the second half of 2006.

2. **Issues for this review.** We remain committed to the policies and objectives as presented in our Letter of Intent and Supplementary Memorandum of Economic and Financial Policies dated March 13, 2006, and would like to draw your attention to the following points:

- **Fiscal policy.** We are confident to achieve our 2006 primary surplus target of 3.7 percent of GDP. We have identified investment in telecommunication and highways, as two new projects under the program's fiscal targets adjustor of ¼ percent of GDP.
- **Monetary policy.** We remain committed to the 4½–6½ percent inflation target range for 2006, in the context of a flexible exchange rate arrangement. With indications of a continued strength in money demand, we have raised our indicative base money growth target for December 2006 to 28 percent. However, we will monitor inflation closely and stand ready to tighten, as necessary. We will reassess the appropriateness of our money targets at the time of the next review.
- **International reserves.** With a stronger than previously expected balance of payments, we have increased our end-2006 reserve accumulation target by US\$410 million. In

addition, we will further increase this target later in the year to the extent that this can be accommodated within the base money target and without compromising the inflation objective.

- **Structural reforms.** Although the agenda for structural reforms is a busy one, we are determined to make additional progress in the period ahead. In particular,
 - **FSAP.** We remain committed to continue reducing financial sector vulnerabilities, including by further enhancing financial sector supervision. After we have had a chance to study in detail the recommendations of the Financial Sector Assessment Program, we hope to discuss new measures in the context of the next review.
 - **Growth agenda.** Many of the recommendations of the Growth Commission are already in the program. As additional measures, we plan to establish a private sector relations office at the Ministry of Finance and to reform government procurement procedures.

3. ***Waivers and new conditionality.*** In light of continued strong performance and in support of the program objectives, we request: (i) a waiver of nonobservance of the performance criterion on police pension reform and its resetting for end-October 2006; (ii) modification of the performance criterion on the tax reform, moving the implementation date to September 15, 2006 and of the performance criterion on financial sector legislation, moving the implementation date to end-November 2006; and (iii) modification of the end-June monetary performance criteria and targets and setting the ones for end-September and end-December 2006; and (iv) two new benchmarks in the growth area. The next reviews will be completed by August and November 2006, covering overall program performance and observance of the associated conditionality (Tables 1 and 2).

4. ***Request for purchase.*** In requesting the completion of the Fourth Review under the stand-by arrangement and purchase of SDR 85.82 million, we note that we remain committed to maintaining 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. Should the external position turn out significantly stronger than we currently anticipate, we will consider making advanced repurchases or treating the arrangement as precautionary in the future.

Sincerely yours,

/s/
Walter Cancela
President
Central Bank of Uruguay

/s/
Danilo Astori
Minister of Economy and Finance
Oriental Republic of Uruguay

Attachment:
Supplementary Technical Memorandum of Understanding

Table 1: Quantitative Performance Criteria and Indicative Targets for the 2006-08 Program 1/

	2005 Stock Sept. 30	2006 Targets				Jun. 30	Sept. 30	Dec. 31	2007 IT Dec. 31	2008 IT Dec. 31
		Mar. 31			Prel. Margin (+)					
		Target	Target (adj.)							
A. Quantitative performance criteria										
(In millions of Uruguayan pesos)										
1. Combined public sector primary balance (floor) 2/	n.a.	2,651	2,651	5,376	2,725	5,196	10,434	16,473	19,311	20,748
2. General government noninterest expenditure (ceiling) 2/	n.a.	13,409	13,409	12,147	1,262	27,050	39,870	53,558	57,735	63,095
3. Net domestic assets of the BCU (ceiling) 3/	51,525	-3,136	-7,264	-14,820	7,556	-6,029	-12,278	-14,378	-10,308	-7,502
(In millions of U.S. dollars)										
4. Net international reserves of the BCU (floor) 3/	-1,546	250	423	779	357	469	732	962	493	393
5. Nonfinancial public sector gross debt (ceiling) 4/	12,309	12,882	13,110	12,327	783	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	0	0	0
B. Indicative targets										
(In millions of Uruguayan pesos)										
7. Combined public sector overall balance (floor) 2/	n.a.	-3,076	-3,076	264	3,340	-5,394	-5,935	-4,512	-2,966	-2,537
8. Combined public sector primary balance (extended) (floor) 2/	n.a.	2,651	2,651	5,783	3,132	5,196	10,434	16,473	19,311	20,748
9. Monetary base (ceiling) 3/	16,146	3,140	3,140	4,558	-1,418	5,118	6,075	9,526	2,106	1,923

PC= Performance Criterion; IT=Indicative Target.

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

1/ As defined in the Technical Memorandum of Understanding.

2/ Cumulative changes from the previous calendar year.

3/ 2006 targets are cumulative from end-September 2005.

4/ All maturities.

Table 2. Uruguay: Structural Conditionality under the 2006-08 Program

Area	Structural Conditionality	Date	Status
A. Structural performance criteria (Country Report No. 06/197)			
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.
Tax reform	Submit to congress a comprehensive tax reform as described in paragraph 7 of the MEFP.	February 28, 2006	Not observed. Implemented with small delay.
Tax reform	Begin to implement the comprehensive tax reform as described in paragraph 7 of the MEFP. 1/	September 15, 2006	
Central Bank	Begin to implement the laws that: (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 modified as specified in paragraph 15 of the December SMEFP); and (iii) provide a suitable bank resolution framework (as described in paragraph 14 of the MEFP). 1/	November 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	Move nonperforming loans into a <i>fideicomiso</i> and adequately capitalize BHU as specified in paragraph 11 of the TMU of March 13, 2006.	August 31, 2006	
BHU	Transform BHU into an institution with a viable business plan and a strong regulatory framework as specified in paragraph 12 of the TMU of March 13, 2006.	November 30, 2006	
Pensions	Begin to implement reform of the pension fund for the police.	May 31, 2006	Not observed; reset for end-October 2006.
Pensions	Submit to Congress reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP of December 27, 2005.	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 of December 27, 2005.	May 31, 2007	
B. New structural performance criteria			
Pensions	Begin to implement reform of the pension fund for the police.	October 31, 2006	
C. Structural benchmarks (Country Report No. 06/197)			
Tax administration	Formulate a plan to strengthen the auditing and enforced collection functions of the BPS.	June 30, 2006	
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	
Budget	Prepare recommendations, with a timetable, to improve legislation, coverage, classification, formulation, controls, and transparency of the budget process.	August 31, 2006	
Growth	Publish agenda of growth-enhancing reforms (including timetable for implementation) prepared by the business environment commission.	March 31, 2006	Not observed. Implemented with slight delay.
Growth	Submit to Congress bankruptcy law (to include Chapter-11 type corporate restructuring).	June 30, 2006	
Financial sector	Adopt a detailed schedule for the implementation of the BHU action plan.	February 28, 2006	Observed.
Financial sector	Sell shares of NBC in amounts that yield managerial control to the private sector.	June 30, 2006	Observed.
Central Bank	Adopt plan to strengthen the central bank finances (outright capitalization or interest payment on government paper). 1/	November 30, 2006	
D. New structural benchmarks			
Growth	Establish a private sector relations office at the MEF.	August 31, 2006	
Growth	Adoption of a detailed plan to strengthen government procurement procedures.	July 31, 2007	

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

1/ Modification of dates requested.

SUPPLEMENTARY TECHNICAL MEMORANDUM OF UNDERSTANDING

This supplements the Technical Memorandum of Understanding (TMU) of March 13, 2006, and will apply to the performance criteria and indicative targets for end-June, end-September, and end-December 2006 test dates.

1. Projects to be covered under the adjustor to the fiscal targets of up to US\$50 million or Ur\$1,200 million for capital expenditure during July 2006–June 2007 as specified in paragraphs 1–4 and 8 of the TMU of March 13, 2006 comprise (i) dredging operations in the port of Montevideo; (ii) railroad construction; (iii) investment on upgrading digital communication; and (iv) partial rehabilitation of route 1.

2. The NFPS debt ceiling as specified in paragraph 8 of the TMU of March 13, 2006 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; (viii) for capital expenditure on identified projects in the period July 2006–June 2007, up to a limit of US\$50 million; (ix) downward by the amount of gross revenues (net of any associated fees and commissions) (excluding receipts in form of shares) from the sale of NBC; (x) 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; and (xi) upward (downward) if the change in the net credit position with the Fund exceeds (falls short of) programmed amounts as specified in Schedule A.

Schedule A (In millions of U.S. dollars)					
	Sept.-05	Mar.-06	Jun.-06	Sept.-06	Dec.-06
Stock of net credit with the Fund	2,337	2,507	2,517	2,396	2,249