Montevideo, Uruguay
May 24, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street NW
Washington, D.C. 20431

Dear Mr. de Rato:

The newly elected government is implementing a comprehensive development strategy which seeks to improve the living conditions of Uruguay's population in a lasting and equitable way. Our strategy is based on three fundamental pillars: (i) a comprehensive economic program which aims at raising investment, stimulating employment and achieving growth and macroeconomic stability; (ii) a temporary social emergency plan to alleviate the most pressing social hardship originating from the recent economic crisis; and (iii) a set of essential and long delayed structural reforms that are key to reducing Uruguay's vulnerability to shocks and raising medium-term growth potential.

The attached policy memorandum and annexes describe in detail the economic policies and objectives of the Government of Uruguay for the period June 2005–June 2008, in support of which the Government requests a 36-month stand-by arrangement from the Fund, in an amount equivalent to SDR 766 million (250 percent of quota). The Government believes that the described policies and the continued support of the international financial organizations will promote a sustainable expansion of the economy, while keeping inflation low and reducing the country's high debt burden. Successful implementation of our program should provide a lasting exit from future Fund financial support. Should the balance of payments position turn out to be stronger than anticipated, we would consider reducing our Fund exposure at an accelerated pace, including by either making repurchases on an expectations basis, foregoing purchases, or treating the arrangement as precautionary.

Performance criteria and indicative targets under the program are set out in Tables 1 and 2 of the Memorandum of Economic and Financial Policies and defined in the Technical Memorandum of Understanding. The Government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but we will take any further measures that may become appropriate for this purpose. We will consult with the

Fund on the adoption of these measures, in accordance with the Fund's practices on such consultations.

Sincerely yours,

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

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

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

A. General Objectives

1. The Government of Uruguay is committed to maintaining macroeconomic stability and implementing a comprehensive structural reform agenda to promote sustainable high growth and sharply reduce poverty. Key to meeting these objectives is to raise investment from its current low level of 13 percent of GDP to 20 percent over the medium term. We expect that the higher investment will boost potential growth of the economy to at least 3 percent, compared with an historic growth rate of just 2 percent during 1960–2000. The anchors for our policy framework will be a disciplined fiscal stance that will sharply reduce the public debt-to-GDP ratio, monetary policy aimed at low inflation, and wide-ranging structural reforms aimed at ensuring durability in the public finances, strengthening the credibility of the central bank's (BCU's) commitment to low inflation, improving the efficiency of the public enterprise sector (which dominates several key areas of economic activity), and restoring the banking system to its fundamental role of financial intermediation while broadening financing options for investment.

2. Concurrent with our commitment to macroeconomic stability, the Government of Uruguay is dedicated to addressing the problem of poverty in the country. Achieving high sustainable growth will allow for a lasting reduction in poverty, but over the short-term the government is committed to providing important poverty alleviation while growth-oriented structural reforms take hold. Toward this end, we are implementing a two-year, temporary social emergency program (SEP) that targets individuals living in extreme poverty and unable to meet basic living necessities. The numbers of such persons increased sharply as a result of the dislocations of the 2002 financial crisis. The safety net will provide about 200,000 persons with coupons for food purchases and free preventive health care. In addition, about 35,000 of the poorest households will benefit from a direct income transfer scheme of about US$55 a month and another 16,000 adults will participate in a temporary employment program. The SEP will also contain education and housing projects, as well as programs targeted for homeless individuals. Throughout the two-year period we will continue to work with the World Bank and IDB to improve the efficiency of the social safety net to ensure that the SEP delivers its objectives and can then be phased out as planned. The SEP will cost US$200 million over two years (about 0.6 percent of GDP on an annual basis).

B. Macroeconomic Policies

3. Our fiscal program aims at converging to our medium-term primary surplus target of 4 percent of GDP by 2007, which will put the public debt on a firm downward path, and which will be kept under review to ensure that it is fully consistent with debt sustainability. In the near term, we are targeting primary surpluses in 2005 and 2006 of at least 3.5 and 3.7 percent of GDP, respectively, and we will save any revenue exceeding program projections in order to reach the medium-term target at an accelerated pace. Fundamental to meeting our fiscal objectives, in August we will submit to Congress a five-year spending plan that will go beyond

legal requirements and include a full-fledged macroeconomic framework with explicit revenue and deficit targets consistent with our fiscal program. The rising primary surplus target will reflect the benefits from improvements in tax administration, a comprehensive tax reform (described below), timely adjustments to public tariffs to cover operating cost changes, and tight control over general government discretionary expenditure. Our fiscal program will also make room for important public investment projects to reduce risks to growth from structural bottlenecks, especially in the areas of port expansion and electricity transmission and generation.

4. The BCU will maintain the current monetary policy framework of achieving inflation objectives (set 12 months ahead) through base money target ranges and a flexible exchange rate, until conditions are in place for a move to a full-fledged inflation-targeting regime. Our inflation target range for 2005 of 5½–7½ percent was lowered to 5–7 percent for the year ending March 2006. We are targeting a gradual reduction in the midpoint of our inflation target range to 3.5 percent by 2008. We will continue to allow flexibility in the exchange rate, intervening primarily to maintain orderly market conditions and smooth out excessive exchange rate volatility. The BCU money base targets are indicative targets under the program, and consistent with the program's floor on net international reserves and ceiling on net domestic assets of the central bank. The BCU will aim to build up its level of gross reserves by US$300 million over the three-year program period to raise its capacity to manage the risks from adverse shocks and address financial and external vulnerabilities. The envisaged increase in gross reserves will be consistent with an increase in net international reserves (program definition) of US$1.1 billion through mid-2008, compared with a negative US$2.2 billion at end-2004. Moreover, should market conditions prove more favorable than envisaged, we would seek to bolster further our international reserve position.

C. Structural Reforms

5. Our policy reform agenda focuses on strengthening the public finances; reforming the central bank to increase its autonomy; improving the framework for financial sector oversight; continuing to reform the public banks to reinvigorate financial intermediation and minimize fiscal contingencies; and bolstering growth prospects through public enterprise reform and improvements in the investment climate.

Fiscal reform

6. We will strengthen the public finances through (i) a comprehensive tax reform; (ii) modernization of tax administration; (iii) reform of the specialized pension funds; and (iv) an overhaul of the budgetary framework.

7. Reforming the current tax system is essential for ensuring a strong fiscal position over the medium term and we have given this our highest priority. We will submit to Congress a comprehensive tax reform plan by December 2005 that would widen the tax base to increase the efficiency and strengthen the durability of revenue collections and distribute more equitably the tax burden by raising the weight of direct taxation. The reform, which we intend to

implement starting in mid-2006, will introduce a personal income tax, streamline the complex system of tax exemptions and subsidies, and rationalize other taxes (including the corporate income tax). Over time, once the yield from the tax reform can be properly assessed to ensure consistency with the program fiscal targets, we intend to reduce the heavy burden of indirect taxes and eliminate a number of small distortionary taxes. We anticipate that the reform will begin yielding net revenue increases in the second half of 2006.

8. To further strengthen revenue collections, we also plan to overhaul the tax administration, with a particular emphasis on reducing evasion, improving the efficiency of the tax collection agencies (the domestic tax service, DGI, the social security, BPS, and the customs service, DNA), and preparing for the introduction of a comprehensive personal income tax. We will begin this process by issuing a decree to implement the DGI's modernization law, establishing a Large Taxpayers Unit (LTU) at the DGI, and formulating a plan to coordinate tax audits between the DGI and the BPS, all prior actions for the program. Looking ahead under the program, we will assess the feasibility of establishing an autonomous agency with responsibility for the collection of domestic taxes, social security contributions, and trade taxes; we expect this assessment to be completed by end-2006.

9. Sustaining an appropriate fiscal position over the medium term requires addressing the financial weaknesses of the specialized pension funds for the police, military, and bank employees. Such reforms are needed to align benefits and contributions to contain the need for government transfers. A reform of the police pension plan is the most advanced and will be implemented before the end of 2005. We will proceed with reforms of the other plans immediately thereafter. We are committed to ensuring a sound general public pension system, and are discussing with the World Bank how to improve the system's finances, both through administrative improvements at the BPS and an assessment of the adequacy of the system's current parameters. We expect to have the results of this assessment by mid-2005, and the resulting policy plans will be a topic for the first program review.

10. Modernization of the budgetary process in line with international best practice will help to ensure appropriate resource allocation and expenditure control over the medium term. In the near term, we will implement recommendations of the 2001 fiscal ROSC by complementing our five-year expenditure plan with a full medium-term macroeconomic framework and will carry out an analysis of tax expenditures for inclusion in the documentation of the 2005 spending plan as well. The government has begun to receive technical assistance from the Fund to evaluate the overall institutional budgetary framework and we will incorporate this work in its plans for further fiscal reform.

11. Improving public debt management is critical to minimize the country's vulnerabilities. Toward this end, we have requested technical assistance from the Fund's International Capital Markets Department and Monetary and Financial Systems Departments and are working to establish a comprehensive debt management strategy while delegating the operational decisions to a debt management unit within the Ministry of Finance (which will be in place by end-2005). The debt management strategy will set guidelines for the composition of the public sector debt

in terms of interest, exchange rate, and roll over (maturity) risks and be carried out in coordination with the BCU, which will remain the financial agent of the government.

Central bank reform and financial system oversight

12. Given our medium-term objective of moving to a full-fledged inflation-targeting regime, it is imperative that the autonomy and structure of the central bank be improved to enhance its credibility and capability to conduct monetary policy. Toward this end, we will submit this year to congress a proposal to modify the BCU's charter to strengthen its legal independence, including by setting staggered terms for Board members, de-linking the appointment cycle from the electoral cycle, and identifying the bank's principal objective as the control of inflation. We intend to begin implementing this reform no later than mid-2006. In addition, credibility for an independent central bank will require strengthening the BCU's financial position, and we will seek technical assistance from the Fund's Monetary and Finance Department to determine the adequate level of BCU capital and recapitalization modalities; we expect that this assistance can be provided within the next 12 months.

13. Strengthening the financial system will require bringing financial sector supervision up to international standards. To ensure adequate oversight of the financial system, supervisory institutions separate from the BCU will be charged with regulating and supervising banks, insurance companies, securities firms, and pension funds. A law establishing the regulatory framework will be sent to Congress concurrent with the law on BCU autonomy, and we will start implementing it by June 2006. Looking ahead, we have requested a Financial Sector Assessment (FSAP) for this year. Such an assessment was begun in 2002, but it was interrupted by the onset of the financial crisis, and we are committed to make the changes that are needed to meet the benchmarks of international standard setting bodies for financial sector regulation, payment systems, and corporate governance.

Financial system restructuring

14. Based on our experience in the financial crisis of 2002 and the temporary suspension of a cooperative bank earlier this year, it is crucial that an adequate framework for dealing with insolvent financial institutions be put in place. Toward this end, we will submit to congress before the end of this year a law to overhaul the bank resolution framework that will allow for resolution techniques that are less disruptive to the financial system than outright liquidation (the only option presently available) and that can be implemented rapidly to minimize the disruption of banking services to the public. This framework should begin to be implemented in mid-2006. As part of the resolution strategy for the cooperative bank, the government introduced (by decree) a limited deposit insurance program and made clear that the government will not use fiscal resources to bail out financial institutions. Given the importance of a well designed deposit insurance regime and the need for depositor confidence grounded in legal certainty, we intend to further develop the scheme and incorporate it into the bank resolution framework law. The key aspect of limited insurance per depositor will be maintained (at US$5,000 for dollar deposits and 250,000 UIs (units whose peso value is indexed to the CPI)—currently about US$14,500—for deposits in pesos per depositor per bank). The deposit

insurance and bank liquidation functions of the central bank will be placed into a newly created deposit insurance agency that will reside outside the central bank.

15. The high degree of dollarization in Uruguay's very open economy has left the country vulnerable to exchange rate and other shocks. We recognize that de-dollarization cannot be forced on economic agents and that it will take time to consolidate confidence in sustained macroeconomic stability. Nevertheless, we are committed to supporting de-dollarization and fostering an increase in financial intermediation in domestic currency through institutional and structural measures. In particular, we will keep higher reserve requirements and deposit insurance premiums on dollar deposits than on peso deposits, and we will encourage banks to develop inflation-indexed savings instruments in local currency, while the Treasury and the BCU continue issuing inflation-indexed notes and bonds. Prudential regulations will ensure that banks take into account the implicit credit risk in lending to clients that do not generate dollar income streams.

16. Strengthening the outlook for the state commercial bank, BROU, which makes up about half of the banking system, is essential for reactivating financial intermediation. We have begun the process of strengthening the bank's governance by appointing a board on the basis of professional experience rather than political considerations. The banks' restructuring will continue through strengthening credit-granting procedures, streamlining operations to reduce costs, improving internal financial reporting, and fortifying internal controls and risk management. The bank will not return to past practices of politically-directed lending, and any credit subsidies will be made explicit in the government's budget.

17. The fiduciary trusts that own and manage the nonperforming loans formerly on the books of BROU will continue to be managed independently of the bank. It will make every effort to maximize the recoveries on the loans so as to minimize the risk to the government (which guaranteed the service of the trusts' debt to BROU). The debt to BROU will be serviced by the trusts or the government in accordance with the agreed payment schedules.

18. The ongoing conversion of the housing bank (BHU) to a mortgage company, a process initiated with the World Bank, is an essential reform for minimizing contingent fiscal risks and improving the BHU's financial health. We intend to accelerate the pace of the BHU's reform program such that the bank will continue to refrain from taking deposits other than pre-saving in local currency for mortgages, while it shifts its revenue base toward the securitization of its mortgage portfolio. In addition, the new president and board of the bank are committed to reducing its operating costs, which remain very high. The debt to BROU will be serviced by the BHU or the government in accordance with the agreed payment schedules.

19. The bank formed with the good assets of the failed banks during the 2002 crisis, *Nuevo Banco Comercial* (NBC), still remains in the government's hands. The bank, which amounts to 10 percent of the system, is highly liquid and well capitalized, but needs to resume normal lending operations. The Government of Uruguay is committed to an active search for a buyer for the bank before the end of the first program year, but in the interim, as a prior action for the

program, we will appoint a Board of Directors with appropriate professional experience and an interim CEO with banking experience.

20. The liquidation funds for three of the private banks that failed during the 2002 crisis will continue to collect their nonperforming loans so as to reduce the cost incurred by the government in addressing the crisis. The funds will continue to publish audited semi-annual financial statements to ensure transparency of their operations. By May 2005, all of the information on the nonperforming loans of the failed banks will be included in the credit registry of the bank supervisor.

Growth-oriented reforms

21. To encourage private sector investment, which is the only means for sustaining high growth, we are working with the IDB and World Bank to improve the investment climate, expand room for private sector activities in public utilities and infrastructure, and promote the development of domestic capital markets.

22. To improve the climate for private investment, we plan to streamline conditions for establishing new businesses in Uruguay and ensure that creditor and debtor rights are well protected. In particular, we will establish a one-stop office for investors for information on all requirements regarding documentation, applications, and regulations. We will protect creditor and debtor rights through strict adherence to established property rights and contracts and by strengthening the framework for firm restructuring by amending the current bankruptcy legislation to include a "Chapter 11-type regime" (restructuring); the current framework only has provision for "Chapter 7-type" actions (liquidation).

23. Public enterprise reform would involve improving governance and preparing them for competition with the private sector. To this end, the government is committed to appointing the managements of public enterprises on the basis of professional experience rather than political considerations, expanding management accountability through enhanced transparency and outside control, and seeking associations in joint ventures with private or public capital partners.

24. We will also seek to develop capital markets to allow firms to diversify their sources of financing, which to date has been almost exclusively carried out through retained earnings or bank borrowing.

25. The Government of Uruguay is committed to the market determination of prices and wages as part of its strategy to improve the investment climate. Labor negotiations will be conducted under a framework of wage councils, with participation of representatives of employees, companies, and the state, that will provide a means for collective bargaining at the industry level. Such a framework will allow for an orderly wage determination and reduce the scope for costly labor disruptions.

26. The government is also committed to implement a number of additional reforms to raise medium-term growth potential and improve living conditions of the population at

large. Intended policies include, among others, reforming the National Health Service, improving public education, and providing better access to housing for the most vulnerable segments of the population. We believe that these measures will go a long way to protect and further expand Uruguay's traditionally strong human capital base. In addition, we intend make the promotion of scientific research and the introduction of new technologies a key priority for the government and part of a broader strategy to position the country as a regional and global provider of high quality products and services.

D. Program Monitoring and Financing Assurances

27. The government's program has adequate financing assurances. Financing needs for 2005 have been identified and financing requirements for the remainder of the program will average about US$2.2 billion a year (about 12 percent of GDP). These will need to be met through sustained fiscal discipline, increasing access to domestic and international financial markets, and continued IFI support. We will implement reforms supported by the IDB and the World Bank lending to ensure timely disbursements from these multilateral lenders.

28. The first program year will have quarterly reviews to assess overall performance and observance of the performance criteria and structural benchmarks (Tables 1 and 2). Quarterly quantitative PCs and targets have been proposed through end-2005, with indicative targets for 2006 and 2007. Quarterly targets for the first half of 2006 will be proposed at the second review of the program and no later than the fourth quarter of this year. The Government of Uruguay will also observe the standard performance criteria against imposing exchange restrictions, multiple currency practices, and import restrictions for balance of payments reasons. The government is working with the Fund on a new safeguards assessment of the BCU, which is envisaged to be completed by end-September 2005.

29. We will provide timely information to the IMF for monitoring performance under the program. The BCU will provide data for assessing observance of the quantitative performance criterion on net international reserves no later than one week after each test date, and data for assessing all other quantitative performance criteria and indicative targets will be provided by the BCU no later than two months after each test date. Data, reports, and other relevant information for assessing progress on structural reforms will be provided to staff in a timely manner.

Table 1. Quantitative Performance Criteria and Indicative Targets Under the 2005–08 Economic Program 1/

	2004 Stock	2005 PC			2006 IT			2007 IT
	Dec. 31	June 30	Sept. 30	Dec. 31	March 30	June 30	Dec. 31	Dec. 31
A. Quantitative performance criteria								
	(In millions of Uruguayan pesos)							
1. Combined public sector primary balance (floor) 2/	…	5,471	9,687	14,647	2,458	7,990	16,996	19,799
2. General government noninterest expenditure (ceiling) 2/	…	23,561	34,643	46,561	12,380	25,010	50,406	52,470
3. Net domestic assets of the BCU (ceiling) 2/	74,079	3,983	3,928	-4,628	5,143	-1,612	-4,580	-13,369
	(In millions of U.S. dollars)							
4. Net international reserves of the BCU (floor) 2/	-2,218	-130	-110	280	-226	50	241	580
5. Nonfinancial public sector gross debt (ceiling) 3/	12,189	12,510	12,575	12,550	12,775	12,740	12,775	12,925
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	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	-7,459	-7,072	-3,939	-3,564	-5,794	-3,913
8. Monetary base (ceiling) 2/	15,648	557	1,029	2,750	-824	-294	1,770	1,914
9. Floating debt of the central government (ceiling)	3,081	3,081	3,081	3,081	...	...	...	...

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 end-December of the previous calendar year.
3/ All maturities.

Table 2. Structural Conditionality Under the June 2005–June 2006 Program

Area	Structural Conditionality	Date
A. Prior actions		
Tax administration	Issue a decree to implement the DGI's modernization law.	
Tax administration	Establish a large taxpayers unit at the DGI.	
Tax administration	Formulate a plan to coordinate tax audits between the DGI, the BPS, and the Ministry of Labor.	
Financial sector	Appoint a Board of Directors for NBC with appropriate professional experience and an interim CEO with banking experience.	
B. Structural performance criteria		
Fiscal	Submit to congress a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets	August 31, 2005
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
Pension	Begin to implement reform of the pension fund for the police.	November 30, 2005
Tax reform	Submit to congress a comprehensive tax reform as described in paragraph 7	December 31, 2005
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); (ii) strengthen the regulation of the financial system (as described in paragraph 13); and (iii) provide a suitable bank resolution framework (as described in paragraph 14)	December 31, 2005
Central Bank	Begin to implement these laws.	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
C. Structural benchmarks		
Fiscal	Establish quarterly revenue collection targets (floors) at the social security bank (BPS)	June 30, 2005
Debt management	Create a debt management unit at the Ministry of Finance.	December 31, 2005
Financial sector	Sell shares of NBC in amounts that yield managerial control to the private sector.	June 30, 2006

TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum presents the definitions of the variables included in the performance criteria and indicative targets annexed to the Memorandum of Economic and Financial Policies.

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 recapitalization of BCU and debt issued to finance the capitalization of the deposit insurance scheme up to a limit of US$20 million); plus (iii) the increase in net non-bank loans, external bank loans, and supplier credits to the NFPS; plus (iv) the net increase in liabilities arising from the forward sale of NFPS assets; *minus* (v) the net increase of NFPS financial assets held by the NFPS outside the domestic financial system (including the loan component of the deposit insurance scheme); plus (vi) gross revenues from the sale of public assets (net of associated fees and commissions); plus (vii) all upfront payments related to future concessions (including the sale of mobile phone licenses); plus (viii) 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.

- The floor on the overall balance of the combined public sector will be adjusted *downward* (*upward*) by the amount by which the actual social security

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

[2] Excluding any cash outlays related to government guarantees (principle plus interest) on the BHU and BROU's fiduciary trusts notes that are called; and the final outcome of the arbitration with the former shareholders of Banco Comercial.

contributions transferred to the private pension system exceeds (falls short of) the projected amounts in the program, specified in Schedule A. The downward adjustor will be capped at a maximum of Ur$250 million. This adjustor will be eliminated after December 31, 2005.

Schedule A (In millions of Uruguay pesos, cumulative basis)			
	Jun-05	Sep-05	Dec-05
Projected social security contributions	1,798	2,712	3,587

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.

- The floor on the overall balance of the combined public sector will be adjusted downward (upward) by the amount by which the actual social security contributions transferred to the private pension system exceeds (falls short of) the projected amounts in the program, specified in Schedule A. The downward adjustor will be capped at a maximum of Ur$250 million. This adjustor will be eliminated after December 31, 2005.

3. **Cumulative ceiling on general government expenditure** applies to total (current and capital) noninterest expenditure of the central administration and the social security system (BPS). The noninterest 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. The ceiling on general government expenditure will be adjusted *upward* (*downward*) by the amount by which the actual revenues from the *Fondos de Libre Disponibildad* (FLD) *exceeds* (*falls short of*) the projected amounts in the program, specified in Schedule B. This adjuster will be eliminated after December 31, 2005.

Schedule B (In millions of Uruguayan pesos, cumulative basis)			
	Jun-05	Sep-05	Dec-05
Projected revenues from the FLD	3,044	4,664	6,277

4. **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.

5. **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.

(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; (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$1.54784 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 December 30, 2004.

- **The NIR floor will be adjusted** upward by the full amount of pre-financing operations for 2006. Prefinancing is the portion of nonproject related foreign currency nonfinancial public sector debt that is issued in 2005 but will be used in 2006 or later, and is clearly earmarked for such later use.

6. **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 4 and 5 below. The flow of NIR will be valued at the accounting exchange rate of Ur$26.35 per US$1.

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

7. **The overall nonfinancial public sector gross debt ceiling** refers to the outstanding stock of debt[3] [4] measured on a *gross* basis[5] in domestic and foreign currency *owed or guaranteed by the NFPS*, valued in U.S. dollars at the accounting rates of Ur$26.35 per U.S. dollar, U.S. dollar 1.3637 per Euro, U.S. dollar 0.0097 per Yen, U.S. dollar 1.54784 per SDR, and Ur$1.4345 per UI. If the Ur$ to UI rate exceeds 1.5420 the UI debt will be valued at Ur$ 1.4345 plus the difference between the actual rate and Ur$1.5420. The debt ceiling will exclude (i) the government guaranteed BHU note (with outstanding obligations estimated at US$624 million at end-December 2004) 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$429 million at end-December 2004); 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-2004; (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$150 million (downward) for the cumulative reduction (increase) in the net credit position of public enterprises

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[3] 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).

[4] The suppliers' contracts of ANTEL with equipment providers Ericsson and NEC, which predate the Fund's consideration of lease contracts for programming purposes, are expensed under goods and services as rental outlays and, therefore, excluded from the definition of nonfinancial public sector gross debt for program purposes.

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

with the BCU; (iv) upward by a maximum of US$150 million for the costs associated with the final outcome of the arbitration award to the former shareholders of Banco Comercial; (v) upward by a maximum of US$100 million for debt issued to finance below-the-line operations of public enterprises (such as recapitalization of ANCAP's subsidiary abroad); and (vi) upward to reflect pre-financing operations for 2006 up to a limit of US$500 million.

8. **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.

9. **Floating debt of the central government** is defined as expenditure which have already been billed but no checks been issued. The ceiling will be adjusted upward (*downward*) by revisions made to the actual stock of floating debt at end-2004. This indicative target will apply through December 31, 2005; and afterwards—once approved in the 2006 budget— monitored by including the floating debt in the definition of the combined public sector overall balance measured from below the line, and in the stock of the NFPS debt.

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 the BHU 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 terms presented in Schedule C.

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

	BHU Note				Fiduciary Trusts 1/			
	Service				Service			
	Principal	Interest 3/	Total	Balance 2/	I	II	III	Balance 2/
2005 Q2	2.5	3.7	6.2	611.8	70.7	4.6	3.6	350.7
2005 Q3	2.5	3.7	6.2	605.7				
2005 Q4	2.5	3.6	6.2	599.5	82.2	5.3	8.9	254.2
2006 Q1	3.8	3.6	7.4	592.1				
2006 Q2	3.8	3.6	7.4	584.7	81.0	5.3	8.8	63.4
2006 Q3	3.8	3.6	7.4	577.3				
2006 Q4	3.8	3.5	7.3	569.9	8.1	0.3	5.8	0.0
2007 Q1	5.1	3.5	8.6	561.4				
2007 Q2	5.1	3.5	8.5	552.8				
2007 Q3	5.1	3.4	8.5	544.3				
2007 Q4	5.1	3.4	8.5	535.8				
2008 Q1	6.4	3.3	9.7	526.1				
2008 Q2	6.4	3.3	9.7	516.5				

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 floating interest rate depends on that for BROU deposits.