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Mongolia: 2005 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Mongolia, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 24, 2005, with the officials of Mongolia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 1, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of September 21, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 21, 2005 discussion of the staff report that concluded the Article IV consultation.

The documents listed below have been or will be separately released.

Ex Post Assessment of Longer-Term Program Engagement
Poverty Reduction Strategy Paper Progress Report—Joint Staff Advisory Note
Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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MONGOLIA

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Mongolia

Approved by Daniel Citrin and Carlos Muñiz

September 1, 2005

This report is based on discussions held in Ulaanbaatar during June 14–24, 2005. The team comprised Messrs. Carter (Head), Kronenberg, D'Hoore, Lee (all APD), and Messrs. Cakir (FAD) and Kikuchi (PDR). Mr. Lee (Advisor, OED) also took part in discussions. The team, which was assisted by Ms. Rehm, Resident Representative, collaborated with overlapping MFD technical assistance and World Bank missions. Attached also is a joint World Bank-IMF staff *Debt Sustainability Analysis*. The authorities' *Progress Report* on their *Economic Growth Support and Poverty Reduction Strategy* (EGSPRS) will be issued separately, along with the associated *Joint Staff Advisory Note* (JSAN).

The team met Prime Minister Elbegdorj, Deputy Prime Minister Ulaan, Minister of Finance Altanhuyag, Minister of Energy Ochir-Huu, Bank of Mongolia Governor Chuluunbat, other senior officials; and with business, donor agencies, and financial sector representatives.

The last Article IV Consultation was concluded on October 2002. Directors considered that, despite achievements in its transition to a market-based system, Mongolia faced daunting challenges in its efforts to promote robust growth, reduce poverty, and achieve fiscal and debt sustainability. They noted that these challenges had been exacerbated by a weather-related slowdown in output growth during 2000-01. In this context, Directors urged the authorities to resist pressures on spending that would threaten to undermine the prospects for sustainable, pro-poor growth.

Mongolia maintains a floating exchange rate regime and an exchange system free of restrictions on current international transactions.

Data provided to the Fund are adequate for surveillance purposes. There remains room for improvement in the quality and timeliness of balance of payments data, whereas significant revisions to annual fiscal data that do not give rise to retroactive monthly imputations complicate economic analysis of fiscal developments.

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Executive Summary

Mongolia has experienced two years of unusually rapid economic expansion, benefiting from good weather and high world mineral prices. Growth prospects should continue to be robust in the medium term, settling around at least 5 percent from 2005 onward. Although this growth has likely contributed to some reduction in the high level of income poverty, measured at 36 percent in 2002, the challenge remains to make significant progress to achieving the Millennium Development Goals. In the longer term, Mongolia's public debt, although large in nominal terms, is seen as highly concessional and sustainable with prudent macroeconomic policies but vulnerable to large terms of trade shocks.

Despite generally adequate macroeconomic policies, inflationary pressures accelerated from mid-2004 as fuel and food prices shot up. Prices continued to increase sharply in 2005 as the Bank of Mongolia failed to tighten the monetary stance. To avoid inflationary expectations increasing, the Bank of Mongolia needs to address promptly high credit growth.

Fiscal performance was good in 2004, with excellent prospects for 2005. Large revenue receipts reflected overall economic growth as well as higher-than-expected prices for copper and volume for gold. Strong revenue performance so far in 2005 suggests that the deficit could remain at its 2004 level, more than one percent of GDP below the budget target. For future years, it is important that fiscal policy focus on tax reforms that make the system simpler and more efficient, while making further improvements in public expenditure allocation and financial management.

Further action to improve the health of the financial system and the strength of the central bank is essential, building on the progress made in recent years. There is concern that the high credit growth may mask the underlying fragility of some banks' positions and the problems of regulatory forbearance. The authorities are encouraged to resolve the capital weakness of the BOM and improve the decision-making structure, with enhanced oversight.

Restructuring of public enterprises should remain an important priority. This can be achieved through both improving the governance of enterprises intended to remain in the public sector as well as resuming the privatization program. In particular, the authorities are encouraged to continue their plans to revamp operations in the vital energy sector.

The recent PRGF arrangement lapsed in July 2005, without the completion of the third and subsequent reviews. Aided by the strong economic performance, most of the quantitative targets set in 2003 were met and some progress made on the structural agenda. However, governance concerns emerged that the authorities recognize will need to be addressed so that strong support can be given by Mongolia's development partners to assist in the government's growth and poverty reduction strategy.

Mongolia's commitment to an open trading system needs to be maintained to benefit from strong regional growth.

I. BACKGROUND, DEVELOPMENTS, AND OUTLOOK

A. Background

1. **Discussions on the 2005 Article IV Consultation took place against the backdrop of two years of unusually rapid economic expansion**, spurred by the confluence of favorable domestic and external factors, mainly good weather and unusually high world prices for copper and gold. Real GDP growth exceeded 10½ percent in 2004, and should continue to be robust, easing to 5 percent in 2005. Despite generally adequate macroeconomic policies, including a firm fiscal stance, inflationary pressures have not been aggressively addressed since they started to accelerate in mid-2004.

2. **The political situation remains in flux**. Consensus building within the grand coalition that emerged from the June 2004 parliamentary elections has proven difficult. It has been further tested in a parliamentary by-election that was precipitated by the election to the presidency, a largely ceremonial post, of former Speaker and Prime Minister Enkhbayar, of the Mongolian People's Revolutionary Party (MPRP). There is much public speculation about possible government changes and a rearrangement of the coalition itself. In this uncertain political context, the pace of economic reforms has slowed considerably, although fiscal management has so far remained firmly under control.

3. **Mongolia remains a poor country facing significant challenges.** Poverty incidence remains high, measured at 36 percent in a 2002–03 household survey (Annex I). While the high growth in the last two years has likely contributed to a reduction in poverty, sustaining those gains may be difficult as the external environment weakens in the medium term. Harsh weather remains a threat to the livestock sector, upon which much of the population still depends. Looking further, the challenges of poverty reduction are daunting. With a territory of 1.6 million km^2 landlocked between Russia and China, a harsh climate, underdeveloped infrastructure, and low population density, it will be difficult to leverage favorable mining prospects to tackle poverty through broad-based growth and job creation.

4. **The current PRGF arrangement, originally approved in September 2001, lapsed in July 2005,** without the completion of the third and subsequent reviews. Aided by the strong economic performance in the past 2 years, most of the quantitative targets set at the time of the combined First and Second Review, September 2003, were met and progress made on the structural agenda (Tables 7 and 8). However, serious governance concerns emerged, especially those stemming from issues related to central bank procedures and the lack of information on transactions related to the end-2003 settlement of the pre-1991 debt to Russia (Box 1). The accompanying Ex Post Assessment examines Mongolia's achievement under this and previous programs, and draws lessons for future Fund involvement.[1]

[1] *Mongolia: Ex-Post Assessment of Longer-Term Program Engagement.*

Box 1. The Settlement of Pre-1991 Transferable Ruble Debts to Russia

The overhang of Mongolia's pre-1991 transferable ruble (TR) debt to Russia had been a longstanding issue between the two countries. Fund staff had encouraged the authorities to resolve the issue in a manner compatible with Mongolia's fiscal and debt sustainability objectives. Given the uncertainty on timing and possible terms for such a resolution, the TR debt was excluded from the staff's external debt estimates and projections in the context of Fund-supported programs. However, the staff's debt sustainability analysis for the 2002 Article IV consultation contained some scenarios, which showed that Mongolia would need to secure highly favorable terms on the settlement of this debt to ensure that its overall debt burden would not rise to unsustainable levels (Country Report 02/252, Annex III).

At the end of 2003, Russia and Mongolia agreed on the settlement of the pre-1991 debt. Based on a total debt stock of TR 11.4 billion (TR1=$1), equivalent to about 10 times Mongolia's GDP, the terms of the settlement comprised: (i) an upfront cash payment by Mongolia of $250 million to be effected by the end of 2003 through a private intermediary based in the Czech Republic; and (ii) the cancellation of the entirety of the TR debt (principal and outstanding interest), yielding the equivalent of a 97.8 percent discount on the notional stock of debt.

International comparison of Russian debt settlement

Countries	Total Debt (1) US$ million	Upfront Discount in percent	Nominal restructured debt (2) US$ million	NPV of restructured debt (3) US$ million	NPV/ total debt (3)/(1) in percent
Mongolia	11,400	97.8	250	250	2.2
Vietnam	11,507	85	1,726	1,346	11.7
Nicaragua	3,444	90	344	103 1/	3.0 1/

1/ Data reflect level to which Russia had agreed to reduce the NPV of Nicaragua's debt at the HIPC completion point; in the event, the debt was reduced to zero at the completion point in March 2004.

The debt settlement with Russia compares favorably in NPV terms with similar deals. While cross-country comparisons are fraught with difficulties, the discount applied to Mongolia's TR debt was significantly higher than the rate effectively applied in the case of Vietnam, and was broadly in line with debt relief that was originally to be received by Nicaragua.

The transactions temporarily weakened Mongolia's macroeconomic position. The government had recourse to short-term borrowing from private domestic and external sources, increasing short term financial vulnerability. The government issued dollar-denominated one-year treasury bills (T-bills) to a foreign mining company, Ivanhoe Mines, (US$50 million) and local currency short-term bills to a domestic private bank ($25 million, 6 to 10 month maturities). An additional $13 million was collected through an advanced settlement of taxes due from Erdenet, a large 51/49 percent government/Russian joint venture copper mining company, and $25 million represented a draw-down from the government's own deposits at the central bank. The rest involved the use of official reserves, financed by a loan from the central bank. With a sharp improvement in the external position, mainly on account of booming copper and gold prices, the impact of this borrowing was absorbed relatively easily. Official reserves rose from $178 million at end-2003 to $205 million at end-2004, despite the repayment of $50 million to Ivanhoe Mines.

The financing resulted in losses for the BOM. The government contracted from the BOM a 10-year, interest-free, $100 million loan and a $37 million, interest-free, short-term loan. This large recourse to BOM financing was highlighted in the 2003 and 2004 BOM external audit reports as violating the Central Bank Law and weakening the BOM's income position. Later Parliament approved the payment of one percent annual interest on the 10-year loan.

The nontransparent aspects of the settlement, coupled with a lack of adequate information on the ultimate disposition of funds paid by Mongolia, have heightened concerns about governance. The Czech intermediary signed separate, confidential side-agreements with the Mongolian and Russian governments. Moreover, the negotiations also encompassed debts incurred by Mongolia to finance its equity stake in two major Mongolian-Russian joint ventures. The debt balance of one of these companies was to be written off soon after the signing of a new intergovernmental agreement between Mongolia and Russia, but no information is known of the signing. Finally, the Mongolian authorities have so far been unable to provide full information on the final structure of the debt deal and related agreements, including with respect to the form and terms of the final payment. Thus, the actual disposition of Mongolia's public funds remains in doubt. Facing increasing awareness of the issue, a parliamentary committee was established in early 2005 to investigate the settlement. The committee comprised 15 leading figures of all the main political parties. The report concluded: (i) $250 million was paid as required by Russians through Czech intermediary as a negotiated settlement (ii) the use of such an intermediary was common in other settlements of transferable ruble debt and no fee was paid by Mongolia to that intermediary, (iii) all debt now confirmed extinguished (iv) there is no evidence of malfeasance and (v) further information is not available. Thus, the commission's report officially endorses a consensus that the deal is no longer an issue.

5. **The World Bank, Asian Development Bank (AsDB) and bilateral donors, particularly Japan, are active.** Gross official aid flows, grants and concessional loans, were equivalent to about 14 percent of GDP in 2004, and should continue to grow. The World Bank's programs focus on civil service reform, public financial management and governance, the legal framework for the mining sector, and the energy and financial sectors. The AsDB is currently developing a new strategy for Mongolia, expected to be completed by late 2005, that would support economic growth, the poor's access to public services, and improved governance. Mongolia is eligible for assistance under the U.S. Millennium Challenge Account and the authorities have been working to identify qualifying projects.

B. Recent Developments

6. **Overall economic performance was stronger than expected and broad based in 2004 and early 2005.** Contributions to high growth included a rebound in the livestock sector from harsh winter shocks of 2000–01 (the "dzuds") and strong mining exploration and exports, boosted by a favorable environment of unusually high copper and gold prices (Box 2). There was also strong foreign direct investment in mineral exploration, growth in services, particularly tourism and transit trade between neighboring Russia and China.

7. **After several years of moderation, however, inflation has accelerated from mid-2004**. Triggered by supply-side shocks, namely the pass-through of higher world oil prices, changes in sanitary regulations which pushed up the price of meat, and price adjustments in utilities, headline inflation rose into double digits in late 2004 while the authorities' measure of core inflation increased to 8–9 percent (Figure 1).[2] Monetary policy since the latter months of 2004 has accommodated the direct and second round effects of the supply shocks; accordingly, headline inflation reached 15¾ percent through July 2005, although the core inflation rate has increased only slightly.

8. **Fiscal performance was good in 2004, with excellent prospects for 2005.** Strong revenue receipts reflected overall economic growth as well as higher-than-expected prices for copper and volume for gold.[3] Control over domestically financed expenditure was broadly appropriate, along the lines of the previous government's 2000–04 Action Plan, although the 2004 budget included large increases in civil service pay and in pensions. The lowest overall deficit since the beginning of transition, about 2 percent of GDP, allowed a notable decrease in indebtedness. For 2005, the budget targeted a widening in the overall deficit to about 3½ percent of GDP, reflecting a new assistance program for poor families with children, much scaled back from original proposals but still at a cost of about 1 percent of GDP. Strong revenue performance so far in 2005, with receipts 22 percent above the first seven months of 2004, suggests that, if spending discipline is maintained, the deficit could

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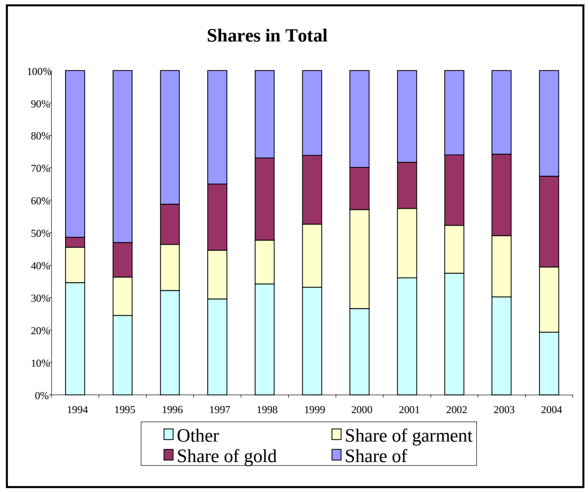
[2] The core inflation index excludes meat, milk, and vegetables. The latter categories' weight in the CPI basket, however, is close to 22½ percent. According to research by the BOM, the core index, while being much more stable, seems to underestimate inflation trends a little.

[3] Minerals-related revenues amounted to about 10 percent of the total in 2004. Their sharply higher than trend prices contributed about 2 percent of GDP to revenue in that year.

Box 2: The Impact of Copper on the Economy

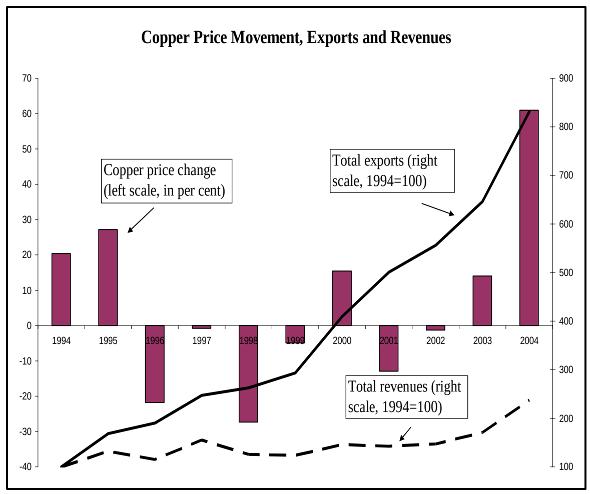
Copper has long been one of Mongolia's economic pillars. In 2004, copper exports contributed 21.5 percent to Mongolia's GDP. During the same year, the copper sector accounted for 8.9 percent of government total revenues. This number is expected to increase to 10.5 percent in 2005, due to significant dividends collected from Erdenet, Mongolia's major mining corporation.

However, the share of copper in Mongolia's total exports is in decline. The share has decreased from 54.1 percent in 1994 to 36.2 percent in 2004. Other export items, prominently gold and garments, have taken over copper's share and driven up the total exports.[1] Gold's share has jumped from 3.1 percent to 27.9 percent between 1994 and 2004. Garments' share doubled, from 10.9 percent to 20.2 percent during the same period.



Mongolia's domestic economy is still very much affected by any fluctuations in the world copper price. The correlation between the change of the world copper price and Mongolia's GDP was 0.59 between 1994 and 2004. During the same period, the share of copper exports in GDP fluctuated in the range of 12.5 and 21.5 percent, partly due to copper price movement.

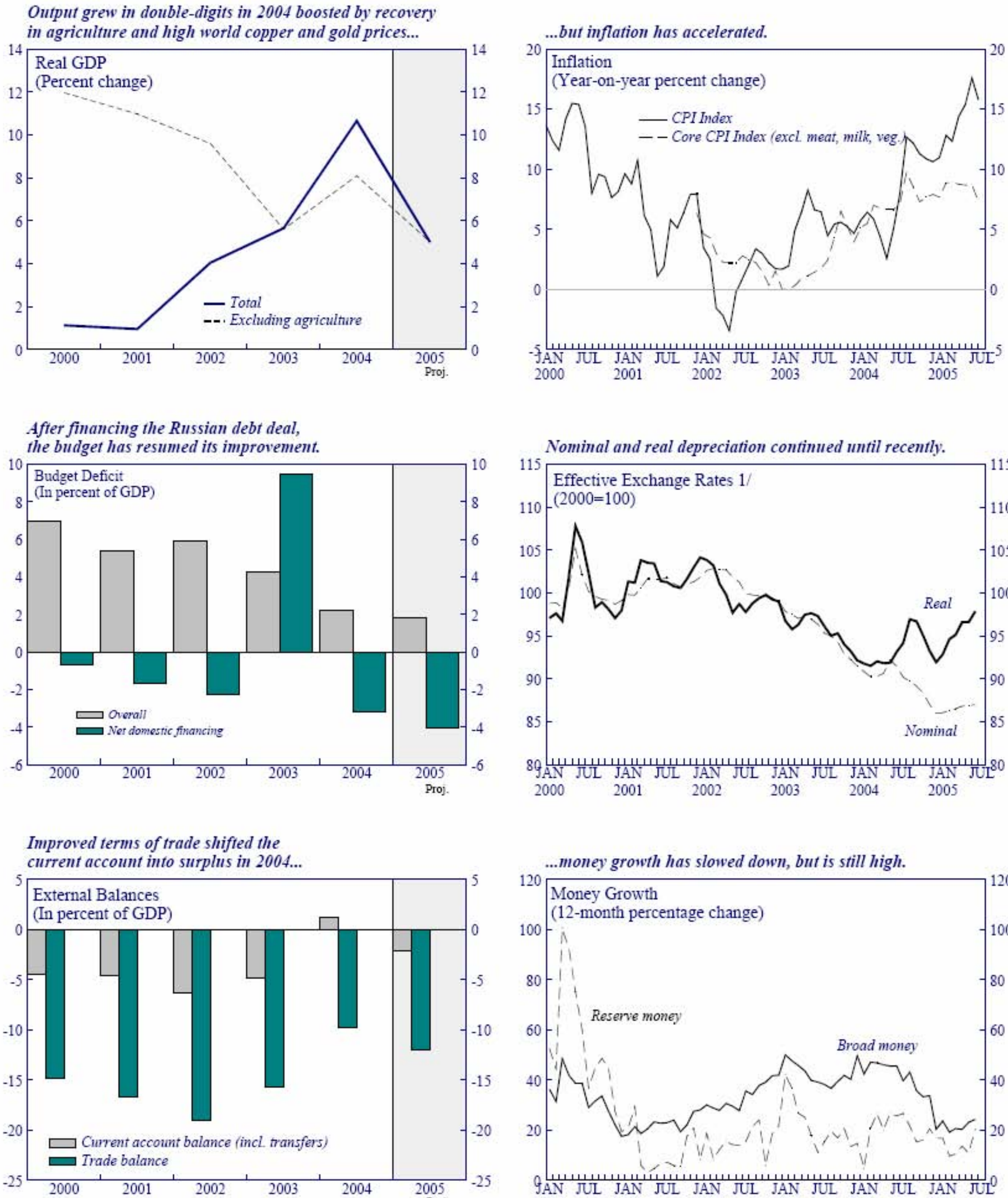
Copper price movements also affect Mongolia's government revenues and exports. Empirical data have shown a strong co-movement between the change of the copper price and government total revenues. The correlation between them was 0.46 between 1994 and 2004. Even though copper's share in total exports has been reduced, copper price fluctuations still account for most of the fluctuation of Mongolia's total exports. The correlation between the change of the copper price and the total exports was 0.66, and that between the change of the copper price and the change of the total exports was 0.79 over the same period.



This suggests that copper price risk management should be considered by the government as a way to smooth its revenues and reduce short-term vulnerabilities. Currently, Mongolia's overall balance and current account are being lifted by the rising wave of the world copper price. However, stress tests show that Mongolia's public external debt sustainability would be highly vulnerable to the shocks from any significant fall in world prices in the coming months or years.

[1] However, garments have a much lower value added because of high import content.

Figure 1. Mongolia: Economic Developments, 2000-05



Sources: Mongolian authorities; and Fund staff estimates and projections.

1/ An increase indicates appreciation.

Figure 2. Mongolia: Fiscal Indicators, 2000-05
(In percent of GDP)

Sources: Mongolian authorities; and Fund staff estimates and projections.

remain at its 2004 level, more than one percent of GDP below the budget target. Personal and corporate income tax, social security contributions, import-related taxes, and dividends led the revenue boost.

9. **While the Bank of Mongolia (BOM) failed to move decisively against the inflationary pressures,** it was faced with the inherent difficulty in setting appropriate monetary policies at the end of a rapid remonetization process. In line with the trend since the banking crisis in 1998/99, monetary growth eased in 2004, to about the rate of nominal GDP growth, slowing down from rates above 40 percent in earlier years.[4] However, the pace of liquidity expansion picked up again in early 2005, as the BOM did not sustain increases in the yields and placements of central bank bills briefly initiated in late 2004, reflecting the Bank's concerns about losses. Private credit growth, which had grown at a torrid pace—more than 200 percent in the two years 2002-03—was still high in early 2005, reaching nearly 33 percent year-on-year at end-June 2005. Despite high lending spreads (more than 10 percentage points), credit demand remains strong, shifting in recent years from the trading sector to real estate, construction and mining.

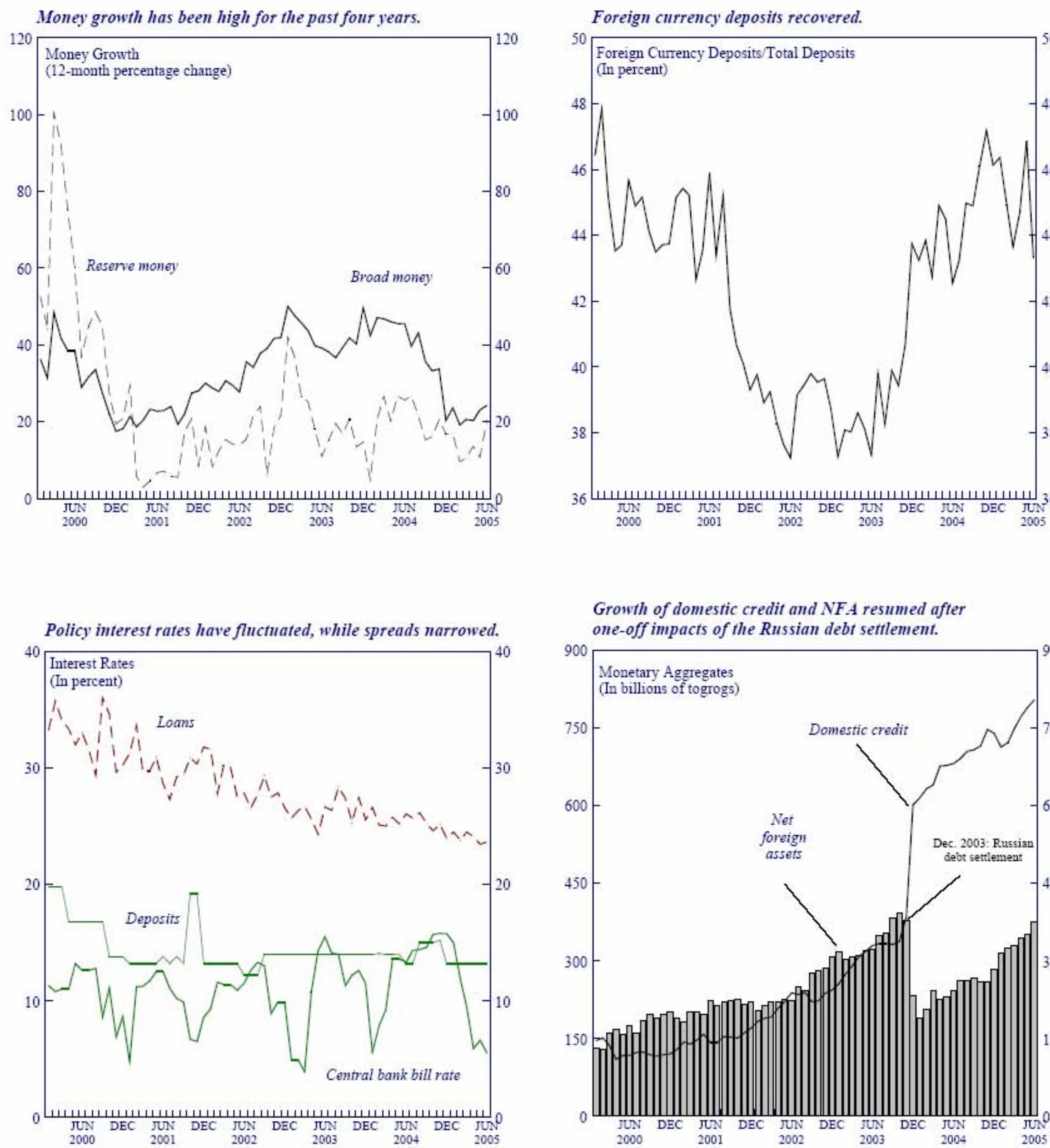
10. **Concerns for the vulnerability of the banking sector have been heightened by high credit growth and remaining weaknesses in supervision and enforcement of prudential rules.** The incidence of nonperforming loans (NPLs) increased from 8.3 percent at end-2003 to more than 10 percent at mid-2005, while other indicators of banking sector soundness are mixed (Table 10). In the current environment of high credit growth, the quality of bank portfolio could be worse than these data suggest, especially with the hard-to-measure systematic rollover of problem loans. Moreover, credit risk management of banks remains fragile. In this regard, the disclosure, in early 2005, of hitherto unreported off-balance sheet exposure in three banks that issued letters of credit (L/Cs) in transactions with a Korean company, only confirmed worrying weaknesses in bank corporate governance, compounded by the lack of strict enforcement of applicable prudential standards.

11. **The balance of payments has been strong, with favorable terms of trade, new gold operations, and robust capital flows in the mining sector**. The current account (including transfers) is estimated to have been in a surplus equivalent to about one percent of GDP in 2004. High commodity export prices, strong tourism, and private transfers, helped offset the increased cost of oil imports (more than a fourth of total imports).[5] The removal however, in early 2005, of US and EU import quotas on textiles and garments has already

[4] The end-year rate of change in M2 underestimates monetary growth. The annual growth rate in average 6-monthly nominal balances, for example, exceeded 40 percent for most of 2004, and was still 34 percent at end-year.

[5] The terms of trade, projected to deteriorate for 2005 as a whole due to higher oil prices, were holding well in early 2005, as copper prices continued to surge.

Figure 3. Mongolia: Monetary Developments, 2000-05



Sources: Mongolian authorities; and Fund staff estimates.

affected Mongolia's small garment sector to a greater extent than so far seen in other Asian countries (Box 3). However, the net external impact has been modest, as most inputs are imported. With steady flows of donor assistance and foreign direct investment, the BOM was able to reconstitute its official reserves, temporarily depleted by the large payments related to the Russian debt settlement at end-2003.

12. **The authorities maintain a flexible exchange rate policy**, with interventions officially limited to smoothing high-frequency fluctuations in the foreign exchange market and the maintenance of an adequate cushion of reserves to facilitate adjustment to large shocks. Throughout the 2000–04 period, the togrog depreciated gradually against the dollar, particularly in 2004 when there was uncertainty about the settlement of Mongolia's large transferable ruble debt to Russia. In 2005, however, the dollar exchange rate has been relatively stable, implying an appreciation of about 4 percent in real effective terms. The staff considers that recent exchange rate movements have appropriately reflected economic fundamentals, which include sharply higher mineral export prices, strong remittances, and the rebuilding of international reserves.

C. Macroeconomic Outlook and Risks

13. **Medium-term prospects are broadly favorable, provided the authorities manage to slow inflation back to single digit and sustain supportive fiscal policies** (Table 6)**.** Growth is expected to settle around at least 5 percent, with a return to trend growth for the livestock sector. The gradual coming on stream of a series of mid-size mining projects is projected to sustain a growing pace of extraction. Telecommunications, transport and tourism should also continue to exhibit strong growth, while construction and financial services are likely to slow down and the garment sector should continue to decline. With appropriate policy action, mainly on the monetary side, inflation could slow down, to about 10 percent year-on-year at end 2005, returning to a 5 percent trend in 2006.

14. **The balance of payments is expected to weaken moderately, in line with a modest decline in the terms of trade.** Export growth is likely to turn negative in 2006 as world prices of copper are projected to decline by a third from their record levels, and garment exports decline further.[6] However, import growth should slow down, as oil prices are projected to stabilize. The current account balance (including official transfers) is projected to move back into a deficit in the range of 4–5 percent of GDP over the medium-term. The financial account should be positive over 2005–10, on account of sustained disbursements of concessional loans and FDI, allowing the BOM to maintain official reserves above 10 weeks of imports of goods and non-factor services.

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[6] Under the latest WEO assumptions, copper prices are projected to fall a combined 30 percent in 2006 and 2007, and slowly decline thereafter.

Box 3. Garment Exports of Mongolia

Non-cashmere garment products have recently become major export items of Mongolia, with a share in the total export and GDP of 11.1 percent and 6.4 percent respectively in 2004. Out of about 100 companies in non-cashmere garment sector, almost all of them were foreign investors; mainly from China (37 percent) and South Korea (19 percent). These companies took advantage of the absence of U.S. quota restrictions on garment imports from Mongolia—more than 90 percent of the non-cashmere garment exports went to the United States.

Mongolia: Garment Exports

	1999	2000	2001	2002	2003	2004
	(in millions of US Dollar)					
Total Exports	454.2	535.8	523.2	523.9	627.3	872.1
Total Garment Exports	96.6	171.7	114.5	80.6	119.4	176.2
o/w, non-cashmere garment	18.4	73.2	44.2	34.6	74.8	96.5
o/w, cashmere	78.2	98.5	70.3	46.0	44.6	79.7
	(in percent of total exports)					
Total Garment Exports	21.3	32.0	21.9	15.4	19.0	20.2
o/w, non-cashmere garment	4.1	13.7	8.4	6.6	11.9	11.1
o/w, cashmere	17.2	18.4	13.4	8.8	7.1	9.1
	(in percent of GDP)					
Total Garment Exports	10.7	18.1	11.3	7.2	9.4	11.6
o/w, non-cashmere garment	2.0	7.7	4.3	3.1	5.9	6.4
o/w, cashmere	8.6	10.4	6.9	4.1	3.5	5.3

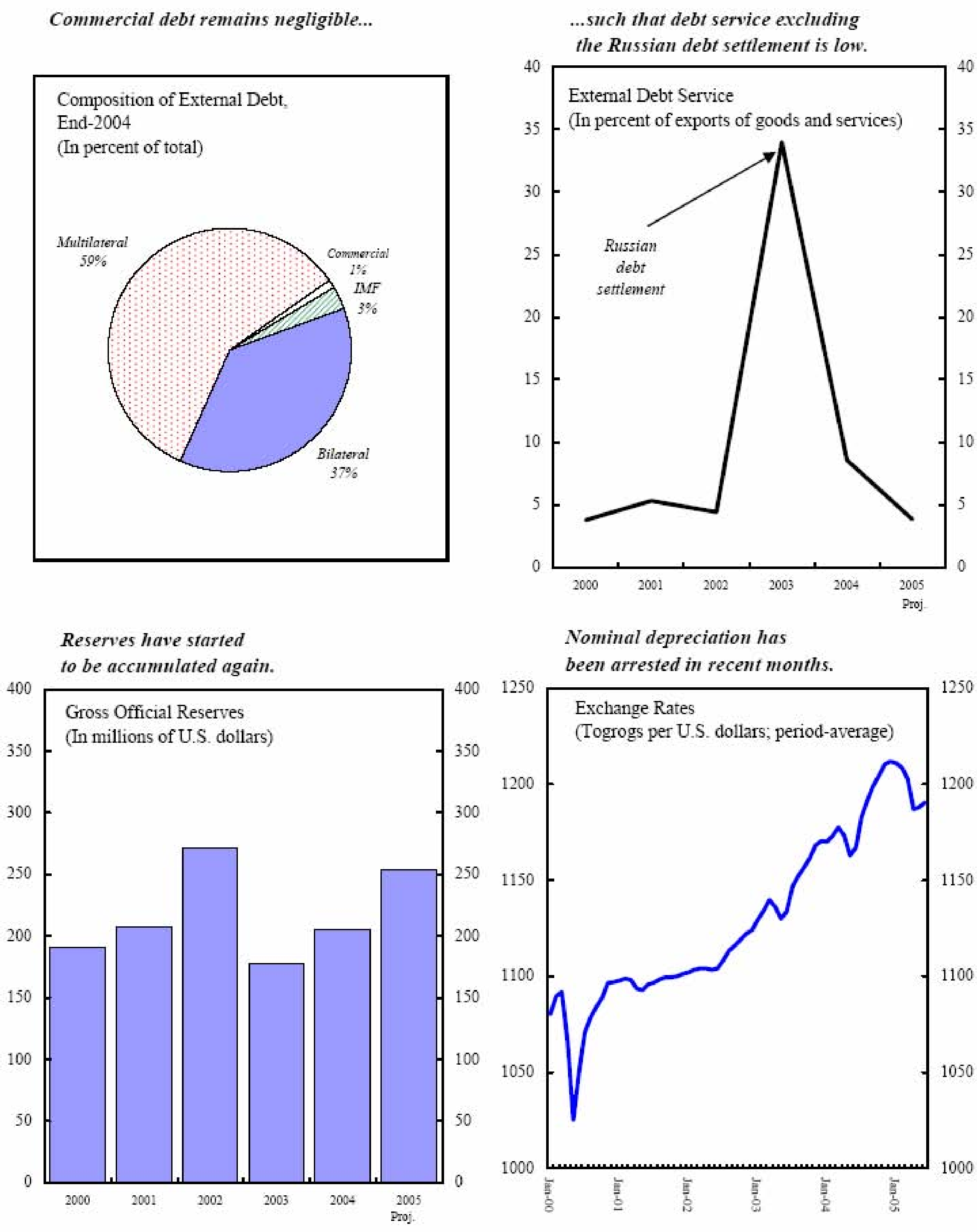
Source: The Bank of Mongolia and staff estimates.

With the ending of the quota restrictions as of January, some Chinese companies have already stopped their operations. In the first four months of 2005, the Mongolian garment exports to the US declined both in value (20 percent) and in volume (40 percent) compared to the same period last year as Chinese investors suspended productions in Mongolia either temporally or permanently. Categories affected by the quota removal –mainly cotton shirts, blouses, and trousers—make up 70 percent of the output. Of about 20,000 full-time workers (mostly ladies), thousands are reported to have lost their jobs by April due to the closure of factories.

Government actions have not successfully arrested the declining garment exports. The government has tried to mitigate the impacts of quota elimination by: i) halving the level of social security contributions by employers for affected firms, from the current 19 percent of the wage bill, and ii) exempting the import tax on raw materials for garment products. The government also intends to take as-yet unspecified measures to promote diversification in the sector, and plan to establish a textile industrial park in Ulaanbaatar (ostensibly to help producers improve productivity and reduce costs).

The announcement by the US government to invoke textile safeguards on three categories of clothing imports from China is expected to have positive impacts on the Mongolian exports if Chinese investors consider that exports from Mongolia should be kept to escape the safeguard or as an insurance for another safeguard that is under consideration. These categories accounted for about 50 percent of Mongolian garment exports to the U.S. in 2004. However, given that the products falling into these categories are also major export products of other countries in a similar situation, such as Cambodia, Mongolia still needs to improve its competitiveness to be preferred to these countries.

Figure 4. Mongolia: External Developments, 2000-05



Sources: Mongolian authorities, Fund staff estimates; and *International Financial Statistics* : IMF.

15. **There remain significant risks to the outlook, but there are also bright prospects.** As well as the risk of an even-greater-than-assumed decline in copper and gold prices, the main recent export drivers, Mongolia remains vulnerable to crippling weather shocks to its agriculture sector. Misguided policy choices on the taxation of the mining sector could scare away FDI, as they once did in the late 1990s, before being corrected in 2000. The banking sector, while stronger than in the 1990s, remains vulnerable. On the other hand, the medium-term scenario does not reflect the possible coming on stream of the Oyu Tolgoï copper and gold mining project, in view of uncertainties on its scope and timing. With large copper and gold reserves (a low estimate is US$6 billion), that project's development, by 2007 or 2008, would have a large, positive impact on activity, government revenues and exports.

16. **Mongolia's external debt remains high but sustainable**. Even after the settlement of pre-1991 Russian debt, which was equivalent to more than 10 times GDP, the outstanding stock of external debt was equivalent to 91 percent of GDP as of end-2004, and 55 percent in Net Present Value terms (NPV). This ratio is well above the 40 percent threshold applied to countries at equivalent levels of policy performance in the joint IMF-World Bank debt sustainability guidelines, placing Mongolia at a relatively high risk of debt distress over the medium-term (Box 4 and attached Debt Sustainability Analysis).[7] The authorities would welcome more grants but they already receive a substantial amount. Under a baseline scenario of sustained growth and fiscal deficits in the 3 percent range, financed solely with concessional loans, Mongolia's external debt ratios would decline substantially in the long-term. However, stress tests suggest the debt could become unsustainable if there were especially negative terms of trade shocks. Moreover, the DSA baseline does not allow for any large-scale nonconcessional loans.

17. **Any relaxation of the government's borrowing policy—**either in signing large loan agreements or in allowing less favorable borrowing terms**—could have severe consequences on its external debt sustainability**. In this regard, there are several proposals for loans, including from the governments of China ($300 million) and Turkey ($50 million), as well as a possible $100 million international bond to be arranged by a foreign commercial bank. These and other possible borrowing would support, inter alia, public infrastructure for housing construction and trade. The loans would be nonconcessional and most of the liabilities would be with the government, at least on a contingent basis.

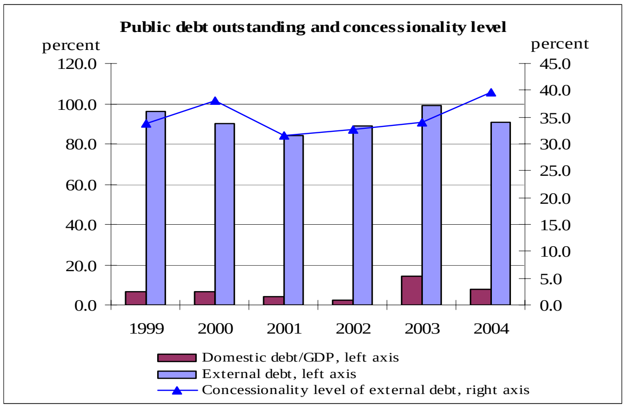
II. POLICY DISCUSSIONS

18. **The discussions covered three main areas:** (i) immediate and medium-term prospects for the economy, the risks to the outlook, and the authorities' main macroeconomic

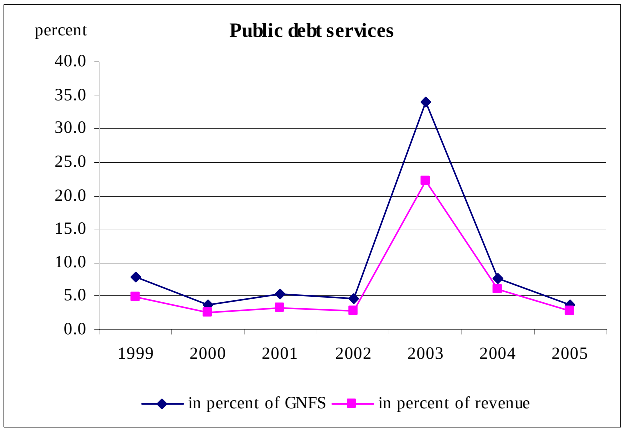
[7] However, reflecting Mongolia strong revenue and export performance, the ratios of NPV of external debt to exports, at 68 percent, and NPV of debt to revenues, at 160 percent, are well below critical thresholds under the debt sustainability guidelines.

Box 4: Mongolia's Public Debt

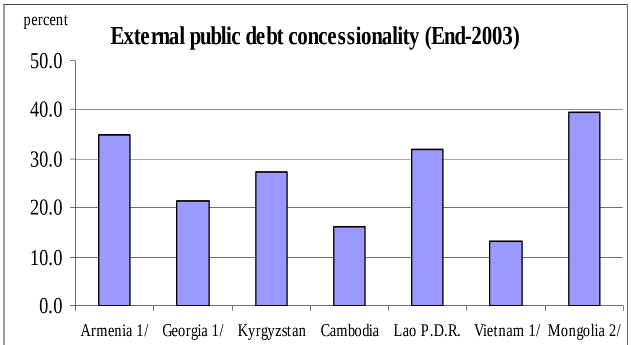
Mongolia has a high stock of public debt even after the settlement of pre-1991 transferable ruble (TR) debt to Russia. At end-2004, Mongolia's stock of total public debt amounted to 91 percent of GDP—almost all external loans from multilateral and bilateral donors. A short-term treasury bill issued to nonresident in 2003 to partly finance the TR debt settlement was fully repaid before the end of 2004. The remaining domestic debt is mostly short-term borrowing from commercial banks to bridge time lags between revenues and expenditures. Mongolian authorities have never availed themselves of the Paris Club rescheduling.



Most of the Mongolia's public external debt is concessional. Three creditors (the World Bank, the Asian Development Bank, and JBIC) account for 80 percent of total public external debt. Calculations of Mongolia's stock of public external debt at end-2004 indicate: (i) the nominal stock amounts to $1.4 billion or 91 percent of GDP (112 percent of goods and services), (ii) the stock of NPV value amounts to $0.8 billion or 55 percent of GDP (68 percent of goods and services). Average concessionality of public external debt compares favorably with other transition economies.



Due to the high concessionality, together with large export share of GDP (80 percent in 2004), debt service has been manageable. The external debt service ratio, which temporally jumped up to 34 percent of goods and services in 2003 due to a cash payment of $250 million in connection with the pre-1991 debt settlement, would fall to its previous low level of about 4 percent in 2005. A high government revenue ratio to GDP (39 percent in 2004) also means fiscal debt service indicators are under control.



Source: World Bank, Global Development Finance; IMF, staff reports
1/Includes private external debt (but less than 10 percent of total external debt)
2/ end-2004 figure

However, given that Mongolia's external position is highly vulnerable to terms of trade shocks, a cautious approach to contracting public borrowing is required. On external side, as copper and gold exports account for more than 60 percent of Mongolian export of goods, the price declines of these commodities would promptly worsen debt service indicators. On fiscal side, revenues also depend, although to lesser extent, on copper and gold production. Therefore, it is crucial for Mongolia to maintain a sustainable debt dynamics over the medium and long-term through limiting its borrowing on concessional terms (see further be discussed in the debt sustainable analysis).

and structural reform policies, and jointly with World Bank staff, (ii) a Debt Sustainability Analysis, and (iii) the authorities' Poverty Reduction Strategy Paper Progress Report.

19. **The authorities broadly shared the staff's assessment for the medium-term outlook, while taking a more sanguine view of the risks related to inflation.** They acknowledged that the high growth rates achieved in 2004 would not be repeated. However, they considered that reforms that improve the environment for the private sector and investment in much needed public infrastructure could provide further impetus to growth, even above the staff's current projections of 5 percent per year. They agreed that macroeconomic stability was a key condition for sustained growth in the future, but saw no critical, unmanageable, risks in the recent upsurge in inflation.

A. Fiscal Policy

20. **Fiscal policy for the remainder of 2005 will aim at saving the revenue windfall from higher minerals sector taxes and dividends.** The authorities said that they were not contemplating amendments to the 2005 budget, and they would contain expenditure strictly within budgeted levels. As a result, the actual budget deficit is expected to be contained to about 2 percent GDP—the same as in 2004 and about 1½ percentage points lower than originally budgeted. At a time when inflationary pressures persist and the economy has no need for additional stimulus, the staff considered that the decision to save the revenue windfall was appropriate. To ensure that the targets could be met, the staff cautioned the authorities on the need for maintaining strong control over spending and addressing remaining weaknesses in budget management systems.

21. **The authorities' Medium-Term Budget Framework (MTBF) for 2006–08 was submitted to Parliament in May 2005.** It envisages an increase in the overall deficit to 4 percent of GDP in 2006, compared with the original 2005 budget target of 3½ percent. Developments since the framework was issued, including the continued buoyancy of revenues and proposed tax reforms that will be discussed by Parliament late this year, suggest that the MTBF will need to be revised to serve as a useful guide for policy. The team urged the authorities to ground the medium-term framework and their tax reform proposals within the context of the overall fiscal allocation priorities. Taking into account the projected deterioration in the terms of trade, an overall fiscal deficit of no more than 3-3¼ percent of GDP would be appropriate from 2006 onward. This would be consistent with a steady decline in the stock of net credit to government and the ratio of public debt to GDP, while allowing room for concessionally financed capital spendings that will be critical for sustained growth.

22. **The staff encouraged the authorities to implement spending reforms in line with the recommendations of a recent FAD technical assistance mission** (Annex VII). Civil service and pension reform, combining employment and compensation reviews, was the main area where efficiency gains and savings could be generated. Key actions included enhancing the pension system's sustainability by raising the retirement age, phasing in a notional defined contribution system, eliminating overlapping family benefits, consolidating public tertiary education institutions, and eliminating public health services of a purely private nature. The wage bill could be contained by a partial hiring freeze to reduce excess support staff, and limiting increases in real wages of support staff.

23. **The authorities expressed willingness to improve their fiscal allocation priorities but progress is likely to be slow.** The Minister of Finance explained that containing the wage bill would focus on eliminating unnecessary positions—at present there was not even a proper count of staffing—while a working group was reviewing hiring and wage levels. The government would also consider proposals from the Ministry of Social Assistance to restore the long-run viability of the pension system and improve the targeting of social benefits programs. While accepting that recent changes broadening the scope of the child money scheme were costly, the authorities were considering a plan to target the payments through applying additional criteria. As regards other spending initiatives, the mission expressed concern about proposals to build 40,000 housing units, financed by very large nonconcessional foreign loans that would require public guarantees or servicing.

24. **On the tax side, the government's chief medium-term focus is on easing the burden of taxation on the private sector and promoting investment-led growth.** Many proposals have been floated that, taken together, could cause substantial revenue losses, reduce the efficiency of tax system, increase income inequality among taxpayers, and worsen the business environment. With a view to simplification, consideration had been given to flat rate proposals that would lower the top rates of both corporate (CIT) and personal (PIT) income taxes while gradually reducing the rate of VAT. At the same time, there are strong pressures to capture more of the benefits of the mining boom through taxes and charges.

25. **The mission argued that a comprehensive, broadly revenue neutral tax reform package, along the main lines recommended by FAD's recent tax policy mission would contribute to these goals.** The mission recommended: removing exemptions; unifying the CIT at 25 percent, in two phases; removing restrictions on legitimate business expenses, and providing for loss carry forward; introducing a cost effective system of tax incentives based on investment tax credits; reducing the cascading under the VAT; increasing the threshold of PIT; introducing taxes on domestic beer and telecommunication services, and increasing the excises on cars to offset revenue losses from these measures. On mining taxation, the team noted that raising royalties to levels well above industry standards as some had suggested would jeopardize the investment climate in this critical sector and urged caution—a World Bank team was providing technical assistance in this area.

26. **After several revisions, the government's latest plans sought to avoid the pitfalls of some of the earlier proposals** although parliament may make further changes when they debate the package during the autumn session. The staff supported the authorities' intention to increase the PIT threshold, allow legitimate expenses in computing taxable income under the CIT, and replace cost ineffective tax holidays with tax credits. The authorities were encouraged to (i) unify the CIT rate nearer the top rate; (ii) amend provisions for loss carry forward; (iii) improve the VAT refund system; and (iv) eliminate remaining non-standard VAT exemptions.

27. **The government continues to implement its plans for further improvements in public financial management.** With support from the World Bank, the government has implemented a fully integrated Government Financial Management Information System that

in time will allow much improved fiscal reporting and control over funds. The staff welcomed these developments, as this and other measures should contribute to improving transparency along the lines recommended in the recently published ROSC update on fiscal transparency.[8] However, the team expressed concern that, while the introduction of the Treasury Single Account (TSA) in 2003 allowed better tracking and transparency in the management of government funds, there has been a sharp increase in balances held outside the TSA, in commercial banks, since mid-2004 when the BOM ceased paying interest on these balances. Thus, the staff argued that budgetary discipline is threatened by the increased autonomy of entities collecting revenues to supplement their appropriations, and urged the authorities to reverse these trends. The authorities noted that the question of interest earned on such deposits would have to be resolved before agencies could be compelled to bring their accounts under the TSA. Plans are also being discussed with the World Bank to improve procurement procedures.

B. Monetary and Exchange Rate Policies

28. **The team took the view that the authorities' medium-term inflation objectives were at risk if they did not withdraw the ongoing monetary stimulus.** The Monetary Policy Guidelines' (MPG) main monetary target for 2005—restraining the growth of reserve money to 15 percent—remained appropriate. In the short run, given the supply-side contributions to price shocks, it was unlikely that inflation can be brought down below 10 percent, well above the MPG target 5 percent. The main concern, looking forward, was that by continuing to accommodate the second-round effects of various real shocks, the lack of monetary policy action would only allow the inflation process to intensify further. The staff recommended that BOM tighten the monetary stance through indirect instruments to meet the MPG target.

29. **Operationally, the onus of monetary tightening rests predominantly on the BOM's issues of Central Bank Bills (CBBs).** To mop up the excess liquidity, the BOM needs to increase the stock of CBBs from Tg. 69 billion at end-2004 to about Tg. 95 billion by end-2005, which would also raise yields. The yields on CBBs declined sharply in early 2005—the discount rate on two-week CBBs was 3-4 percent at end April, down from nearly 16 percent in December 2004. Commercial bank interest rates would likely remain close to their current relatively high levels—23 percent for lending rates, and an average of 13 percent of deposit rates—as earlier these rates did not drop in line with the CBB rates.

30. **Other tools for achieving a tighter stance are available, if needed.** The team supported a transfer of treasury funds now in commercial banks back to the government's BOM account to help tighten liquidity. The team argued that other possible measures, such as increases in reserve requirement, should only be considered once the BOM has exhausted its policy room with its main current instrument, the issuance by open tender of CBBs. This

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[8] See IMF Country Report 05/170, Mongolia ROSC on Fiscal Transparency Update.

said, the team noted that the BOM might re-examine the effectiveness of its instruments and operational procedures, possibly with assistance from the Fund's MFD experts.

31. **Although arguing that the current bout of inflation was fundamentally a supply phenomenon, the BOM recognized the need to tighten the monetary stance through issuing additional CBBs.** However, the BOM is concerned about losses, and called on the government to offset the cost of the monetary operations by paying interest on the remaining $90 million balance of the loan that financed the Russian debt settlement. The team supported this position, also calling on the BOM to pay suitable interest on all government deposits held with them—reducing the incentive for budget agencies to keep their holdings in commercial banks.

32. **The authorities stressed their commitment to the flexible exchange rate policy, with interventions limited to smoothing high-frequency fluctuations in the foreign exchange market and the acquisition of reserves.** Given the low level of short-term debt, the team noted that international reserve levels were broadly adequate (2½–3 months of imports). Looking forward, it was clear that new shocks were in store, both favorable (new mining prospects) and unfavorable (additional increases in oil prices). If favorable shocks predominated, allowing the togrog to appreciate would help contain overheating pressures, while if negative shocks did, nominal depreciation would facilitate the adjustment process. In either case, the amplitude of medium-term movements to be expected in the bilateral and effective exchange rates might well be higher than that observed over the last two years.

C. Financial Sector Policies

BOM Governance

33. **The BOM reported incurring significant losses in 2005 and the interest cost of CBBs has made the BOM hesitant to issue them in adequate volume.** In addition, in the team's view, dealing with its financial problems is bound to distract the BOM's senior management from what should be its core focus, monetary policy and banking supervision. The staff argued for a comprehensive approach to dealing with losses. The full extent of the losses should be assessed, the legal framework reviewed to establish the obligations of the Ministry of Finance and BOM in the event that the net worth of the Bank falls below best-practice norms, and a plan submitted to Parliament to strengthen BOM finances and governance in the medium term.

34. **Ministers and the BOM concurred with the mission on the need to strengthen the BOM's financial position and governance.** They also acknowledged that no concrete steps had been taken so far to address the likely breaches of the Central Bank Law (CBL) identified in the audit reports of the BOM's accounts for 2003 and 2004. These include government borrowing in excess of statutory limits, unauthorized lending to the private sector, premature transfers of profits to the Budget, and poor international reserve management practices. The authorities agreed with the Supervisory Board's suggestion that its role should be strengthened, with its reports more widely disseminated to Parliament.

35. **The BOM recognized that its own-account trading and intermediary gold operations were unconventional for a central bank, but stated that until the private sector took over this role, the BOM would continue.** In line with earlier Safeguards Assessment recommendations, the mission stressed that such gold operations, including futures and derivatives, represent highly risky investment for its reserves, thus weakening the governance of the BOM. Nevertheless, the BOM felt that the trading operations provided a critical service to Mongolian gold producers while their officials were experienced and highly competent in conducting futures and derivative operations backed by monetary gold.

Commercial banks, Nonbank Financial Institutions (NBFIs) and Savings Cooperatives

36. **The team, together with an overlapping technical assistance mission from MFD, argued that the vulnerability of the banking sector continues to be cause for concern.** NPLs (including overdue loans) have increased during the past 12 months, with a ratio of NPLs to total loans rising to more than 11 percent. Furthermore, the prospect of one or more banks getting into serious difficulty in the relatively near future cannot be ruled out. Indicators of bank profitability have also deteriorated in recent times. The conjunction of even limited bank default and macroeconomic shocks would thus create an environment ripe for a confidence crisis to damage the banking system.

37. **The BOM recognized that some banks could get into serious difficulty but believed that there was no systemic risk.** The Bank has improved supervision in many areas, particularly strengthening of requirements for identification and provisioning of NPLs, and its requirements, fully enforced, for a higher capital base. Clearly, however, a deepening of bank problems called for continued strengthening of banking supervision, avoidance of regulatory forbearance, and an improvement of corporate governance of banks. The MFD team also recommended that the BOM prepare detailed contingency plans to deal with a systemic banking crisis, including consultations with other interested parties as necessary; that it take more targeted actions against problem banks, including intensifying on-site examination; and encourage, or even require, problem banks to engage in management advisory contracts, preferably with experienced banks.

38. **The BOM acknowledged that its supervision could have been more effective, and that breaches of banking laws were incurred, in the case of three banks involved in the issuance of a large amount in L/Cs.** These events, in the staff's views, exemplify the continued need to improve bank governance and management quality, and supervision effectiveness. There are issues about the validity of these L/Cs. Nevertheless, the potential for bank failure, if legal judgments are held against any of these three banks, remains significant, as the L/C amounts in dispute are very large relative to these banks' capital or assets. The BOM agreed that it should stand ready to take strong action toward the banks themselves in the event of default arising from a negative judgment, but it was non-committal on the staff's view that it should also take action against the management of these banks. Following the MFD team's recommendation, the BOM intends to carry out an in-depth check for similar transactions for the whole banking system, and review its own procedures to prevent a recurrence of this problem.

39. **The mission also discussed ways for the Ministry of Finance and BOM to extend current collaborative efforts in the strengthening of the regulatory and supervision of credit and savings cooperatives (CSCs).** CSCs continue to be largely unregulated, yet advertise for deposits despite existing prohibitions, with risks of spillovers to the banking system, even though their aggregate size remains small. Proposals for a regulatory framework (including powers of supervision and prudential standards) will be submitted to Parliament in the fall of 2005. The authorities acknowledged that the key would be to provide adequate resources to establish the agency vested with supervisory powers over CSCs. Consideration is being given to a supervision agency to cover the whole non-bank financial sector.

D. External Policies—Debt and Trade

External Debt Management and Debt Sustainability Analysis

40. **The authorities agreed with the staff's macroeconomic assumptions and main findings of the debt sustainability analysis (DSA).**[9] They concurred with the DSA's conclusions that a strict continuation of the government's current external borrowing policy––relying only on concessional external borrowing or grants—was called for, and acknowledged the need to resist pressures to enter into agreements that involve nontransparent negotiation and procurement procedures. The team also underscored the critical need for improved debt management, and welcomed the tracking by Ministry of Finance debt management staff of the same debt indicators as used by the DSA, as well as plans to inform the Parliament on debt management and its importance.

41. **The mission urged the authorities to finalize the negotiations on clearing existing overdue debts to bilateral creditors and continue to avoid any new arrears.** Although negotiations have taken place with the Russian authorities to resolve the accumulating arrears of post-1991 Russian debt (US$10 million as of end-2004), a formal agreement has yet to be reached; moreover long-standing restructuring and rescheduling negotiations with Italy (US$13 million) have yet to reach conclusion.[10]

Trade Policy

42. **A recent Trade Policy Review (TPR) by the World Trade Organization (WTO) confirmed that Mongolia maintains a generally open trade regime,** with a low uniform level of import tariff, limited non-tariff barriers, and only a few, small export taxes. At the

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[9] The draft DSA was prepared jointly with the World Bank, in accordance with the procedures for low-income country DSA, approved by the two Executive Boards.

[10] A debt to Finland (US$9 million) also remains unresolved. The authorities do not regard this as in arrears because they are still ready to provide meat as payment, as earlier agreed.

same time, the trade regime is under political pressure, and the TPR cautioned the authorities against protectionist pressures that are emerging especially in the food, drink and cashmere processing sectors. The authorities noted that the liberalization process had not been painless to some sectors. In addition to proposals for selective duty increases that were floated during tax reform debates, there are also proposals for new export tariffs, especially on mineral products and raw cashmere. The mission argued that even while these proposals were not inconsistent with WTO commitments, they should be resisted. New minerals export taxes would clearly hurt prospects for mining sector investment, FDI and growth, while the proposed tax on raw cashmere exports could lead to the loss of income to the herders or increased smuggling.

43. **Changes in the international trade regime have had only a modest impact on Mongolia, although the recent lifting of quota under the ATC has hurt the small garment sector**. The authorities did not think Mongolia had been affected by the increasing numbers of bilateral or regional free trade agreements, as its major trading partners are large, neighboring countries. However, the government has approached the United States and the European Union to obtain a favorable bilateral treatment, especially in the face of the (still evolving) removal of quotas on garment imports into those markets. Mongolia could seek to obtain from its trading partners greater access, in such markets as meat, where sanitary regulation has sometimes been an impeding factor.

E. Poverty Reduction Strategy

44. **After some delay, the authorities have completed a progress report of the Economic Growth Support Poverty Reduction Strategy formulated in 2003.**[11] This progress report reaffirms the approach of the earlier document published by the previous administration, focusing on ways to enhance broad-based growth while embracing the pursuit of the Millennium Development Goals. Progress on achieving those goals has been limited (Annex I). Jointly with the World Bank staff and other donors, the team discussed with the authors areas in which assistance could be given to help enhance the priority setting and costing of the various initiatives outlined in the EGSPRS. The discussion was in the context of one broad framework that could replace the various action plans and guidelines currently available, as well as improving poverty monitoring.

F. Ex Post Assessment of Program Engagement, 1991–2005

45. **The EPA team concluded that overall program design for macroeconomic policies for the SBA and three structural programs supported by the Fund had generally been appropriate.** The level of intended financing provided by the Fund was adequate, given the large amounts of other donor support. Even though the arrangements

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[11] The progress report and accompanying Joint Staff Advisory Note are being separately circulated to the Executive Board for information.

were frequently delayed and incomplete, the level of official grants and lending from the international development banks and bilateral donors was generally as projected and constant. However, because of the steady flow of concessional financing, external debt had been allowed to rise to levels threatening sustainability.

46. **The programs differed in their emphasis, in line with evolving stages of transition and the need to address emerging challenges but were unable to be completed.** There remained a large part of the structural agenda unfinished, with the financial sector still weak, public enterprises in need of further restructuring or privatization, and the poverty reduction goals yet unrealized. Part of the failure to complete the arrangements could be linked to country ownership of the process not being fully sustained, undermined by frequent elections and government changes.

47. **The EPA team saw a strong case for a continued close policy dialogue between the Fund and the Mongolian authorities, backed if possible by a low access financial arrangement.** Macroeconomic stability remained fragile, tax and expenditure reforms needed to be further enhanced, and the financial sector strengthened—all areas of Fund expertise. The current strength of the economy and external prospects indicated that there was some time to build up both a track record of adherence to prudent macroeconomic policies and cautious structural reform and to build a consensus among the various political parties and civil society for major reforms of key institutions and governance.

48. **The authorities agreed with the broad conclusions of the EPA report and endorsed the concept of having broad multiparty backing for any future Fund-supported program.** Looking at the period since 1991, they felt the policies had achieved the main objectives despite difficult conditions. Addressing the issue of sustained ownership, the authorities thought that there were two key factors. First, the politicized society that meant continuity was difficult as politicians sought to attract votes. Second, government control over implementation had been poor. Thus, they sought focused programs that concentrated on timely actions. On the build up of external debt, it was noted that there had been a lack of linkage between foreign-financed projects and the longer term fiscal implications. In that regard, the Deputy Prime Minister favored foreign direct investment as a vehicle for future development wherever possible. In terms of the possible scope of any future Fund arrangement, the authorities agreed that poverty reduction and job creation was important, with strengthening of the financial sector and fiscal operations as key conditions—including a fully agreed and integrated medium term budget framework.

G. Other Issues

49. **Public enterprise reform and privatization appear to have stalled but the government was looking to make progress.** The authorities did not view the recent slowdown as indicating a shift in political support for continued transition to a market economy, and were confident that the momentum could be regained soon. The next 3-year privatization program includes key enterprises in sectors designated as strategic, such as cashmere processing, banking, and energy. In the energy sector, there was recognition at all

levels of government of the need to secure more energy supply with the involvement of the state and private sector. Guidelines for privatizing power plants, distribution and transmission networks had been submitted to Parliament. However, there was public opposition to efforts to adjust tariffs needed to enhance the financial viability of the enterprises.

50. **The authorities agreed that a forceful move on as broad a front as possible to improve public sector governance would be beneficial.** As earlier discussed, improvement of BOM governance would be a priority and the settlement of the Russian debt revealed a need to ensure accountability of government operations. In addition, the Extractive Industries Transparency Initiative, the envisaged new anti-corruption law (instituting income disclosure requirements on senior officials), adoption and implementation of Anti-Money Laundering and Combating the Financing of Terrorism (AML-CFT) law, and legal and judicial reforms could all contribute to achieve gains.[12] The staff also pointed out that the business community would welcome transparency of the operations of the tax and customs administration.

51. **Although Mongolia produces a wide range of statistics, the authorities recognized there remain a number of weaknesses in key economic data.** Some progress has been made in developing a national accounts framework, but the authorities welcomed assistance to improve the quality of GDP estimates and to develop a producer price index. The authorities noted the quality of fiscal data could be further improved with the introduction of the chart of accounts. Despite the improvement in the coverage of the BOP, further upgrading was needed, particularly on data on remittances of migrant workers abroad and foreign direct investment, and further technical assistance would be useful.

III. Staff Appraisal

52. **Medium-term prospects are broadly favorable, provided the authorities manage to slow inflation back to a single digit and sustain supportive fiscal policies.** Growth is expected to settle around the 5 percent range, with a return to trend growth for the livestock sector. The gradual coming on stream of a series of mid-size mining projects is projected to sustain a stable pace of extraction. With appropriate policy action, mainly on the monetary side, inflation should slow down, to about 10 percent year-on-year at end 2005, returning to a 5 percent trend in 2006.

53. **The balance of risks to growth appears broadly even.** Susceptible to a more pronounced decline in copper prices than currently anticipated, Mongolia also remains vulnerable to large weather shocks. Additional risks to the outlook lie on the policy front, especially on fiscal policies. As in the past, pressures for measures that could derail the fiscal

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[12] The authorities need to ensure that a comprehensive AML-CFT law that conforms to international standards is enacted.

stance remain intense. On the other hand, there is potential for a very large increase in mineral extraction that could transform the economy significantly.

54. **With the external environment expected to remain strong in 2005, the staff supports the authorities' aim to keep the overall deficit to 2 percent of GDP, 1½ percentage points less than in the budget.** At a time when inflationary pressures are high, when the strong economy has no need for additional stimulus, and when current account prospects are weakening, this policy stance is appropriate, making a positive contribution to macroeconomic stability. The lower deficit target will require that the authorities avoid expenditure slippage from the approved budget, and save additional revenues arising from temporarily favorable macroeconomic factors.

55. **For 2006 and beyond, the direction of the fiscal stance should be broadly neutral, provided inflationary pressures have subsided.** Some small widening of the overall fiscal deficit to about 3–3¼ percent of GDP from 2006 would be appropriate as the terms of trade gains unwind. Taking advantage of the revenue windfall, this deficit would be considerably lower than that envisaged at the time of the PRGF review. Net domestic borrowing would continue to be significantly negative, and public debt would decline in GDP terms, even while financing infrastructure improvements critical for growth.

56. **The staff urges the authorities to resist seeking short-term advantage through tax giveaways,** focusing rather on eliminating the distortions in the current income taxes and VAT. Similarly, they should avoid inappropriate spending increases—such as large pay rises in the absence of staffing reforms, and general increases in social transfer programs—or engaging in large infrastructure projects with limited rates of return. The staff welcomes the intention to reform the civil service and pension system, but notes that such changes will need perseverance if past failures are not to be repeated.

57. **In the longer term, Mongolia's public debt is seen as sustainable but vulnerable to extreme terms of trade shocks.** With aid from bilaterals, the AsDB and the World Bank at favorable terms, the resulting debt dynamics are consistent with sustainability. In the staff's view, although the debt to GDP ratio is above the sustainability threshold for low-income countries in the same category of policy performance ratings and would remain above for some time to come, the strong export and revenue base is important. Thus, the NPV of debt to exports and to revenues remain significantly below sustainability thresholds, although an extreme permanent drop in mineral prices could undermine the position.

58. **In this context, the staff advises against loan agreements that entail nonconcessional terms and/or implicit or explicit government guarantees.** Nonconcessional external borrowing by the public sector on such a large scale as suggested would threaten external sustainability, while raising governance concerns. Any loans should also adhere strictly to the regulations relating to government borrowing and guarantees.

59. **Plans for further improvements in public financial management should be implemented vigorously, to ensure a tight control over public finance and to improve**

transparency. The government's Government Financial Management Information System is an ambitious undertaking that in time will allow much improved fiscal reporting and control over funds. All budget resources should be consolidated in the treasury single account. This and other measures should contribute to improving transparency.

60. **A tighter monetary stance is essential to tame inflationary pressures.** In this respect, the staff looks forward to a resumption of central bank bill issues in the remaining months of 2005 that can provide the basis for achieving the central bank's target growth for reserve money and help prevent the current supply-driven price increases from being embedded in persistent double-digit inflation.

61. **For a commodity exporter like Mongolia, a flexible exchange rate regime remains appropriate, and the government should resist demand for trade-based measures to support sectors hit by shocks.** A flexible exchange rate, with interventions limited to smoothing high-frequency fluctuations in the foreign exchange market, provides a guard against erosion of competitiveness. In the expected environment of continued temporary high mineral prices, the authorities are urged to save some of the windfall gains through some further reserve build up. The authorities are to be commended for their position so far to resist undermining the open trading system.

62. **Further progress to improve the health of the financial system and the strength of the central bank is essential, building on the progress made in recent years.** There is concern that high credit growth may mask the underlying fragility of some banks' positions, and the problems of regulatory forbearance. In the face of indications that some banks are weakening, the BOM needs to take forceful corrective actions, to tighten supervision and strictly enforce prudential norms, including those requiring painful adjustments for individual financial institutions. Signs of problems in the non-bank financial sector should be tackled vigorously. While savings cooperatives remain small, some may be running into difficulties and the consolidated non-bank financial watchdog agency proposed by the authorities would be welcome. The staff encourages the authorities to finalize drafting laws for Anti-Money Laundering and Combating the Financing of Terrorism.

63. **To address issues of governance at the BOM, the staff urges the authorities to resolve the capital weakness of the BOM and improve the decision-making structure.** An enhanced supervisory board with direct access to parliament could assist in providing oversight. It would also be advisable that the BOM move away from intermediation operations in gold, in particular with respect to derivative transactions. If it is necessary for such functions to remain within the public domain, they should be carved out into an agency that is legally and operationally separate from the central bank.

64. **Restructuring of public enterprises remains a priority.** This can be done through both improving the governance of enterprises intended to remain in the public sector as well as resuming the privatization program. In particular, the energy sector would benefit from efforts to revamp its operations and ensure additional electricity supply in the longer term.

65. **The staff urges the authorities to use the current strong external environment to provide the fiscal space to consolidate debt sustainability, while resuming a strong structural program to ensure progress in tackling outstanding poverty and growth issues.** Combined with early action to address the governance weaknesses in the BOM as well as normalizing links with the government, such steps could provide the basis for a resumption of Fund program support. It would also be important that the highest standard of transparency and accounting be applied to any large-scale loan operation or settlement such that the population can take full confidence in the process.

66. **The authorities are also encouraged to improve the quality and coverage of fiscal statistics** and address the priority issues for the national accounts and balance of payments. The government-wide chart of accounts will help resolve the technical issues for the fiscal data. The authorities are urged also to focus on improved poverty indicators to assist their work on the MDGs.

67. **It is recommended that Mongolia be on a 12-month consultation cycle.** The authorities have indicated that they, in principle, would consent to the publication of the staff report.

Table 1. Mongolia: Selected Economic and Financial Indicators, 2002–06

Nominal GDP (2003): $1,274 million
Population (2003): 2.47 million
Per capita GDP (2003): $516
Poverty incidence: 36 percent. 1/
Quota: SDR 51.1 million

	2002 Act.	2003 Act. 2/	2004 Est.	2005 Proj. 3/	2006 Proj.
			(Percent change)		
Real GDP	4.0	5.6	10.6	5.0	6.0
Consumer prices (end period)	1.7	4.7	10.6	10.0	5.5
			(In percent of GDP)		
General government revenue	38.4	37.9	39.4	39.1	37.4
General government expenditure	44.4	42.1	41.7	41.0	40.4
Current balance	4.4	7.6	9.2	9.3	7.4
Primary balance	-4.3	-3.0	-1.0	-0.7	-2.0
Overall balance	-5.9	-4.2	-2.2	-1.8	-3.0
Net domestic bank credit to government	-2.2	9.5	-3.2	-4.2	-2.6
Total public debt 4/ 5/	91.7	113.9	99.0	88.0	86.5
NPV of total public debt 4/ 5/ 6/	62.7	80.2	60.2	55.3	53.4
Domestic debt	3.0	14.9	8.1	3.2	0.5
			(Percent change)		
Net foreign assets	40.1	-24.9	22.0	39.9	...
Net domestic assets	45.4	191.6	19.5	13.4	...
Domestic credit	43.2	147.0	23.0	10.0	...
Broad money	41.9	49.7	20.3	19.3	...
Reserve money	21.7	14.7	16.8	14.3	...
Broad money velocity (GDP/BM) 7/	2.6	2.1	2.1	2.0	...
Annual interest rate on central bank bills (percent) 8/	8.0	15.0	15.8	...	...
			(In millions of US dollars; unless otherwise indicated)		
Current account balance, including official transfers 9/	-108	-99	18	-37	-83
(In percent of GDP)	-9.6	-7.7	1.2	-2.2	-4.6
Trade balance	-229	-199	-149	-206	-267
(In percent of GDP)	-20.5	-15.6	-9.8	-12.0	-14.9
Exports, fob	524	627	872	914	883
(Percent change)	3.2	19.7	39.0	4.9	-3.5
Of which: Gold	118	157	240	272	290
Copper	140	162	284	308	268
Imports, cif	753	827	1,021	1,120	1,150
(Percent change)	8.6	9.8	23.5	9.7	2.7
Financial and capital account balance 9/	174	1	11	101	89
Foreign Direct Investment	78	132	93	110	115
Gross official international reserves (end-period) 10/	271	178	205	268	269
(In months of next year/projected imports c.i.f.)	3.9	2.1	2.2	2.8	2.7
Public and publicly guaranteed external debt 4/	978	1,237	1,360	1,417	1,511
(In percent of GDP)	88.7	99.1	90.9	84.8	86.0
NPV of public and publicly guaranteed external debt 4/ 5/ 6/	658	816	822	871	930
(In percent of GDP)	59.7	65.3	54.9	52.1	52.9
(In percent of exports of goods & services)	92.9	97.7	67.9	68.1	73.3
Debt service	32.0	284.0	91.1	47.6	44.3
(In percent of exports of goods & services)	4.5	34.0	7.5	3.7	3.5
Exchange rate					
Togrogs per US dollar (end of period)	1,125	1,170	1,209	...	...
Trade prices					
Export prices (U.S. dollar, percent change)	-4.7	6.6	23.1	5.1	-4.3
Import prices (U.S. dollar, percent change)	2.3	5.4	15.1	10.0	0.2
Nominal GDP (billion togrogs)	1,241	1,461	1,808	2,060	2,248
Nominal GDP (million U.S. dollars)	1,118	1,274	1,516	1,717	1,790

Sources: Mongolian authorities; and Fund staff estimates and projections.

1/ Share of households below national poverty line, 2003 Household Income and Expenditure Survey
2/ The outturn for 2003 reflects the impact on fiscal, monetary and external accounts of the $250 million settlement of the TR debt.
3/ Projection based on latest WEO assumptions. Overall fiscal deficit differs from budget target of 3.4 percent of GDP.
Monetary figures are projected based on the authorities' 2005 monetary policy guideline.
4/ Includes IMF loans, guarantees and arrears.
5/ Includes treasury bills outstanding, and gross claims of the BoM on the government.
6/ Calculated based on 5 percent discount rate from 2004 onwards.
7/ Seasonally adjusted figures for broad money velocity.
8/ Annualized yield on end-period auction of 14-day bills.
9/ From 2004 onwards, revised estimates for remittances in the current account, offset by adjustments mainly in capital account.
10/ Beginning December 2000, includes commercial banks' foreign exchange deposits with the Bank of Mongolia.

Table 2: Mongolia- Summary Operations of the General Government, 2001-2006

	2001	2002	2003	2004	2005		2006
	Actual	Actual	Actual	Actual	Budget	Proj.	Proj.
			(In billions of togrogs)				
Total revenue and grants	429.5	477.0	553.9	713.1	738.9	806.1	839.9
Total expenditure and net lending	489.7	550.5	615.8	753.7	806.8	843.7	908.2
Overall balance (incl. grants)	-60.2	-73.4	-61.9	-40.6	-67.8	-37.6	-68.3
Financing	60.2	73.4	61.9	40.6	67.8	37.6	68.3
Foreign financing	72.8	81.8	-115.8	68.1	134.1	132.4	119.6
Domestic financing	-12.6	-8.3	177.7	-27.6	-66.2	-94.9	-51.3
			(In percent of GDP)				
Total revenue and grants	38.5	38.4	37.9	39.4	35.9	39.1	37.4
Current revenue	37.7	37.9	37.3	39.1	35.7	38.9	37.1
Tax revenue and social security contributions	29.4	28.9	28.8	32.3	29.7	31.8	30.3
Income taxes	5.8	5.8	6.7	8.0	6.5	7.9	6.0
Enterprise income tax	3.9	3.7	4.7	5.5	4.2	5.4	4.2
Personal income tax	1.9	2.1	2.0	2.5	2.3	2.6	1.8
Social security contributions	4.8	4.4	4.5	4.5	4.2	4.5	4.5
Sales tax and VAT	9.3	9.6	8.3	9.0	8.4	8.9	8.9
Excise taxes	4.8	4.1	4.0	3.9	4.5	3.7	4.1
Customs duties and export taxes	2.4	2.0	2.2	2.5	2.2	2.4	2.4
Other taxes	2.3	3.0	3.1	4.4	3.9	4.4	4.4
Nontax revenue	8.2	8.9	8.5	6.8	6.0	7.1	6.7
Capital revenue and grants	0.8	0.6	0.6	0.4	0.1	0.2	0.3
Total expenditure and net lending	43.9	44.4	42.1	41.7	39.2	41.0	40.4
Current expenditure	32.9	33.5	29.8	29.9	28.7	29.6	29.6
Wages and salaries	8.3	8.5	8.0	7.7	7.5	7.5	7.4
Purchase of goods and services	14.6	14.6	12.0	12.0	10.1	11.7	11.4
Subsidies to public enterprises	0.5	0.7	0.6	0.6	0.4	0.5	0.5
Transfers	8.0	8.2	7.9	8.2	8.9	8.9	9.0
Interest payments	1.5	1.6	1.2	1.3	1.4	1.1	1.0
Contingency allocation	…	...	...	...	0.4	0.0	0.4
Capital expenditure and net lending	11.0	10.9	12.4	11.8	10.5	11.4	10.8
Capital expenditure	5.3	5.5	6.2	5.8	4.8	5.4	5.4
Domestically-financed	4.4	4.2	4.6	4.6	3.6	4.2	4.2
Foreign-financed	0.9	1.3	1.6	1.2	1.2	1.2	1.2
Net lending	5.7	5.4	6.2	6.0	5.7	6.0	5.4
On-lent foreign project loans (net)	5.3	5.4	5.8	5.9	5.9	5.8	5.3
Domestic lending minus repayments	0.5	0.1	0.4	0.2	-0.1	0.2	0.2
Current balance (excl. privatization receipts)	4.8	4.4	7.6	9.2	7.1	9.3	7.4
Primary Balance	-3.9	-4.3	-3.0	-1.0	-1.9	-0.7	-2.0
Overall balance (incl. grants)	-5.4	-5.9	-4.2	-2.2	-3.3	-1.8	-3.0
Financing	5.4	5.9	4.2	2.2	3.3	1.8	3.0
Foreign Financing (net)	6.5	6.6	-7.9	3.8	6.5	6.4	5.3
Project loans	6.2	6.5	7.3	7.1	7.0	7.0	6.4
Program loans	2.1	1.3	1.9	1.5	1.0	0.0	0.0
Short term external debt	0.0	0.0	4.0	-3.3	0.0	0.7	0.0
Amortization	1.8	1.2	21.1	1.5	1.5	1.2	1.1
Arrears	0.0	0.0	0.0	0.7	…	-0.7	…
Privatization receipts	0.5	1.4	1.5	0.9	0.7	0.1	0.4
Domestic Bank Financing (net)	-1.7	-2.2	9.5	-3.2	-3.9	-4.2	-2.6
Domestic Non-Bank Financing (net)	0.0	0.2	1.2	0.1	0.0	0.2	-0.1
Memoranda items:							
Total public debt (incl. IMF)/GDP	89.1	91.7	113.9	99.0	88.3	88.0	86.5
Foreign debt (incl. IMF)/GDP	84.3	88.7	99.1	90.9	84.8	84.8	86.0
Domestic debt/GDP	4.8	3.0	14.9	8.1	3.5	3.2	0.5
NPV of total public debt	62.8	62.7	80.2	60.2	55.6	55.3	53.4
Nominal GDP	1,116	1,241	1,461	1,808	2,060	2,060	2,247

Sources: Ministry of Finance; and Fund staff estimates and projections.

Table 3. Mongolia: Monetary Aggregates 2001–05

	2001	2002	2003	2004				2005	
	Dec.	Dec.	Dec.	Mar.	June	Sept.	Dec.	Mar.	June
Monetary survey				(In billions of togrogs)					
Broad Money	331	470	704	740	812	827	846	892	1,009
Currency	109	121	131	140	170	163	144	133	177
Deposits	222	349	572	600	642	664	703	760	832
Net foreign assets	220	308	232	242	242	266	283	330	376
Net international reserves	227	322	278	288	294	318	294	342	388
Bank of Mongolia	176	254	151	176	183	185	198	222	252
Commercial banks	51	68	128	112	110	133	96	120	136
Other foreign assets, net	-7	-13	-47	-46	-52	-52	-11	-12	-12
Net domestic assets	111	162	472	498	570	561	564	562	633
Domestic credit	170	243	601	640	681	708	740	747	804
Net credit to government 1/	31	7	152	131	114	98	94	65	48
Claims on nonbanks	139	236	449	509	567	610	646	682	756
Of which:									
Claims on public enterprises	10	12	16	15	14	13	13	14	22
Claims on the private sector	115	204	390	442	495	511	552	581	646
Nonperforming loans	11	17	37	42	49	76	71	76	76
Other items, net	-59	-82	-129	-142	-111	-147	-176	-185	-172
Monetary authorities									
Reserve money	144	175	201	229	245	255	235	253	296
Net foreign assets	177	254	151	176	183	189	199	224	253
Net international reserves	176	254	151	176	183	185	198	222	252
Other assets, net	0	0	0	0	0	3	1	1	1
Net domestic assets	-32	-79	50	53	62	67	36	30	42
Net credit to government	35	6	128	101	100	98	106	84	87
Claims on deposit money banks	7	8	13	19	16	22	22	22	19
Claims on nonbanks	1	1	1	0	0	0	0	0	0
Minus: Central bank bills (net)	50	61	76	60	73	46	69	70	82
Other items, net	-26	-33	-15	-8	19	-6	-23	-7	17
Memoranda items:					(In percent)				
Annual broad money growth	28.0	41.9	49.7	46.8	45.5	35.7	20.3	20.6	24.3
Annual growth of credit to nonbanks 2/	101.5	70.4	90.3	77.9	70.3	69.5	43.7	34.1	33.3
Annual reserve money growth	8.4	21.7	14.7	26.5	25.6	15.2	16.8	10.5	20.4
					(Ratio)				
Money multiplier, seasonally adjusted									
Velocity (Annual GDP/BM)	3.4	2.6	2.1	2.4	2.2	2.2	2.1	2.4	2.1
Velocity, seasonally adjusted	3.4	2.6	2.1	2.5	2.2	2.2	2.1	2.4	2.0
Broad money/reserve money	2.3	2.7	3.5	3.2	3.3	3.2	3.6	3.5	3.4
Nonperforming loans/total loans (%)	7.8	7.0	8.2	8.3	8.6	12.4	10.9	11.2	10.0
NIR of the BOM (million, U.S. dollar)	160.0	225.7	129.0	149.7	156.1	153.9	163.5	186.4	211.4

Sources: Mongolian authorities; and Fund staff estimates and projections.

1/ Valued at actual exchange rates and gold price.
2/ Includes nonperforming loans.

Table 4. Mongolia: Balance of Payments, 2001–10

(In millions of US dollars, unless indicated otherwise)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Act.	Act.	Act.	Est.	Projections					
Current account balance (including official grants)	-77	-108	-99	18	-37	-83	-80	-86	-90	-102
Trade balance	-170	-229	-199	-149	-206	-267	-279	-286	-295	-313
Exports, f.o.b.	523	524	627	872	914	883	897	923	962	1,001
Copper	147	140	162	284	308	268	238	218	208	199
Gold	75	118	157	240	272	290	319	350	379	402
Imports, c.i.f.	-693	-753	-827	-1,021	-1,120	-1,150	-1,177	-1,209	-1,258	-1,315
Services, net	-22	-12	-49	-60	-56	-58	-62	-66	-70	-75
Receipts	114	185	208	338	364	385	406	429	452	478
Payments	-136	-196	-257	-398	-420	-442	-468	-494	-522	-553
Income, net	3	-5	-12	-41	-48	-50	-47	-53	-54	-55
Official med- and long-term interest payments	-9	-11	-12	-15	-17	-17	-18	-19	-19	-20
Private transfers, net	25	64	74	146	158	167	176	185	194	204
Official grants	72	53	49	87	85	88	92	94	96	98
Other grants	15	20	38	36	30	36	40	40	40	40
Financial and capital account	79	145	-30	19	101	89	71	83	96	125
Direct investment	43	78	132	93	110	115	110	125	130	135
Portfolio investment	0	0	50	-3	0	5	5	5	8	10
Loans	48	90	-187	-1	69	51	38	36	41	60
Medium- and long-term, net	69	99	-170	25	100	81	68	61	56	55
Disbursements	167	182	176	157	165	157	160	164	168	175
Amortization	-98	-83	-346	-132	-65	-76	-92	-103	-112	-120
Short-term, net	-21	-9	-17	-27	-31	-30	-30	-25	-15	5
Currency and deposits, net	4	-9	-21	-74	-84	-90	-92	-95	-98	-100
Commercial banks, net	4	-9	-21	0	-35	-40	-42	-43	-45	-47
Other	0	0	0	-75	-49	-50	-51	-52	-53	-54
Trade credits, net	-15	-14	-4	4	6	8	10	12	15	20
Errors and omissions	13	29	31	-8	0	0	0	0	0	0
Overall balance	15	66	-98	29	64	6	-9	-3	6	23
Financing	-15	-66	98	-29	-64	-6	9	3	-6	-23
Increase in net official reserves (-)	-20	-66	97	-35	-69	-7	9	3	-6	-23
Use of IMF credit (+)	-2	-4	3	-7	-6	-6	-6	-5	-6	-5
Increase in gross official reserves (-)	-18	-61	94	-27	-63	-1	16	8	0	-18
Arrears accumulation (+) / payments (-) (net)	5	-1	1	5	-11	0	0	0	0	0
Exceptional financing / rescheduling 1/	0	0	0	0	16	1	0	0	0	0
Memoranda items:										
Current account balance (in percent of GDP)										
Excluding official grants	-14.7	-14.4	-11.6	-4.5	-7.1	-9.6	-9.1	-8.9	-8.5	-8.6
Including official grants	-7.6	-9.6	-7.7	1.2	-2.2	-4.6	-4.2	-4.3	-4.1	-4.4
Trade balance (in percent of GDP)	-16.7	-20.5	-15.6	-9.8	-12.0	-14.9	-14.7	-14.1	-13.6	-13.6
Net official reserves (end-period)	160	226	129	164	232	240	230	227	233	256
Gross official reserves (end-period)	207	271	178	205	268	269	253	245	245	263
(In months of next year/ projected imports of goods)	3.3	3.9	2.1	2.2	2.8	2.7	2.5	2.3	2.2	2.3
Outstanding arrears (end-period) 2/	5	4	5	11	0	0	0	0	0	0
Debt service (in percent of exports of goods and services) 3/	5.3	4.5	34.0	7.5	3.7	3.5	3.9	4.2	4.4	4.2

Sources: Mongolian authorities; and Fund staff estimates and projections.

1/ Assuming that rescheduling agreement would be signed in 2005, covering total payment obligations that fall due during 2005-06 on post-1991 Russian debts including existing arrears as of end-2004.

2/ Arrears on post-1991 Russian debt. Excluded debts to Finland (US$9 million) that no longer accepts payments through originally agreed form of payment by meat due to phytosanitary reasons, and to Italy (US$13 million) with which repayment term needs to be determined as Mongolian government assumed its contingent liability.

3/ Excludes private external debt services.

Table 5. Mongolia: External Debt and Debt Service, 2002–10

	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Act.	Act.	Est.	Projections					
				(In millions of US dollars)					
Nominal Debt Stock 1/	978	1,237	1,360	1,417	1,511	1,596	1,675	1,747	1,823
IMF	42	49	44	37	31	24	19	13	9
Non-IMF	936	1,188	1,316	1,380	1,480	1,571	1,655	1,734	1,814
of which: current outstanding	936	1,188	1,316	1,257	1,242	1,217	1,186	1,150	1,112
Multilateral	548	669	796	766	758	748	734	718	701
Official bilateral	375	456	507	478	470	456	439	419	398
Treasury bill in US$ to nonresident	0	50	0	0	0	0	0	0	0
Commercial	13	13	13	13	13	13	13	13	13
of which: additional	0	0	0	123	239	354	470	585	702
Total Debt Service (inc. TR debt resolution)	32	284	91	48	44	51	56	62	62
Amortization	21	272	75	31	27	34	38	43	43
Interest	11	12	16	17	17	18	19	19	20
Debt Service on Existing Debt									
Amortization	21	21	25	31	27	34	38	43	43
Medium and long term	21	21	25	31	27	34	38	43	43
Multilateral	9	10	11	12	14	17	19	22	22
Official Bilateral	12	11	14	19	14	17	19	20	21
Commercial	0	0	0	0	0	0	0	0	0
Interest	11	12	15	15	15	14	14	13	13
Medium and long term	11	12	15	15	15	14	14	13	13
Multilateral	5	6	7	7	7	7	7	7	7
Official Bilateral	6	6	8	8	7	7	7	6	6
Commercial	0	0	0	0	0	0	0	0	0
Debt Service on TR settlement									
Amortization	0	251	50	0	0	0	0	0	0
Russia	0	250	0	0	0	0	0	0	0
Slovakia	0	1	0	0	0	0	0	0	0
N. Korea	0	0	0	0	0	0	0	0	0
Treasury Bill	0	0	50	0	0	0	0	0	0
Interest	0	0	1	0	0	0	0	0	0
Russia	0	0	0	0	0	0	0	0	0
Treasury Bill	0	0	1	0	0	0	0	0	0
Debt Service on New Borrowing	0	0	0	1	2	4	5	6	7
Amortization	0	0	0	0	0	0	0	0	0
Interest	0	0	0	1	2	4	5	6	7
Memoranda items:									
Total debt service									
In percent of exports of goods and services	5	34	8	4	4	4	4	4	4
In percent of GDP	3	22	6	3	2	3	3	3	3
Total debt stock									
In percent of exports of goods and services	138	148	112	111	119	122	124	124	123
In percent of GDP	89	99	91	85	86	85	84	82	80
Net present value of debt 2/	658	816	822	871	930	984	1,034	1,083	1,134
In percent of exports of goods and services	93	98	68	68	73	75	77	77	77
In percent of GDP	60	65	55	52	53	53	52	51	50

Sources: Mongolian authorities; and IMF staff estimates and projections.

1/ This does not include TR11.4 billion debt to Russia, which has been settled in December 2003 with the upfront payment of $250 million.
2/ The applied discount rates are currency based CIRR before 2003, and 5 percent for all currencies after 2004.

Table 6. Mongolia: Medium-Term Macroeconomic Framework, 2002–10

	2002	2003	2004	2005	2006	2007	2008	2009	2010
	(In percent of GDP; unless otherwise indicated)								
Real sector									
Nominal GDP (in billions of togrogs)	1,241	1,461	1,808	2,060	2,248	2,465	2,716	2,995	3,284
Nominal GDP (in millions of U.S. dollars)	1,118	1,274	1,516	1,717	1,790	1,898	2,027	2,170	2,310
Real GDP (percent change)	4.0	5.6	10.6	5.0	6.0	5.0	5.0	5.0	5.0
GDP deflator (percent change)	6.9	11.5	11.8	8.5	2.9	4.5	4.9	5.0	4.4
Consumer prices (period average, percent change)	0.9	5.1	7.9	12.1	4.3	5.2	5.0	5.0	5.0
Consumer prices (end-period, percent change)	1.7	4.7	10.6	10.0	5.5	5.0	5.0	5.0	5.0
Per capita GDP (in U.S. dollars)	457	513	602	671	690	720	758	799	839
Fiscal accounts									
Total revenue and grants	38.4	37.9	39.4	39.1	37.4	36.6	35.7	35.1	34.7
Domestic revenue	37.9	37.3	39.1	38.9	37.1	36.3	35.4	34.8	34.4
Grants	0.6	0.6	0.3	0.2	0.3	0.3	0.3	0.3	0.3
Total expenditure and net lending	44.4	42.1	41.7	41.0	40.4	39.8	38.8	38.3	37.9
Current expenditure	33.5	29.8	29.9	29.6	29.7	29.4	28.8	28.7	28.4
Wages and salaries	8.5	8.0	7.7	7.5	7.4	7.3	7.0	7.0	7.0
Goods and services	14.6	12.0	12.0	11.7	11.4	11.3	11.1	10.9	10.7
Interest payments	1.6	1.2	1.3	1.1	1.1	0.9	0.9	0.9	0.8
Other	8.9	8.6	8.9	9.4	9.8	9.8	9.8	9.8	9.8
Capital expenditure and net lending	10.9	12.4	11.8	11.4	10.8	10.4	10.0	9.7	9.5
Current balance	4.4	7.6	9.2	9.3	7.4	6.9	6.6	6.1	6.0
Primary balance	-4.3	-3.0	-1.0	-0.7	-2.0	-2.2	-2.2	-2.4	-2.3
Overall balance (including grants)	-5.9	-4.2	-2.2	-1.8	-3.0	-3.2	-3.1	-3.2	-3.2
Foreign financing	6.6	-7.9	3.8	6.6	5.3	4.6	4.1	3.7	3.5
Monetary sector									
Broad money (percent change)	41.9	49.7	20.3	19.3	21.3	12.9	15.0	12.3	11.1
Velocity (GDP/M2)	2.6	2.1	2.1	2.0	1.9	1.8	1.7	1.7	1.7
Balance of payments									
Exports (percent change)	0.1	19.7	39.0	4.9	-3.5	1.6	2.9	4.3	4.1
Imports (percent change)	8.6	9.8	23.5	9.7	2.7	2.3	2.8	4.0	4.6
Current account balance (excluding official transfers)	-14.4	-11.6	-4.5	-7.1	-9.6	-9.1	-8.9	-8.5	-8.6
Current account balance (including official transfers)	-9.6	-7.7	1.2	-2.2	-4.6	-4.2	-4.3	-4.1	-4.4
Capital and financial account balance	15.6	0.1	0.7	5.9	5.0	3.7	4.1	4.4	5.4
Overall balance	5.9	-7.7	1.9	3.7	0.4	-0.5	-0.2	0.3	1.0
Gross official reserves									
(In millions of U.S. dollars)	271	178	205	268	269	253	245	245	263
(In weeks of imports of goods)	17.1	9.0	9.5	12.1	11.9	10.9	10.1	9.7	9.9
Debt indicators									
Total public debt	91.7	113.9	99.0	88.2	86.7	85.5	84.0	81.9	80.2
Of which: External debt	88.7	99.1	90.9	84.8	86.0	85.5	84.0	81.9	80.2
In millions of U.S. dollars	978	1,237	1,360	1,417	1,511	1,596	1,675	1,747	1,823
NPV of total public debt	62.7	80.2	60.2	55.5	53.6	52.7	51.9	50.7	49.9
Of which: External debt	59.7	65.3	54.9	52.1	52.9	52.7	51.9	50.7	49.9
In millions of U.S. dollars	658	816	822	871	930	984	1,034	1,083	1,134
External public debt service (in percent of exports)	4.5	34.0	7.5	3.7	3.5	3.9	4.2	4.4	4.2

Sources: Mongolian authorities; and staff estimates and projections.

Table 7. Mongolia: Structural Benchmarks and Performance Criteria, September 2003-March 2004

Policy Action	Timing	Status
A. Prior Actions		
1. Secure Parliamentary approval of Medium-Term Budget Framework in line with understandings reached with Fund staff.	August 31, 2003	Observed.
2. Secure Parliamentary approval of amendment to the Central Bank Law to prohibit the conduct of quasi-fiscal operations and establish oversight of the Bank's operations by an independent Supervisory Board, and prepare draft terms of reference for the Supervisory Board, in consultation with Fund staff, for consideration by the fall session of Parliament.	August 31, 2003	Observed.
B. Structural Benchmarks		
1. Issue a ministerial resolution stipulating clear rules for the allocation of excess own-revenues and indicate in semi-annual and annual fiscal reports the adjustments to spending plans due to excess own-revenues by economic classification.	October 31, 2003	Observed.
2. Adopt ministerial regulation that obliges budget managers to make commitments strictly according to their monthly apportionments of budget appropriations and report monthly to the Treasury on commitments entered, and develop Treasury cash plans to prevent the accumulation of arrears	October 31, 2003	Observed.
3. Tighten enforcement of prudential controls on the banking system by requiring banks to submit internal audit reports to the BOM in accordance with the new supervisor's manual issued in December 2002.	October 31, 2003	Observed.
4. Fully adopt IAS, including IAS 39, in 2003 and all future BOM financial statements	March 31, 2004	The BOM applied IAS 39 since November 2003, but does not yet adopt IAS in full range.
C. Performance Criteria		
1. Secure Parliamentary approval of terms of reference (TOR) for BOM's Supervisory Board in line with the understandings reached with the staff.	October 31, 2003	Observed with delay; Parliament approved the TOR in January 2004.
2. Establish Supervisory Board (SB) empowered to carry out independent oversight of BOM operations along the lines indicated in the above-mentioned TOR and begin to enforce the amendments to the Central Bank Law approved in June 2003.	November 30, 2003	Observed with delay.
3. Complete special audits of the BOM's NIR as of end-June and end-September 2003, with a view to ensuring appropriate valuation of gold-related and derivatives transactions and contingent liabilities, including any impairment, guarantees or commitments against gold deposits or other reserve assets.	November 30, 2003	Partially observed; audit on NIR as of end-June 2003 has raised some questions.
4. Increase BOM's provisioning requirements on commercial banks from 25 percent to 50 percent for substandard loans and from 50 percent to 75 percent for doubtful loans.	March 31, 2004	Observed.

Table 8. Mongolia: Quantitative Performance Criteria and Indicative Targets Under the PRGF Arrangement, 2003–04 1/

	2003												2004					
	End-March			End-June			End-Sept			End-Dec.			End-March			End-Dec.		
	Indicative Targets	Adjusted Targets	Actual	Indicative Targets	Adjusted Targets	Actual	Performance Criteria	Adjusted Targets	Actual	Indicative Targets	Adjusted Targets	Actual	Performance Criteria 2/	Adjusted Targets	Actual	Indicative Targets 3/	Adjusted Targets	Actual
Quantitative Performance Criteria																		
	(In billions of togrogs)																	
1. Net bank credit to government (ceiling)	10.0	10.9	-4.5	15.0	39.1	-13.1	-5.0	18.4	-37.8	-20.8	-32.6	139.5	5.0	-17.1	-20.5	-12.0	-22.4	-58.2
2. Net domestic assets of the Bank of Mongolia (stock, ceiling)	-65.9	-57.4	-58.6	-65.3	-61.8	-68.3	-68.8	-75.0	-68.1	-81.7	-80.5	52.1	-76.5	-76.5	59.1	81.9	40.8	38.7
3. Domestic interest arrears (stock, ceiling)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0
	(In millions of dollars)																	
4. Net international reserves of the Bank of Mongolia (stock, floor)	222.0	214.5	212.7	233.0	215.7	233.9	245.0	227.7	256.9	250.0	249.1	131.6	250.0	250.0	149.5	121.1	129.5	165.0
5. New nonconcessional external debt contracted or guaranteed by the government or the BOM (ceiling)																		
Maturities of less than 1 year 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Maturities of 1–12 years	0.0	0.0	0.0	26.5	26.5	26.5	26.5	26.5	26.5	26.5	26.5	26.5	0.0	0.0	0.0	0.0	0.0	0.0
Maturities of 12 or more years	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. External payments arrears (stock, ceiling) 5/	4.1	4.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Indicative Target																		
Net domestic assets of the banking system (stock, ceiling) (In billions of togrogs)	189.7	198.2	199.2	235.1	254.6	239.4	240.0	259.5	236.7	252.0	253.2	468.2	269.5	269.5	497.9	636.4	626.5	561.0
Memoranda items:																		
BOM's monetary gold pledged as collateral for external loans to domestic private companies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance of payments support Excluding disbursements from the IMF	7.5	7.5	0.0	17.3	17.3	0.0	17.3	17.3	0.0	20.0	20.0	19.1	5.0	5.0	5.0	20.0	20.0	28.4
External budgetary assistance (program loans) (In billions of togrogs)	8.5	8.5	0.0	19.5	19.5	0.0	19.5	19.5	0.0	22.6	22.6	21.4	5.7	5.7	5.6	23.5	0.0	33.4
Privatization receipts (In billions of togrogs)	0.5	0.5	8.1	8.2	8.2	8.6	8.5	8.5	9.6	11.1	11.1	20.7	0.5	0.5	17.6	19.1	19.1	14.6
Transfer from the BOM to government (In billions of togrogs)	0.0	0.0	0.0	5.0	5.0	0.0	5.0	5.0	0.0	5.0	5.0	8.4	0.0	0.0	5.0	0.0	0.0	5.0
Reserve money (In billions of togrogs)	184.0	184.0	180.8	197.0	201.0	195.1	207.0	213.5	221.0	199.7	199.7	200.3	204.9	204.9	227.5	232.0	239.8	233.9

1/ The attached technical memorandum of understanding (TMU) sets out the definitions for the above targets under which Mongolia's performance under the program will be assessed.
2/ Figures after end-June 2003 reflect nonconcessional suppliers' credits for Durgun hydropower station.
3/ The targets were not set formally, but agreed implicitly in reflection of the macroeconomic framework discussed during the Fund missions.
4/ Short-term loans include domestic private company borrowings from an international metals trading company under an administrative guarantee by the BOM which is backed.
5/ Excludes external debt in arrears that is in dispute.

Table 9. Mongolia: Fund Position and Indicators of Fund Credit, 2002–10 [1/]

	2002	2003	2004	2005	2006	2007	2008	2009	2010
	(In millions of SDR)								
Transactions during the period (net)	-6.1	1.9	-5.0	-4.1	-4.2	-4.4	-3.3	-4.3	-3.1
Poverty Reduction and Growth Facility 2/									
Repayments (net)	-5.9	2.0	-4.9	-4.0	-4.0	-4.3	-3.2	-4.2	-3.0
Disbursements	0.0	8.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	5.9	6.1	4.9	4.0	4.0	4.3	3.2	4.2	3.0
Total changes	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.0
Total Fund Credit Outstanding (end of period)	31.3	33.4	28.5	24.5	20.4	16.1	13.0	8.7	5.7
	(In percent of quota)								
Total Fund Credit Outstanding (end of period)	61.3	65.3	55.8	47.9	40.0	31.6	25.4	17.1	11.2

Sources: International Monetary Fund, Finance Department; and staff projections.

1/ Assumes disbursements and debt service under the prospective PRGF arrangement.
2/ Before September 1999, named Enhanced Structural Adjustment Facility

Table 10. Mongolia: Indicators for Vulnerability and Financial Soundness

	2000	2001	2002	2003	2004
Key Economic and Market Indicators					
Real GDP growth (in percent)	1.1	1.0	4.0	5.6	10.6
CPI inflation (end of period, in percent)	8.1	7.9	1.7	4.7	10.6
Short-term interest rate (in percent) 1/	8.5	8.8	8.0	15.0	15.8
Exchange rate, Tugrik/US$ (end of period)	1,097	1,102	1,125	1,170	1,209
External Sector		-----	Floating	-----	
Exchange rate regime					
Current account balance (percent of GDP) 2/	-4.4	-6.1	-9.6	-7.7	1.2
Net FDI inflows (percent of GDP)	4.2	4.2	7.0	10.3	6.1
Export growth (US$ value, GNFS)	18.0	-2.4	0.1	19.7	39.0
Real effective exchange rate (end of period, 1995=100)	111.1	113.6	111.0	106.2	103.7
Gross international reserves (NIR) (in US $ million)	190.9	206.8	271.5	177.7	205.1
NPV of total gross external debt (percent of GDP)	57.3	57.7	58.9	64.0	54.2
General Government					
Overall balance (percent of GDP)	-7.0	-5.4	-5.9	-4.2	-2.2
Primary balance (percent of GDP)	-5.2	-3.9	-4.3	-3.0	-1.0
Public sector financing requirement (percent of GDP)					
Foreign financing	6.5	6.5	6.6	-7.9	3.8
Domestic financing	0.4	-0.5	-0.9	11.4	-2.4
Financial Sector					
Capital adequacy ratio (in percent)					
Tier I capital ratio	21.7	21.6	17.7	18.5	17.4
Total regulatory capital/risk-weighted assets	27.0	24.6	20.0	20.4	20.0
Total regulatory capital/total assets	11.9	14.2	12.4	13.4	15.6
Foreign exchange loans/total loans (in percent)	40.8	35.2	32.5	40.0	45.6
FX liabilities/total liabilities (in percent)	39.9	36.3	37.7	45.2	33.9
NPLs/total loans (in percent)	23.1	7.8	7.0	8.2	10.9
Provisions/NPLs (in percent) 3/	84.3	85.8	74.0	57.6	97.2
Profitability (in percent)					
Return on (Average) Assets	4.2	3.6	4.3	3.1	2.5
Interest Margin/Gross Income	44.2	41.3	39.8	39.3	31.5
Non-interest Expenses/Gross Income	42.5	55.4	50.3	65.7	58.8
Personnel Expenses to Non-interest Expenses	23.1	22.2	35.6	29.5	15.3
Liquidity (in percent)					
Loans to Deposits	36.6	51.5	60.9	72.9	88.3
Liquidity Assets/Total Assets	21.0	41.3	39.9	35.3	31.6
Liquidity Assets/Short-term Liabilities 4/	38.9	86.0	90.9	94.3	106.1

Sources: Mongolian authorities; and Fund staff estimates.

1/ Annual interest rate on central bank bills at the end of period.
2/ Including official grants.
3/ NPL includes past due loans.
4/ Short-term liabilities are the sum of current account and demand deposits.

MONGOLIA—POVERTY PROFILE

According to the *2005 World Development Indicators*, the per capita PPP Gross National Income (GNI) in Mongolia was around US$1,820 in 2003 and the country was ranked 165th among 208 nations. Given an average per-capita PPP GNI of US$1,926 in all low-income countries, Mongolia has one of the lowest living standards in the world.

The Living Standards Measurement Surveys (LSMS) and Household Income and Expenditure Survey (HIES) for 2002/2003, conducted in collaboration with the World Bank and the UNDP, are the most reliable sources of quantitative data on poverty available. Based on these sources, Mongolia's poverty profile can be summarized as follows.

- **With the poverty line at around 25,000 Tugrik per person per month, the head count ratio was 36 percent—**around 900,000 persons among 2½ million of total population did not have the necessary means to purchase the value of a minimum food and non-food package. In addition, the depth of poverty was substantial: on average the consumption of the poor is 11 percent below the poverty line.

- **Taking into account broader concepts of poverty such as capabilities or social inclusion in addition to income/consumption, it was estimated that 55 percent of Ulaanbaatar population were living in a poverty situation.** 33 percent of population were under poverty in terms of income/consumption, 25 percent in terms of capabilities, and 24 percent in terms of social inclusion.[13]

- **The head count ratio indicates that overall poverty has not improved in comparison with that existing in the 1990s, with improved urban conditions offset by a worsening in rural areas.[14]** The number of people living below the poverty line in the 1990s was around 35–36 percent throughout the previous LSMS conducted in 1995 and 1998. By region, however, the trends were very different; the number of poor people in urban areas was significantly lowered from 39 percent in 1998 to 30 percent in 2003 whereas the ratio in rural areas rose from 33 percent in 1998 to 43 percent in 2003. The improvement of the poverty situation in urban area seemingly resulted from relatively better economic performances in both industry and services, starting from 2001. On the contrary, the deterioration of poverty in rural area was a consequence of several dzuds and droughts that resulted in a dramatic loss of the livestock population in 2000-2002.

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[13] Among these, 21 percent of the poor population overlapped two or three types of poverty.

[14] However, there exist problems of direct comparability between some indicators in the previous LSMS, as the methodology utilized was not entirely consistent.

- **Similarly there has not been any significant improvement in income inequality since 1998.** In 2002-2003, the Gini coefficient, an index for the consumption gap, was 0.33, down only marginally from 0.35 in 1998. Nationally, the richest 20 percent of population has 5½ times more consumption than the poorest 20 percent. As expected, poverty inequality was greater in urban areas than in the countryside.

- **Labor market status and educational achievement are important determinants of poverty.** Employment in the livestock or agriculture sectors was prone to poverty, whereas those employed in the service sectors were less likely to be poor. Employees with public sector and state companies enjoyed better living standards. The poor had lower educational accomplishment than the non-poor: more than half of the poor reached only the 8th grade of secondary school compared to one-third in the non-poor category. Enrollment rates of children in poor and non-poor households were similar at the primary level, while at the secondary level, non-poor children had significantly higher enrollment rates.

- **Poverty is also correlated with the size of household.** Whereas only 10 percent of households with up to three members were poor, the poverty incidence for households with more than five members was about 50 percent and for households with 8 and more members, 70 percent lived under the poverty line.

- **The type of housing reflected living standards.** In urban areas, those living in apartments were less likely to be poor, while those living in gers were most likely to be poor. In rural areas, those who live in houses were poorer than those living in gers.

However, most social indicators, in particular, those for health and education, have improved since late 1990s. Health indicators, such as infant mortality, immunization rate, and life expectancy, has been improved. In particular, secondary school enrollment rates rose to a quite high level, compared to that in other low income countries. The Human Development Index for Mongolia improved from 0.628 in 1998 to 0.668 in 2003, but the country remains ranked 117th among 177 countries.

Mongolia—Millennium Development Goals

	1990	1995	2000	2002	2003
Eradicate extreme poverty and hunger 1/	(2015 target = halve 1990 $1 a day poverty and malnutrition rates)				
Percentage share of income or consumption held by poorest 20 percent	..	..	..	..	..
Population below $1 a day (percent)	..	14	..	..	..
Population below minimum level of dietary energy consumption (percent)	..	..	..	28	..
Poverty gap ratio at $1 a day (incidence x depth of poverty)	..	3	..	..	..
Poverty headcount, national (in percent of population)	..	36	..	..	36
Prevalence of underweight in children (under five years of age)	..	..	13	..	..
Achieve universal primary education 2/	(2015 target = net enrollment to 100)				
Net primary enrollment ratio (in percent of relevant age group)	90	..	90	79	..
Primary completion rate, total (in percent of relevant age group)	..	..	102	108	..
Proportion of pupils starting grade 1 who reach grade 5	..	..	..	..	..
Youth literacy rate (in percent ages 15-24)	99	99	98	..	..
Promote gender equality 3/	(2005 target = education rate to 100)				
Proportion of seats held by women in national parliament (in percent)	25	..	8	11	11
Ratio of girls to boys in primary and secondary education (in percent)	109	..	112	110	..
Ratio of young literate females to males (in percent ages 15-24)	100	101	101	..	..
Share of women employed in the nonagricultural sector (in percent)	49	48	48	47	..
Reduce child mortality 4/	(2015 target = reduce 1990 under 5 motality by two thirds)				
Immunization, measles (in percent of children ages 12-23 months)	92	85	94	98	98
Infant mortality rate (per 1,000 live births)	74	67	60	..	56
Under 5 mortality rate (per 1,000)	104	89	75	..	68
Improved maternal health 5/	(2015 target = reduce 1990 maternal mortality by three fourths)				
Births attended by skilled health staff (in percent of total)	..	..	97	..	99
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	110	..	..
Combat HIV/AIDS, malaria, and other diseases 6/	(2015 target = halt, and begin to reverse, AIDS, etc.)				
Contraceptive prevalence rate (in percent of women ages 15-49)	..	..	67	..	..
Incidence of tuberculosis (per 100,000 people)	220	209	199	196	194
Number of children orphaned by HIV/AIDS	..	..	..	..	..
Prevalence of HIV, female (in percent ages 15-24)	..	..	..	..	..
Prevalence of HIV, total (in percent of population aged 15-49)	..	..	..	..	0
Tuberculosis cases detected under DOTS (in percent)	..	7	62	74	68
Ensure environmental sustainability 7/	(2015 target = various)				
Access to an improved water source (in percent of population)	62	..	..	62	..
Access to improved sanitation (in percent of population)	..	..	..	59	..
Access to secure tenure (in percent of population)	..	..	..	..	..
CO2 emissions (metric tons per capita)	5	3	3	..	..
Forest area (in percent of total land area)	7	..	7	..	..
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	..	..	..	..	..
Nationally protected areas (in percent of total land area)	..	..	..	..	12
Develop a global partnership for development 8/	(2015 target = various)				
Aid per capita (current US$)	6	93	91	85	100
Debt service (in percent of exports)	..	..	..	..	..
Fixed line and mobile phone subscribers (per 1,000 people)	32	35	115	142	186
Internet users (per 1,000 people)	..	0	13	21	58
Personal computers (per 1,000 people)	..	3	13	28	77
Total debt service (in percent of exports of goods and services)	..	10	6	7	32
Unemployment, youth female (in percent of female labor force ages 15-24)	..	..	..	..	..
Unemployment, youth male (in percent of male labor force ages 15-24)	..	..	..	..	..
Unemployment, youth total (in percent of total labor force ages 15-24)	..	..	..	..	..
General indicators					
Fertility rate, total (births per woman)	4	3	..	2	2
GNI per capita, Atlas method (current US$)	..	260	400	450	480
GNI, Atlas method (current US$, in millions)	..	601	948	1,097	1,188
Gross capital formation (in percent of GDP)	38	29	30	31	31
Life expectancy at birth, total (years)	63	..	..	65	66
Literacy rate, adult total (percent of people ages 15 and above)	98	98	98	..	..
Population, total (in thousands)	2,106	2,275	2,398	2,449	2,480
Trade (in percent of GDP)	77	128	147	148	148

Source: World Bank: *World Development Indicators Database* , and UNDP and NSO: Living Standard Measurement Survey 2002/2003.

1/ Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day, and the proportion of people who suffer from hunger.

2/ Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

3/ Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

4/ Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

5/ Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

6/ Have halted by 2015, and begun to reverse, the spread of HIV/AIDS and the incidence of malaria and other major diseases.

7/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water.

8/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states.

Mongolia—Fund Relations
(As of June 30, 2005)

I. **Membership Status:** Joined: 02/14/1991; Article VIII

II.	**General Resources Account:**	**SDR Million**	**Percent Quota**
	Quota	51.10	100.0
	Fund Holdings of Currency	50.97	99.74
	Reserve Position in Fund	0.14	0.27

III.	**SDR Department:**	**SDR Million**	**Percent Allocation**
	Holdings	0.03	N/A

IV.	**Outstanding Purchases and Loans:**	**SDR Million**	**Percent Quota**
	ESAF/PRGF Arrangements	26.79	52.43

V. **Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
PRGF	09/28/2001	07/31/2005	28.49	12.21
ESAF/PRGF	07/30/1997	07/29/2000	33.39	17.44
ESAF	06/25/1993	06/24/1996	40.81	29.68

VI. **Projected Obligations to Fund:** (SDR Million; based on existing use of resources and present holdings of SDRs):

			Forthcoming		
	2005	**2006**	**2007**	**2008**	**2009**
Principal	2.30	4.04	4.30	3.19	4.22
Charges/interest	0.06	0.11	0.09	0.07	0.05
Total	2.36	4.15	4.39	3.26	4.28

VII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the Bank of Mongolia (BOM) was subject to a full safeguards assessment with respect to the PRGF arrangement that was approved by the Executive Board on September 28, 2001. An on-site safeguards assessment of the BOM was completed on September 10, 2003. Staff recommended that the BOM implement measures to strengthen its external audit mechanism and financial reporting framework. The BOM has so far implemented several of the recommendations. Staff continues to monitor the BOM's efforts to: (i) commit to the full adoption of International Accounting Standards (IAS) and to disclose its guarantees and pledges in its financial statements; and (ii) disclose the fair value of derivatives in its net international reserve position and financial statements. At the conclusion of the December 2002 PRGF discussions, the BOM agreed to implement special semi-annual audits of NIR to provide further assurance on the NIR position and to identify any related pledges or guarantees.

VIII. **Exchange Arrangement:**

On May 27, 1993, Mongolia moved from a fixed exchange rate against the U.S. dollar to a floating exchange rate system. However, the BOM has, at times, made active use of its intervention practices to maintain a stable nominal exchange rate vis-à-vis the U.S. dollar over extended periods of time. The official exchange rate is now set daily on the basis of transactions in the interbank market. At end-June 2005, the official midpoint rate was Tog 1,190 per U.S. dollar. The official exchange rate is applied to the public sector's transactions in imports and services, including debt-service payments, and to trade and service transactions conducted under bilateral payments arrangements. Mongolia accepted the obligations of Article VIII, Sections 2, 3, and 4 on February 1, 1996, and maintains an exchange system that is free from restrictions on payments and transfers for current international transactions.

IX. **Article IV Consultation:**

The 2002 Article IV consultation (Country Report No. 02/252) was concluded by the Executive Board on October 25, 2002. Mongolia will be on the 12–month cycle.

X. **ROSC Assessments:**

- ROSC, Data Module, May 4, 2001 (www.imf.org)
- ROSC, Fiscal Transparency Module, November 8, 2001 (Country Report No. 01/218)
- ROSC, Fiscal update, May, 2005

XI. **Recent Financial Arrangements:**

A three-year arrangement under the Enhanced Structural Adjustment Facility in an amount equivalent to SDR 40.81 million (80 percent of quota) with a first annual arrangement in an amount of SDR 18.55 million (36.3 percent of quota), was approved on June 25, 1993. The second annual arrangement in an amount of SDR 11.13 million (21.8 percent of quota) was approved on November 23, 1994. The ESAF arrangement lapsed on June 24, 1996.

A three-year arrangement under the ESAF/PRGF in an amount equivalent to SDR 33.4 million (65.4 percent of quota), with a first annual arrangement in an amount of SDR 11.13 million (21.8 percent of quota), was approved by the Executive Board on July 30, 1997. The first year arrangement lapsed on July 30, 1998. The second annual arrangement of SDR 14.8 million (29 percent of quota) was approved on June 16, 1999. The first review under that arrangement was completed in January 2000 and the arrangement lapsed on June 15, 2000. The ESAF/PRGF arrangement lapsed on July 29, 2000.

A three-year arrangement under the PRGF in an amount equivalent to SDR 28.49 million (55.8 percent of quota), with the first year of the arrangement in an amount of SDR 12.21 million (23.9 percent of quota), was approved by the Executive Board on September 28, 2001. The first and second review under the PRGF was completed on September 12, 2003, and the Executive Board approved the extension of the PRGF through July 31, 2005. The arrangement expired on that date without the completion of the third and subsequent reviews.

XII. **Technical Assistance:**

Missions:

- Banking supervision and payment systems (MFD), June 2005.
- Options for Expenditure Savings and Efficiency Improvements (FAD), January 2005.
- Banking supervision and prudential framework (MFD), October 2004.
- Reforms of Tax Policies (FAD), October 2004.
- Government Finance Statistics (STA), August 2004.
- Balance of Payments Statistics (STA), July-August 2004.
- Banking supervision and prudential framework, (MFD), May-June 2004.
- AML/CFT Action Plan and legislative awareness, May 2004.
- Banking supervision and accounting (MFD), October 2003.
- Government Finance Statistics (STA), August 2003.
- AML/CFT (MFD), June 2003.
- Banking supervision and accounting (MAE), November 2002.
- Revenue administration (FAD), September 2002.
- Banking supervision and accounting (MAE), May 2002.
- Review of treasury and intergovernmental fiscal reforms (FAD), August 2001.
- Banking supervision and accounting (MAE), May–June 2001.
- Money and banking statistics (STA), May 2001.
- Government finance statistics (STA), March 2001.
- Fiscal transparency and ROSC (FAD), March 2001.
- Intergovernmental fiscal relations and budget reform (FAD), January 2001.
- Visits by MAE peripatetic experts on banking supervision, payments system, monetary policy, and accounting and audit, November 2000 (ongoing).
- Consumer price statistics (STA), September–October 2000.
- ROSC: data module (STA), May 2000.
- Restructuring bonds and other securities (MAE), March 2000.
- National accounts statistics (STA), February 2000.

Resident Advisors:

- National accounts statistics (STA), August 2001–September 2003
- Treasury reform (FAD), June 1999–November 2003
- Balance of payments (STA), March 1999–May 2001

Technical assistance for the period May 1995–October 1999 is reported in Annex II of the Staff Report for the 1999 Article IV Consultation.

XIII. **Resident Representative**:

Ms. Rehm succeeded Mr. Martin as the Fund's resident representative in Mongolia at end-December 2002.

Mongolia: IMF-World Bank Relations

(As of August 31, 2005)

Partnership In Mongolia's Development Strategy

Mongolia became a member of the World Bank, IDA and IFC in February 1991. The World Bank now has a wide-ranging policy dialogue covering structural reforms to promote economic growth and poverty reduction, including public administration/civil service reform, financial sector reform, private sector development, education, health, social reforms, urban and rural development, infrastructure, and judicial reforms.

Mongolia's vision for development and poverty reduction is laid out in the Government's Economic Growth Support and Poverty Reduction Strategy (EGSPRS) which, along with a Joint Staff Assessment (JSA), was discussed by the respective Boards of Executive Directors of the Bank and the Fund in September 2003. The EGSPRS builds on the strategy articulated in the earlier interim report (I-PRSP) that was presented to the IDA and IMF Boards in September 2001. The strategy, which provides an adequate framework for implementing the government's development agenda, is based on the following five main pillars: (i) ensuring macroeconomic stability and enhancing public sector effectiveness; (ii) establishing a sound institutional and regulatory environment to complete Mongolia's transition to a market economy and enabling the private sector to become an engine of growth; (iii) enhancing balanced and environmentally sustainable development; (iv) fostering sustainable human development and equitable distribution of the benefits from growth through improved service delivery in education, health, and social welfare; and (v) promoting good governance and gender equality. The Bank and the Fund have jointly assisted the Government in the formulation and preparation of the EGSPRS. They continue to advise the Government in the implementation of this strategy and monitor progress through EGSPRS progress reports. The first Progress Report was discussed by Government Cabinet on May 4, 2005 and sent thereafter to Parliament for hearing. The World Bank and the IMF have just prepared a Joint Staff Advisory Note (JSAN) to advise the Government on how to further improve the implementation of the EGSPRS. Meanwhile, the Bank is assisting the Government improve the integration of its planning, budgeting, and monitoring systems.

World Bank Group Country Assistance Strategy And Lending

***Country Assistance Strategy*.** The current Country Assistance Strategy (CAS) was approved by World Bank Board on April 29, 2004. The Bank's CAS is broadly aligned with the EGSPRS and supports a subset of priorities that reflect development areas where the World Bank has a comparative advantage. The Bank plays a significant financial role in Mongolia, with Bank funds accounting for 25 percent of Government investment. The Bank also plays a strategic role in Mongolia's development through its analytical and advisory services. The structure of Bank's lending program is well aligned with the EGSPRS. According to the IDA-14 grant eligibility criterion calculations, Mongolia has qualified to receive grant-only assistance in the Bank's fiscal year 2006. About 49 percent of the portfolio is in infrastructure projects (Energy, Transport, and Services Improvement), 29 percent of the projects are in financial and private sector development, 11 percent of the portfolio is focusing on providing sustainable livelihoods to the poor, while the remaining 11 percent of the projects assisting with public sector reform. The Bank's CAS embodies a "results based approach" that relates outcomes to the country's longer term EGSPRS goals, including the MDGs.

Aid coordination. Bank lending to Mongolia represents about 11 percent of the country's overall Official Development Assistance (ODA) flows, implying the need to be selective and to complement other donor efforts. The Government is working with external partners to implement a harmonization plan presented at the 2003 Consultative Group meeting held in Tokyo. To this end, four government-donor working groups have been established to improve sectoral and cross-sectoral coordination. The five major development partners of Mongolia are the Asian Development Bank (ADB), Germany, Japan, the United States, and the World Bank accounting for approximately 87 percent of gross ODA in 2001-02. External partners are moving toward aligning their support for capacity building and addressing some of the bottlenecks identified in the EGSPRS. The new ADB country strategy paper (CSP) for 2005-2006, which was finalized in 2004, is also aligned with EGSPRS priorities. At the Consultative Group meeting in 2003 both the ADB and the World Bank re-confirmed the need to strengthen upstream donor coordination through their respective CSP and CAS processes. The USAID 2004-2008 Strategic Plan for Mongolia, which was approved in 2003, is also broadly in line with EGSPRS objectives on private sector development and governance. The 2002-2006 United Nations Development Assistance Framework (UNDAF) further complements the development activities that are being undertaken in Mongolia by the Government, civil society and other international donors.

IMF-World Bank Collaboration In Specific Areas

The Bank and Fund teams are closely coordinating their policy advice to the Mongolian authorities. There is collaboration in terms of common objectives, joint missions (such as participation in the IMF's Article IV Consultations and the Expenditure Policy Reform missions, among others) and in determining structural reform measures to help implement the Government's EGSPRS.

Public Sector and Fiscal framework. The Bank is working with the Government to strengthen the public finance management framework and civil service administration through the provision of analytical advice, technical assistance, and investment projects. The proposed first Poverty Reduction Support Credit (PRSC) will focus on public expenditure management and civil service reforms. Meanwhile, the Fund is providing advice on fiscal policy, monetary policy, and to strengthen Central Bank governance. Treasury reform advice is a shared responsibility with the Bank, with the latter undertaking this in the context of the Economic Capacity Technical Assistance Credit (ECTAC) project, a recently completed Fiscal Technical Assistance (TA) project and several related trust fund-supported activities.

Public expenditure management. The Bank is assisting the Government to improve budget planning, execution, reporting and accountability and improve public administration. This includes technical assistance (Fiscal Technical Assistance Project – Fiscal TA and Economic Capacity Technical Assistance Credit –ECTAC) to support institutional reforms and policy development; training and capacity building; and a major upgrading of core information systems for public financial management. These interventions are based on recommendations of the Bank's Public Expenditure and Financial Management Review for Mongolia (2003). In addition, the Bank has been implementing an Institutional Development Fund (IDF) Grant to provide technical assistance to the Ulaan Baatar Municipality (UBM) for strengthening the processes for formulation and execution of its public expenditure policies.

Civil service reform. Through the ECTAC and an IDF grant the Bank is providing advice and capacity-building support to: (i) assist with implementation of the Civil Service Reform Strategy, passed by Parliament in 2004; (ii) strengthen medium term human resource policy and expenditure formulation in context of the medium term budget framework (MTBF) in light of the EGSPRS; and (iii) human resource expenditure execution by improving payroll management through greater control of personnel expenditures.

In the financial sector, the Bank has increased its involvement since late 1999 through a financial sector review and the Financial Sector Adjustment Credit (FSAC) program. The objectives of the FSAC were to support the government's medium-term strategy for financial sector reform and development, focusing on strengthening of prudential regulation and supervision, bank restructuring and privatization, resumption of Government payments services in the rural areas, and timely servicing of Government debt. The FSAC was closed in September 2004 with all the tranches disbursed. The Bank is also working with the Government and selected commercial banks to strengthen the banking system's capacity in credit risk management, automated payments system and Savings Bank resolution under the Financial Capacity Development Project (FCDP). The mid-term review is under way with a view to updating the Bank's assistance program to address the new challenges, and renewing the government's long-term strategy for financial sector reform and development. In addition, development of the legal and regulatory framework for financial holding companies and NBFIs is an important policy requirement under the PRSCs.

In the area of Private Sector Development, the Bank Group started its assistance program for private sector development through operations which supported state-owned enterprise reforms and legal and regulatory changes in the early and mid-1990s. Since late 1990s, the Bank has focused on alleviating the access to finance problem through the above mentioned PSDC project. Following the closing of this project, the Bank has prepared a follow up operation (PSDC II) which was approved by the Board in June 2005. This project will continue to support SME growth through longer-term financing of eligible capital investment projects. In addition, the Bank has been promoting private sector participation in service delivery through lending and non-lending operations that aim at enhancing the regulatory framework and business environment. In mid-2004, the Bank initiated an integrated study that combines an assessment of the investment climate (through surveys of firms and household-based enterprises) with competitiveness studies of supply chains in priority sectors and a diagnostic trade integration study. The aims of this integrated study are (i) to help both the Government and the Bank better understand the main constraints to private sector development in Mongolia and (ii) to identify a set of concrete steps—policy reforms and/or programmatic interventions—that the government of Mongolia might take to promote market-oriented private-sector activity and greater integration with the global economy. The study, which is to be completed in end-2005, complements the earlier cashmere report (2003) and the mining sector (2004) reports. The findings from these studies are expected to feed into the development of a PSD strategy and the Bank's assistance program in these areas. New lending operations encouraging private sector participation in infrastructure sector are also being considered over the next three- to four-year period.

Meanwhile, ***IFC*** became a minority owner of two Mongolian banks in 2004. The IFC involvement is expected to help enhance corporate governance and introduce international best banking practices in the banks. In addition, IFC provided funding support to a microfinance bank to support its operations and liquidity, and is currently providing technical assistance for developing leasing industry. IFC has also provided funding support to encourage micro-finance through the banking sector in Mongolia.

Social Sector and Poverty. The Bank has provided assistance to the Government to redesign and implement its household income and expenditure surveys. It has also assisted the Government conduct the subsequent poverty analysis and to obtain an updated poverty profile for Mongolia, albeit as of 2002 due to data availability and access considerations. The Bank is currently undertaking a Poverty Assessment. In this regard, a series of policy notes were discussed with the Government and other stakeholders in June 2005. The full report is under preparation. Also, the Bank is working with the Government to improve financial and budget management in the social sectors. In terms of sectoral policies in health, the Bank has been working with the Government on hospital rationalization, and will work on broader health financing/system issues in the coming years. The Bank has assisted in analyzing the sustainability of the pension scheme, and a study is being initiated to assess the efficiency of the targeted social assistance schemes in Mongolia using household survey data. Together with the updated poverty assessment, the study will form the analytical basis for the redesign of the cash transfer programs. In this regard, a workshop was organized at the request of the Government on social transfer programs in October 2004.

The Bank is working with the Fund and ADB to ensure policy consistency and coordination, particularly regarding the budgetary impact of social policies and the need to protect social expenditures and pro-poor investments in Mongolia. The Bank is also working towards preparing a Rural School Support project in order to support rural schools in *bagh* and *soums* (the lowest level administrative units in Government) in remote areas, to train its teachers, and supply these schools with reading materials and school supplies. The Bank is conducting a Public Expenditure Tracking Survey (PETS) that aims to identify gaps in the planned and approved budget for the education sector. This study is expected be disseminated later this year. Under the PHRD-I Grant for the preparation of the PRSC-I, an analysis of Mongolia's existing pension system; an audit of the SSIGO (State Social Insurance General Office) and SIF (Social Insurance Fund); an operational assessment of the State Training and Education Fund (in charge of issuing student loans and grants) have been undertaken. Currently, the

Bank is working with the government to create a database for tracking implementation progress of the recently initiated Child Money program.

Rural and Urban Development. In the rural sector, the Bank is assisting the Government in the development of rural strategies and promotes secure and sustainable livelihoods through activities in pastoral risk management, microfinance services, basic infrastructure investment (through community-driven approaches), and the piloting of a new index-based livestock insurance product. To this end, an Index-based livestock insurance project (IBLIP) was approved by the World Bank Board in May 2005. In the area of urban development, the Bank is assisting the Government formulate its city development strategy. The Bank is also supporting the improvement of basic services delivery, particularly the provision of water supply and *Ger* area upgrading.[15] Finally, the Bank also helping the Government assess the urban poverty situation in Mongolia. Meanwhile, the Bank and the Fund are collaborating and coordinating their assistance in the domain of municipal finance and intergovernmental fiscal relations.

Infrastructure. With a view of helping to shape sectoral strategies in Mongolia, the Bank is preparing an Infrastructure Strategy Report that will examine the Government's prioritization of infrastructure investments and their fiscal impact. The Bank and Fund have a common interest in monitoring inter-enterprise arrears, conducting social impact assessments of energy prices, enhancing transparency in investment decisions and related financing arrangements (e.g. in road sector financing), along with the efficient management and cost-effective use of public funds.

Corruption, Justice and Legal Environment. There is an increasing recognition among many policymakers and key stakeholders that the problem of corruption has reached levels that warrant focused attention in Mongolia. The implementation of the Public Sector Management and Finance Law (PSMFL) and the drafting of an Anti-Corruption Law are positive steps towards tackling this problem, but much will depend on the quality of the laws, associated implementing rules and regulations many of which are still being drafted or yet to be approved. Media publicity is significant and could act as a deterrent against corruption. However, key systemic constraints remain. Decision making is still perceived to be non-transparent, and patronage and lack of accountability remain major problems. In an endeavor to assist the Government strengthen the rule of law in Mongolia, the Fund focuses on the Central Bank and Anti-Money Laundering laws, while the Bank assists in enhancing public confidence in the legal system with a focus on judicial reforms. Nevertheless, challenges remain in enhancing access to justice, especially for the poor; disseminating new laws to the public; and enforcing existing laws.

MIGA**:** Mongolia signed the MIGA convention in 1991 and ratified it the following year. MIGA will be able to assist the country in attracting foreign investment through its marketing and guarantee activities.

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[15] A *Ger* is the traditional Mongolian dwelling tent.

WBI**:** Finally, to support the Bank's program of lending and non-lending activities, the World Bank Institute, the World Bank's external training division, has organized a number of seminars and courses in Mongolia. Courses included economic management, business valuation, financial sector development, and social sector reform.

Mongolia—Relations with the Asian Development Bank[1]

Mongolia became a member of the Asian Development Bank (AsDB) in February 1991. AsDB operations in Mongolia have been guided by its Country Operational Strategy (COS). The first COS covering 1994–99 was prepared in 1994. It was aimed at facilitating Mongolia's transition to a market economy by (i) creating an environment in which a competitive efficient market economy can flourish; (ii) developing the human resources and skills necessary for a market economy; and (iii) developing the infrastructure needed for a market economy.

In line with the Poverty Reduction Strategy approved by the AsDB Board in 1999, AsDB entered into a Poverty Partnership Agreement (PPA) with the Government of Mongolia in 2000. Within the framework of the PPA and built on the lessons learned during the period 1994–99, AsDB formulated in May 2000 its new COS for 2000–05, placing poverty reduction at the highest level of importance to be achieved through pro-poor interventions that foster private sector-led economic growth and good governance, through selected interventions in AsDB six core sectors, namely, finance, public sector, social sector, agriculture, urban development and road.

AsDB is currently developing the new strategy for Mongolia, now called Country Strategy and Program (CSP), expected to be completed in September 2005. This new CSP, covering the period 2006-2008, is based on extensive consultations with stakeholders, on an analysis of development constraints and poverty conditions, and on the Government's strategic priorities as set out in the EGSPRS. AsDB's strategy over 2006–2008 will rest on two pillars: (i) promoting broad-based economic growth—in particular economically diverse, stable, and geographically distributed growth; and (ii) supporting inclusive social development—with a concentration on improving the access of the poor to stable incomes and public services.

This CSP also takes an important step towards adopting a results-based program. Effectiveness and efficiency of development initiatives are a major consideration in the selection of strategic interventions. This CSP identifies development results that AsDB will help achieve and establishes clearly defined outcomes that are expected during the implementation of the CSP. This results-based approach is set within the larger context of assisting the Government in improving the effectiveness and efficiency of its own governance mechanisms.

AsDB also has a window—the Private Sector Operations Department (PSOD) for private sector operation without government guarantee. After the successful participation of AsDB in providing assistance to the Government in the privatization of selected banks, PSOD is exploring the feasibility of setting up a shareholders loan fund in Mongolia.

[1] Prepared by Asian Development Bank staff.

By December 2004, the AsDB had approved 34 loans from the Asian Development Fund (ADF) totaling $605.8 million. In addition, by that date, the AsDB had approved 118 technical assistance (TA) grants amounting to $57.22 million. In 2005 two loans are expected to be approved, the Financial Sector Reform Program to address remaining weaknesses in the banking and in the non banking financial sectors, and the Education Sector Development Project which mainly focuses on the development of a new education master plan. In addition $2 million are planned for technical assistance in urban and housing, governance, transport, and capacity building for education and the financial sector.

To ensure more effective use of development resources to achieve the development goals, AsDB follows the policy on performance-based allocation of its concessional ADF resources. According to this policy AsDB allocates the ADF resources to its eligible member countries including Mongolia, based on a country performance assessment. The country assessment focuses on major indicators concerning sustainable economic growth, socially inclusive development, governance and public sector management, and portfolio performance. Mongolia has performed satisfactorily measured against these benchmarks.

The AsDB has regularly participated in Mongolia Consultative Group meetings and coordinated its operations with the IMF, the World Bank and other donors. At the Tenth Assistance Group Meeting held Tokyo in November 2003, the AsDB delivered the joint donors' statement. Through this and other forums, the AsDB will continue to be actively involved in policy dialogue with the government, particularly with regard to continuing of reforms in: (i) achieving greater efficiency in the delivery of social services; (ii) the promotion of good governance in formulating effective policies and establishing efficient institutions; (iii) public sector management and finance which will lay a foundation for effective macroeconomic management; and (iv) the financial sector, to provide affordable financing services badly needed for increased private sector investment and production efficiency. The AsDB will also continue to assist the Government in strengthening its capacity in aid coordination, and planning and management of public investments. AsDB's effectiveness in delivering its program of assistance to Mongolia has been strengthened with the official opening and full operation of a Resident Mission in August 2001.

Since March 2002, Mongolia participates as a full member of the AsDB supported sub-regional cooperation for the Central Asian Republics and People's Republic of China (PRC). This sub-regional cooperation provides Mongolia with a new dimension to participate in regional cooperation on a wider geographic basis. Started with a moderate program in 2000, AsDB has assisted Mongolia and PRC to establish a very effective institutional framework to promote and coordinate between the two countries. Cooperation in transportation, trade and investment and environmental management has been identified as a common priority.

Mongolia: Statistical Issues

1. **Progress to Date**

The Mongolian authorities have established a framework for monitoring macroeconomic developments and have made substantial improvements in all statistical areas with extensive technical assistance, including from the Fund. Core data are provided on a timely basis. Mongolia is participating in the General Data Dissemination System (*GDDS*), and its metadata were posted on the Dissemination Standards Bulletin Board (*DSBB*) in August 2000. A ROSC mission that visited Mongolia in May 2000 assessed data dissemination practices in Mongolia in relation to the IMF's *GDDS.* The data module of the ROSC for Mongolia was published on the IMF website in May 2001.[1]

A STA mission to assist in further improving national accounts visited Mongolia in February 2000. In conjunction with this mission, the authorities revised the annual GDP estimates for 1995–99 to incorporate new source data and rebase the accounts to 1995 prices. An advisor assisted the NSO during August 2001- September 2003, in improving primary data collection and compilation systems for national accounts and price statistics.

Based on the recommendations of the 2000 STA mission on consumer price statistics, the methodology utilized to compile the CPI was substantially revised in January 2001. The main revisions were : (i) the CPI basket was updated based on the results of the 1999 Household Income and Expenditure Survey (HIES); (ii) the CPI weights were updated using the results of the 1999 HIES and the 2000 HIES, with the latter update done in March 2002; and (iii) the CPI was rebased from December 1995 to December 2000.

The authorities adopted systematic procedures for compiling annual fiscal reports for the general government and each of its subsectors. GFS data are also compiled on a monthly basis for all subsectors, except the extrabudgetary central government. All extrabudgetary agencies and funds should be examined to determine whether they should be included in the budgetary central government sector or the public corporations sector. The authorities also completed an inventory of all government bank accounts and instituted stricter standards for registering bank accounts for government agencies to allow full reconciliation between government accounts data and banking data. However, adequate reconciliation of monetary and fiscal data and implementation of other technical assistance recommendations are pending.

In November 2004, STA assisted the authorities in compiling the government accounts for 2003 according to the guidelines of the *Government Finance Statistics Manual 2001*. The

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[1] As the ROSC was not prepared on the basis of the Data Quality Assessment Framework, no ratings were given. Consequently, the TCIRS does not include memo items on data quality.

mission also provided extensive on-the-job training in GFSM 2001 methodology. Data were prepared and reported in the new format for publication in the 2004 *GFS Yearbook*. Although the chart of accounts generally follows the *GFSM 2001*, the mission recommended further improvements to the classification of assets and liabilities. A planned introduction of a computerized government financial management information system could improve data collection and processing, although severe staff constraints may limit the MOF's ability to implement all the recommendations of the mission and further technical assistance may be required.

The 2001 monetary and financial statistics mission found that the Bank of Mongolia (BOM) implemented most of the recommendations of the 1997 STA mission, including the valuation of monetary gold and the recording of Fund accounts in the BOM balance sheet.

In May 2001, a long-term resident advisor completed a 26-month assignment to help develop the balance of payments statistics compilation system, which included the implementation of an enterprise survey. The results from the survey were reflected in the 1999 balance of payments data and used to generate partial international investment position estimates for the nonbank sector. A new report form on international transactions that pass through domestic banks was developed. With the BOM's new regulation requiring banks to report international transactions effective from January 1, 2002, the accuracy and timeliness of BOP statistics are expected to be substantially enhanced.

The 2004 technical assistance mission, however, noted that the Bank of Mongolia failed to sustain the implementation of the work of the long-term advisor, as very little use is made of data from the enterprise survey due to its low response rate. In addition, although partial information exists to compile an international investment position, such data are not compiled.

2. **Outstanding Issues**

- While some progress has been made in developing a national accounts framework, the quality of GDP estimates, particularly with respect to the current deflation methods for constant price estimates, could be improved further. A proper methodological treatment of animal losses due to harsh winters has been finalized. Efforts are also needed to improve coverage of the informal sector and small-scale activity, especially in the services sector. Raw data could be refined with a view to producing reliable quarterly estimates of GDP. Furthermore, the construction of expenditure-based national accounts in constant price terms would serve as a useful check for the production side estimates.

- The NSO has produced a national CPI, but progress in implementing the recommendations of the STA mission to develop a producer price index has been limited mainly due to resource and capacity constraints.

- There are a number of deficiencies in the data on wages and earnings. The development of labor market statistics through the establishment of quarterly sample surveys would help mitigate these shortcomings. The government conducted a survey of the civil service in May 2002, which would help to produce a detailed database on civil service employment and wages.

- The May 2001 STA mission identified a number of issues, including the coverage of monetary statistics, classification of a number of foreign on-lent loans, and recording of repurchase agreements on the treasury bills. The BOM is following up on the recommendations of the mission. A TA mission is scheduled for October 2005 to review the progress to date and to assist the BOM in the implementation of the *MFSM* methodology.

- The quality of fiscal data—provided for budgetary purposes and publication in the *GFS Yearbook*—could be further improved. Improvements are underway in light of the FAD/STA mission of March 2001 and subsequent GFS missions in 2003 and 2004. Key shortcomings affecting annual and subannual data have been lack of coverage of the government accounts, weaknesses in source accounting data, undocumented compilation and consolidation procedures, and lack of reconciliation between government accounts data and banking data at an aggregate level. The implementation of an integrated government-wide chart of accounts should help resolve the underlying technical problems while ongoing treasury reforms should significantly improve accounting and reporting practices.

- Despite the improvement in the coverage of the BOP, further improvement is needed, particularly on data on remittances of migrant workers abroad and foreign direct investment.

3. **Publications**

The NSO publishes monthly and annual *Statistical Bulletins* in English and Mongolian. These bulletins include data on population, employment, national accounts, prices, household income and expenditure, central and local government revenue and expenditure, and external trade. The BOM publishes a monthly *Statistical Bulletin* (within 15 days of the end of the month, which includes summary statistics for the central bank, consolidated balance sheet of commercial banks, and interest and exchange rate data) and *Annual Reports* since 1993.

Mongolia: Table of Common Indicators Required for Surveillance

As of July 27, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	6/30/05	7/14/05	D	W	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/30/05	7/15/05	D	W	M
Reserve/Base Money	6/30/05	7/15/05	W	W	M
Broad Money	6/30/05	7/15/05	M	M	M
Central Bank Balance Sheet	6/30/05	7/18/05	W	W	M
Consolidated Balance Sheet of the Banking System	6/30/05	7/18/05	M	M	M
Interest Rates[2]	6/30/05	7/15/05	W	W	M
Consumer Price Index	June 2005	7/10/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	June 2005	7/14/2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	June 2005	7/14/2005	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2004	Feb 2005	A	A	A
External Current Account Balance	Q1 2005	6/10/05	Q	Q	Q
Exports and Imports of Goods and Services 7/	April 2005	6/15/05	M	M	M
GDP/GNP	2004	Feb 2005	A	A	A
Gross External Debt	2004	Feb 2005	A	A	A

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA)
[7] Except for data on services accout, which become available together with external current account balance.

Options for Tax and Expenditure Policy Reforms

Options for Tax Policy Reforms

With tax revenues at about 30 percent of GDP, Mongolia compares favorably with countries of comparable levels of development. The revenue productivity of taxes, especially VAT, is significantly higher than in many developing countries, despite tax rates broadly in line with those in the region and even, in some cases, lower than in many other developing countries. However, high spending requires high and distortionary taxation and borrowing, which reduces the resources available to the private sector and increases incentives for informality. To enhance the private sector's economic environment, the authorities intend to improve their tax system by undertaking further reforms of their tax policies and clarifying and simplifying their tax laws. In addition, the authorities have been considering specific proposals to unify the CIT, PIT and VAT rates, and increase royalty rates to extract more revenue from the mining sector. A FAD Technical assistance mission visited Ulaanbaatar in October 2004, reviewed Mongolia's tax system and made recommendations to improve efficiency, revenue productivity, and equity of the tax system. The Article IV mission's recommendations were based on the findings of FAD mission.

Identified weaknesses in the current tax system:

- corporate income tax (CIT) limits deductions such as for advertising, has no provisions for loss carry-forward, and its dual rate system is distortionary;
- the system of tax incentives, relying on tax holidays and concessional PIT rates, discriminates between and within sectors, and between domestic and foreign investors;
- there is a significant amount of cascading under the VAT due to a poorly working refund system and important exemptions;
- the threshold for the personal income tax (PIT) is substantially lower than in many other developing countries, raising equity and administrative issues.

In order to remove these weaknesses under a comprehensive, revenue neutral tax reform program, the Article IV mission recommended:

- removing exemptions;
- unifying the CIT at 25 percent, in two phases;
- removing restrictions on legitimate business expenses, and providing for loss carry forward;
- introducing a cost effective system of tax incentives based on investment tax credits;
- reducing the cascading under the VAT by providing, among other things, input tax credits for pre-production expenses and pre-registration stock of goods;
- increasing the threshold of PIT by 75 percent;
- introducing taxes on domestic beer and telecommunication services, and restructuring and increasing the rate of excises on cars in order to offset revenue losses from these measures.

On the possible proposal for a flat tax system, the mission acknowledged that single rates can encourage compliance and reduce complexity, but also noted that it is generally unlikely that tax rate cuts would pay for themselves unless authorities undertake significant reforms to improve tax administration and to improve the efficiency, equity, and revenue productivity of their tax system.

As to increasing the tax burden on mining sector, the mission raised its concerns that increasing the taxes unduly on the mining sector would send a negative signal, scaring away new investment in a sector that is key to growth of the Mongolian economy. The authorities were advised to heed the recommendations that will be provided by the World Bank on mining sector taxation.

In July 2005, the authorities submitted to parliament a draft tax reform proposal to be discussed during the Fall session of the parliament. The proposal incorporates part of the mission's recommendations such as the removal of the limits on legitimate business expenses, introduction of investment tax credits, removal of the tax incentives in the form of tax holidays and reduced tax rates, and increasing the threshold of PIT by 75 percent. However, the authorities have not yet incorporated some other key recommendations such as unifying the CIT at 25 percent and introducing changes to reduce the cascading under the VAT. The authorities are also considering several proposals that also have some elements about which the Article IV mission had raised concerns. These were increasing custom tariffs for imported goods on milk and milk products, soft drinks, alcoholic beverages, leather products. Not included in the package but also being discussed were reducing the social insurance employer contribution rates and increasing the royalties and mining license fees.

Options for Expenditure Reforms

At over 40 percent of GDP, public spending in Mongolia is high in comparison with other transition countries, comparing, for example, with an average spending level of 19 percent of GDP in 2000-03 in seven low-income countries of the Commonwealth of Independent States. Moreover, despite significantly higher social spending than in these countries, social outcomes indicators, such as education achievement and health outcomes, are comparable. A January FAD Expenditure Policy mission assessed options for government expenditure savings and efficiency enhancement.

Identified weaknesses in the expenditure policy of the authorities:

- despite highly favorable demographics, the pension system is unsustainable, due to low retirement ages, a limited contribution base, and a high minimum benefits;
- social assistance for vulnerable groups is a patchwork of overlapping and poorly targeted benefits;
- government spending on education and health is relatively high and inefficient;
- administrative expenditures are high, reflecting duplication, and overstaffing.

In light of the recommendations of the TA mission, to increase spending efficiency and identify areas for savings the Article IV mission recommended:

- enhancing the pension system's sustainability by raising the retirement age, lengthening the wage reference period for pension calculations, phasing in the notional defined contribution system, indexing the minimum pension to CPI instead of the minimum wage, and integrating the collection of social contributions with the administration of taxes;

- rationalizing social assistance by eliminating overlapping family benefits, developing an information management system for monitoring of the system of benefits, designing and introducing a specific social safety net for vulnerable herders to provide cost-effective protection during occasional severe winters;

- increasing the efficiency in health and education by increasing the weekly norm for teaching hours, consolidating public tertiary education institutions, eliminating public health services of a purely private nature, limiting fully free public health insurance only to the poor;

- reducing administrative expenditures, including the wage bill, by eliminating retirement and tuition grants for civil servants, imposing a partial hiring freeze to reduce excess support staff, and containing increases in wages of support staff to inflation.

MONGOLIA—JOINT FUND-BANK DEBT SUSTAINABILITY ANALYSIS

A. Introduction

1. This appendix presents the joint debt sustainability analysis (DSA) of the IMF and the World Bank staff based on the common standard framework for low-income countries, which has been approved by the respective Executive Boards.[1] The assessment is based on a forward-looking analysis of debt and debt-service dynamics, taking into account debt burden thresholds that depend on the quality of a country's policies.

2. **The DSA comprises: (i) a baseline scenario, and (ii) set of alternative scenarios and bound tests.** Whereas the baseline scenario is set up on the most plausible medium- and long-term assumptions on key macro economic parameters and economic policies, the alternative scenarios and bound tests are intended to explore the robustness of baseline projections to alternative assumptions and shocks to macroeconomic policies and indicators. Bound tests include the customary analysis of macroeconomic variables at one standard deviation from their historical averages, as well as Mongolia-specific shocks, such as copper and gold price fluctuations. The importance of a borrowing strategy that seeks to contain the risk of debt distress is also covered.

3. **Reflecting data availability, the DSA covers only public and publicly-guaranteed debt and excludes private sector debt and contingent liabilities.** There are several proposals being discussed with foreign partners that would represent large borrowing commitments (more than 20 percent of GDP). These have been excluded from the analysis given that terms and conditions as well as government involvements in repayment obligations are not clear at the time of this analysis. It is also assumed that all the domestic public debt will be fully repaid by 2008; therefore, all the public debts are external after 2009.

4. **While there are important differences across the various debt and debt-service indicators, the overall results suggest Mongolia is at relatively high risk of debt distress.** The main findings include: (i) only one indicator—NPV of debt to GDP ratio—is above its threshold under the baseline scenario, (ii) other indicators are well below their threshold over the entire projected period, but (iii) terms of trade shock would exacerbate these indicators above the thresholds.

5. **Discussions for the DSA were conducted jointly by the Fund mission team, the authorities, and the World Bank mission team in the context of the 2005 Article IV consultation discussions. The Fund and Bank teams were in agreement about the**

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[1] See *Operational Framework for Debt Sustainability Assessments in Low-Income Countries—Further Considerations(www.imf.org).*

implications of the scenarios. While noting the difficulties of long-term forecasting, the authorities also agreed broadly on the baseline macroeconomic assumptions and with the main findings.

B. Baseline Medium- and Long-Term Scenario

Basic Assumptions and Thresholds

6. **The baseline scenario is built on continuation of prudent macroeconomic management.** The key assumptions include: (i) an average real GDP growth rate at 5 percent (except for 6 percent in 2006), (ii) an increase in export growth in current dollar terms from about 3½ percent in the medium term to 6½ percent in the long term, and (iii) a more gradual increase in import growth in current dollar terms from about 4¾ percent in the medium term to 6 percent in the long term. The output growth around 5 percent is based on the continued development in mining sector, with no large-scale discovery of new mining fields assumed. In addition to the mining sector, the main drivers of Mongolia's economic growth are the agriculture (livestock) and services sectors (especially trade, transport and wholesale activities). The export projections reflect the WEO assumption of copper price adjustment to their long-term trend. The improved trade and investment policies, which create the environment for business and attract foreign direct investment, are also key factors to support a favorable output and export growth. With fiscal policy aimed at saving the current high-export price windfall, it is also assumed that all the domestic public debt will be fully repaid by 2008.

7. **On the external financing side, it is assumed that new borrowing continues to be modest and contracted on concessional terms.** New borrowing is projected to remain at around US$115 million annually over the medium term, and then to increase by about 2 ½ percent annually over the longer term, reflecting a prudent external debt management strategy. An average concessionality level of new external borrowing is assumed at around 47 percent, which is equivalent to the current level. Grants are assumed to increase by 2 percent annually over time with slightly higher rates in 2006 and 2007 to reflect IDA grant financing that would be allocated during 2005-06.

8. **Mongolia is rated as a medium performer with regard to its policies and institutions as of end-June 2005 under the joint IMF-WB DSA framework for LICs.**[2] As a medium performer, the thresholds applied to Mongolia are: (i) 150 percent for Net Present Value (NPV) of debt-to-exports, (ii) 40 percent for NPV of debt-to-GDP, and (iii) 250 percent for NPV of debt-to-fiscal revenue. The relevant debt service thresholds are

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[2] In the LIC DSA framework, the quality of country's policies and institutions is measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index, and classified into three categories: strong, medium and poor.

(i) 20 percent of exports and (ii) 30 percent of revenues. Therefore, the debt sustainability is analyzed in relation to these thresholds in this appendix.

External DSA (Table 2a)

9. **Under the staff's baseline scenario, the NPV of the debt-to-GDP ratio (55 percent at end-2004), which is the only indicator initially above its threshold, declines to below the threshold in the long term.** The indicator is expected to come down below the threshold but only during the later stage of projected period. On the other hand, the NPV of the debt-to-export ratio begins well below the corresponding threshold (150 percent) and remains there during the entire projection period. This reflects the fact that Mongolia would continue to benefit from the rich mineral resources that have led to the high export-to-GDP ratio. Also, given that most of the external debt is on concessional terms, the debt service ratio would stay at around 4 percent of exports under the baseline scenario, against the 20 percent threshold.

Fiscal DSA (Table 1a)

10. **Debt indicators relative to government revenue also stay well below the threshold, and experience a steady improvement.** The NPV of debt-to-revenue ratio would decline from around 150 percent in the medium term to 121 percent by 2015 and further to below 100 percent by 2025. The associated debt service ratio would increase to 7.3 percent in 2009, but subsequently would decline gradually to 5 percent in 2025. These projections are based on a slight decline of revenue-to-GDP ratio from 39 percent in 2005 to 34 percent by 2010, keeping the same level thereafter.

C. Bound Tests Applied to Baseline and Alternative Scenarios

External DSA (Table 2b)

11. **The bound tests suggest that external debt indicators could deteriorate considerably in the face of adverse external developments, especially terms of trade shocks.** Given that copper and gold account for about half of the Mongolia's total exports, the impacts of exogenous shocks on these commodities were simulated as a Mongolia-specific bound test. Specifically, the test assumes that copper and gold prices decline by 30 percent and 20 percent, respectively, in 2008, and each rises by 1 percent annually during 2009-25; the test also assumes that the volume growth of gold export is half of the baseline scenario in and after 2008 as the lower price would reduce investors' motivations for exploration and development (Case B.2 in Table 2b). As a consequence of these terms of trade shocks and their income effects, it is assumed that the real GDP growth rate is less by 0.5 percent in 2008 and by 0.25 percent thereafter compared to baseline scenario. Under these assumptions, both NPV of debt-to-GDP ratio and debt-to-export ratio deteriorate to well above the corresponding thresholds and do not return to the sustainable paths, showing high vulnerability to international commodity prices.

12. **While the shocks to the interest rate remain manageable in the long term, the debt burden would become heavier in the medium term.** This test is to try to capture the impacts of low concessionality of external borrowing (Case A.2 in Table 2b). We assume that the average interest rate rises to 1.6 percent in 2008 and gradually to 2.4 percent until 2012 and stays thereafter, while grace and maturity periods are the same as in the baseline scenario. Under this test, which is equivalent to treating all new external debt as nonconcessional, the debt burden becomes heavier over the medium term before the debt dynamics return to the sustainable path in the long term.[3] For example, the NPV of debt-to-GDP ratio would reach 60 percent after 2008, and remains high for several years.

13. **Any relaxation of the authorities' prudent approach to contracting external debt could have serious consequences for debt sustainability.** In particular, large scale external borrowing on non-concessional terms, currently under negotiations on top of the baseline scenario, would further worsen the situation. Especially, the involvement of nontransparent negotiations and procurement procedures arising from any political pressure would increase a total cost of projects even if the terms of financial contracts alone were concessional. The calling for contingent liabilities such as central bank guarantees on private sector borrowing would also risk a sustainable path under the baseline scenario.

Fiscal DSA (Table 1b)

14. **Indicators relative to government revenue also show vulnerability to some shocks and alternative scenarios.** For example, if real GDP growth and fiscal performance were to revert to their historical averages (case A1 in Table 1b), the analysis shows that the level of public debt would be unsustainable, with the NPVs of public debt rising to nearly 100 percent of GDP (300 percent of revenue). Also, under the hypothetical 30 percent real exchange rate depreciation in 2006 (case B4 in Table 1b), the NPV ratio would jump up to 76 percent of GDP (203 percent of revenue) in 2006 and would remain around 70 percent of GDP (200 percent of revenue) though 2010.

D. Debt Distress Classification

15. **Mongolia is at moderate risk of debt distress over the medium term, although the debt burden should be sustainable over the long term if the authorities continue to contract external debt only on concessional terms and the external economic environment is not very unfavorable.** The NPV of debt-to-GDP ratio indicates a breach of its threshold over a number of years under the baseline scenario. In addition, some of the alternative scenarios and bound tests exacerbate other debt indicators by breaching or

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[3] This assumption reflects a hypothetical situation where possible nonconcessional borrowing from China and Turkey under negotiations would completely substitute concessional borrowing assumed under the baseline scenario, meaning that additional nonconcessional borrowing on top of the baseline scenario is not assumed.

nearing the relevant thresholds. However, under the staff's baseline scenario, Mongolia's public external debt ratio declines substantially in the long term. Also, given the high concessionality of external public debt, debt service indicators to export and revenue remain well below relevant thresholds. Other indicators such as NPV of debt-to-export ratio and NPV of debt-to-revenue ratio also stay well below the respective thresholds of 150 and 250 percent.

16. **Mongolia's past record suggests authorities' strong commitment in meeting external debt obligations.** Reflecting a large share of highly concessional borrowing from multilaterals, debt service obligation has been manageable. Thus, Mongolia has never availed itself of the Paris Club debt relief. The authorities continue to negotiate with some bilateral creditors over rescheduling and/or restructuring agreements that were originated during the early stage of economic transition.

E. Summary and Conclusions

17. **Under the prudent macroeconomic and external debt management policies, Mongolia's debt indicators are projected to improve over the medium-to-long term, but any slippage of these policies would have adverse consequences on public external debt sustainability.** The stress tests suggest that external debt indicators would become unsustainable under adverse external developments, especially terms of trade shocks such as the sharp decline in copper and gold prices or a substantial currency depreciation. Also, while the shocks to the interest on new external borrowing should remain manageable over the longer term, the debt burden could initially worsen over the near-to-medium term.

18. **Staying on a sustainable path would crucially require that Mongolia** (i) continues to secure concessional external loans and grants, (ii) resists any political pressures of large borrowing commitments, which would involve nontransparent negotiation and procurement procedures. Mongolia also needs to promote private sector development to underpin investment-led solid growth, which contributes to sustainable debt dynamics.

Table 1a.Mongolia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2002-2025
(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2002	2003	2004	Historical Average 5/	Standard Deviation 5/	2005	2006	2007	2008	2009	2010	2005-10 Average	2015	2025	2011-25 Average
Public sector debt 1/	91.7	113.9	99.0			88.2	86.7	85.5	84.0	81.9	80.2		66.2	40.4	
o/w foreign-currency denominated	88.7	99.1	90.9			84.8	86.0	85.5	84.0	81.9	80.2		66.2	40.4	
Change in public sector debt	2.6	22.2	-14.9			-10.8	-1.5	-1.2	-1.5	-2.1	-1.7		-2.7	-2.8	
Identified debt-creating flows	-2.8	8.9	-23.9			-11.4	-2.4	-2.8	-3.2	-3.0	-2.4		-3.2	-2.9	
Primary deficit	4.3	3.0	1.0	4.6	3.1	0.7	2.0	2.2	2.2	2.4	2.3	2.0	1.3	-0.1	0.9
Revenue and grants	38.4	37.9	39.4			39.1	37.4	36.6	35.7	35.1	34.7		34.6	34.4	
of which : grants	0.6	0.6	0.3			0.2	0.3	0.3	0.3	0.3	0.3		0.3	0.3	
Primary (noninterest) expenditure	42.8	40.9	40.4			39.9	39.4	38.9	37.9	37.4	37.0		35.9	34.3	
Automatic debt dynamics	-5.8	-9.6	-17.9			-9.4	-3.4	-4.2	-4.6	-4.6	-4.1		-4.4	-2.7	
Contribution from interest rate/growth differential	-3.5	-5.4	-12.9			-6.2	-5.6	-4.8	-4.8	-4.7	-4.6		-3.8	-2.4	
of which : contribution from average real interest rate	0.0	-0.5	-1.9			-1.5	-0.6	-0.7	-0.7	-0.7	-0.7		-0.6	-0.4	
of which : contribution from real GDP growth	-3.5	-4.9	-11.0			-4.7	-5.0	-4.1	-4.1	-4.0	-3.9		-3.3	-2.1	
Contribution from real exchange rate depreciation	-2.4	-4.2	-5.0			-3.2	2.2	0.6	0.2	0.0	0.4		...	...	
Other identified debt-creating flows	-1.4	15.4	-7.0			-2.7	-1.0	-0.9	-0.8	-0.7	-0.7		-0.2	-0.1	
Privatization receipts (negative)	-1.4	-1.5	-0.9			-0.1	-0.4	-0.4	-0.4	-0.3	-0.3		-0.2	-0.1	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	16.9	-6.0			-2.6	-0.5	-0.5	-0.4	-0.4	-0.4		0.0	0.0	
Residual, including asset changes	5.4	13.3	9.0			0.5	0.9	1.6	1.7	0.9	0.8		0.5	0.1	
NPV of public sector debt	62.7	80.2	63.0			55.5	53.6	52.7	51.9	50.7	49.9		42.0	26.0	
o/w foreign-currency denominated	59.7	65.3	54.9			52.1	52.9	52.7	51.9	50.7	49.9		42.0	26.0	
o/w external	59.7	65.3	54.9			52.1	52.9	52.7	51.9	50.7	49.9		42.0	26.0	
NPV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Gross financing need 2/	7.1	24.9	6.7			5.7	4.2	4.6	4.7	4.9	4.8		3.7	1.6	
NPV of public sector debt-to-revenue ratio (in percent) 3/	163.2	211.6	159.8			141.8	143.4	143.9	145.3	144.6	143.9		121.4	75.7	
o/w external	155.3	172.3	139.3			133.1	141.5	143.9	145.3	144.6	143.9		121.4	75.7	
Debt service-to-revenue ratio (in percent) 3/ 4/	7.2	57.8	14.6			6.5	6.0	6.5	7.1	7.3	7.2		6.7	4.9	
Primary deficit that stabilizes the debt-to-GDP ratio	1.8	-19.2	15.9			11.6	3.5	3.4	3.7	4.5	4.0		4.1	2.7	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	4.0	5.6	10.6	4.3	3.6	5.0	6.0	5.0	5.0	5.0	5.0	5.2	5.0	5.0	5.0
Average nominal interest rate on forex debt (in percent)	1.1	1.2	1.2	1.0	0.1	1.2	1.2	1.2	1.1	1.1	1.1	1.2	1.1	1.1	1.1
Average real interest rate on domestic currency debt (in percent)	10.2	1.2	-8.2	2.2	6.4	-6.3	1.0	-0.4	...	...	...	-1.9	...	...	...
Real exchange rate depreciation (in percent, + indicates depreciation)	-2.9	-5.0	-5.7	-2.1	6.0	-3.7	2.8	0.8	0.2	0.0	0.6	0.1	-0.8	-0.8	-0.8
Inflation rate (GDP deflator, in percent)	6.9	11.5	11.8	9.5	1.9	8.5	2.9	4.5	4.9	5.0	4.4	5.0	5.9	5.8	5.8
Growth of real primary spending (deflated by GDP deflator, in percent)	5.0	1.1	9.2	4.3	5.1	3.6	4.7	3.6	2.4	3.7	3.8	3.7	4.5	4.6	4.5
Grant element of new external borrowing (in percent)	0.0	0.0	0.0	0.0	0.0	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	...

Sources: Country authorities; and Fund staff estimates and projections.

1/ The data covers the gross debt of the consolidated general government.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues including grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 6 years due to limitations on data availability.

Table 1b.Mongolia: Sensitivity Analysis for Key Indicators of Public Debt 2005-2025

	Estimate	Projections						
	2005	2006	2007	2008	2009	2010	2015	2025
NPV of Debt-to-GDP Ratio								
Baseline	56	54	53	52	51	50	42	26
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	56	58	61	64	66	69	79	102
A2. Primary balance is unchanged from 2004	56	53	51	49	47	44	34	25
A3. Permanently lower GDP growth 1/	56	54	54	54	54	54	55	65
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-2007	56	58	62	63	65	66	68	67
B2. Primary balance is at historical average minus one standard deviations in 2006-2007	56	61	66	65	63	62	53	34
B3. Combination of B1-B2 using one half standard deviation shocks	56	61	66	64	63	62	52	32
B4. One-time 30 percent real depreciation in 2006	56	76	73	71	69	67	55	35
B5. 10 percent of GDP increase in other debt-creating flows in 2006	56	63	62	61	60	59	49	31
NPV of Debt-to-Revenue Ratio 2/								
Baseline	142	143	144	145	145	144	121	76
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	142	156	167	179	189	198	228	296
A2. Primary balance is unchanged from 2004	142	141	139	137	133	128	99	72
A3. Permanently lower GDP growth 1/	142	145	147	151	154	157	158	190
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-2007	142	154	168	177	184	190	197	196
B2. Primary balance is at historical average minus one standard deviations in 2006-2007	142	162	181	182	181	180	153	98
B3. Combination of B1-B2 using one half standard deviation shocks	142	162	180	181	179	178	149	94
B4. One-time 30 percent real depreciation in 2006	142	203	200	199	196	193	158	101
B5. 10 percent of GDP increase in other debt-creating flows in 2006	142	170	170	171	170	169	143	91
Debt Service-to-Revenue Ratio 2/								
Baseline	7	6	7	7	7	7	7	5
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	7	6	10	12	13	14	17	30
A2. Primary balance is unchanged from 2004	7	6	6	6	5	5	5	4
A3. Permanently lower GDP growth 1/	7	6	7	8	8	9	11	17
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-2007	7	6	9	11	12	13	14	19
B2. Primary balance is at historical average minus one standard deviations in 2006-2007	7	6	13	16	12	10	9	8
B3. Combination of B1-B2 using one half standard deviation shocks	7	6	12	14	11	9	8	7
B4. One-time 30 percent real depreciation in 2006	7	7	8	9	9	9	8	7
B5. 10 percent of GDP increase in other debt-creating flows in 2006	7	6	15	11	9	9	8	7

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
2/ Revenues are defined inclusive of grants.

Table 2a. Mongolia: External Debt Sustainability Framework, Baseline Scenario, 2002-2025 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Estimate	Projections								
	2002	2003	2004			2005	2006	2007	2008	2009	2010	2005-10 Average	2015	2025	2011-25 Average
External debt (nominal) 1/	**89.4**	**99.1**	**90.9**			**84.8**	**85.9**	**85.4**	**83.9**	**81.7**	**80.1**		**66.2**	**40.4**	
o/w public and publicly guaranteed (PPG)	89.4	99.1	90.9			84.8	85.9	85.4	83.9	81.7	80.1		66.2	40.4	
Change in external debt	0.2	9.7	-8.1			-6.1	1.1	-0.5	-1.5	-2.1	-1.7		-2.7	-2.8	
Identified net debt-creating flows	-4.6	-13.1	-23.8			-8.4	-6.7	-5.6	-5.9	-5.8	-5.3		-4.3	-3.4	
Non-interest current account deficit	**8.8**	**7.0**	**-2.2**	**3.1**	**5.9**	**1.2**	**3.7**	**3.4**	**3.4**	**3.3**	**3.6**		**3.0**	**1.4**	2.5
Deficit in balance of goods and services	21.8	19.9	14.0			15.7	18.5	18.3	17.6	17.1	17.1		13.7	8.8	
Exports	64.2	66.9	80.9			76.5	72.1	69.7	67.7	66.2	65.0		60.3	52.5	
Imports	86.1	86.8	94.9			92.2	90.6	88.0	85.3	83.3	82.0		74.0	61.3	
Net current transfers (negative = inflow)	-12.5	-12.9	-15.6	-9.9	3.1	-14.5	-14.6	-14.3	-13.9	-13.5	-13.2		-11.0	-7.7	-10.0
Other current account flows (negative = net inflow)	-0.6	0.0	-0.6			0.1	-0.2	-0.6	-0.3	-0.2	-0.2		0.3	0.3	
Net FDI (negative = inflow)	**-7.1**	**-10.5**	**-6.2**	**-4.3**	**3.0**	**-6.6**	**-6.5**	**-5.9**	**-6.3**	**-6.1**	**-5.9**		**-4.9**	**-3.2**	-4.4
Endogenous debt dynamics 2/	**-6.3**	**-9.5**	**-15.3**			**-3.1**	**-3.9**	**-3.1**	**-3.1**	**-3.0**	**-3.0**		**-2.5**	**-1.6**	
Contribution from nominal interest rate	1.0	0.9	1.0			1.0	1.0	0.9	0.9	0.9	0.9		0.7	0.4	
Contribution from real GDP growth	-3.3	-4.5	-8.8			-4.1	-4.8	-4.0	-4.0	-3.9	-3.8		-3.2	-2.0	
Contribution from price and exchange rate changes	-4.0	-6.0	-7.5			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**4.8**	**22.8**	**15.7**			**2.3**	**7.8**	**5.1**	**4.4**	**3.7**	**3.6**		**1.6**	**0.5**	
o/w exceptional financing	0.1	-0.1	-0.4			0.6	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of external debt 4/	59.7	65.3	54.9			52.1	52.9	52.6	51.8	50.6	49.8		42.0	26.0	
In percent of exports	92.9	97.7	67.9			68.1	73.3	75.5	76.5	76.5	76.7		69.7	49.6	
NPV of PPG external debt	**59.7**	**65.3**	**54.9**			**52.1**	**52.9**	**52.6**	**51.8**	**50.6**	**49.8**		**42.0**	**26.0**	
In percent of exports	92.9	97.7	67.9			68.1	73.3	75.5	76.5	76.5	76.7		69.7	49.6	
Debt service-to-exports ratio (in percent)	4.5	34.0	7.5			3.8	3.6	4.1	4.3	4.5	4.3		3.9	3.3	
PPG debt service-to-exports ratio (in percent)	4.5	34.0	7.5			3.8	3.6	4.1	4.3	4.5	4.3		3.9	3.3	
Total gross financing need (billions of U.S. dollars)	0.1	0.2	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Non-interest current account deficit that stabilizes debt ratio	8.5	-2.7	5.9			7.4	2.6	3.9	4.9	5.4	5.3		5.8	4.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	4.0	5.6	10.6	4.2	2.8	5.0	6.0	5.0	5.0	5.0	5.0	5.2	5.0	5.0	5.0
GDP deflator in US dollar terms (change in percent)	4.7	7.2	8.2	2.1	13.2	6.4	-0.7	1.2	1.8	2.0	1.4	2.0	2.8	2.8	2.8
Effective interest rate (percent) 5/	1.2	1.1	1.2	1.3	0.3	1.2	1.2	1.2	1.2	1.2	1.1	1.2	1.1	1.1	1.1
Growth of exports of G&S (US dollar terms, in percent)	11.3	17.9	44.9	13.1	19.7	5.7	-0.9	2.8	3.7	4.7	4.6	3.4	6.4	6.4	6.4
Growth of imports of G&S (US dollar terms, in percent)	14.5	14.2	31.0	13.3	10.6	8.5	3.4	3.3	3.6	4.5	4.9	4.7	5.9	5.9	5.9
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	46.4	46.6	46.9	46.9	46.8	46.8	46.7	46.7	46.7	46.7
Memorandym item:															
Nominal GDP (billions of US dollars)	1.1	1.2	1.5			1.7	1.8	1.9	2.0	2.1	2.3		3.3	7.2	
New external loan disbursement	0.087	0.116	0.129			0.124	0.115	0.115	0.115	0.115	0.118		0.134	0.174	

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments devided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

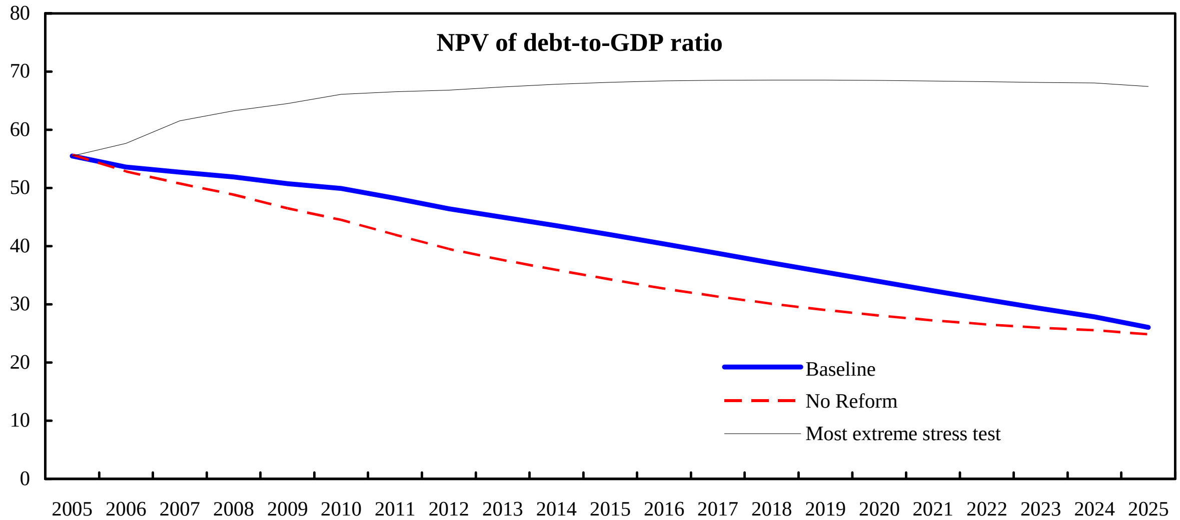
Table 2b. Mongolia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2005-25
(In percent)

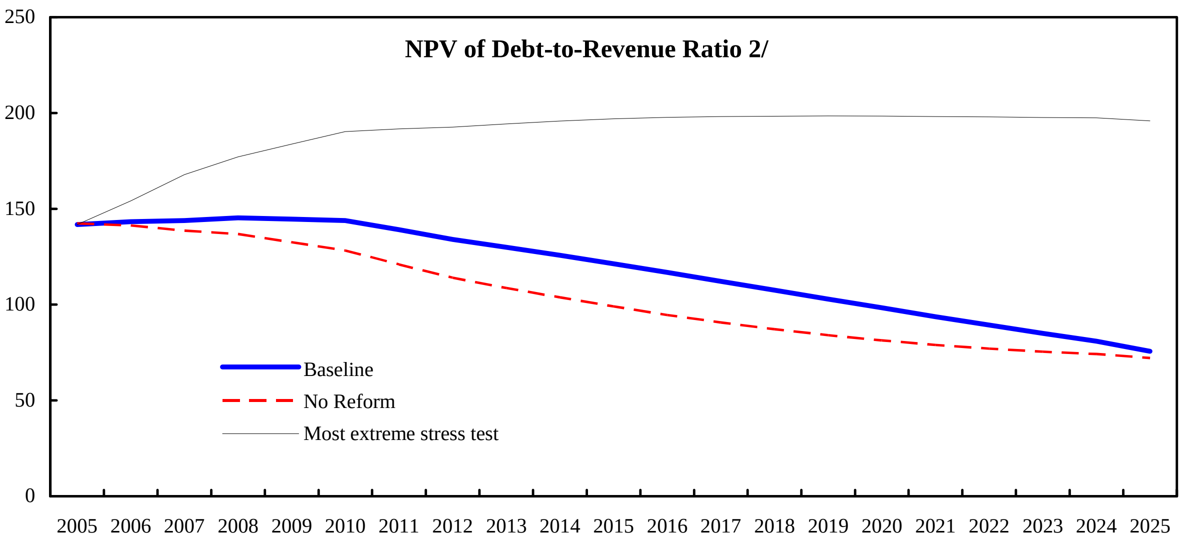
	Estimate	Projections						
	2005	2006	2007	2008	2009	2010	2015	2025
NPV of debt-to-GDP ratio								
Baseline	52	53	53	52	51	50	42	26
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-25 1/	52	53	54	54	54	54	51	38
A2. New public sector loans on less favorable terms in 2006-25 2/	52	53	58	60	61	62	56	38
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	52	55	57	56	55	54	45	28
B2. Terms of trade shocks on copper and gold exports in 2008 and lower growth thereafter 3/	52	53	53	56	59	62	76	102
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	52	59	67	66	64	63	53	33
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	52	60	66	65	64	62	52	30
B5. Combination of B1-B4 using one-half standard deviation shocks	52	59	66	65	64	62	52	32
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	52	76	75	74	73	71	60	37
NPV of debt-to-exports ratio								
Baseline	68	73	75	77	77	77	70	50
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-25 1/	68	74	77	80	81	83	84	71
A2. New public sector loans on less favorable terms in 2006-25 2/	68	74	84	88	92	95	93	73
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	68	73	75	77	77	77	70	50
B2. Terms of trade shocks on copper and gold exports in 2008 and lower growth thereafter 3/	68	73	75	92	100	106	148	245
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	68	73	75	77	77	77	70	50
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	68	83	95	96	96	96	86	56
B5. Combination of B1-B4 using one-half standard deviation shocks	68	73	78	79	79	79	71	49
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	68	73	75	77	77	77	70	50
Debt service ratio								
Baseline	4	4	4	4	4	4	4	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-25 1/	4	3	4	4	5	4	5	5
A2. New public sector loans on less favorable terms in 2006-25 2/	4	4	4	5	5	5	5	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	4	4	4	4	4	4	4	4
B2. Terms of trade shocks on copper and gold exports in 2008 and lower growth thereafter 3/	4	4	4	5	5	5	6	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	4	4	4	4	4	4	4	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	4	4	4	5	5	5	5	4
B5. Combination of B1-B4 using one-half standard deviation shocks	4	3	4	4	4	4	4	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	4	4	4	4	4	4	4	4
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	46	46	46	46	46	46	46	46

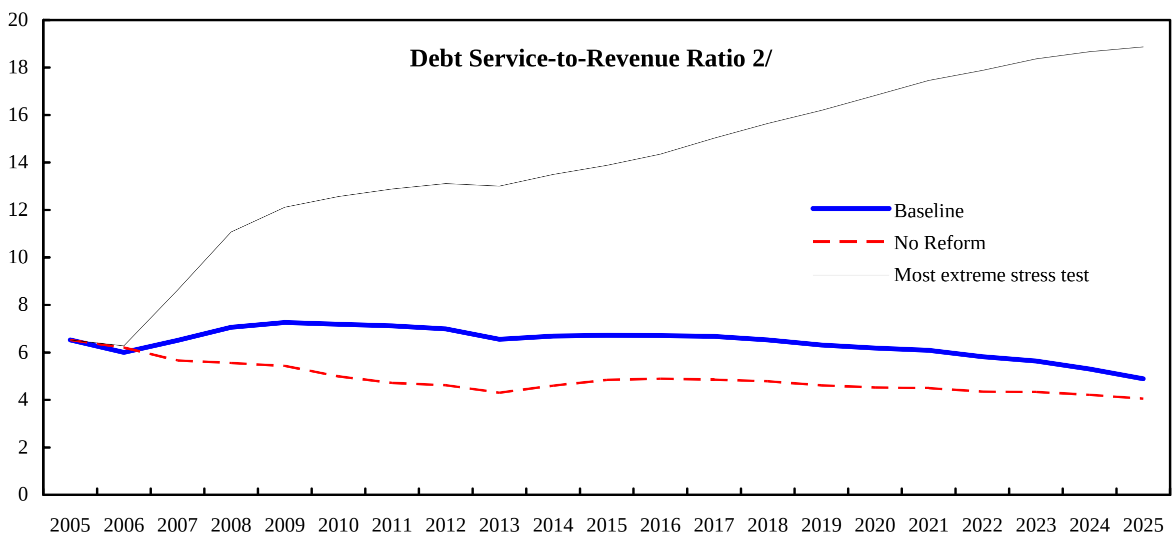
Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the average interest rises to 1.6 percent in 2008, and gradually to 2.4 percent until 2012 and stays thereafter, while grace and maturity periods are the same as in the baseline.
3/ Assumes that copper and gold prices decline by 30 percent and 20 percent respectively in 2008 on top of the WEO assumptions of sharp decline in copper prices through 2006-08, and each rises by 1 percent in 2009-25, and also assumes that the growth of the gold export volume is half of the baseline scenario after 2008. As a consequence of these terms of trade shocks, assumes that the real GDP growth rate is less by 0.5 percent in 2008 and by 0.25 percent thereafter compared to baseline scenario.
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 1.Mongolia: Indicators of Public Debt Under Alternative Scenarios, 2005-2025 1/
(In percent)

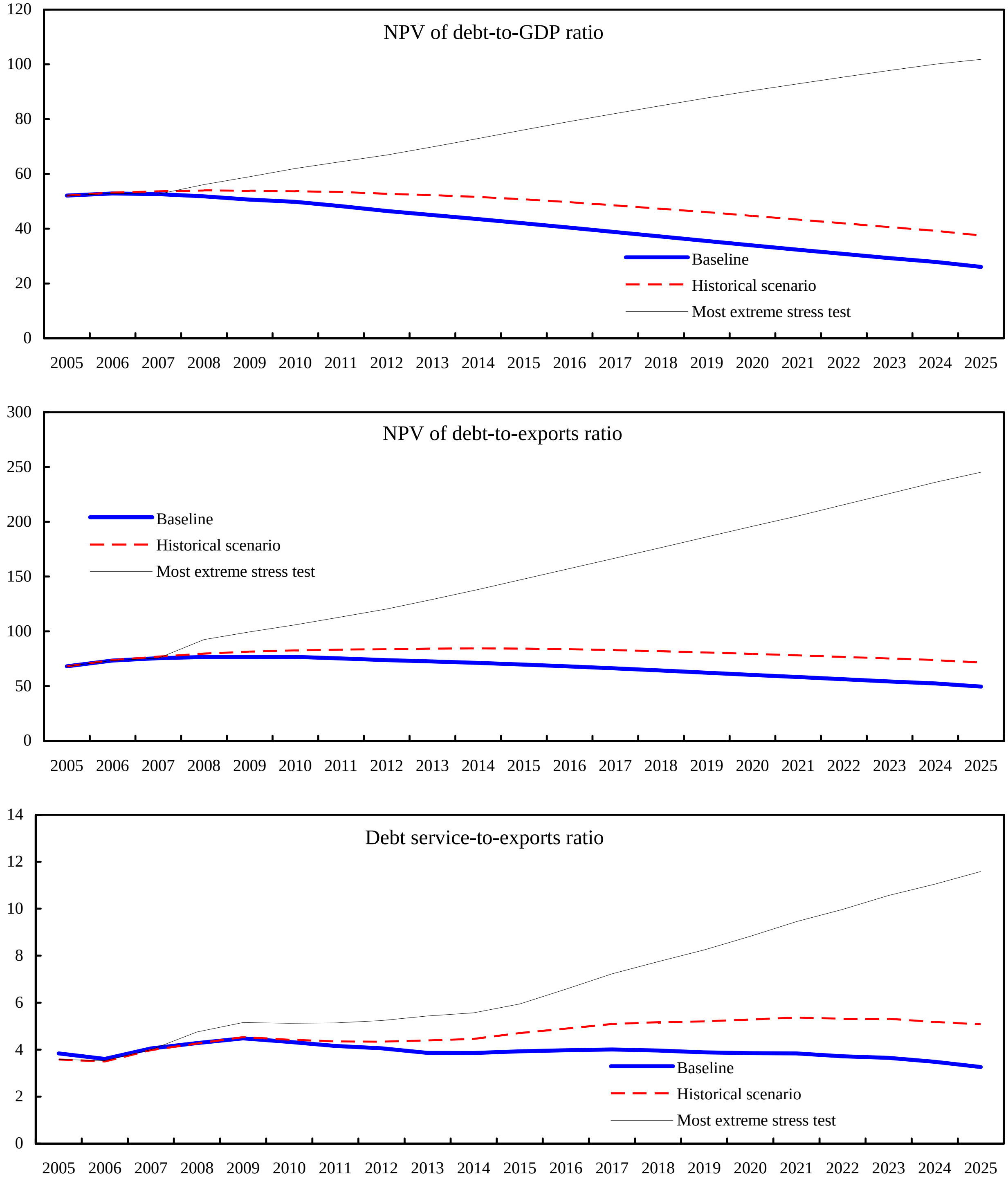






Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2015.
2/ Revenue including grants.

Figure 2. Mongolia: Indicators of Public and Publicly Guaranteed External Debt
Under Alternative Scenarios, 2005-2025
(In percent)



Source: Staff projections and simulations.

Statement by the IMF Staff Representative
September 21, 2005

This statement outlines developments since the staff report was issued. The reported information does not affect the thrust of the staff appraisal.

Fiscal and monetary developments over the past two months remained broadly consistent with the trends in the first half of the year.

- According to the latest available fiscal data, revenues continue to perform strongly across the whole array of taxes and the stock of net domestic bank financing has been reduced by 3¼ percent of GDP in the first eight months of the year. If spending discipline is maintained, the overall deficit could remain below 2 percent of GDP in 2005.

- Monetary aggregates continued to grow rapidly. Broad money grew by 28 percent, year-on-year, at end-August, and reserve money growth accelerated, reflecting the continued accumulation of net international reserves. After issuing extra central bank bills in July, the Bank of Mongolia has not taken further steps to tighten monetary policy.

As anticipated in the staff report, inflation is finally slowing down. The annual headline inflation rate declined to 11½ percent at end-August, from 17½ percent at end-June, while core inflation also slowed to 5 percent year-on-year, from close to 9 percent at end-June. Underlying this favorable movement is the waning of supply shocks in the meat and vegetables markets, and broad stability in other components of the index, including petroleum products, whose domestic prices did not move between June and August. Further increases in the price of petroleum products imported from Russia have already been announced, which would bring Mongolia's prices closer into line with world market levels. Nevertheless, inflation for the year as a whole is still expected to be contained to the staff projection of 10 percent.

Separately, Mongolia's main Russian supplier of refined products has announced that it would no longer sell to Mongolian importers after September. While other suppliers are expected to fill this void, the move has the potential to cause temporary supply disruptions and could lead to higher domestic prices.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/140
FOR IMMEDIATE RELEASE
October 6, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Mongolia

On September 21, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mongolia.[1]

Background

Mongolia's overall economic performance was stronger than expected and broad based in 2004 and early 2005. Sectoral contributions to high growth included a rebound in the livestock sector from harsh winter shocks of 2000-01 (the "dzuds") and strong mining exploration and exports, boosted by a favorable environment of unusually high copper and gold prices. The balance of payments has been strong, with favorable terms of trade, new gold operations, good performance by the service sector, and robust capital flows in the mining sector. The current account (including transfers) is estimated to have been in a surplus equivalent to about one percent of GDP in 2004. High commodity export prices and strong tourism and private transfers helped offset the increased cost of oil imports (more than a fourth of total imports).

After several years of moderation, however, inflation has accelerated, reaching 17½ percent through June 2005 (before easing significantly in August), as prices of fuels and meat have increased very sharply in the past twelve months. These inflationary pressures threaten the hard-won gains in macroeconomic stabilization in recent years.

Fiscal performance was good in 2004, with excellent prospects for 2005. Strong revenue receipts reflected overall economic growth as well as higher-than-expected prices for

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

copper and volume for gold. The lowest overall deficit since the beginning of transition, about 2 percent of GDP, allowed a notable decrease in indebtedness. For 2005, better-than-projected revenue performance in the first half suggest the overall fiscal deficit is likely to be lower than the budget target of about 3½ percent of GDP.

Monetary policy accommodated supply-side shocks, namely the close-to-full pass-through of higher world oil prices, regulatory changes in the meat supply chain, and administrative price adjustments in utilities. Although broad money grew at about the rate of nominal GDP growth in 2004, slowing down from rates above 40 percent in earlier years, private credit growth was still high in early 2005, reaching nearly 33 percent year-on-year at end-June 2005.

Concerns for the vulnerability of the banking sector have been heightened by high credit growth and remaining weaknesses in supervision and enforcement of prudential rules. The incidence of nonperforming loans (NPLs) increased from 8.3 percent at end-2003 to more than 10 percent at mid-2005. Moreover, credit risk management of banks remains fragile due to weaknesses in bank corporate governance, compounded by the sufficient enforcement of applicable prudential standards.

Progress continues on structural reform, with efforts continuing to improve the tax administration, banking supervision, and public enterprise restructuring. The authorities are currently focusing attention on the vital energy sector. In addition, Mongolia's poverty reduction strategy concentrates on enhancing growth prospects and improving provision of key services and social assistance.

Medium-term prospects are broadly favorable, provided the authorities manage to slow inflation back to single digit and sustain supportive fiscal policies. Growth is expected to settle around at least 5 percent, with a return to trend growth for the livestock sector. With appropriate policy action, mainly on the monetary side, inflation should slow down, to about 10 percent year-on-year at end 2005, returning to a 5 percent trend in 2006. The balance of payments is projected to weaken moderately, in line with a modest decline in the terms of trade. Export growth is likely to turn negative in 2006 as world prices of copper are projected to decline by a third from their record levels. However, import growth should slow down, as oil prices are projected to stabilize. The current account balance (including official transfers) is projected to move back into a deficit in the range of 4-5 percent of GDP over the medium-term. Public debt, although high, is broadly sustainable because of its concessional terms and the external and fiscal outlook.

Executive Board Assessment

Executive Directors commended the Mongolian authorities for the recent strong growth performance, the maintenance of broad macroeconomic stability, and for bringing the public debt onto a more sustainable path. The potential for large increases in mineral extraction was strengthening the medium-term economic outlook. Directors observed, however, that Mongolia remains vulnerable to pronounced declines in copper prices and weather conditions affecting the agricultural sector. They encouraged the authorities to implement an ambitious structural reform agenda in order to strengthen sustainable growth and the resilience of the economy, in particular by improving the environment for the private sector, and to maintain their efforts to tackle poverty and achieve the Millennium Development Goals. They also saw the need to take advantage of the favorable external environment to continue debt consolidation and lower inflation further.

Directors welcomed the authorities' aim to keep the overall deficit in 2005 well below the original budget target in light of inflationary pressures and weaker current account prospects. They urged the authorities to avoid expenditure slippages and save additional revenues. For 2006 and beyond, Directors considered that the fiscal stance should be broadly neutral, provided that inflationary pressures will have subsided. This would allow a further sharp fall in borrowing from the domestic banking sector, with public debt declining in GDP terms, while infrastructure improvements that will be critical for growth would be fully financed.

Directors encouraged the authorities to proceed with revenue-neutral reforms aimed at improving the overall efficiency of the tax system, broadening the tax base, eliminating distortions in income taxes and the VAT, and strengthening revenue administration. On the spending side, they recommended that the authorities avoid embarking on large infrastructure projects with low rates of return. Given the still high debt level and the need to preserve external sustainability, project borrowing should only be on concessional terms, and without government or central bank guarantees. Directors welcomed plans for further improvements in public financial management, including consolidating all budget resources into the treasury single account, to ensure a tight control over public finances and to improve transparency. They encouraged the authorities to press on with their plans for reform of the civil service and pension systems.

Directors emphasized that further tightening of the monetary stance is needed to help prevent supply-driven price increases from becoming embedded in persistent double-digit inflation. They supported the use of central bank bills to mop up liquidity. Some Directors, noting the high cost of these operations to the Bank of Mongolia (BOM), also recommended that the BOM undertake a review of its monetary policy instruments.

Directors emphasized that Mongolia's flexible exchange rate regime remains appropriate. Directors urged the government to resist demands for trade-based measures to support sectors hit by shocks, or other actions that would undermine the country's open trading system.

Directors stressed that further progress to strengthen the financial system is essential. They urged the authorities to resolve the capital weakness of the BOM and improve its independence and decision-making structure, noting that an enhanced supervisory board could assist in providing oversight. They recommended that the BOM disengage from gold operations. Forceful corrective actions should be taken to tighten supervision and enforce strictly prudential norms for banks, and signs of problems in the non-bank financial sector should be dealt with expeditiously and vigorously. Directors encouraged the authorities to complete the process of drafting laws on Anti-Money Laundering and Combating the Financing of Terrorism, and move to their implementation.

Directors observed that restructuring of public enterprises remains a priority. The governance of enterprises intended to remain in the public sector needs to be improved, and the privatization program should be reinvigorated. Directors underlined the need for reforms in the energy sector.

Directors encouraged the authorities to improve the quality and coverage of fiscal statistics and address the priority issues for the national accounts and balance of payments. Also, they urged the authorities to focus on improved poverty indicators to assist their work on the Millennium Development Goals.

Turning to the Ex Post Assessment of the Fund's long-term engagement with Mongolia, Directors agreed that the overall program design for macroeconomic policies for the last four Fund-supported programs had generally been appropriate. Nevertheless, a large part of the structural agenda remained unfinished, with the financial sector still weak, public enterprises in need of further restructuring, and poverty reduction goals yet unrealized. Directors stressed the need to continue efforts to forge a broad political consensus on the reform agenda to strengthen political ownership and improve implementation of policies. Directors welcomed a continued close policy dialogue between the Fund and the authorities, which could be backed, as appropriate, by a strong Fund-supported program that is fully owned by Mongolia.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the Article IV consultation with Mongolia may be made available at a later stage if the authorities consent.

Mongolia: Selected Economic Indicators, 2001–05

	2001	2002	2003	2004 Est.	2005 Proj.
Domestic economy (percent change)					
Real GDP	1.0	4.0	5.6	10.6	5.0
Consumer prices (end period)	7.9	1.7	4.7	10.6	10.0
Fiscal position (in percent of GDP)					
General government revenue	38.5	38.4	37.9	39.4	39.1
General government expenditure	43.9	44.4	42.1	41.7	41.0
Overall balance	-5.4	-5.9	-4.2	-2.2	-1.8
Total public debt 1/	89.1	91.7	113.9	99.0	88.0
NPV of total public debt 1/	62.8	62.7	80.2	60.2	55.3
Domestic debt	4.8	3.0	14.9	8.1	3.2
Financial variables (percent change)					
Broad money	28.0	41.9	49.7	20.3	19.3
Domestic credit	41.6	43.2	147.0	23.0	10.0
Reserve money	8.4	21.7	14.7	16.8	14.3
Interest rate (percent per annum) 2/	8.8	8.0	15.0	15.8	...
External economy (in millions of US dollars; unless otherwise indicated)					
Current account balance, including official transfers	-77	-108	-99	18	-37
(In percent of GDP)	-7.6	-9.6	-7.7	1.2	-2.2
Exports, fob	523	524	627	872	914
Of which: Gold and Copper	222	258	319	524	580
Imports, cif	693	753	827	1,021	1,120
Financial and capital account balance	92	174	1	11	101
Gross official international reserves (end-period) 3/	207	271	178	205	268
(In months of next year/projected imports c.i.f.)	3.3	3.9	2.1	2.2	2.8
Public and publicly guaranteed external debt	854	978	1,237	1,360	1,417
(In percent of GDP)	84.3	88.7	99.1	90.9	84.8
NPV of public and publicly guaranteed external debt	587	658	816	822	871
(In percent of GDP)	57.7	59.7	65.3	54.9	52.1
Exchange rate					
Togrogs per US dollar (end of period)	1,102	1,125	1,170	1,209	...
REER, period average (1995=100)	114	111	106	104	...

Sources: Mongolian authorities; and IMF staff estimates and projections.

1/ Total public debt includes IMF loans, guarantees and arrears as well as treasury bills outstanding, and gross claims of the central bank on the government.

2/ Annualized yield on end-period auction of 14-day central bank bills.

3/ Beginning December 2000, includes commercial banks' foreign exchange deposits with the Bank of Mongolia.