



MONGOLIA

SELECTED ISSUES

September 2019

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CONTENTS

PRINCIPAL GOVERNANCE CHALLENGES	3
A. Introduction	3
B. Key Areas and Recommended Reforms	3
C. Rule of Law and Regulatory Framework	5
D. Fiscal Governance	6
E. Financial Sector Oversight	11
F. Central Bank Governance and Operations	12
G. Anti-Money Laundering/Combating the Financing of Terrorism	13
References	15
BOX	
1. Selected Recommendations of the 2019 OECD-ACN Monitoring Report	4
ACHIEVING GREEN AND INCLUSIVE GROWTH IN MONGOLIA	17
A. The Mongolian Context	17
B. The Overgrazing Challenge Facing the Livestock Sector	18
C. Four Macro-Critical Implications of Land Degradation	19
D. Policies to Achieve Green and Inclusive Growth	23
E. Role of the International Community	27
F. Final Thoughts	28
References	29
MAKING MONGOLIA'S FISCAL FRAMEWORK FIT FOR THE FUTURE	31
A. Stylized Facts About Fiscal Policy: High Volatility, Deficits and Debt	31

B. Mongolia's Experience with Fiscal Rules	33
C. Options to Strengthen the Fiscal Rules Framework	34
D. A Fiscal Rules Framework Without Considering Mongolia's Mineral Wealth?	36
E. Conclusion	38
References	39

ANNEX

I. Assumptions for PIH Calculation	40
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PRINCIPAL GOVERNANCE CHALLENGES

Mongolia faces several challenges with respect to governance which in turn weigh on potential economic growth and increase macro-economic volatility. Mongolia has taken important steps to address these challenges, but more should be done to tackle remaining gaps and ensure effective enforcement.

A. Introduction

1. Improving governance is a crucial step for Mongolia to achieve sustainable and inclusive growth. As a still young democracy and a natural resource-based economy, Mongolia has many features that weigh on governance including relatively weak institutions, large lumpy capital projects, and windfall revenues from mining booms. Shortfalls in governance have manifested themselves in a variety of ways including foregone FDI due to concerns about the investment climate, higher public debt because of insufficient fiscal procedures, and pressures on correspondent banking relationships following concerns about insufficient Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) controls.

2. Encouragingly, there are important signs of progress in addressing these challenges. The authorities have made upgrades to the anti-corruption legal framework over the last two decades. Issues with governance are well known by the public, and civil society is active in advocating for required reforms. Recently, there has been growing public scrutiny regarding the opaque financing of political parties and the role of vested interest groups in entrenching poor governance. Nonetheless, more work remains and achieving the sustainable growth vision in the government's Economic Recovery Plan crucially depends on further improving governance.

3. This paper aims to take stock of key challenges and propose recommendations on how to address them. The discussion of governance in this note is broken down into 6 categories: A) Anti-Corruption Framework, B) Rule of Law and Regulatory Framework, C) Fiscal Governance, D) Financial Sector Oversight, E) Central Bank Governance and Operations, and F) AML/CFT. The focus within each category is on the governance issues that are macro-critical in nature.

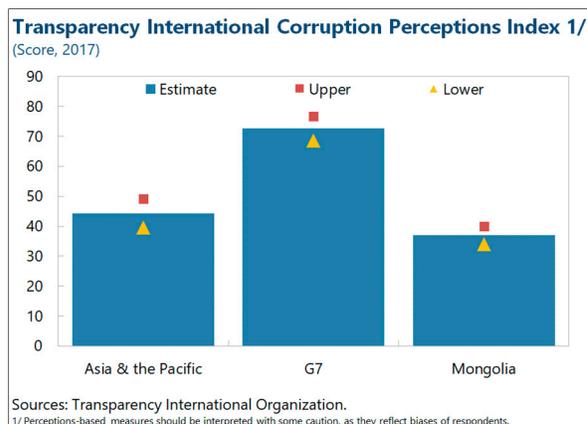
B. Key Areas and Recommended Reforms

Anti-Corruption Framework

4. Mongolia has taken important steps to develop an anti-corruption framework. Mongolia adopted the Anti-Corruption Law in 1996, ratified the United Nations Convention against Corruption in 2006, amended its Anti-Corruption law in the same year to introduce criminal penalties for corruption and most recently revised its Criminal Code in 2017. Mongolia has also signed up to the Istanbul Anti-Corruption Action Plan (the sub-regional peer-review program launched in 2003 supporting the OECD's Anti-Corruption Network for Eastern Europe and Central Asia) which monitors compliance with the UN Convention. The Independent Authority Against

Corruption (IAAC) was established in 2007 to oversee the implementation of the law and the anti-corruption strategy. The first anti-corruption strategy covered the period of 2002–10. The next strategy was adopted in 2016 and covers the period of 2016–23. The IAAC prepares an annual report on implementation of the anti-corruption strategy that is submitted to Parliament.

5. Nonetheless, corruption is still seen as a concern. The 2019 Monitoring Report by the OECD's Anti-Corruption Network for Eastern Europe and Central Asia (OECD-ACN) finds that corruption remains widespread.¹ It emphasizes that implementation of the authorities' action plans has been limited and uneven. Moreover, the IAAC lacks the independence, resources, and necessary support from state bodies to fully exercise its mandate. The 2019 OECD-ACN Monitoring Report included many recommendations focusing on the legal framework, institutional capacity, accountability, operational independence, and enforcement of existing laws and regulations (see box).



Box 1. Summary of Some Key Recommendations of the 2019 OECD-ACN Monitoring Report

- Address the numerous gaps and weaknesses remaining in the legal framework such as lack of criminalization of all corruption offences.
- Strengthen capacities of key institutions, especially the IAAC, the Judiciary and the General Prosecutor's Office, and guarantee their independence.
- Ensure transparent selection of and accountability for the Public Council members responsible for the oversight of the IAAC. Any decisions to change management must be based on credible arguments.
- Strengthen the implementation of the National Anti-Corruption Strategy and the Action Plan by the responsible bodies and provide necessary cooperation to the IAAC to advance reforms.
- Intensify efforts to detect, investigate and prosecute high-profile corruption cases using diverse sources of detection and tools. Eliminate immunity and put in place protections for whistleblowers.
- Take necessary measures to address the politicization of the civil service and malpractices in appointments, as well as the high turnover of staff after each political change.
- Ensure the systematic and objective verification of income and asset declarations by Politically Exposed Persons (PEPs) and follow-up on potential violations.
- Ensure proactive and systematic engagement with civil society.

6. To substantially reduce corruption, a stronger anti-corruption framework should be accompanied by governance reforms across a range of state functions. Reforms to strengthen governance in areas such as the rule of law, the regulatory framework, fiscal and central bank governance, financial sector oversight, and AML/CFT controls will reduce vulnerabilities to

¹ Organization for Economic Co-operation and Development (OECD), 2019, "Anti-corruption Reforms in Mongolia 4th Round of Monitoring of the Istanbul Anti-Corruption Action Plan".

corruption and hence substantially aid the anti-corruption effort. Such reforms will also improve economic efficiency and growth more generally. The following sections thus examine ways to strengthen governance in selected areas.

C. Rule of Law and Regulatory Framework

7. On rule of law, the Worldwide Governance Indicators (WGI) place Mongolia above peers in Asia but below regional averages, indicating room for improvement. While Mongolia has developed a legal framework since the transition to a market economy, observers point out that there are often loopholes and unintended consequences.² The relevant laws should be reviewed and amended specially to ensure a level playing field between foreign and local investors. Regarding enforcement, it is important that local courts do not discriminate between local and foreign investors in any disputes and that de facto practices should be consistent with the de jure protections to investors. Investment protection guarantees that have been signed with key trading partners to provide legal predictability and local remedies should be fully implemented. In particular, the Investor Protection Council (IPC), established in 2016, should upgrade its capacity through training and more funding to enhance investor confidence. The following reforms would help improve the investment climate in Mongolia:

- The judiciary can improve its capabilities through new judges, better training in specialized areas, and improvements in IT. Mongolia also needs to develop arbitral institutions, professionals, practice and case-law.
- The insolvency and creditor rights regime needs to be reformed in line with advice provided by the IMF and other institutions to facilitate creditors' ability to collect collateral in the event of non-payment.
- Although systems are in place to ensure the proper distribution of mining licenses, in practice, there is scope for rent seeking activities by well-connected insiders. Existing regulations including the "use it or lose it" requirement need to be properly enforced.
- Laws and regulations that discriminate between local and domestic investors and the number of areas that are closed to FDI could be reduced to promote investment improve productivity.
- Consider the recommendations to strengthen judicial institutions, as presented in the 2019 OECD ACN Monitoring Report.

² Meville et al.

D. Fiscal Governance

8. **Given the scope for windfall tax revenues in natural resource rich countries such as Mongolia, fiscal governance is a macro critical area where special efforts should be focused.**

The WGI for Government Effectiveness has a score of -0.26 (on a scale of -2.5 to 2.5).³ This is better than peers in Asia although relatively low compared to the global average and emerging-market countries in Asia. Mongolia has a well-designed fiscal rule-based system, embedded in the Fiscal Stability Law of 2010 (FSL) and the Integrated Budget Law. However, adherence to the key requirements of the FSL, including on fiscal deficits and debt, has been uneven with serious implications for macroeconomic stability. At a high level, it is important to ensure a strong institutional framework with clear roles and responsibilities amongst various agencies such the National Audit Office, Fiscal Stability Council, Ministry of Finance and Parliamentary offices. Below are some recommendations in key areas.

Revenue Administration

9. **Weak revenue administration can undermine fiscal sustainability while uneven enforcement of tax rules can damage the investment climate.** The Asia Foundation's 2018 survey of the private sector's perceptions of corruption found that the "Tax Office, Specialized Inspection Agency, and Customs highest among government agencies creating obstacles for business...the three agencies are the most affected by corruption."⁴ To improve the impact of revenue administration on the economy, the IMF has provided large scale TA on tax administration by the General Department of Taxation (GDT) and tax policy by the MOF. Key recommendations include:

- Implement fully and consistently the revised tax laws that strengthen the effectiveness of the tax administration and support a simplified tax regime for small and micro businesses (namely, General Tax Law, Corporate Income Tax Law and Personal Income Tax approved by Parliament in March 2019). To support the introduction of tax legislation changes, the GDT should formulate a detailed action plan for designing and implementing new regulations, tax forms and instructions, administrative processes, information systems and training programs for taxpayers and tax offices.
- Formalize the adoption of a Compliance Risk Management (CRM) process to improve taxpayers' compliance. This should feature greater differentiation across the four taxpayer segments with a simplified regime for smaller businesses. Allocate adequate budgetary funding to support the implementation of the compliance improvement strategies.
- Build a well-developed data management, research, and analytics capability to implement effective CRM. The GDT is in the process of adopting a new Tax Administration Integrated System (TAIS), which will integrate the GDT's currently dispersed tax data and will provide automated reporting of management information for compliance strategies.

³ "Worldwide Governance Indicators", 2018.

⁴ Asia Foundation, 2018, "Study of Private Sector Perceptions of Corruption (STOPP) Survey".

- Remove tax expenditures. Current tax legislation provides too generous tax exemptions and holidays that lead to revenue losses and inefficiencies.⁵ According to the World Bank's Public Expenditure Review 2018 (PER), tax expenditures are a significant source of tax base erosion in Mongolia and undermine budgetary discipline with macroeconomic consequences.⁶ Key recommendations include: broadening the tax base by progressively removing distortionary tax exemptions/incentives by initiating a process of comprehensive and systematic evaluation (cost-benefit analysis) of tax expenditures and enhancing transparency in the process of establishing tax expenditures.⁷
- Avoid establishing tax amnesty schemes and consider alternatives such as payment instalment agreements, voluntary disclosure programs, simplification of the tax policy regime, and strengthening of the legal framework.⁸

Expenditure Policy and Public Financial Management

10. Public investment management needs to be upgraded. There are four main concerns highlighted by recent reports by the IMF and WB.⁹ First, Mongolia's capital expenditures in recent years have been among the highest in the world. At an average of about 11 percent of GDP in 2010-16, Mongolia's capital expenditures far exceed the 4.8 percent of lower middle-income countries and the 3 percent of East Asia and Pacific countries. Second, Mongolia ranks 124th globally regarding the efficiency of that public spending in the World Economic Forum's Global Competitiveness Index.¹⁰ Third, the high level of volatility of annual aggregate spending on public investment makes it difficult to plan over the project cycle of the portfolio of ongoing projects and results in project delays, arrears, and project cancellations when funding is less than expected. And finally, Mongolia has a history of engaging in public-private partnerships which are associated with higher costs and poor selection. To address these concerns, improve investment efficiency, and reduce vulnerabilities to corruption, several steps would help

- Estimating sustainable levels of public investment spending, separate from proposed public investment spending levels, and publish it in the Medium-term Budget Framework.
- Continuing to strengthen the annual budget formulation for public investment by:

⁵ Total tax expenditures were estimated at 3.2 percent of GDP, which accounts for nearly 14 percent of total revenues in 2017. Direct investors and service providers in the mining sector are given tax incentives on profit and VAT exemptions. Tax expenditures due to Corporate Income Tax and Value Added Tax exemptions in 2017 amounted to 1.15 and 0.75 percent of GDP, respectively. Exemptions from excise and Personal Income Tax laws represent the next largest sources for tax expenditures.

⁶ World Bank, 2018, Public Expenditure Review 2018.

⁷ Mongolia is now a member of the G20/OECD Inclusive Framework on BEPS, and has committed to implement the various BEPS minimum standards, including Action 5 on countering harmful tax practices which may require the amendment or removal of some of its tax incentive schemes.

⁸ Voluntary disclosure programs (VDPs) should be carefully designed to ensure their effectiveness in bringing taxpayers forward to disclose past non-compliance while minimizing unfairness to compliant taxpayers. A poorly designed VDP can have a negative impact on tax morale in the country and discourage tax compliance.

⁹ IMF, 2016, Public Investment Management Assessment.

¹⁰ World Economic Forum, 2017, Global Competitiveness Index 2016-17.

- Requiring all projects, regardless of financing source (including concessions), to be appraised prior to the budget process and be approved through the budget process.
- Establishing project selection criteria for investment projects consistent with planning guidelines and publish the criteria.
- Establishing a consolidated methodology for determining the appropriate level of maintenance funding by sector and publish the methodology.
- Improving payables reporting to better control the execution of public investment projects and monitor arrears.
- Expanding the MTFE and annual budget narrative to highlight maintenance needs and the allocation in the budget for routine maintenance, capital repairs, on-going investment projects and new investment projects.

11. The Development Bank of Mongolia (DBM) needs continued improvements in management to limit fiscal risks.

The DBM was established in 2011 to finance large-scale projects that can have a significant impact on the economy. However, in 2012–16, the government used the DBM as the major off-budget financing vehicle with allocations averaging 5.2 percent of GDP. The recent audit by the National Audit Office and a special audit by PricewaterhouseCoopers (PwC) both confirmed significant weaknesses in corporate governance, policies and procedures, and internal control of the DBM during 2012–17.¹¹ In 2017, as part of the Extended Fund Facility (EFF) commitments, Parliament passed a revised DBM Law that strengthens its independence and restricts it to purely commercial activities. Nonetheless, asset quality remains a major concern at DBM, primarily on legacy loans. To improve its operations further, key recommendations include:

- Adopt a Conflict of Interest policy and clearly define the situations that could create conflict of interest. Approve a risk strategy and develop a robust risk management framework for all material risks. Manage, control, and monitor risks on a consolidated level. Adopt the internal control framework and define overall methodology components of ICS.
- Improve the credit granting process and rely more on a debtor's ability to repay the loan from its cashflow. Review the methodology for defining NPLs and adopt a methodology for identification of forbore exposures. Update the collateral valuation methodology.

12. State-owned enterprises (SOEs) would benefit from better governance, particularly given their central role in output and potential for creating fiscal liabilities. SOEs operate in key sectors including utilities, energy, transport, and mining and have an important influence on the overall efficiency and productivity of the economy. In addition, they are important contributors to the fiscal accounts. For instance, the Erdenet copper mine is traditionally the largest tax payer in Mongolia. However, their ownership, management, and activities are typically opaque and there is limited data on their balance sheets. Moreover, it is unclear whether there is a consistent investment approach across the SOEs that is integrated into the overall development strategy. To lower fiscal risks, increase productivity, and reduce vulnerabilities to corruption, key recommendations include:

¹¹ "Financial Diagnostic of the Development Bank of Mongolia" PwC, December 2018

- SOE ownership and reporting structures should be made transparent. Fiscal oversight, especially of hidden subsidies and fiscal costs, for instance in the energy sector, should be improved through better reporting and budgeting. Special focus should be placed on improving the accountability and transparency of Erdenes Mongol as it holds the country's strategic mining assets and any weakness in its governance structure will have an important impact on the overall economy.
- SOEs should comply with government procurement standards.
- There should be a level playing field with the private sector in terms of tendering, competition policies, and disclosure.
- The privatization process should move ahead as a way of encouraging competition and best standards in corporate governance. Allowing foreign participation would help in this regard.

13. The government's 'special funds' need greater attention as these have raised substantial governance concerns. After public reports of financial mismanagement regarding some of the 29 special funds (as at end 2018), a special examination carried out in 2018 and early 2019 by the Ministry of Finance into the operations and management of these funds revealed significant deficiencies. These included the provision of direct loans to PEPs, lack of public oversight, and absence of risk management practice. One of these funds, the Future Heritage Fund Law (FHF) approved in February 2016, deserves special attention. This fund is likely to increase substantially in the coming years as mining revenues increase and thus will need strong governance. Key recommendations include:

- Greater disclosure and accountability for each fund.
- Better integrating these special funds into the annual budgetary process.
- Ensuring that the governance and independence of the FHF are in line with best international practices.

14. PPPs are an important source of fiscal risk. PPPs have been widely used to implement capital projects. While such structures can be an efficient means of leveraging private sector capital, they have also proven to be a way to bypass the deficit constraints of the Fiscal Stability Law and parliamentary oversight. Often these PPP projects were only brought into the budget when the projects had been completed and needed to be paid. Under the EFF, such practices have stopped and the MOF has strengthened its gatekeeping role regarding PPPs. However, safeguards relating to contract management, integration with the budget, risk allocation, and government guarantees should be formalized including through a new PPP Law.

15. Procurement rules and procedures need to be properly enforced. Notionally, the government has a strong framework for procurement. There is the Public Procurement Law (PPL) introduced in 2000 (with the last amendments in 2019) and the Government Procurement Agency (GPA) established in 2012. Importantly, all contracts are to be made available online (Law on Glass

Accounts).¹² A e-procurement system (from publication of the procurement notice through the award of the contract to the successful bidder) was introduced in December 2016. While there are still gaps, the volume of procurement that used the electronic system has increased more than seven-fold during 2015–18. Nonetheless, the particularly large scale of public investment continues to create opportunities for corruption, lowering the boost to productivity of such investments and undermining fiscal sustainability. To reduce the scope for rent seeking, reforms should include: ensuring that (i) the Procurement Agency is independent and has an adequate budget with well qualified staff and (ii) all procurements use the e-procurement system. Under the National Anti-Corruption Strategy, Mongolia aims to transfer all tender processes to the e-procurement system, but this has been slow.

16. Fiscal transparency should be enhanced to lower the scope for rent seeking activities.

This is especially crucial given the importance of the public sector in the economy and its involvement in the mining sector. Reforms in the following two areas are especially important:

- **Budgetary transparency.** The Law on Glass Accounts (2014) requires all government agencies and SOEs to make information on budgets and financial matters, including financing and debt, available to the public. However, according to the 2017 Open Budget Index (OBI) of the International Budget Partnership, Mongolia is among the countries that release limited budget information.¹³ Although budget oversight and public-sector auditing are satisfactory, Mongolia's score on transparency dropped from 60 (out of 100 points) in 2010 to 46 (out of 100) in 2017. Mongolia is also lagging the global average score regarding opening opportunities for citizen participation (7 out of 100 points). The Fiscal Council that was established in 2018 lacks sufficient autonomy and budget. The Natural Resource Governance Institute (NRGI) has highlighted the need to quickly return to the original fiscal rule targets adopted in 2010 as part of the FSL and to improve the newly established Fiscal Stability Council's independence, capacity, transparency, and remit to oversee compliance with the FSL.¹⁴ Key recommendations include:
 - Undertaking regular dialogue with members of the public during both the formulation of the national budget and the monitoring of its implementation. Holding legislative hearings on the formulation of the annual budget, during which members of the public or civil society organizations can testify. Establishing formal mechanisms for the public to participate in relevant audit investigations. Ensuring that audit processes are reviewed by an independent agency.
 - Ensuring the independence of Fiscal Stability Council with a view to strengthen budget oversight and compliance with fiscal rules.

¹² Since BOM is not financed from the state budget, the law does not apply but, BOM publishes its budget, contracts, tenders etc. on its website according to the Glass Account Law.

¹³ International Budget Partnership (IBP), 2017, Open Budget Survey 2017, Mongolia.

¹⁴ Natural Resource Governance Institute, 2018, "Fiscal Sustainability in Mongolia in 2018"

- **Mining sector transparency.** Mongolia is complaint with the Extractive Industries Transparency Initiative (EITI).¹⁵ It has also undertaken the Open Government Partnership—an initiative by which civil society and government work together to agree on ways to strengthen governance. Under this, the government of Mongolia has committed in the 2016–18 National Action Plan to the “transparency of contracts of public resource exploitation.”. However, the Natural Resource Governance Institute (NRGI) has noted that many of the most important contracts for publicly owned oil, gas, and minerals in Mongolia remain undisclosed.¹⁶ To improve transparency, it is important to strengthen EITI compliance by high level participation in the EITI National Council and ensure the comprehensive and consistent publication of all contracts in the mining sector.

17. Improving public financial management (PFM) controls. Weak PFM raises fiscal risks with limited monitoring, reporting, and control mechanisms in place. These gaps and weaknesses are macro critical. To address challenges in the public financial management system, the Ministry of Finance has adopted a Public Financial Management Reform Strategy for 2018–2020 in September 2018. Important steps include:

- **Integrating the Accounting and Reporting Frameworks.** Financial reporting in Mongolia is still fragmented due to the absence of a fully integrated Government Financial Management Information System (GFMIS) system. Success of PFM reforms heavily depends on the successful implementation of the new version of GFMIS. There’s a further need to improve the Chart of Accounts (COA).
- **Enhancing the Accounting Policies.** Limited compliance with International Public Sector Accounting Standards (IPSAS) raises fiscal risks and is macro critical. Review of accounting practices of the government revealed that substantial work needs to be done to achieve full compliance with IPSAS. The government formulated an IPSAS action plan 2017–22 and is gradually moving towards achieving full compliance.
- **Better consolidation of Financial Statements.** Lack of consolidation limits monitoring and raises fiscal risks. Consolidated financial statements exclude part of the government-controlled entities and other government engagements with the private sector. Despite recent improvements in implementing E-tailan¹⁷, consolidation and elimination still involves manual processes and require developing additional guidelines.

E. Financial Sector Oversight

18. Weak management and supervision of the banking sector has contributed to frequent boom bust cycles including the most recent economic crisis. Tackling these issues is a macro-critical priority. Regulatory forbearance has allowed weak banks to expand credit rather than build needed capital. In addition, it has boosted overheating pressures and undermined the key program

¹⁵ Mongolia EITI Report 2017, Extractive Industries Transparency Initiative.

¹⁶ Mongolia’s Missing Oil, Gas and Mining Contracts, Robert Pitman NRGI, 2019.

¹⁷ E-tailan, a web-based software for the consolidation of the financial statements introduced by MOF.

objective of reserves accumulation. While improving the financial system, policymakers should start to focus on the following key recommendations:

- The regulators should strengthen the financial sectors' corporate governance and ensure proper implementation of international best standards. They should focus on the following:
 - Ensuring full transparency in terms of beneficial ownership of financial sector institutions and require that they maintain arms-length relationship in dealing with shareholders, directors, and intra group entities;
 - Requiring that banks explore ways of listing on the Mongolian Stock Exchange to: raise new capital; diversify ownership; and enhance market discipline and disclosure.
 - Being more proactive in relation to regulation on transactions with related parties (including those with shareholders) with a sufficiently broad definition of related-parties' transactions and ensuring effective monitoring and strict enforcement.
- The regulators should move ahead with upgrading credit risk management to improve credit culture of Mongolian banking industry. Specific technical assistance (TA) areas include regulations and supervision on: (i) asset classification and provisioning; (ii) collateral valuation; (iii) non-performing loan (NPL) management; and (iv) loan origination/risk management.
- Regarding the supervision of non-bank financial institutions, the FRC should address fundamental issues first – the adequacy of human (qualified staff) and IT resources, above all. TA focusing on improvement of regulatory and supervisory framework on non-banks could be useful once these preconditions are met.
- Financial sector infrastructure, including professional skills such as accounting, auditing, and valuation, needs to be enhanced through better training and enforcement of standards.

F. Central Bank Governance and Operations

19. Poor governance at the central bank has had macro-economic consequences and required reforms are macro-critical. As highlighted in the 2018 Klynveld Peat Marwick Goerdeler (KPMG) Report on BOM activities, past governance weakness lead to high levels of quasi fiscal activities; politicized monetary policy decisions; and weak supervision with a culture of forbearance and lack of transparency in the banking sector, including with respect to the ownership of the banks.¹⁸ These factors contributed to the boom-bust cycles and the 2016 crisis. The 2017 IMF Safeguards Assessment by the IMF's Finance Department and TA by the IMF's Legal Department both recommended a thorough review of the BOM Law. The Legal Department's TA included a detailed set of drafting recommendations strengthening the BOM's autonomy, mandate, and governance. Amendments of the BOM Law, enacted in January 2018, resulted in several notable improvements, such as redrafting its mandate, limiting monetary financing of the government, prohibiting the BOM from conducting quasi-fiscal activities, and the appointment of Monetary Policy Committee (MPC) non-executive members by the Economic Standing Committee of

¹⁸ "Bank of Mongolia, Special Review of Quasi-Fiscal Policy Activities", November 15, 2018, KPMG

Parliament rather than just the Governor. However, some weaknesses remain and key improvements with respect to the BOM governance and autonomy include:

- **Institutional Autonomy.** The mandate of the BOM should be sharpened to highlight core mandates of maintaining price and financial stability. The BOM should be autonomous in formulating and implementing its policies; it should not be obliged nor allowed to seek approval or instructions on this from any third person or entity, including the Government or the Parliament.
- **Personal Autonomy:**
 - The incompatibility criteria for the appointment of key officials of the BOM (including Governor and Deputy Governors) or members of its decision-making bodies (such as the Monetary Policy Committee) should be strengthened and explicitly provided for in the BOM Law. The criteria should prohibit government officials, civil servants, and officials and employees and persons with close links to institutions overseen by the BOM from occupying positions at the BOM.
 - Appointment (i.e. the introduction of a so-called double veto procedure) and dismissal procedures need to be revisited especially as the grounds for the latter are too wide and flexible: currently the BOM Law allows for a dismissal in case of unsatisfactory fulfillment of duties. The term of appointment of members of the Supervisory Board needs to be explicitly provided for in the BOM Law.
 - Legal immunity for banking supervisors. This was removed in 2018 but should be reinstated in the BOM law.
- **Financial autonomy.** The BOM's power to provide emergency liquidity support to banks should be accompanied by additional safeguards, such as application of penalty interest rates and limiting the coverage of lending to illiquid or (possibly) insolvent banks which would require a state guarantee.
- **Oversight.** In addition to safeguarding the autonomy of the BOM, legal amendments would also need to strengthen further the Supervisory Board's oversight of BOM's activities. The Supervisory Board should have fiduciary responsibilities only to the BOM, and its mandate should be expanded to be aligned with that of a conventional audit committee.
- **Accountability.** Recommendations to strengthen the autonomy of the BOM should be complemented with improvements to accountability. There should be stronger independent oversight, increased transparency, and other checks and balances.

G. Anti-Money Laundering/Combating the Financing of Terrorism

20. The AML/CFT legal framework needs to be strengthened and effectively implemented.

The second mutual evaluation (ME) of Mongolia's AML/CFT regime was conducted by the Asia/Pacific Group on Money Laundering (APG) in 2016 and found a low level of compliance with

the FATF 40 Recommendations and a low level of effectiveness of the AML/CFT system.¹⁹ Mongolia is weak in areas that affect governance – i.e. risk-based supervision, monitoring the activities of PEPs, access to beneficial ownership information, and in ensuring fit and proper criteria for bank shareholders. Appropriate legal and institutional frameworks are being developed, but gaps and weakness remain. The effectiveness of law enforcement and criminal justice measures is low with only a small number of prosecutions underway. Inter-agency cooperation is weak—although it is improving. Key recommendations include:

- Recent IMF TA indicates that there needs to be continuous political will, more commitment, and prompt decisive action to ensure effective implementation of AML/CFT measures. A high level of TA from donors on a range of technical and operational issues will be needed. High priority areas include:
 - Increasing risk-based supervisory activities, notably onsite examinations by the BOM, the FIU, and the FRC. These should focus on high-risk areas, such as implementation of requirements relating to targeted financial sanctions (TFS), beneficial ownership, and PEPs, and on high-risk sectors such as banks, real estate, and designated non-financial businesses and professions (DNFBPs).
 - Improve the legal framework. This includes the following: (i) passing and ensuring the effective implementation of additional amendments to the law and regulations relating to AML/CFT and preventative measures and targeted financial sanctions (TFS) on proliferation financing (PF) and terrorist financing (TF); (ii) putting in place provisions relating to TFS and fit and proper requirements for senior management and owners of financial institutions; (iii) increasing the powers of the FIU; and (iv) enforcing current TFS regulations.
 - Increasing resources for the FIU, BOM, FRC, and law enforcement agencies is needed to support fulfilment of their respective mandates. Improving the operations of the FIU, including the quality of its analysis. Implementing the appropriate criminal justice measures and enforcement by investigators and prosecutors and ensuring adequate inter-agency coordination.²⁰
 - Ensuring that constitutional issues relating to the Administrative Court, which hears appeals related to fines imposed under the Law on Infringements related to breaches of the AML/CFT Law, are resolved so that this problem does not affect existing or future penalties imposed under the Law on Infringements.

¹⁹ A low level of effectiveness was found in 9 out of 11 rubrics and moderate in 2 rubrics. Regarding the Technical Compliance Ratings, the AML/CFT regime was either partially compliant or non-compliant in half the rubrics. APG (2018).

²⁰ The World Bank's Stolen Asset Recovery (StAR) initiative should play an important role focusing on verification and enforcement. World Bank (WB), 2018, Stolen Asset Recovery Initiative (StAR).

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ACHIEVING GREEN AND INCLUSIVE GROWTH IN MONGOLIA

Upgrading the livestock/agriculture sector offers a vital opportunity to diversify the economy and achieve green and inclusive growth. However, the livestock sector is threatened by rapid climate change, significant overgrazing, and imbalance in livestock species. These factors have led to massive land degradation with serious macro-critical consequences and socio-economic costs. Going forward, balancing the livestock population with nature's capacity to regrow is crucial to secure the sector's sustainability. Three key macro policies can help achieve green and inclusive growth: a pasture tax to address the problem of the commons, incentives to boost quality of animal products, and promotion of meat exports. These policies can bring the livestock population below the carrying capacity of the grasslands, while improving the value added of each animal—thus offering better and sustainable livelihoods to the herders.

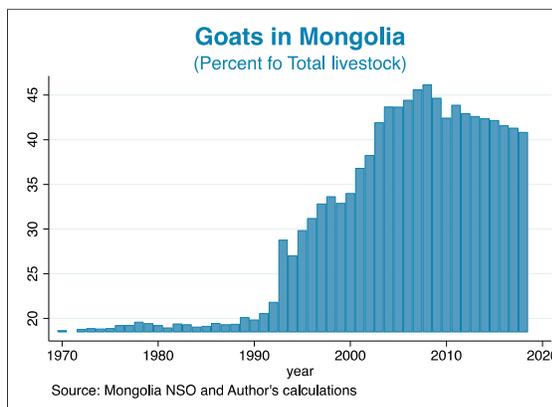
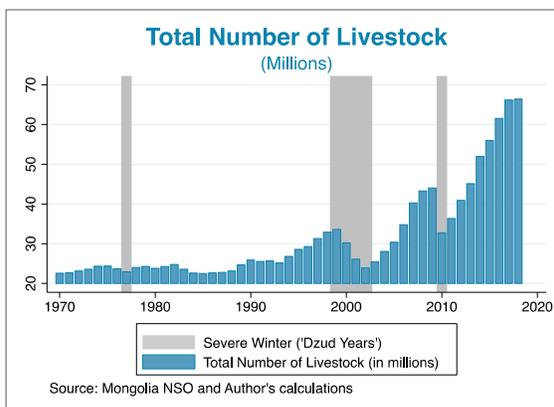
A. The Mongolian Context

1. **Mongolia is struggling to achieve inclusive and job-rich growth.** After the 2016 crisis, overall economic growth in Mongolia has been strong and has averaged between 6–7 percent. However, the poverty rate has barely fallen over the past few years, and remains high at 28.4 percent in 2018 (according to the National Statistics Office). Worse, unemployment rate has increased in the past two years. Thus, despite strong overall growth, job creation and poverty alleviation remains a significant challenge.
2. **The disconnect between job creation and growth is likely due to the heavy reliance on the mining sector and low productivity of the livestock sector.** Much of the growth experienced over the past 2-3 years has been driven by the mining sector, despite the mining sector accounting for about a fifth of the total value added. However, since the employment share of the mining sector is small, mining-led growth is unlikely to deliver job-rich growth. By contrast, the livestock sector is still the biggest employer in Mongolia—but it still operates as a low-value-added sector.
3. **Going forward, upgrading the livestock sector offers Mongolia a vital opportunity to diversity its economy and achieve green and inclusive growth.** Given Mongolia's endowments—vast grasslands spanning 80 percent of Mongolia and proximity to large markets in Asia—Mongolia holds a comparative advantage in livestock production. The livestock industry accounts for about 90 percent of agriculture production and is central to the nation's social fabric: it employs 1 in 4 Mongolian—tying the livelihoods of the entire rural population to common weather shocks.
4. **The government is already focused on improving the sector but efforts need to be stepped up.** Mongolia's constitution (1992) states: "The livestock of the country is national wealth and subject to state protection." In 2010, the Parliament adopted the National Livestock Program with the aim of (i) making the livestock sector adaptable to climate change and social development, (ii) providing safe food supply, and (iii) increasing production and export of livestock products

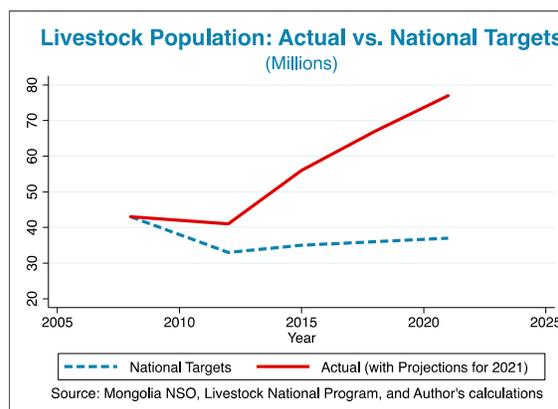
(mainly cashmere, meat, and milk). However, a decade later, there still remains a huge scope to upgrade the industry with key goals of the program remaining unmet.

B. The Overgrazing Challenge Facing the Livestock Sector

5. Amidst rapid climate change, overgrazing and imbalance in livestock species has led to massive land degradation threatening the livestock industry. After independence, with virtually no land use regulations or pasture management, the rising global demand for cashmere led herders to vastly expand their goatherds. At the same time, without a developed meat industry and strategic animal breeding there have been no serious limits on growth of livestock. This has tripled the livestock population since 1990 to about 70 million animals now (based on NSO data), with the share of goats rising from about 15 percent to about half—leading to serious overgrazing pressures. At the same time, due to its unique geography Mongolia has warmed three times faster than the rest of the world and 80 percent of the country is defined as highly vulnerable to climate change (Government of Mongolia TNC report under the UNFCCC, 2018; Batima, 2006). Amidst such rapid climate change, the overgrazing—especially by goats—has led to significant land degradation and desertification (affecting 76.8% of all Mongolian territory as of 2015), threatening the entire livestock industry (Government of Mongolia TNC report under the UNFCCC, page 31, 2018).



6. Worse, the overgrazing problem is becoming bigger, with actual livestock numbers much greater than the estimated official carrying capacity of the grasslands. Based on various scientific studies, the government adopted a limit on the number of livestock in its 2010 National Livestock Program (Resolution of State Great Khural of Mongolia, 2010). However, the actual number of livestock now vastly outnumbers the targets by a ratio of almost 2 to 1. This is putting massive environmental pressure, and if left unchecked risks jeopardizing the sustainability of the entire sector. According to the National Report on the Rangeland Health of Mongolia (2015), the decline in rangeland (grasslands) health is the

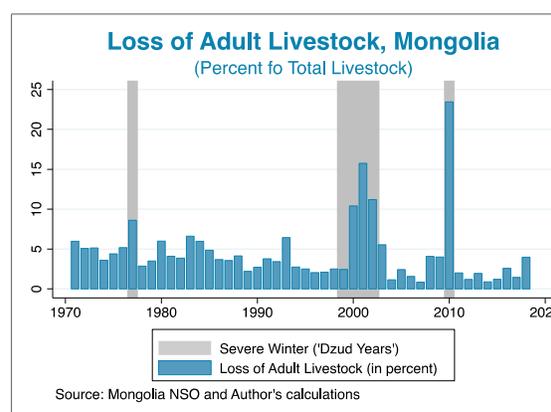
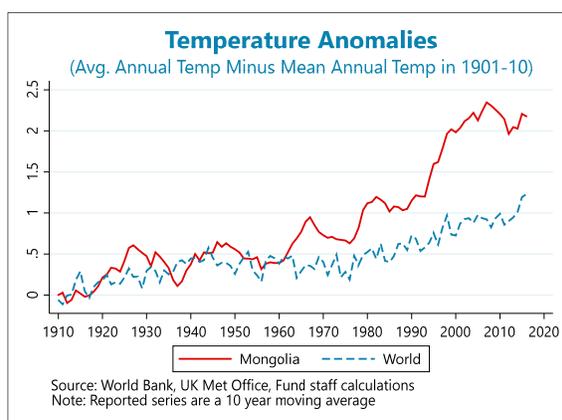


central challenge to sustainable livestock production in Mongolia, and “the control of livestock numbers is a fundamental pre-condition for effective rangeland management.”

C. Four Macro-Critical Implications of Land Degradation

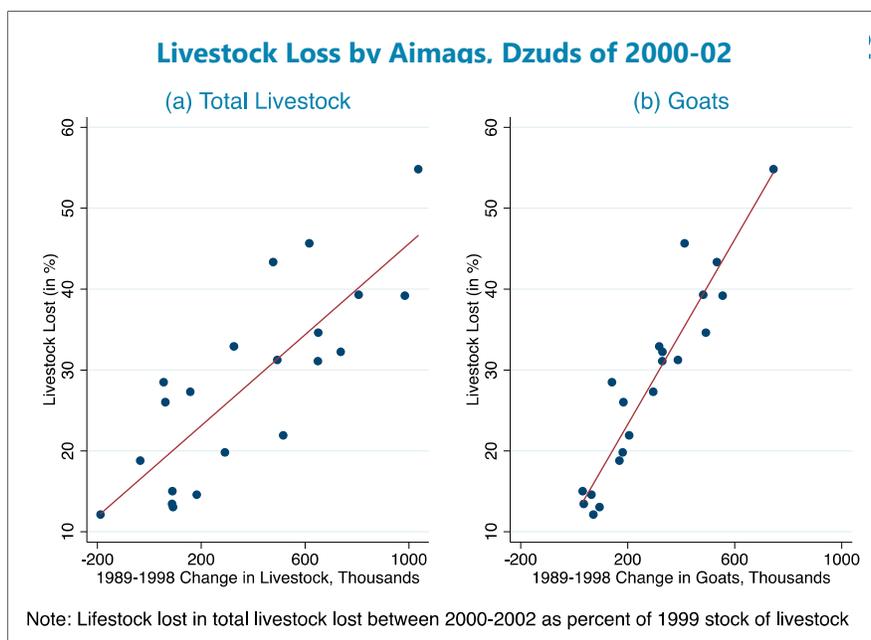
7. The combination of land degradation and climate change has serious macro-critical implications. Below we discuss four key implications.

8. First, there has been a significant increase in severity and frequency of livestock loss. Livestock herds living in degraded environments are less able to withstand climate shocks, leading to extreme losses of wealth (of up to an estimated 8-12 percent of GDP in a year) during harsh winters called ‘dzuds’—that have grown in frequency (Government of Mongolia TNC report under the UNFCCC, page 205, 2018). Furthermore, our estimation results suggest that the combination of harsh winters and harsh summers strongly predict loss of adult livestock. On average, a 1°C colder winter is associated with 1.8 percentage points increase in loss of adult livestock, while a 1°C warmer summer is associated with a 1.5 percentage points increase in loss of adult livestock.

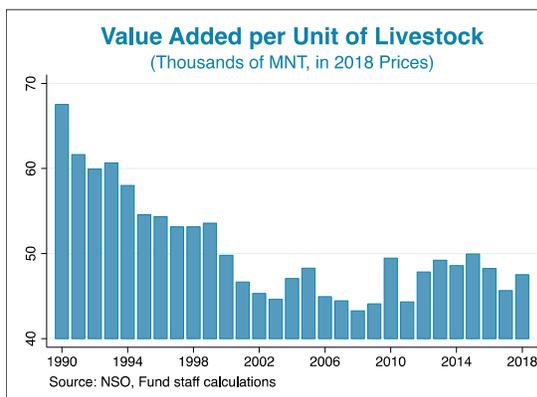
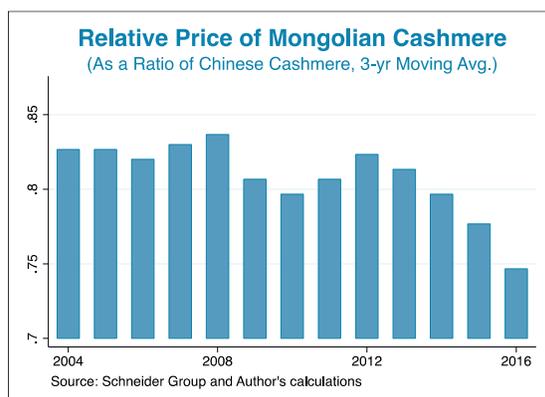


9. Moreover, the impact of climate shocks has been worse in provinces (aimags) with greater increase in livestock numbers. The empirical setting to examine the role of unregulated increase in herd size on amplifying the impact of climate shocks is to examine how different provinces (or aimags) experienced the dzud climate shocks differently. Mongolia is divided into 21 aimags and one provincial municipality (the capital). The idea behind this identification strategy is to examine whether the same climate shock had larger impact on the aimags that experienced a greater increase in livestock immediately preceding the climate shock. We study the first dzud episode of 2000–2002. We first focus on livestock lost as an outcome variable. We present the results graphically here. The first panel of the figure below reports the results for the impact of growth in all livestock, while the second panel presents the results for the impact of growth in goats. The estimation suggests that during the dzud episode, an increase of livestock by 100,000 units in the pre-period was associated with a 2.8 percentage points increase in livestock lost during the dzud episode. This result is statistically significant at the 1 percent level. The role of goats on amplifying the climate shock was even larger. The estimation suggests that during the dzud episode, an increase of goats by 100,000 units in the pre-period was associated with a 5.7 percentage points

increase in livestock lost during the dzud episode. This result is statistically significant at the 1 percent level. That is, about twice the effect size. Overall, the estimation suggests that the percentage loss of livestock (in percent of total livestock) during the dzud was biggest in aimags where livestock had grown the most in the preceding decade after the end of communist period. Moreover, the impact on livestock lost during the dzud was twice as big when goats drove the increase in livestock. This is consistent with other studies that find that since goats are voracious eaters than other livestock and consume the roots of the grass, goat herding can further aggravate land degradation and vulnerability to climate change (NEASPEC Report on Combating Desertification in North-East Asia, 2012; Hilker et al., 2014; Batkhisig, 2013).

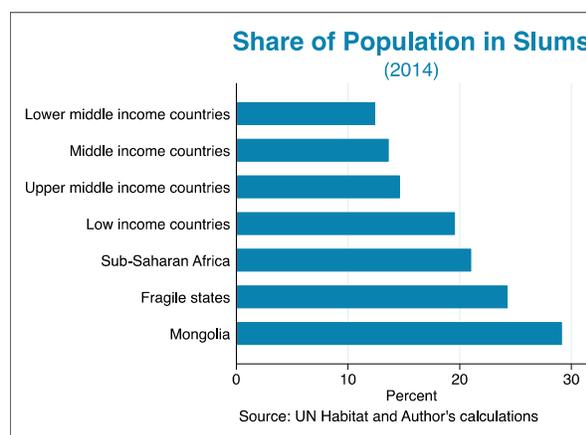
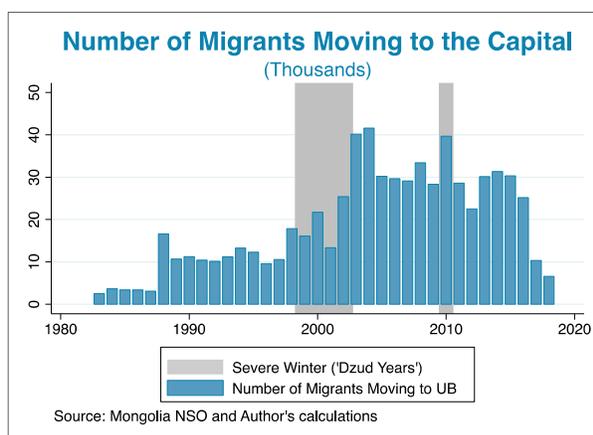


10. Second, there has been a decline in the sector’s productivity and value-added per unit of livestock. With absence of culling programs (leading to older less productive animals) and absence of strategic breeding, there has been a decline in quality of animal products (particularly cashmere) (Danforth, 2017; Spina 2018; World Bank, 2003). Part of this is driven by the rising global demand of cashmere. Since Mongolia supplies about 1/3 of global supply of cashmere, over the past decades livestock herders in Mongolia have been pushed to pursue volumes rather than



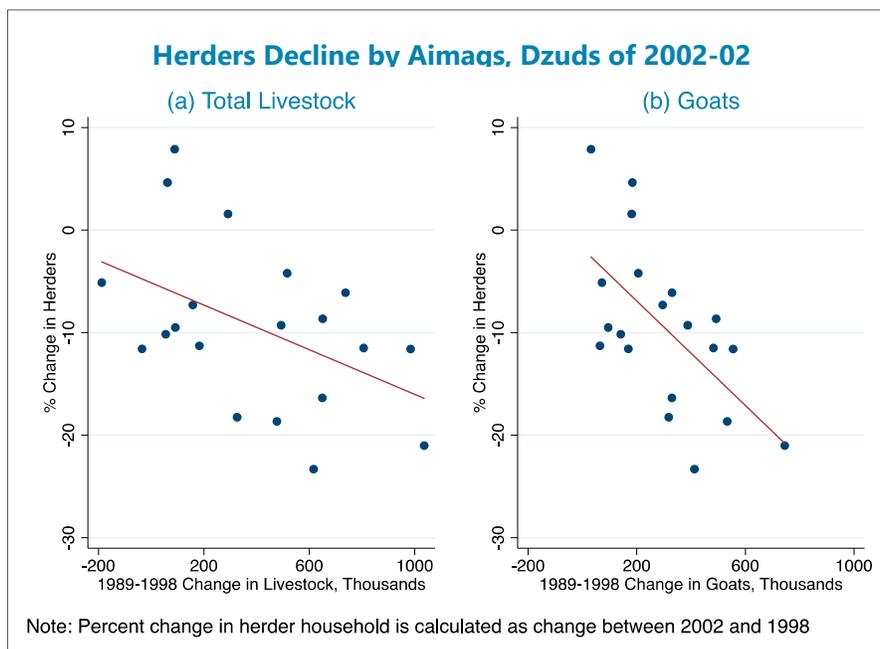
quality. This has worsened the tragedy of commons in Mongolia by putting more burden on the Mongolian grasslands, while there has been a significant reduction in the value added of Mongolia's livestock sector. For instance, our estimates suggest that between 1990 and 2018 the value added per unit of livestock declined by about 30 percent. This clearly suggests a significant shift from quality towards quantity in the livestock sector.

11. Third, herders have been forced into becoming climate refugees leading to huge socioeconomic costs. With fragile and poor livelihoods, each climate shocks have led to a surge of herders migrating to the capital (Ulaanbaatar). Today, about 1 in 4 Mongolian lives in shantytowns (the ger district) in the outskirts of the capital—most of whom are former herders. The dzuds have been a primary driver of this migration flow, as the migration to Ulaanbaatar intensified after both the dzud episodes of the early 2000s and of 2010 (IMF, 2003; Save the Children, 2013; International Organization of Migration, 2018). Overall, the volume and speed of internal migration has outpaced the government's ability to provide basic services—including housing, clean water, sanitation, heating, health care, and education (Mongolia Habitat-III National Report, 2016; World Bank, 2010a). Moreover, the lack of basic services in the ger district has also led to a significant pollution problem (with the highest PM2.5 emissions in the world) causing its own set of severe health hazards (World Health Organization, 2015; World Bank 2010b; UNICEF, 2018).

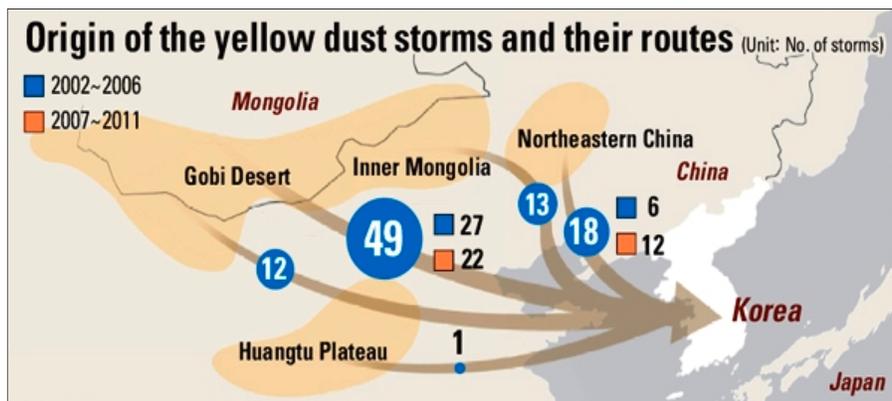


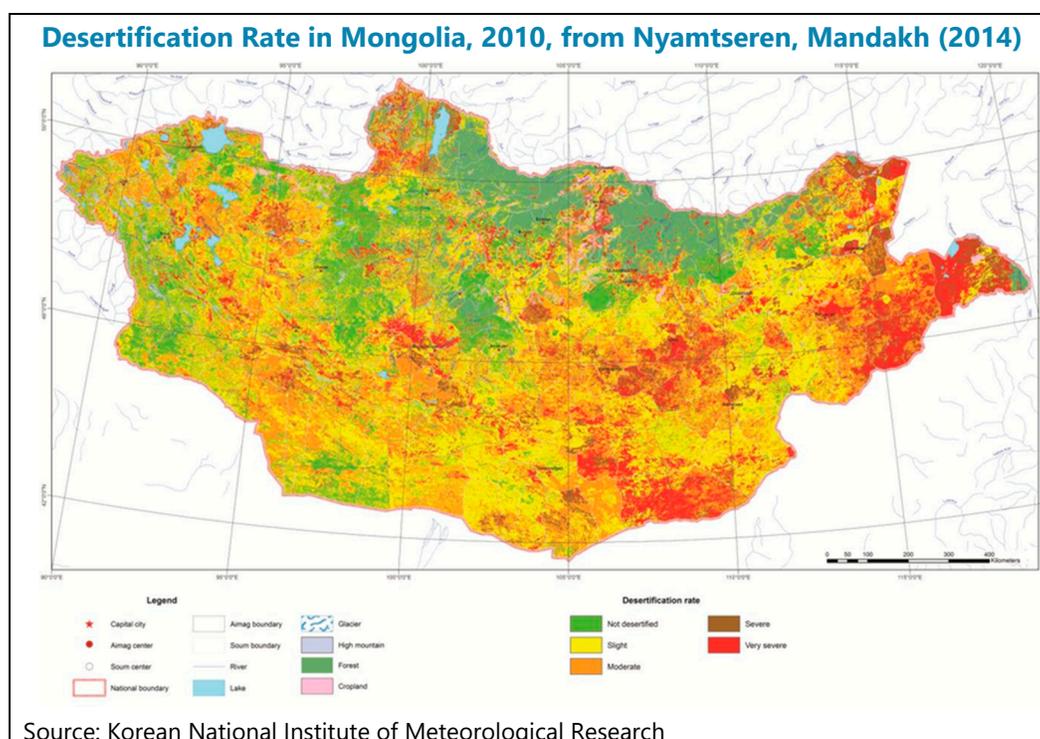
12. Moreover, the decline in herding and outmigration to the capital has been worse in provinces (aimags) with a greater increase in livestock numbers. We examined how the climate shock affected the decline in herder households in different provinces as a function of increase in the number of livestock. The outcome variable of interest is defined as percent change in herder household between 2002 and 1998. In the figure below, the first panel reports the results for the impact of growth in all livestock, while the second panel presents the results for the impact of growth in goats. Our estimation suggests that during the dzud episode of 1999–2001, an increase of livestock by 100,000 units in a given aimag in the pre-period was associated with a 1.1 percentage points decline in herders during the dzud episode. This result is statistically significant at the 5 percent level. Again, for decline in herder shares the role of goats on amplifying the climate shock was even larger. The estimation suggests that during the dzud episode, an increase of goats by 100,000 units in the pre-period was associated with a 2.6 percentage points decline in herders during the dzud episode. That is, about two and half times the effect size estimated for livestock.

Overall, the results suggest that decline in share of households engaged in herding (expressed as a percent of total households) during the dzud was biggest in aimags where livestock had grown the most in the preceding decade after the end of communist period. Moreover, the impact on livestock lost during the dzud was 2.5 times as big when goats drove the increase in livestock. This evidence provides support for the hypothesis that unregulated increase in livestock has amplified the economic impact of climate shocks in Mongolia—by both increasing the loss of wealth and livelihood.



13. Fourth, the land degradation and desertification has contributed to the increase in frequency and severity of huge dust storms across East Asia. Over 90 percent of Mongolia’s grassland is prone to some level of desertification and about 77 percent of Mongolian territory has been affected by desertification, largely due to degradation caused by overgrazing and limited pasture management (Government of Mongolia TNC report under the UNFCCC, 2018; Convention of Biological Diversity, 2014). Moreover, Mongolia’s shift into goats has accelerated the desertification process: goats can thrive on the desert shrubs that replace grass—leading to further desertification as their sharp hooves pulverize the protective crust of the soil that naturally checks wind erosion. This has led to intense dust storms (also called ‘Yellow Dust’) across East Asia (China, Japan, and S. Korea), associated with rising health and economic costs across the region.





D. Policies to Achieve Green and Inclusive Growth

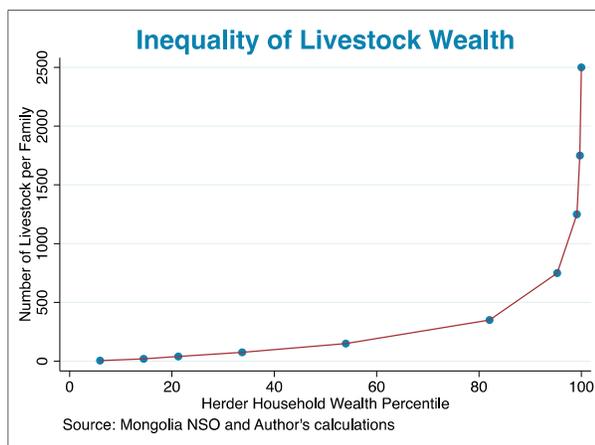
14. Overall Mongolia needs effective land/pasture use policies and quality improvement programs to sustainably boost value added of the sector. To firmly place the livestock industry on a sustainable path and boost livelihoods of the most vulnerable households, Mongolia needs to (i) increase resilience to climate change by addressing overgrazing and balancing the size of its herds with nature's capacity for regrowth, and (ii) improve governance, pasture management, and livestock productivity in line with commitments of its National Livestock Program. The government is already trying to more in this domain. For instance, in December 2018, the Mongolian Cabinet approved a National Program to promote and develop intensive animal husbandry. It plans to spend MNT166.3 billion on the program implementation for 2019–23. Under the plan, the funding will be spent on rendering support to build capacity of managers and professional association of intensive animal husbandry, transform it into cluster system, import high productive livestock, naturalize, ensure food safety and safety and introduce technology. Moreover, the plan aims to boost processing and export of meat, while reducing import of milk and other dairy products. While these efforts are welcome, effective implementation is key and more is needed to upgrade the livestock sector.

15. From a macro perspective three key policies can help: a pasture tax, incentives to boost quality of animal products, and promotion of meat exports. First, reintroducing a *pasture tax*—with an exemption for small/medium herders—can reduce herd size and in turn help reduce land degradation and wealth inequality. Second, *incentives to boost quality of animal products* (and reducing focusing on boosting quantity) will enable the sector to become more productive. Third,

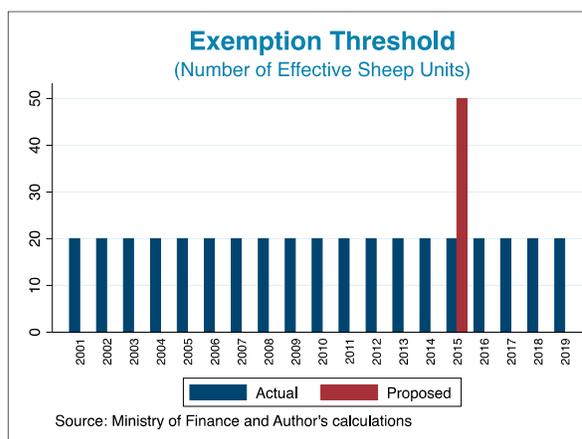
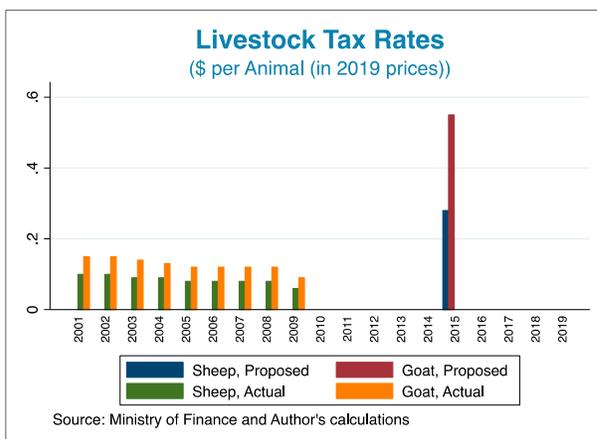
upgrading the meat industry would provide a natural limitation on herd size and incentivize herders to focus on quality over quantity.

Pasture Tax

16. Herders now pay no taxes on livestock holdings, contributing to high inequality in rural wealth. Ahead of the 2009 Presidential elections, the Parliament repealed all taxes on livestock herders. Before then herders were liable to pay between 50-100 MNT (or less than USD 0.1 in 2019 prices) per head of sheep. Goats were considered equivalent to 1.5 sheep for taxation purposes. 20 sheep per member of herder household were exempt from taxes. However, since 2009 herders are liable to pay no taxes after the Parliament repealed the taxes. An analysis of concentration of livestock wealth in 2018 using micro data (see figure below) suggests that households with below median wealth have about 91 livestock, while top 1% households had about 1835 livestock—which is 20 times more. The very high concentration of livestock wealth among herder households suggests that the re-introduction of the pasture tax can be designed in an equitable way, thereby protecting the most vulnerable households.



17. Building on a 2015 proposal that was submitted to Parliament, there is interest in reintroducing the pasture tax, and the idea is gaining traction. The Asset Tax Law proposal that was submitted to Parliament in 2015 proposed to grant power to local authorities to set the livestock tax between the range MNT 0-1000 per head of sheep (with all livestock being converted to sheep head units for tax purposes). Note that the law dealt with other assets beyond livestock, including housing, vehicles, and guns. The tax exemption threshold was raised from 20 to 50 heads of sheep. While this proposal did not pass in the Parliament, there is again discussion and interest in passing the tax.



This interest is also shared by herders (based on our conversations with the cooperatives) as they recognize the fragility of the environment and the impact overgrazing is happening on the livestock sector and the grasslands.

18. Designing a progressive pasture tax—combined with a generous exemption for small/medium herders—can help address overgrazing in an equitable way. Policy change is essential to limit the large externalities associated with unregulated pasture use. Re-introducing a pasture tax that is at least as high as the one proposed in the 2015 draft law will be an appropriate place to start. The right level of the tax will need to be calibrated over time to achieve a reduction in livestock numbers at least in line with national targets (introduced in the 2010 National Program). To mitigate the impact on small/medium herders a more generous exemption threshold could be considered. For instance, an exemption of 100 livestock heads would imply that over half of the herder households would be exempt from taxation. Such an exemption threshold could also improve political acceptability of the tax. In addition, to further increase political acceptance of this tax, the local governments should be allowed to retain the tax revenues at the local government level—and allocated to improve pasture quality, water resources, and livestock productivity.

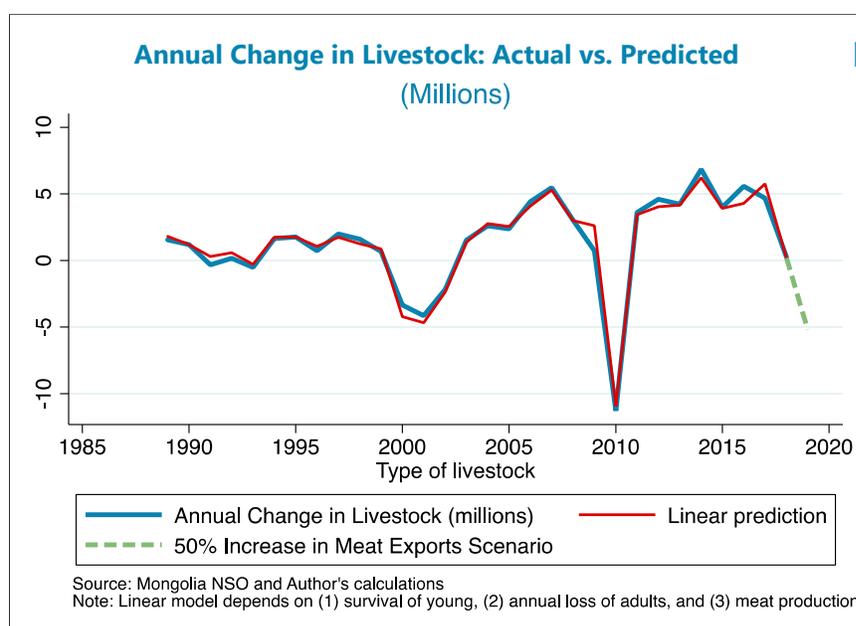
Incentives to Promote Quality of Animal Products (particularly Cashmere)

19. Government incentives and regulation to promote high quality animal products—particularly cashmere—is crucial. Beyond the pasture tax it will be important for the government to introduce additional incentives to promote quality over quantity in the livestock sector. Currently, a significant majority of subsidies under the National Livestock Program are given to wool and hides producers, but they are geared towards quantity of produce rather than quality of produces. Given the lack of emphasis on quality, Mongolian cashmere fiber has thickened over time, implying that a large share of Mongolian cashmere is unfit for use by the luxury knitted/woven garment industry (Dash, 2017; Spina 2018; World Bank, 2003). Going forward, boosting the value added of the industry will require significant upgrade to cashmere quality. In this context, streamlining the incentive schemes and targeting programs towards promoting quality, developing better animal management practices (including strategic breeding programs and culling programs), improving grading and standardization, and expanding market access of Mongolian traders/processors to the world cashmere market will be essential.

Boosting Meat Exports

20. Mongolia's proximity to China and Russia offers it great potential to boost its meat exports. With livestock population nearing 70 million, the stock of livestock far exceeds domestic demand. Thus, boosting meat exports, would enable Mongolia to improve the share of the agriculture sector in the overall economy and reduce the reliance on mineral exports. In this context, Mongolia is uniquely placed between two large markets—Russia and China—which offer significant opportunity to expand meat export to these countries. For instance, in a joint press release issued by the foreign ministers of China and Mongolia in December 2017, the Chinese authorities expressed interest in expanding meat imports from Mongolia.

- 21. However, Mongolia’s meat exports remain significantly below its potential when compared to other livestock-intensive countries.** Mongolia has made significant progress in boosting its meat exports over the past three years. Our estimates suggest that meat exports were about 2,800 tons in 2015, but it increased to about 70,000 tons by 2018. Despite this impressive increase, meat export potential of Mongolia could be 5-10 times higher than the 2018 exports if Mongolia’s export rate (i.e. exports per unit of livestock) matched that of other countries like Uruguay or New Zealand (Danforth and Dash, 2017).
- 22. At present the major obstacles to boosting meat exports are food safety concerns, lack of regulation and standards, and poor logistics.** One of the main barriers to meat exports from Mongolia is concerns about Food and Mouth Disease (FMD). Due to the contagious nature of FMD and its presence in Mongolia, many countries have implemented import bans on meat from Mongolia. Eradicating FMD and achieving FMD-free status from the World Organization for Animal Health (OIE) will be a significant step—as all major suppliers of meat to China have attained this status (Food and Agriculture Organization of the United Nations, 2019). However, it requires significant investment and action from the government to address institutional weaknesses in animal health services delivery, including boosting resources and governance of the veterinary services and the national vaccine program. Encouragingly, the government is working with OIE and other development partners to attain the FMD-free status and address food safety/disease concerns more generally. This should remain a critical short-term priority. In addition, Mongolia needs to improve regulation and formal supply chain to both effectively monitor food safety and to create high quality Mongolian brands. Beyond this, improving investment over the medium term in infrastructure, storage facilities, scientific labs, and transportation will also help.
- 23. Simulations show that greater meat exports can feasibly cut livestock numbers in half while boosting value-added of the entire sector—when combined with a pasture tax.** Meat exports were about 70,000 tons in 2018. The government aims to achieve 100,000 tons of exports by 2020 and 200,000 tons of exports by 2025. However, promoting exports will need to be combined with the pasture tax (discussed above) to control the overgrazing problem. Without such a tax, trying to boost exports can worsen the overgrazing and land degradation problem by incentivizing herders to have more livestock. Thus, a pasture tax is a critical complementary tool to achieve sustainability in the sector. Simulations show that, ceteris paribus, combining a pasture tax with gradually increasing meat exports by 50 percent initially (and eventually doubling) can halve the livestock population in line with national targets within a decade. This could boost the value added of the sector by shifting the focus more quantity to quality and would be a win for both the Mongolian livestock sector and the environment.
- 24. Greater meat exports will also benefit the cashmere industry, as it will incentivize herders to sell their low-quality goats to the meat industry.** Higher meat prices will incentivize herders to streamline their livestock and sell off the older lower-quality goats to the meat industry. This will enable the herders to focus on boosting the quality of their herd, practice strategic breeding, and focus on improving the quality of their cashmere products.



E. Role of the International Community

25. The international community can also help Mongolia in its endeavor to achieve green growth in at least three ways. The neighboring countries have a strong incentive to enable the right environment in Mongolia to practice sustainable herding to limit the growing health and economic costs of dust storms. But even beyond that, to preserve the unique ecosystem in Mongolia and to help Mongolia cope with the climate shocks, the international community can help.

26. First, the international community can help by supporting quality. Luxury goods customers expect—and are willing to pay for—consistent high quality. The success of all luxury good industries depends on their ability to consistently produce high quality goods. For the cashmere and meat industry in Mongolia to grow sustainably it must prioritize quality over quantity. An article in the Science magazine directly linked the explosive global demand for cashmere fueled by “fast fashion and increased knitting capacity” in the world as factors in ruining Mongolia’s grassland (McLaughlin, 2019). Consequently, it is important for all actors along the production chain to ensure that quality is preserved. Starting with Mongolia, improving the quality of the national herd would substantially increase the quality of Mongolian cashmere and meat. Beyond that international trade partners can help by improving the access of Mongolian traders and processors to the world cashmere market. Improvements in the legal and regulatory environment that encourage the establishment of strategic alliances between domestic processors and herders, or foreign markets and the Mongolian industry, would improve profitability and give these processors some certainty on supplies of raw material.

27. Second, trade policy of neighboring countries can become more environmentally conscious. This will enable Mongolia to align incentives between expanding the meat industry while fighting overgrazing. Therefore, current MOUs between Mongolia and trading partners to promote

Mongolian meat export can emphasize the need to address overgrazing, land degradation, and desertification.

28. Third, end consumers and retailers can practice ethical supply chain in their procurement. For instance, Patagonia, the apparel brand, is addressing the degradation of pastures in Mongolia, by promoting the use of waste scrap from other cashmere purveyors. *"We didn't want to be a part of that, so we stopped using virgin cashmere several years ago,"* Patagonia said in its 2018 environmental and social initiatives report. *"By providing a market for recycled cashmere, we help divert discards from landfills and incinerators and, in our own small way, take no part in the desertification of Mongolian grasslands."* It is unclear what impact Patagonia's effort has had on market demand. Another effort focused on cashmere sustainability, the Wildlife Conservation Society's cashmere initiative is concentrating on the sustainability of Gobi Desert region cashmere production (Deneen, 2019). One of the immediate goals of this project is to convince herders to keep fewer goats, by helping them raise the quality of cashmere produced by improving herd quality. The project is also encouraging herders to negotiate prices directly with clothing manufacturers, potentially cutting out the middlemen who control the cashmere market. Overall, initiatives to practice ethical supply chain can reduce the environmental burden on the fragile Mongolian grasslands.

F. Final Thoughts

29. Policy change is needed to make the livestock sector more sustainable, inclusive, and adaptable to climate change. Balancing the livestock population with nature's capacity to regrow is crucial to secure the sector's sustainability. To upgrade the sector in a sustainable way it is essential to reduce quantity of livestock, while improving the value added of each animal. Bringing about change in the sector will be challenging, as it will require changing herding approaches and methods. However, upgrading the sector is essential to ensure inclusive and sustainable growth in the country.

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MAKING MONGOLIA'S FISCAL FRAMEWORK FIT FOR THE FUTURE¹

The conduct of fiscal policy in Mongolia has recently improved, but over a longer horizon, it suffered from high volatility and deficits. Aware of these challenges, the authorities adopted a comprehensive framework of fiscal rules in 2013 but adherence to the rules has been uneven. Options to enhance the effectiveness of the fiscal rules include recalibrating and streamlining the existing rules and strengthening enforcement mechanisms. Unlike in other resource-rich countries, the fiscal policy framework should abstract from Mongolia's mineral wealth because Mongolia still has high public debt and its mineral reserves are highly uncertain.

1. Predictable and sustainable fiscal policy is crucial for unlocking Mongolia's significant economic potential. Mongolia is a small, resource-dependent economy with large economic potential (see IMF 2017). Unlocking this potential to create jobs and economic opportunities for all Mongolians is the country's overarching challenge. In pursuit of this goal, one important step will be to improve the conduct of fiscal policy. In the past, fiscal policy has exacerbated the volatility of the international commodity cycle, leading to large deficits and rapid rise in public debt. Mongolia adopted a comprehensive fiscal rules framework in 2013, but its effectiveness has been mixed.

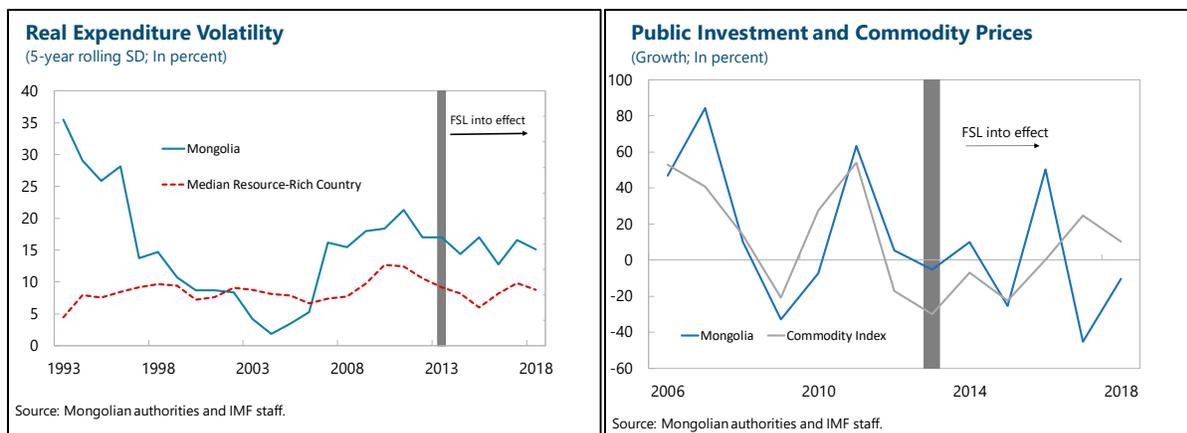
2. This paper reviews the current framework and presents simple options to strengthen the fiscal rules. Section A presents stylized facts about Mongolia's fiscal policy performance compared to other resource-rich countries. Section B and C review and assess Mongolia's fiscal framework, and present options for improvement. Section D discusses why Mongolia's mineral wealth should not be a factor in the recommended revamp of the framework. Section E concludes by summarizing the three recommendations towards building a more resilient and robust fiscal framework—a framework fit for the future.

A. Stylized Facts About Fiscal Policy: High Volatility, Deficits and Debt

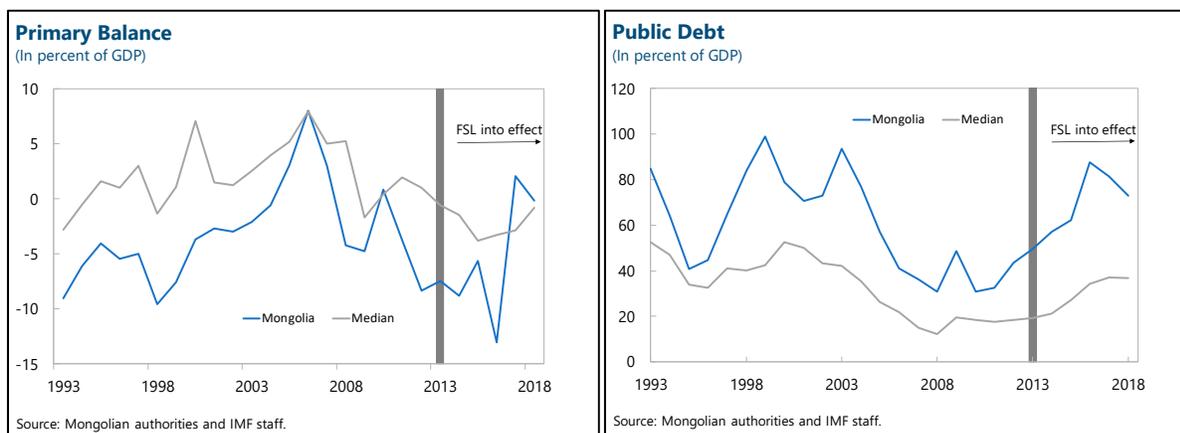
3. Stylized fact: volatility in public spending has been high, driven by large swings in public investment. In the period from 1990 to 2018, the rolling five-year standard deviation of growth of public expenditure in Mongolia has been significantly higher than the median standard deviation in a comprehensive sample of resource-rich countries (see chart; country sample is from IMF 2012). Zooming into spending categories reveals that Mongolia has especially suffered from large swings in public investment; volatility in current spending, in contrast, has been average. To illustrate, public investment increased by almost four percentage points of GDP in 2016, one of the largest increases in public investment in the sample of resource-rich countries since 1990s. This increase was followed by an equally large decline in 2017 in response to acute threats to fiscal sustainability. Public investment has displayed a strong and positive relationship with commodity prices over the past decade (see chart). The procyclical behavior of public investment therefore helps

¹ By Robert Blotvogel (FAD), Rui Xu (APD), and Buyankhishig Khulan (APD).

explain high overall volatility in public spending. This finding is important: cross-country experience suggests that volatility harms economic activity, lowering average growth in the short run and also damaging long-run potential (IMF 2015). Volatility creates uncertainty, which undermines consumer demand and investment in new structures and technology.



4. Stylized fact: high deficits have fueled public debt, most recently following the global decline in commodity prices in 2013-14. Mongolia’s primary deficit reached 13 percent of GDP in 2016, its highest level in recent history. The ratio of public debt to GDP peaked at 87 percent of GDP in the same year, well above prudent debt thresholds. Even after a significant fiscal consolidation over the past two years, Mongolia’s public debt was among the highest of resource-rich countries (only Bahrain and the Republic of Congo had higher debt levels at the end of 2018). With high public debt, Mongolia’s ability to withstand future swings in commodity prices is limited. And commodity price volatility is an empirical reality—the historic volatility of a Mongolia-specific commodity price index (a weighted average of coal and copper prices) suggests that the index will change (either increase or decrease) by 50 percent from its current level over the next three years with a 15 percent probability. Creating buffers that will allow protecting public spending, and by implication the Mongolian economy, against this downside scenario is an important objective for the conduct of fiscal policy.



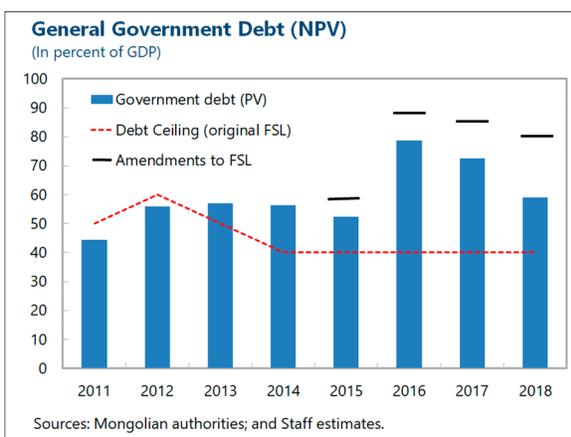
5. The two previous stylized facts suggest that Mongolia stands to gain significantly from reducing spending volatility and keeping public debt on a sustainable path. Building fiscal space by reducing public debt will allow Mongolia to weather short-run declines in mining revenue and to protect public investment that can stimulate jobs and growth. Prudent spending and primary surpluses in the years ahead would help bring public debt back in line with levels of peer resource-rich countries. The next section takes a fresh look at Mongolia's experience with its fiscal rules framework aimed at guaranteeing sustainable and predictable fiscal policies.

B. Mongolia's Experience with Fiscal Rules

6. Mongolia passed the Fiscal Stability Law (FSL) in 2010 to enhance the conduct of fiscal policy. The FSL aimed to make fiscal policy more predictable in the face of volatile mining revenue and ensure debt sustainability. Three fiscal rules became effective in 2013, addressing the deterioration in the fiscal position after the GFC. The law requires the budget proposal for each fiscal year to comply with the rules. The FSL was an important first step towards improving the conduct of fiscal policy.

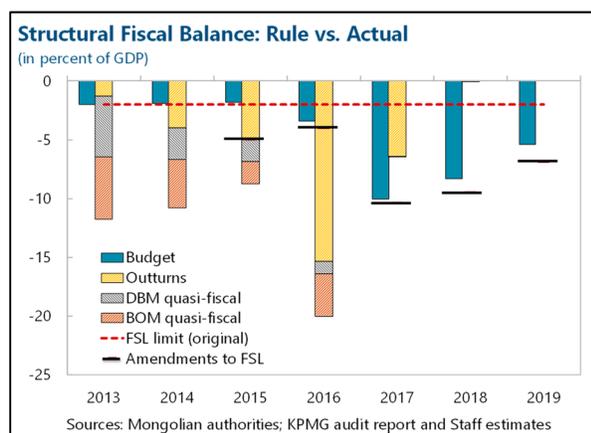
7. The FSL obliges the budget to comply with three fiscal rules. The parameters of the rules at the time the FSL was approved were as follows:

- i. **Expenditure Rule.** The growth rate of total nominal expenditure is not to exceed whichever is higher: the growth rate of non-mining nominal GDP in the budget year (projection) or the average growth rate of non-mining nominal GDP over the previous 12 years.
- ii. **Structural Fiscal Balance Rule.** The structural balance must be equal to or stronger than a deficit of 2 percent of GDP. The structural balance is defined as the overall balance minus cyclical revenues on major minerals. Cyclical revenues are those which stem from prices above a 16-year average (previous 12 years, the budget year and projected prices in the next 3 years). If actual mining revenues are above the structural level, the positive difference would be saved in the Fiscal Stabilization Fund.
- iii. **Debt Rule.** The present value (PV) of government debt should not exceed 40 percent of GDP after 2014 (higher debt ceilings were set in 2011-2013). At the time of adoption, public debt stood at 31 percent of GDP. To calculate the NPV of public debt, the law discounts all future interest and principal payments of concessional public debt by using an interest rate of 5 percent.



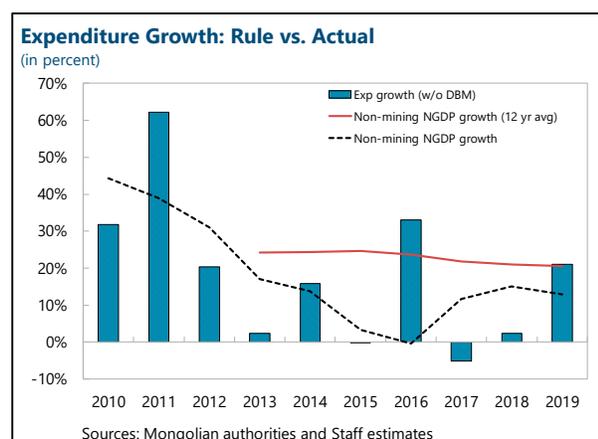
8. The effectiveness of the law has been uneven. For most of the period since 2013,

governments have not complied with the original parameters in the law, either because of overly loose budget submissions or significantly weaker than budgeted outturns. To accommodate this, Parliament adjusted the parameters in the laws, making four amendments to the debt limit and the structural deficit ceiling in the 2015-17 period. In 2016, the debt ceiling was lifted permanently from 40 percent to 60 percent in present value terms. In addition, fiscal performance suffered from off-budget quasi-fiscal spending by the Development Bank of Mongolia and Bank of Mongolia, which further aggravated consolidated fiscal deficits and debt. The non-compliance and frequent revisions have compromised the credibility of the rules and led to costly volatility in expenditures and sharp increases in public debt.



9. Three critical challenges have beleaguered the FSL. First, the original calibration of the

rules was not internally consistent. The operational expenditure rule has a cyclical component that is tied to projected non-mining nominal GDP growth. When past or projected growth is high, the expenditure rule allows a level of spending that is too loose to reach the other targets under realistic assumptions. Second, there were loopholes to the laws in the form of quasi-fiscal spending by SOEs, including DBM and BOM. And third, the rules lack a specific procedure by which Parliament is required to adjust subsequent budgets to account for past slippages.

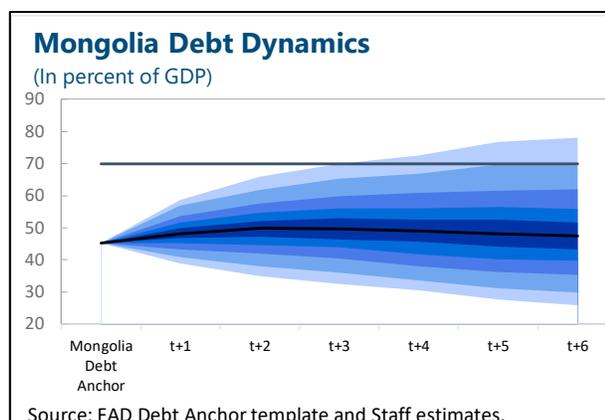


C. Options to Strengthen the Fiscal Rules Framework

10. Although the basic structure of the FSL remains sound, there is scope to streamline and strengthen the rules. This can help with monitoring, communication, and achieving rapid debt reduction. Several changes could be considered going forward.

11. First, A debt ceiling of 50 percent of GDP in nominal terms seems more appropriate for Mongolia. This anchor was calibrated to ensure safe levels of public debt under most adverse

scenarios, and further adjusted to reflect Mongolia's significant share of concessional lending. An FAD template was applied to Mongolia, which calibrates debt anchors for low income countries using stochastic simulations on historical shocks. This methodology suggests a debt anchor of 45 percent of GDP to be sufficient in providing buffers against adverse shocks in the medium term. Considering Mongolia's substantial share of concessional lending, the debt anchor is adjusted upward to 50 percent of GDP. The proposed anchor is appropriately tighter than the current debt ceiling of 60 percent of GDP in PV terms, given Mongolia's vulnerability to commodity price and exchange rate shocks.



12. Second, expenditure ceilings should ensure rapid debt reduction towards 50 percent of GDP and operate as an automatic stabilizer thereafter. Public debt is still elevated at 73 percent of GDP at end-2018, notwithstanding the authorities' success in tightening fiscal policies since 2017 and reducing public debt by 13 percentage points. To bring debt to the safe level, the priority of fiscal policy in the next five years should be rapid debt reduction.

- *Transition period (2020-2024).* Based on the current macro projections, nominal expenditure growth should be capped at 13 percent—significantly below the long-run average growth rate of non-mining nominal GDP—to reach the debt anchor of 50 percent of GDP by 2024.
- *Steady state (i.e. when debt is below 50 percent of GDP).* Growth of public expenditure should be capped by long-run average of historical non-mining nominal GDP. The revised rule removes the cyclical factor in the original expenditure rule and allows automatic stabilizers to operate.

13. Third, the structural balance rule could be suspended. With the debt ceiling as the fiscal anchor and expenditure rule providing operational guidance, the structural balance rule imposes little additional constraint on government spending. In fact, the government can adjust structural revenue projections to meet the deficit target with little scrutiny as there has been no independent body (such as a Fiscal Council) that examines the validity of the technical assumptions. In addition, the structural balance rule is difficult to communicate to the public, challenging to monitor, and can postpone fiscal adjustment at a time of falling commodity prices, as structural revenues and hence structural balance will appear better than actual fiscal balance.

14. Fourth, transfers to the Future Heritage Fund could be suspended until debt reaches the debt anchor. The FHF was set up in 2016 to serve as a sovereign wealth fund.² The law

² The FHF was the successor to the Human Development Fund that was terminated in 2016. As a result, it inherited 1 trillion MNT debt from the HDF to the state budget. Buoyant fiscal revenues in 2017 and 2018 allowed FHF to pay down all the debt by June 2019. Transfers in 2H2019 will accumulate in the FHF.

governing the FHF requires the state budget to make deposits to the fund from four sources: i) dividends on the public shares of mining-sector SOEs; ii) 65 percent of mineral royalty payments excluding transfers to the Fiscal Stabilization Fund; iii) 20 percent of excess mineral revenues relative to the budgeted amount; and iv) investment income. Annual inflows are estimated at 2-3 percent of GDP. According to the law, no withdrawal from the Fund, other than management fee, is allowed until 2030. With public debt still above 70 percent of GDP and low investment returns worldwide, starting a SWF now is not consistent with comprehensive asset-liability management of the government's balance sheet as a whole. As a resource-rich country, Mongolia needs to save for future generations, but debt reduction should take priority at the current juncture (see discussion on PIH analysis below).

15. Extending the coverage of public debt in the fiscal rules to SOEs can help monitor and control state contingent liabilities. Quasi-fiscal lending by DBM was a main contributor to the debt buildup in 2013-2016. Under the Fund's EFF-supported arrangement, such activities have been curtailed in 2017-2019, following the adoption of new the Banking and the DBM laws. However, the authorities have recently announced intentions to embark on a series of mega projects through SOEs to overhaul Mongolia's infrastructure (e.g. roads, railroads, power plants and coal-washing plants). These projects may impose significant fiscal risks, despite its potential positive impact on trade balance and long-term growth. Data availability on SOE debt is uneven at the moment, but there are ongoing efforts to include key SOEs in the GFS reporting. The debt anchor could be adjusted after SOE data become available.

16. A successful implementation of the revised fiscal rules would benefit from a more independent Fiscal Council. The recently created Fiscal Council could play an important role in building the credibility of the revised fiscal rules by: (i) issuing an independent assessment of government's budget assumptions; (ii) assessing eventual deviations from the fiscal rules; and (iii) recommending corrective measures in case budget outturns significantly deviate from the limits set by the fiscal rules. The FSL contains an escape clause that allows for a temporary suspension of the fiscal rules under two types of negative shocks: a sharp fall in commodity prices and a projected recession. As of now, it is up to the government to declare that the conditions for a temporary suspension of the rules are met. However, the FSL does not stipulate the length of the suspension nor any correction mechanism for the immediate period after the suspension when the limits are presumably still out of reach. The fiscal council is well placed to fill this void. Specifically, the council could analyze the reasons for deviating from the fiscal rules to recommend to the government: (i) an appropriate timeframe for suspending the application of the fiscal rules; (ii) and appropriate corrective fiscal actions to restore compliance. For the sake of transparency and accountability, the Council would submit these opinions to the government. The government in turn would respond publicly to the Council's opinion and subsequently submit revised fiscal plans to parliament.

D. A Fiscal Rules Framework Without Considering Mongolia's Mineral Wealth?

17. Mongolia has vast mineral wealth that would typically guide fiscal policy. The fiscal rules framework proposed in this paper emphasizes fiscal sustainability viewed through the lens of

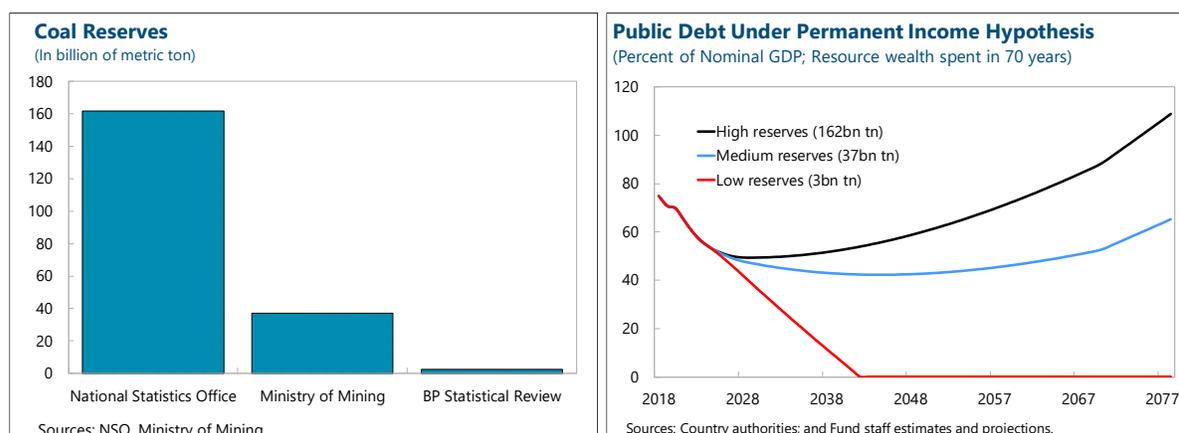
public debt. But the proposal does not contain an explicit reference to Mongolia's mineral wealth, which could be substantial (IMF 2017). Typically, countries with significant natural resource revenues would incorporate the expected income from expected future resource flows when developing fiscal policy (IMF 2012). Mongolia's mineral wealth could generate revenues far into the future and could therefore be brought into the government's intertemporal budget constraint.

18. The Permanent Income Hypothesis (PIH) is the standard way to incorporate mineral wealth into the design of fiscal policy. The PIH calculates fiscal balance targets that are consistent with the government's intertemporal budget constraint over the very long run. The calculation of these targets typically proceeds in three steps: (i) putting a nominal value on all of Mongolia's proven mineral wealth (even if most of it is still underground); (ii) calculating total wealth, the sum of mineral wealth and current financial assets (international reserves and government deposits) and liabilities (public debt); and (iii) creating an annuity from this notional amount of total wealth that is constant over time, which can serve to finance a permanent budget deficit of the same magnitude as the annuity (see Annex for more details about the methodology and assumptions).

19. However, Mongolia is ill-suited to use this approach to guide fiscal policy. Standard PIH estimates would risk suggesting deficit targets that would lead to spiraling public debt in the near and medium term. Mongolia has two features that prevent the PIH from producing reliable fiscal anchors.

- i. **Uncertainty.** The quantities and time-profile of mineral extraction are highly uncertain. Specifically, it is unclear how much of Mongolia's mineral wealth can be extracted in a commercially viable manner; the existence of substantial mineral deposits on Mongolian territory itself, on the other hand, is not in doubt. To illustrate, estimates of proven reserves of coal range from 3 to 162 billion metric tons, depending on assumptions about future coal prices and costs of extraction. Mongolia's coal may therefore run out in 20 years or last for several centuries. Using conservative estimates would basically mean that mineral wealth will run out soon and therefore should not play a dominant role in the conduct of fiscal policy. Conversely, a higher estimate of mineral wealth can unleash destabilizing debt dynamics (see next paragraph).
- ii. **High debt.** The PIH can suggest deficit targets that are weaker than current debt-stabilizing balances. The result would be to put public debt, which is already very high, on an explosive path. This is true even if over the very long run the PIH-derived deficits would be consistent with the government's intertemporal budget constraint. This problem is particularly likely to arise if one uses more optimistic estimates of total mining reserves as they would imply mining revenue long into the distant future. In other words, the PIH is not fit for purpose to deal with countries where public debt is already high and debt reduction is an important near-term fiscal policy objective. To illustrate this point, remember that Mongolia's projected public debt will be just below 60 percent of GDP in 2024, according to current projections. The primary balance that would stabilize debt at this level is about 0.5 percent of GDP, assuming that effective interest rates and nominal GDP are at their long-run averages. The

PIH, on the other hand, would suggest an average primary balance target of 0 percent (when using the intermediate estimate of Mongolia's total mineral wealth). Primary balance targets would be even weaker if mineral wealth was assumed to be higher, as higher mineral wealth implies larger sustainable fiscal deficits. Because of the gap between debt-stabilizing and targeted deficits, public debt could become unsustainable over a 50-year horizon.



E. Conclusion

20. Mongolia will benefit significantly from reducing volatility in public spending and bringing down public debt to safe levels. As a commodity exporter and a young democracy, Mongolia is highly vulnerable to both external shocks (including commodity price fluctuations and changes in demand from China) and domestic political cycles. Reducing fiscal vulnerabilities by building buffers and increasing the predictability of fiscal policy will be essential to prevent boom-bust cycles in the future, and therefore should be the overarching goal of fiscal policy at present.

21. The existing rules-based fiscal framework can be strengthened to help achieve that goal. Improvements suggested in this paper focus on: (i) recalibrating the fiscal rules, centered on a more prudent debt ceiling, a simple expenditure rule that facilitates debt reduction over the medium term and a suspension of the structural balance rule; (ii) including key SOEs in public debt coverage, and (iii) enhancing the enforcement of the fiscal rules with the help of an independent Fiscal Council and guided by a legally binding correction mechanism. These reforms would help to achieve the ambitious objective of bringing down public debt to 50 percent of GDP by 2024. At that point, Mongolia will have built a significant safety cushion to dampen with the vagaries of the international commodity cycle, which creates the necessary conditions for a more predictable and sustainable fiscal policy. These structural improvements in turn will be a crucial milestone in Mongolia's quest to generate jobs and economic opportunity for all Mongolians.

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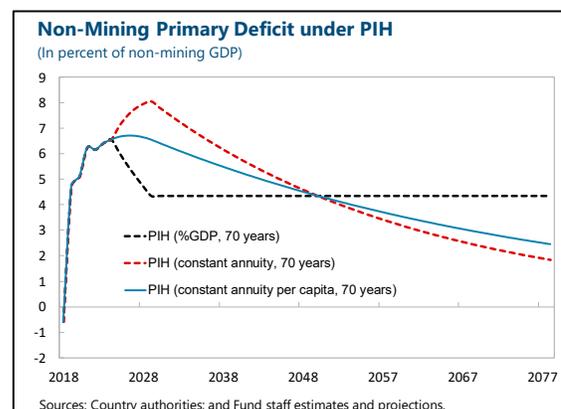
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Annex I. Assumptions for PIH Calculation

The table at the end of the annex summarizes the assumptions underlying the PIH calculation labelled “medium reserves” in paragraph 19. This particular application of the PIH assumes 37 billion tons of unexplored coal reserves (towards the lower end of the range of existing estimates of unexplored coal reserves) and a time horizon of 70 years to spend the entirety of Mongolia’s resource wealth—a finite horizon for spending resource wealth can be appropriate if countries have large development needs, as in the case of Mongolia (IMF 2012).

Several assumptions about macroeconomic parameters are necessary to translate the quantity of underground mineral resources into an estimate of financial wealth, which can then be related to fiscal policy. To start with, assumptions about the evolution over time of mineral prices, production, and the exchange rate underpin the calculation of the total value of export revenue stemming from extracting and selling minerals between now and the distant future. In addition, as only a fraction of the export revenue ends up in the coffers of the government (mainly through royalties, corporate income tax, and dividends from state-owned enterprises), the calculation needs to assume a sharing rule to allocate export revenue to the budget. Assumptions about inflation and interest rates are required to discount back into the present future mineral revenue. Finally, assumptions about sustainable growth rates of the non-mining economy and population growth are necessary to translate the notional amount of total wealth into a constant annuity, which can be constant in real terms, as a share of non-mining GDP or on a per-capita basis.

Under the assumptions, the PIH suggests a constant non-mining primary balance (that is, fiscal balances without mining revenue and interest rate costs) of -4.3 percent of non-mining GDP. If deficits are constant in real terms (growing with inflation) or on a per-capita basis (growing with inflation and population growth), the PIH-consistent deficit path starts out higher and gradually decline towards -2 percent of non-mining GDP.



Those assumptions are empirically calibrated on recent macroeconomic trends of the Mongolian economy. This approach may or may not be appropriate, in so far as the past may or may not be a good guide for the future. Long-run macroeconomic parameters are always surrounded by large uncertainty. It is therefore easy to imagine a preference for more conservative or more aggressive assumptions. And any change in assumptions will lead to different fiscal balance targets. As a caveat though, bear in mind that the PIH calculations abstract from Mongolia’s existing public debt and do not force the fiscal balance targets to be above the debt-stabilizing fiscal balances—this omission can lead to destabilizing debt dynamics, as discussed in paragraph 19.

Assumptions for PIH Calculation

(Percent, unless otherwise indicated)

Mineral sector	
Recovery rate coal (cumulative extraction until 2100/proven reserves)	48.7
Recovery rate copper (cumulative extraction to 2100/proven reserves)	100.0
Coal production growth	3.0
Copper production growth	0.1
Domestic consumption growth of coal	1.0
Domestic consumption growth of copper	0
Nominal increase in copper and coal prices	3.0
Interest rates, inflation, exchange rate	
Nominal interest rate MNT	10.0
Nominal interest rate USD	4.0
GDP deflator inflation	6.0
Real interest rate MNT	3.8
Real interest rate USD	2.1
Annual exchange rate change MNT/USD	3.0
Real sector	
Real GDP growth	3.0
Real non-mineral GDP growth	3.0
Population growth	1.0
Fiscal sector	
Share of mineral revenues to budget	17.0
PIH parameters	
Time to reach PIH post WEO projections (years)	5
Time horizon for modified PIH (years)	70

Source: IMF staff.