Policy Research Paper

Knowledge Partnership Project

Financial and Fiscal Policies for Economic Sustainability in Mongolia

March 2004

Korea Development Institute (KDI)

Korea International Cooperation Agency (KOICA)

Foreword

Knowledge is a critical factor in economic and social development in the 21st century. Knowledge Partnership (KP) Project, a new cooperative framework established between the World Bank and the Korean government has endeavored to bridge the knowledge gap between developed and developing countries by disseminating Korea's economic development experience.

Amid the transition toward a market-based economy, the Mongolian economy is confronted with various challenges in the financial sector, which include weak banking sector, expanding distressed assets, low public trust and ineffective government regulations. This, in turn, increased the risk of financial instability, calling for appropriate policy responses from the government.

The policy research paper "Financial and Fiscal Policies for Economic Sustainability in Mongolia," jointly prepared by Dr. Dongsoo Kang, Dr. Moon Soo Kang, Dr. Seok Kyun Hur from KDI and Dr. Chiho Kim from the Korea Deposit Insurance Corporation, offers a comprehensive assessment on the sustainability of economic system in Mongolia. The paper presents in-depth analysis on major issues in financial and fiscal policies including the Non-Performing Loan (NPL) management, deposit protection, non-banking financial institutions, and fiscal sustainability and scrutinizes economic theories in order to provide relevant policy alternatives for the Mongolian government. In addition, the Korean experience as well as international practices was shrewdly reviewed for reference guide.

KDI would like to express gratitude to all the members of research team for their hard work and scholarly endeavors. Also, we would like to thank the Mongolian Ministry of Finance and Economy (MOFE) for their cooperation during the consultation and research activities. Please note that opinions and recommendations of this report are those of the authors' and full utilization of this report for relevant fields in other developing countries is allowed.

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CHAPTER 1

Introduction

In the early 1990s, Mongolia embarked on its transition to a market-based system. From the early 1920s to the late 1980s, Mongolia was closely linked to the Soviet Union that was her role model from both economic and political perspectives. Following the collapse of the Soviet Union, however, Mongolia began her transformation from a centrally planned economy to a market-based decentralized economy in the early 1990s.

The transition process was not smooth in Mongolia like many other former socialist economies. She experienced a painful “transformational recession” in the first few years before beginning to recover as a result of efficiency gains from market-oriented reforms. The real GDP had remained below the level at the time of initial transition for almost ten years. Inflation surged in the first few years of transition, followed by steady deflation in its subsequent years.

Macroeconomic instability in Mongolia stems partly from the lack of experiences in the market-based economy, but fundamentally from inherent geographical conditions that make her exposed to numerous risks. The Mongolian economy is known to be vulnerable to risks coming from various sources. The sources of risks encompass a landlocked position, frequently occurring natural disasters (e.g. drought and heavy snow), volatility in the terms of trade, political and socio-economic relationship with and dependency on neighboring countries.

Detailed descriptions of the risk factors prevalent in Mongolia are as follows. First, natural disaster affects the productivity of agriculture, which is still the largest industry of Mongolia. Through the recent experiences, Mongolia realized the huge negative impact of a natural disaster on the economy. The risk of natural disaster, such as drought and cold winter, is catastrophic in the sense that the magnitude of shock can be extremely severe. To make it worse, it seems more problematic than other catastrophes like earthquakes and typhoons can occur.

Second, the volatility of international market prices of raw materials influences the mining sector as well as agriculture. The mining sector comprises a major portion of exports in Mongolia. Furthermore, it is common knowledge that the price fluctuations of raw materials are greater than those of finished goods. The risk from the price fluctuation is mechanically decomposed into the exchange rate risk and the dollar price fluctuation.

The third risk factor is political and economic relations with two big neighbors, China and Russia. Historically, Mongolia and these two countries have influenced one another for centuries and they are still closely connected both economically and politically. At this stage, it would be insightful to raise the question whether the two countries regard each other’s economy as complementary, as potential competitor, or a foreign market for their products. Mongolia has some disadvantages for industrialization due to various reasons. To name a few: first, being landlocked geographically and being under-invested in SOCs, the transportation cost will add up your production cost, which lowers the price competitiveness of Mongolia. Second, the small population with low density sets the limits for the size of the domestic markets, which makes it difficult for the Mongolian economy to benefit from the scale of economy.

This research monograph studies the overall Mongolian economy, putting more emphasis on the financial and fiscal policies. In order to establish a sustainable regime, Mongolia is trying to correct its inefficient and ineffective systems that had brought about unsatisfactory performances, but faces further challenges. Note that the real problem does not lie only in the existence of the above mentioned risk factors, but in that those risk factors are not hedgeable under the current economic structure. True that the above mentioned Mongolian risk factors are hardly controllable, but does not necessarily mean that it is impossible to hedge the economy against them by any means. Thus, this study aims to suggest policy recommendations, which may help Mongolian economy insure itself from unpredictable macroeconomic shocks.

The contents of this monograph are construed in the following order. In Chapter 2, we display a macroeconomic overview of Mongolia. We identify all the dormant risk factors in Mongolia and discuss the anticipated magnitudes of impacts from them, reflecting on the past macroeconomic experiences. The past history of the Mongolian economy is summarized in the form of summary statistics, which cover sectoral GDP growth rates, import/export, interest rate, exchange rate, and money growth. Also, the current fiscal management system of Mongolia is diagnosed. Government debt to GDP ratio and fiscal deficit to GDP ratio are mainly used for analysis. Based on fiscal sustainability of Mongolia, the long run sustainability of Mongolian fiscal system is investigated. In addition, we address why the balanced fiscal management is critical for the Mongolian economy.

In Chapter 3, we review briefly the financial sectors. The events from the 1990s to the crisis in 1996 were listed to deepen the understanding of the policy proposals. We also spare spaces to explain the current financial system, focusing on the banking sectors. Past and current performances of the commercial banks are summarized and their financial health is assessed. By looking at the operation of the Bank of Mongolia, the central bank in Mongolia, we are able to glance at the bank supervision. Finally, the other financial sectors like insurance, security market and non-bank financial institutions are introduced.

Chapter 4 deals with one of the most serious problems that Mongolian financial policy makers encounter: resolving non-performing loans. Usually, a financial crisis is triggered by accumulation of massive non-performing assets in the banking sector. Mongolia has struggled with the overwhelming amount of financial masses and tedious speed of their resolution. In nearly seven years after the outbreak of the banking crisis, three quarters of acquired non-performing loans are still remaining unresolved. On top of the existing bad assets, further occurrence of problematic assets seems to emerge in the near future in view of recent steep increase in private credits. This chapter proposes ideas for how the Mongolian government should react to these issues.

In Chapter 5, we introduce the general information regarding the deposit insurance system that Mongolian government considers to fill up the financial safety net. History, theory, best practices and international comparison are offered. Finally, the policy suggestions are provided that the Mongolian government should bear in mind. Some comments on the draft on the Deposit Insurance Law are made as well.

Chapter 6 deals with the supervision on the non-bank financial institutions (NBFIs) sector. The NBFIs have positive aspects that they enable the isolated people like rural areas and poor strata to get access to the financial services. Non-existence of proper regulation mechanisms on the sector, however, has invited various problems such as fraudulent behaviors, excessive credit expansion, and failure of consumer protection. These problems are typically observed worldwide in the development process. In this chapter, we summarize the evolution of NBFIs sector in Mongolia and suggest policy recommendations for effective supervision on the sector.

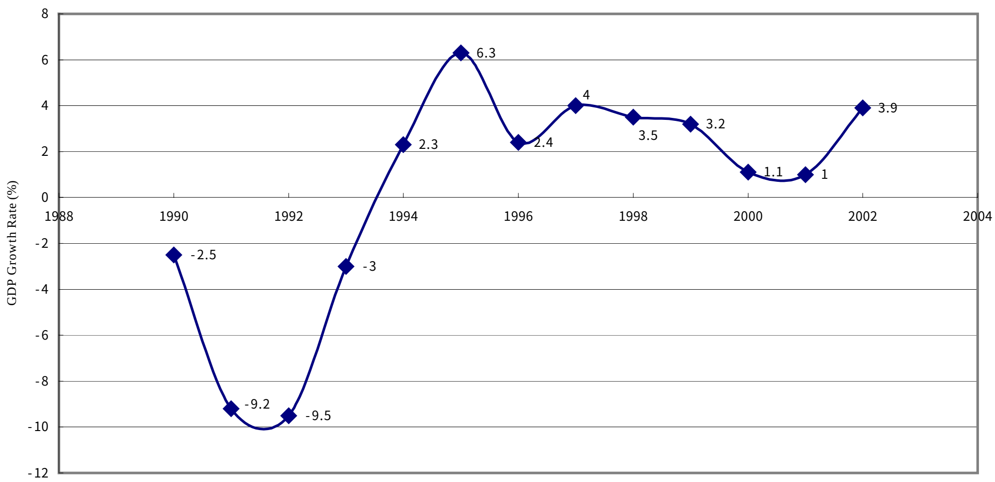
In Chapter 7, we propose fiscal policy directions, towards which the Mongolian economy should progress: a short run measure for fiscal consolidation should be accompanied by a long run measure to enhance the efficiency of public expenditure system. Through a harmonious mix of these measures, we believe, the Mongolian economy will achieve a stabilized growth path. For practical implementation of the proposed policy directions, we compare the relative performances of various fiscal programs in several countries. Finally, Chapter 8 makes concluding remarks.

CHAPTER 2
Macroeconomy

2.1. Overview

Mongolia is a large but sparsely populated country sandwiched between China and Russia. Since Mongolia was liberated from China in the 1920s, Mongolia has been under the leadership of the communists, the Mongolian Peoples' Revolutionary Party, until the early 1990s. Just after the former Soviet Union collapsed and the Council for Mutual Economic Assistance (COMECON) was disorganized as a result of Perestroika, the Mongolian transition from a planned economy to a market economy began. After the transition was launched, real GDP of Mongolia recorded a negative growth for three consecutive years (-9.2% in 1991, -9.5% in 1992 and –3.0% in 1993). However, the Mongolian economy put an end to the fall of its national output in 1994. Real GDP has continued to increase since 1994. Even when other economies in East Asia suffered severe recession due to the Asian financial crisis, national output of Mongolia went up by 4.0% in 1997 and 3.5% in 1998 (Figure 2-1).

Figure 2-1 Growth Rate of Real GDP in Mongolia



Overall, Mongolian economy is characterized by the following factors:

First, the Mongolian economy is in transition from a centrally-planned economy to a market-oriented economy. The transition started in 1991 and the economic reforms initiated by the Mongolian government began with privatizing national enterprises and attracting Foreign Direct Investment (FDI). The government privatized the retail sector and the herding industry, which is the original basis for her economy. In addition, the government attracted foreign capital to facilitate the mining industry. However, the Mongolian economy suffered from a variety of obstacles for economic growth, which were also experienced by other transition economies. The obstacles range from inadequate financial intermediation and excessive reliance on cash transaction to inefficient national enterprises; inadequate or antiquated infrastructure; workers who are poorly trained, equipped and motivated; inadequate distribution systems; lack of access to modern technology and methods of production and distribution; and lack of information about market condition at home and abroad.[1] These obstacles explain a large aspect of the decline in the national output in the Mongolian economy from 1991 to 1993. However, compared to a 50 percent decline in the national output suffered by the countries of the former Soviet Union, Mongolia suffered a smaller fall in its national output.

Second, the Mongolian economy is highly vulnerable to natural phenomena and international economic environment. With an area of 1.5641 million square kilometers and a population of 2.4 million, Mongolia is the 18th largest and the most sparsely populated country in the world. The climate of Mongolia is a harsh continental one with four clearly differentiated seasons and most of its territory is composed of desert and steppe. In Mongolia, agriculture is of great importance to the economy. The agriculture sector's share of GDP exceeds 30% (Table 2-1). In particular, the livestock sector produces more than 80% of gross agricultural product and is the only source of income for more than 34% of all households in Mongolia (Table 2-3). However, livestock production is entirely seasonal, taking place in harmony with the Mongolian climate. That is, the pastoral character of animal husbandry makes it extremely vulnerable to such natural phenomena as severe winters preceded or followed by droughts, known as "dzud". Therefore, the Mongolian economy must reduce its susceptibility to the weather factor, or natural disasters, by effectively protecting the livestock sector from such exogenous risks. Raw materials produced by the agriculture sector and the mining sector such as cashmere and mineral products are the main source of Mongolia's export earnings. Table 2-5 shows that mineral products, leather (raw and processed hides, skins and fur and articles thereof) and cashmere products (textile and textile products) comprise more than 90% of the total export earnings. Price fluctuation of raw materials is relatively high compared with that of finished goods. Therefore, export earning of the country is significantly dependent on the exchange rate and the dollar prices of raw materials in world market.

Third, Mongolia is landlocked by China and Russia. Landlocked territory of Mongolia is an adverse geographical condition for international trade. Table 2-10 shows that the Mongolian economy, regarding freight, is totally dependent on ground transport, which results in high transportation cost. Railway is the most important means of transportation to Mongolia. There are railways that connect Mongolia to ports in China and Russia. Mongolia uses the ports when trading with countries other than the two countries. The Mongolian economy is significantly affected by China and Russia. Historically, Mongolia has been connected with these countries. Mongolia had been under the rule of China for centuries before it was liberated in the 1920s. Since she was liberated from China, the country had been politically and economically under the influence of the former Soviet Union until the early 1990s. The Mongolian economy is still closely related to China and Russia, which can be confirmed by Table 2-7 and Table 2-8.

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[1] Black, Stanley W., "Obstacles to Faster Growth in Transition Economies: The Mongolian Case," IMF Working Paper WP/01/37, March 2001

2.2. Detailed Descriptions

2.2.1. Aggregate and Sectoral GDPs

The Mongolian economy suffered a fall in gross domestic output from 1990 to 1993. However, as a result of assistance from the international world and economic reforms, the economy experienced recovery of its GDP from 1994. Since 1994, gross output of the economy has continued to increase. In 1995, the economy recorded a positive growth of 6.1 % due to the extensive privatization of state enterprises and rapid increase in foreign direct investment. In 1998, the economy overcame a negative demand shock caused by the Asian financial crisis and the Russian financial crisis, and grew by 3.5%. The growth rate of the Mongolian economy was relatively low in 2000 and 2001. Stagnated economic growth in the two years can be attributed to sharp decrease in real gross agricultural product (14.9% decrease in 2000 and 18.5% decrease in 2001). During the period, output in the agricultural sector rapidly decreased due to the massive livestock losses caused by the cold weather in the winter of 2000 (Table 2-4). This confirms the vulnerability of the Mongolian economy to risk factors.

The aggregate domestic output of the Mongolian economy is decomposed into 15 industry sectors. Table 2-1 shows each sector’s share in real GDP from 1995 to 2001, and Table 2-2 shows the growth rate of each industry sector during the same period. The agriculture sector (agriculture, hunting and forestry), the commerce sector (whole sale and retail trade; repair of motor vehicle, motorcycle, personal and household goods) and the mining sector (mining and quarrying) are the three major industries in Mongolia, which produces more than 60% of real GDP of the Mongolian economy. In contrast, the manufacturing sector’s share in real GDP is relatively small and it had continuously decreased until 2000.

Table 2-1 Share of Real GDP

(unit: %)

	Classification	1995	1996	1997	1998	1999	2000	2001	Mean
1	Agriculture, Hunting and Forestry	38	38.8	38.9	39.9	40.3	34	27.4	36.8
2	Mining and Quarrying	12	12.4	12.6	12.8	12.8	13.5	14.6	13.0
3	Manufacturing	12.1	10.2	8.3	8.3	7.8	7.5	9.7	9.1
4	Electricity, Gas and Water Supply	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.7
5	Construction	1.7	1.7	1.6	1.5	1.5	1.3	1.4	1.5
6	Whole Sale and Retail Trade; Repair of Motor Vehicle, Motorcycle, Personal and HH	17	16.7	18.8	17.6	17.2	21.5	23.4	18.9
7	Hotel and restaurants	0.7	0.7	0.7	0.7	0.7	0.8	0.7	0.7
8	Transport, Storage and Communication	6.4	6.9	7	7.3	7.5	9.3	10.6	7.9
9	Financial Intermediation	1.2	1.7	1.2	0.8	1	1.1	1.3	1.2
10	Real Estate, Renting and Business Activities	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.6
11	Public Administration and Defense; Compulsory Social Security	3	3.1	3	3	2.9	3	2.8	3.0
12	Education	3.8	3.8	3.8	3.9	4	4.1	4.1	3.9
13	Health and Social Work	2.6	2.7	2.7	2.6	2.6	2.6	2.7	2.6
14	Other Community, Social and Personal Service Activities	0.2	0.1	0.2	0.2	0.1	0.2	0.3	0.2
15	Financial Institution Service Indirect Merchandise / FISIM /	-1	-1.1	-1	-0.8	-0.8	-1.1	-1.4	-1.0
	GDP / Current Prices /	100	100	100	100	100	100	100	

Source: Ministry of Finance and Economy of Mongolia.

Table 2-2 Growth Rate of Real GDP

(unit: %)

	Classification	1996	1997	1998	1999	2000	2001	Mean
1	Agriculture, Hunting and Forestry	4.4	4.3	6.4	4.2	-14.9	-18.5	-2.9
2	Mining and Quarrying	6.1	5.6	4.9	3.2	6.6	9.6	6.0
3	Manufacturing	-13.8	-15.0	3.2	-2.8	-3.3	31.8	-1.1
4	Electricity, Gas and Water Supply	0.7	0.4	3.2	4.6	0.4	3.5	2.1
5	Construction	2.6	-2.7	-1.1	1.6	-14.6	10.8	-0.9
6	Whole Sale and Retail Trade; Repair of Motor Vehicle, Motorcycle, Personal and HH	0.3	17.1	-3.1	1.3	26.1	9.8	8.1
7	Hotel and Restaurants	6.8	0.2	0.5	8.7	13.2	-6.9	3.5
8	Transport, Storage and Communication	11.2	5.8	7.4	6.1	25.2	14.9	11.6
9	Financial Intermediation	42.2	-26.7	-33.0	39.9	7.0	22.4	4.2
10	Real Estate, Renting and Business Activities	4.2	-2.4	8.4	-4.7	12.5	7.1	4.0
11	Public Administration and Defense; Compulsory Social Security	3.5	2.2	1.9	1.5	3.5	-5.7	1.1
12	Education	4.0	4.1	6.8	4.6	3.2	1.3	4.0
13	Health and Social Work	4.4	3.0	1.4	3.1	-0.1	4.6	2.7
14	Other Community, Social and Personal Service Activities	0.8	6.2	5.3	0.5	57.1	10.4	11.9
15	Financial Institution Service Indirect Merchandise / FISIM /	15.6	-7.5	-16.6	7.0	30.5	27.1	8.0
	GDP / Current Prices /	2.4	4.0	3.5	3.2	1.1	1.0	2.5

Source: Ministry of Finance and Economy of Mongolia.

Output in the agriculture sector (agriculture, hunting and forestry) had increased till 1999. However, in 2000 and 2001, the sector experienced a huge negative growth in output. The cold weather in the winter of 2000 led millions of heads of livestock to death, which sharply reduced gross product in the agriculture sector (Table 2-1 and Table 2-2). In Mongolia where the agriculture sector is of great importance to the economy, climatic condition such as *dzud* works as an exogenous risk factor that significantly influences the supply side. In view of the importance of the livestock sector, the Mongolian government has to take measures to facilitate the prevention of livestock losses arising from *dzud* such as:

i) improvement of forecasting and analysis and the expansion of the information network in isolated areas;

ii) strengthening the capacity to respond to and take urgent measures to tackle naturally-occurring climatic phenomena;

iii) the revitalization and improvement of the work of forage production units;

iv) the supply of cattle-breeding farms in isolated areas with power from renewable energy sources;

v) the improvement of pastureland management and veterinary assistance in preventing various animal parasites.

Table 2-3 Gross Agricultural Output of Mongolia

Sector	1995	1999	2000	2001
At Constant Prices of 1995 (million tugrik)				
Total	267,465.7	3,204,544.7	275,460.3	236,174.8
Livestock	227,874.4	282,389.1	238,054.0	194,014.0
Crops	39,591.3	38,155.6	37,406.3	42,160.8
Share(%)				
Livestock	85.2	88.1	86.4	82.1
Crops	14.8	11.9	13.6	17.9

Source: *Mongolian Statistical Yearbook 2001*, p.129, National Statistical Office of Mongolia.

Table 2-4 Number of Livestock and Household Animals

Type	1995	1999	2000	2001
Livestock, thousand heads				
Total	**28,572.3**	**33,568.9**	**30,227.5**	**26,075.3**
Camel	367.5	355.6	322.9	285.2
Horse	2,648.4	3,162.5	2,660.7	2,191.8
Cattle	3,317.1	2,824.7	3,097.6	2,069.6
Sheep	13,718.6	15,191.3	13,876.4	11,937.3
Goat	8,520.7	11,033.9	10,269.8	9,591.3
Household Animals, head				
Pig	23,518	21,864	14,864	14,773
Poultry	99,287	78,090	89,122	54,367
Reindeer	900	662	680	644
Donkey	913	1,491	890	778
Bees, Hives	1,165	1,154	1,530	1,007
Rabbit	118	189	48	32
Fox	568	45	25	15

Source: *Mongolian Statistical Yearbook 2001*, p.130, National Statistical Office of Mongolia.

Output in the mining sector (manufacturing and quarrying) has been steadily increasing. From 1996 to 2001, the sector recorded 6.0% of annual growth rate, which is about 2.4 times the GDP growth rate. Such a high growth rate in the mining sector implies that the sector has significantly contributed to the growth of the Mongolian economy. Whereas the agricultural sector is susceptible to natural phenomena, the mining sector is vulnerable to market risks. Generally, the price fluctuation of raw material tends to be more severe compared with that of finished goods; thus, output in the mining sector is more affected by market than that in the manufacturing sector is. Moreover, in the Mongolian economy, a large share of export earning comes from mineral products produced in the mining sector.

Therefore, the mining sector in the country is susceptible to exchange rate and dollar prices of mineral products in the world market.

Table 2-5 Export, by Groups of Commodities, Percentage to Total

(unit: %)

Groups of Commodities	1995	1999	2000	2001
Live Animals, Animals Origin Products	2.2	6.1	5.0	5.5
Vegetable Origin Products	1.0	0.0	0.0	0.2
Animal and Vegetable Fat and Oil	0.0	0.0	0.0	0.0
Food Products	0.5	0.7	0.2	0.1
Mineral Products	**65.5**	**41.0**	**40.5**	**44.2**
Chemical and Chemical Industry Products	0.3	0.1	0.0	0.8
Plastics, Rubber, and Articles thereof	0.0	0.0	0.3	0.1
Raw and Processed Hides, Skins and Fur and Articles thereof	**5.0**	**8.4**	**9.1**	**10.9**
Wood and Wooden Articles	1.0	1.5	0.2	0.0
Cellulose, Paper, Card-Board and Articles thereof	0.0	0.0	0.0	0.0
Textile and Textile Articles	**17.1**	**35.5**	**41.3**	**35.9**
Foodwear, Headwear, Umbrellas Feather and Artificial Flowers	0.0	0.0	0.0	0.0
Articles of Stone, Plaster, Cement, Asbestos, Glass and Glassware	0.1	0.0	0.3	0.0
Natural or Cultured Pearls, Preslous Metal, Jewellery	0.0	0.9	1.3	0.2
Base Metals and Articles thereof	3.6	2.3	1.3	1.2
Machinery, Equipment Electric Appliances, Recorders, TV Sets and Spare Parts	0.3	1.9	0.3	0.4
Auto, Air and Water Transport Vehicles and Their Spare Parts	2.8	1	0.1	0.4
Optical, Photographic, Cinematographic, Measuring, Control, Medical, Surgical and Musical Instruments, Watches	0.1	0.1	0.1	0
Various Industrial Goods	0.2	0.2	0.	0
Other	0	0	0	0

Source: *Mongolian Statistical Yearbook 2001*, p.203, National Statistical Office of Mongolia.

Table 2-6 Import, by Groups of Commodities, Percentage to Total

(unit: %)

Groups of Commodities	1995	1999	2000	2001
Live Animals, Animals Origin Products	0.3	0.2	0.3	0.7
Vegetable Origin Products	3.7	3.5	7.6	5.3
Animal and Vegetable Fat and Oil	0.6	1.1	1.0	0.9
Food Products	4.5	7.0	7.7	7.8
Mineral Products	**20.0**	**16.6**	**19.6**	**23.7**
Chemical and Chemical Industry Products	8.7	3.9	4.6	5.5
Plastics, Rubber, and Articles thereof	1.6	2.5	2.2	2.3
Raw and Processed Hides, Skins and Fur and Articles thereof	0.3	0.1	0.0	0.1
Wood and Wooden Articles	0.3	0.2	0.3	0.3
Cellulose, Paper, Card-Board and Articles thereof	2.9	1.2	1.4	1.6
Textile and Textile Articles	6.8	9.0	13.0	10.3
Foodwear, Headwear, Umbrellas Feather and Artificial Flowers	2.0	0.2	0.3	0.3
Articles of Stone, Plaster, Cement, Asbestos, Glass and Glassware	1.3	0.9	0.9	1.6
Natural or Cultured Pearls, Preslous Metal, Jewellery	0.0	0.0	0.0	0.0
Base Metals and Articles thereof	8.4	3.8	3.7	4.9
Machinery, Equipment Electric Appliances, Recorders, TV Sets and Spare Parts	**20.5**	**34.5**	**21.7**	**18.4**
Auto, Air and Water Transport Vehicles and Their Spare Parts	**15.2**	**10.6**	**10.9**	**11.8**
Optical, Photographic, Cinematographic, Measuring, Control, Medical, Surgical and Musical Instruments, Watches	1.4	3.4	3.4	2.9
Various Industrial Goods	1.4	1.3	1.4	1.3
Other	0.1	0	0.1	0.1

Source: *Mongolian Statistical Yearbook 2001*, p.203, National Statistical Office of Mongolia.

Output in the manufacturing sector has been volatile. The manufacturing sector recorded –6.6% of annual growth rate from 1996 to 2000, and share of the sector in real GDP decreased during the same period from 12.1% in 1995 to 7.5% in 2000. However, the manufacturing sector in Mongolia experienced a 31.8% positive growth in 2001, and share of the sector's output in real GDP increased from 7.5% in 2000 to 9.7% in 2001. The track record in the last couple of years shows some signs of recovery and also some economists believe that the recovery is the anticipated outcome of manufacturing sector development policy of Mongolian governments. However, it seems too early to make such prospects. Maybe it was just sort of a technical rebound from the recent downturn.

Output in the finance sector (financial intermediation) has been very volatile. The finance sector suffered a sharp decline in output in 1997 and 1998, which resulted from occurrence of the massive non-performing loans and shocks from abroad (the Asian financial crisis and the Russian financial crisis). Output increase of 39.9% in 1999 seems to be a technical rebound. Though the finance sector recorded 4.2% of the annual growth rate, output volatility shows that the finance sector in the Mongolian economy has a very weak industrial basis.

Output growth rate in the commerce sector (whole sale and retail trade; repair of motor vehicle, motorcycle, personal and household goods) has been rather unstable, but output on the sector recorded 8.1% of annual growth, which is almost 3.2 times real GDP growth rate. High growth rate of the sector can be attributed to increase in circulation of imported goods. In Mongolia, the manufacturing sector focuses mainly on semi-processing raw material such as cashmere and mineral and is not capable of producing finished good such as motor vehicle and machinery, which Mongolia imports from abroad. Import increased from USD 415.3 million in 1995 to USD 554.8 million in 2001.

Table 2-7 Export of Mongolia Categorized by Countries

(unit: million USD)

Countries	1995	1999	2000	2001
Austria	0.1	0.0	0.0	0.0
USA	**25.8**	**46.3**	**92.9**	**84.7**
Afghanistan	0.1	-	-	-
Belgium	2.2	0.9	1.6	1.3
Bulgaria	0.0	0.0	0.0	-
South Korea	26.1	2.1	2.7	3.4
North Korea	0.1	0.2	-	0.0
Germany	7.6	2.4	1.9	2.3
Denmark	-	0.0	0.0	0.0
Italy	11.4	14.6	14.5	11.5
United Kingdom	18.7	13.6	11.2	6.7
Kazakhstan	74.4	0.3	1.0	1.0
Netherlands	4.6	3.7	3.4	2.7
Russian Federation	**68.9**	**48.2**	**45.1**	**39.7**
Poland	0.0	0.0	0.0	2.9
Romania	0.0	0.0	-	-
Singapore	1.8	0.9	0.1	0.0
Turkey	0.0	0.4	0.8	0.1
Ukraine	-	0.0	2.1	0.0
Hungary	0.0	0.0	0.0	-
France	0.3	0.7	1.8	0.1
China	**77.8**	**208.2**	**274.3**	**212.4**
Hong Kong	3.0	-	-	-
Czech Republic	0.4	0.1	0.0	0.1
Switzerland	76.9	0.6	0.8	0.5
India	0.0	0.6	0.4	0.0
Japan	46.7	10.9	8.1	12.6

Source: *Mongolian Statistical Yearbook 2001*, p.203, National Statistical Office of Mongolia.

Table 2-8 Import of Mongolia Categorized by Countries

(unit: million USD)

Countries	1995	1999	2000	2001
Austria	5.6	0.4	1.9	0.6
USA	14.5	31.5	28.4	13.9
Afghanistan	0.0	-	0.7	-
Belgium	0.9	2.0	2.4	6.0
Bulgaria	0.6	3.2	3.6	1.0
Belarus	0.2	2.4	4.2	6.1
South Korea	21.5	36.2	55.6	53.6
North Korea	0.2	0.0	0.0	0.0
Germany	18.5	23.6	29.7	28.4
Denmark	4.1	3.0	4.4	7.5
Italy	3.6	4.5	3.0	2.4
United Kingdom	2.7	3.9	6.0	3.6
Kazakhstan	0.8	0.7	6.8	3.3
Netherlands	0.6	1.0	2.7	2.2
Russian Federation	**208.0**	**149.8**	**206.2**	**201.9**
Poland	1.1	4.5	4.9	4.1
Romania	0.1	0.0	0.0	0.0
Singapore	7.4	9.1	10.6	8.5
Turkey	0.2	0.3	1.1	1.2
Ukraine	0.9	1.6	1.1	2.0
Hungary	0.5	1.4	1.7	1.0
France	1.8	8.5	8.3	4.8
China	**44.5**	**77.6**	**125.8**	**121.4**
Hong Kong	6.1	-	-	-
Czech Republic	9.9	4.9	3.5	5.6
Switzerland	6.1	2.3	3.2	4.2
India	1.4	1.8	1.8	1.1
Japan	**45.3**	**115.0**	**73.3**	**52.8**

Source: *Mongolian Statistical Yearbook 2001*, p.203, National Statistical Office of Mongolia.

Output in the TSC[2] sector recorded 11.6% of annual growth rate from 1996 to 2001, which is almost 4.6 times real GDP growth rate. Growth rate of the sector is highest among major industry sectors in the Mongolian economy (agriculture: -2.9%, mining: 6.0%, manufacturing: -1.1% and commerce: 8.1%). Such a high growth rate in the sector can be attributed to the growth of communication service industry and transport industry. Table 2-9 shows that communication service revenue in 2001 is almost 4.4 times that in 1995 and demand for mobile communication service and internet provision service increased tremendously during the same period. Table 2-10 shows that freight turnover in 2001 is almost 2.2 times that in 1995 and passenger turnover increased by 40% during the same period.

[2] TSC stands for transport, storage and communication.

Table 2-9 Main Indicators of Communication

Year	1995	1996	1997	1998	1999	2000	2001
Number of Telecomm. Office	385	385	385	391	389	384	383
Number of Post Office	28	58	74	298	298	298	362
Communication Services Revenue (Million Tog., at Current Prices)	7,944.8	10,297.7	13,431.4	14,983.7	23,983.4	31,572.8	34,723.3
Number of Telephones (Thousand Pcs.)	75.5	82.1	86.8	93.8	104.1	112.2	119.7
Number of Transition And Relay TV Stations	674	664	633	639	645	625	619
Number of Wired-Radio Outlets (Thousand Pcs.)	155.1	158.0	158.9	159.0	155.9	139.2	121.4
Number of TV Sets (Thousand Pcs.)	142.8	148.9	150.5	151.5	168.8	169.1	173.1
Number of Cell-Phone Users (Thousand Pcs.)	-	-	-	-	48.2	75.1	91.2
Number of Internet Users (Thousand Pcs.)	-	-	-	-	4.2	5.2	10.3

Source: *Mongolian Statistical Yearbook 2001*, p.189, National Statistical Office of Mongolia 40% during the same period.

Table 2-10 Main Indicators of Transport

Types of Transport	1995	1999	2000	2001
Freight turnover, million ton * kilometer				
Total	2,437.1	3,623.3	4,418.3	5,427.3
Railway	2,279.5	3,491.7	4,282.5	5,287.9
Road	152.9	123.2	126.1	129.5
Air	4.5	8.2	9.4	9.5
Water Transport	0.2	0.2	0.3	0.4
Carried freight, thousand tons				
Total	8,950.8	9,534.0	10,643.4	11,810.5
Railway	7,298.0	8,199.3	9,158.5	10,147.7
Road	1,648.5	1,330.4	1,480.4	1,658.2
Air	2.7	2.8	2.9	2.9
Water Transport	1.6	1.5	1.6	1.7
Passenger turnover, million passenger * kilometer				
Total	1,424.2	1,800.7	1,946.0	1,972.2
Railway	679.7	100.9	1,067.2	1,062.2
Road	424.3	358.4	364.2	371.1
Air	320.2	432.7	514.6	538.9
Carried passengers, million passenger				
Total	110.3	87.6	93.0	98.5
Railway	2.9	4.1	4.3	4.1
Road	107.2	83.3	88.4	94.1
Air	0.2	0.2	0.3	0.3

Source: *Mongolian Statistical Yearbook 2001*, p.183, National Statistical Office of Mongolia.

Table 2-11 shows correlation coefficients between the economy's sectoral growth rates and real GDP growth rate. The table reveals some interesting patterns at a different angle.

First, the high correlation of growth rates between agriculture sectoral products and aggregate GDP indicates that the agricultural sector still takes the dominant position in Mongolian economy.

Second, public expenditure has smaller positive correlation with the GDP growth rate. That means that public expenditure is more or less pro-cyclical. According to the traditional public finance theory, a well-designed fiscal system carries out the role of automatic stabilizer, which dampens fluctuations of business cycles. However, the result shows that the past fiscal policy was rather discretionary and furthermore it amplified the swing of the economy.

Table 2-11 Correlation of Sectoral Growth Rates with Real GDP Growth Rate

Sector	Correlation
Agriculture, Hunting and Forestry	0.91
Mining and Quarrying	-0.73
Manufacturing	-0.56
Electricity, Gas and Water Supply	0.08
Construction	0.02
Whole Sale and Retail Trade; Repair of Motor Vehicle and HH Goods	-0.42
Transport, Storage and Communication	-0.87
Financial Intermediation	-0.47
Real Estate, Renting and Business Activities	-0.67
Public Administration and Defense; Compulsory Social Security	0.4
Education	0.76
Health and Social Work	0.02
Other Community, Social and Personal Service Activities	-0.62
Financial Institution Service Indirect Merchandise	-0.93

Third, the growth rate of financial sector is negatively correlated with the real GDP growth[3], which reflects that monetary expansion during the hyperinflation period hampered the economic growth. In other words, it indicates a trace of the government's heavy dependence on monetary policy during the past decade. Mongolia has been through the experience of hyperinflation in the last decade. It still lives in the memory of Mongolians. In the advent of another shock, the use of monetary policy may cause intractable chaos. Therefore, it seems that the fiscal policy might be the one Mongolian government can use in times of trouble. That explains why we allocate substantial portion of the paper on the fiscal performance of Mongolia.

2.2.2. Inflation, GDP Deflator and Money

Figure 2-2 shows inflation rate (change in consumer price index) of the Mongolian economy from 1991 to 2001. The economy experienced an extremely high inflation from 1991 to 1997. Average inflation rate during the period exceed 80% per year. Since 1998, inflation rate of the economy has been maintained at a relatively low level. In the economy, change in GDP deflator has a positive correlation with the inflation rate, but correlation

[3] The correlation after the hyperinflation period gets smaller or changes a sign.

coefficient, 0.677, indicates that the correlation between inflation rate and change in GDP deflator is not very strong. Table 2-12 shows that inflation rate and change in GDP deflator moved in the opposite direction in 1998. GDP deflator includes, by definition, only goods and services produced within the country whereas inflation rate contains consumer good and services regardless of place of production. Magnitude of the correlation coefficient, 0.677, implies that foreign sector plays an important role in the Mongolian economy.

Figure 2-2 Inflation Rate of Mongolia

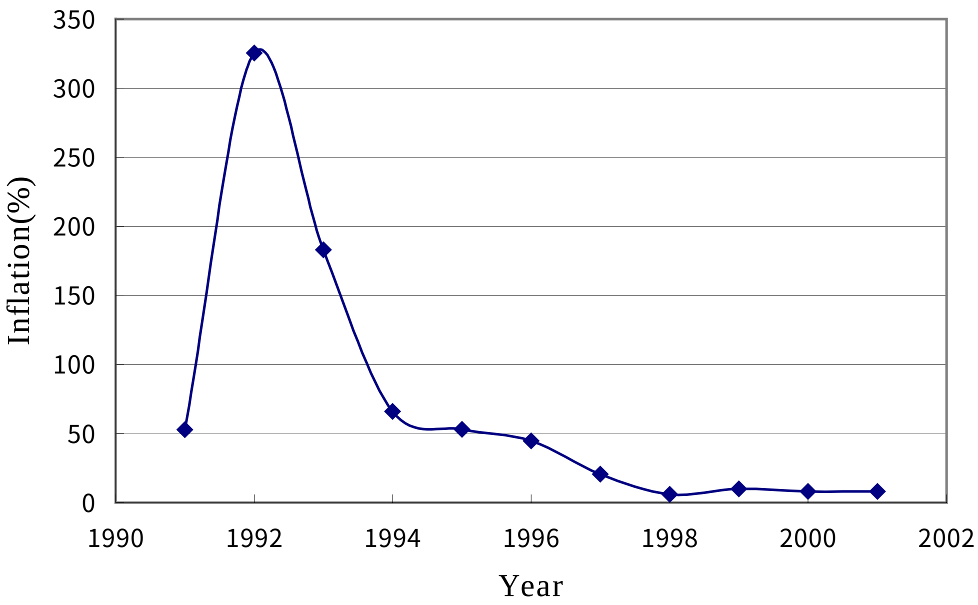


Table 2-12 CPI, CDP Deflator Change, M1 and M2

(unit: %)

Year	Inflation Rate (1995=100, CPI)	GDP Deflator Change (1995=100)	Growth Rate of M1	Growth Rate of M2
1996	46.89	14.8	42.68878	17.19815
1997	36.5561	23.829	25.10212	42.20177
1998	9.357	-5.18	8.504907	-1.6557
1999	7.5649	9.68	39.04483	31.63978
2000	11.5955	8.958	13.86881	17.55576
2001	7.9954	8.384	19.40712	27.90212

Note: 1) M1 = Money, not seasonally adjusted
2) M2 = Money and quasi money

Source: International Monetary Fund, International Financial Statistics.

Table 2-13 Correlation of CPI and GDP Deflation Change and Growth Rate of M1, M2

Classification	Inflation Rate	GDP Deflation Change	Growth Rate of M1	Growth Rate of M2
Inflation Rate (CPI)	1	0.677	0.543	0.234
GDP Deflation Change	0.677	1	0.544	0.85
Growth Rate of M1	0.543	0.544	1	0.445
Growth Rate of M2	0.234	0.85	0.445	1

2.2.3. Exchange Rate and Trade

The Mongolian currency has been continuously depreciated since 1992. It recorded a 38.5% of average annual depreciation rate from 1992 to 2002. The exchange rate of the Mongolian currency with respect to US Dollar went up from 42.6 in 1992 to 1021.9 in 1999. (Table 2-14) However, the exchange rate has been relatively stabilized since 2000. In the Mongolian economy, export earning has been stable since 1997 whereas import has increased from USD 468.3 million in 1997 to USD 554.8 million in 2001. The ratio of trade deficit with respect to GDP increased from 3.1% in 1996 to 8.7% in 2001. It can be inferred that the rising trend of exchange rate will be inevitable and the duration of stabilized exchange rate will not be long as long as the trade deficit continues.

Table 2-14 Exchange Rate & Interest Rate

Year	Exchange Rate (tugrik / US$: average)	Discount Rate (E.O.P: %)	Deposit Rate (%)	Lending Rate (%)	Real interest Rate (%)
1992	42.6				
1993	303.2	628.8	280.2	300.0	10.4
1994	412.7	180.0	115.7	279.2	100.2
1995	448.6	150.0	74.6	134.4	50.8
1996	548.4	109.0	44.8	87.9	43.8
1997	790.0	45.5	36.4	82.1	40.5
1998	840.8	23.3	27.5	46.8	25.6
1999	1,021.9	11.4	23.4	39.3	25.5
2000	1,076.7	8.7	16.8	32.7	16.7
2001	1,097.7	8.6	14.3	30.2	-
2002	1,110.3	9.9	13.2	28.4	-

Note: Real interest rate is the lending interest rate adjusted for inflation as measured by the GDP deflator. International Monetary Fund, International Financial Statistics and data files using World Bank data on the GDP deflator source: International Monetary Fund, International Financial Statistics, 2002. World Bank, WDI CD-ROM, 2002.

Currently, the trade balance is stabilized around –10% of GDP. Matched with this trend, the financial account shows surplus of approximately equivalent amount. It is inferred that FDI maintains the stability of the Mongolian currency (tugrik) despite of the huge deficit in current account. However, once Mongolian economy staggers slightly, suspicious foreign investors will withdraw their money and then a new crisis may arise. In this sense, the stability of the foreign exchange market reached will not sustainable in the long term.

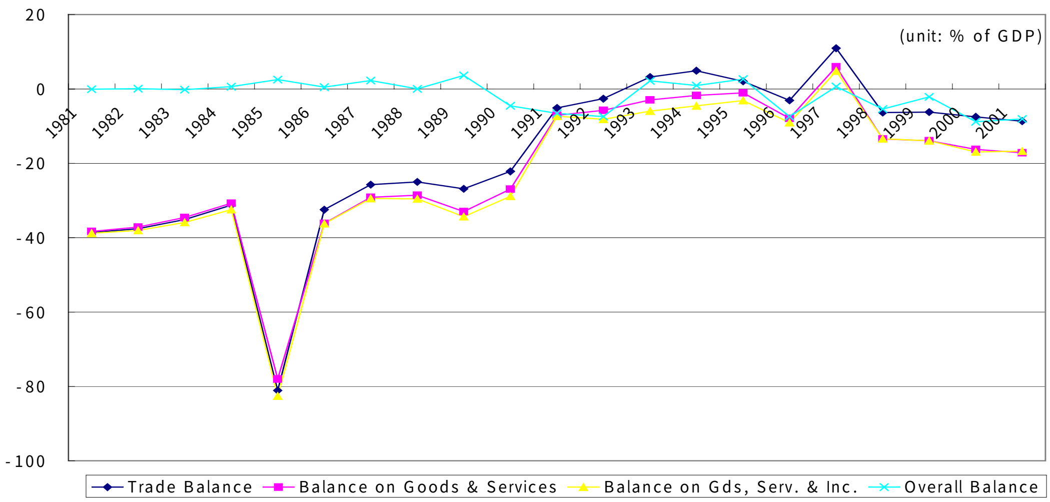
Table 2-15 Balance of Payments

(unit: million USD)

Year	Trade Balance	Rate (GDP)	Balance on Good & Service	Rate (GDP)	Balance on Gds, Serv. & Inc.	Rate (GDP)	Overall Balance	Rate (GDP)
1992	-29.1	-2.6	-64.0	-5.8	-90.9	-8.2	-82.3	-7.4
1993	21.3	3.2	-19.6	-2.9	-39.8	-6.0	14.5	2.2
1994	33.7	4.9	-12.1	-1.8	-31.4	-4.6	6.4	0.9
1995	25.3	2.1	-12.8	-1.0	-38.2	-3.1	32.1	2.6
1996	-36.3	-3.1	-93.4	-7.9	-106.7	-9.1	-87.3	-7.4
1997	115.4	10.9	63.0	6.0	51.0	4.8	6.6	0.6
1998	-61.8	-6.4	-130.8	-13.5	-130.4	-13.4	-52.6	-5.4
1999	-56.4	-6.2	-126.3	-13.9	-126.2	-13.9	-19.0	-2.1
2000	-72.6	-7.5	-157.7	-16.3	-164.2	-16.9	-85.5	-8.8
2001	-89.3	-8.5	-176.7	-17.2	-172.4	-16.7	-83.2	-8.1

Source: International Monetary Fund, International Financial Statistics, 2002.

Figure 2-3 Trade / Overall Balance as a Percentage of GDP



2.2.4. Interest Rates

Interest rate in Mongolia has continuously decreased since 1993. Discount rate decreased from 628.8% in 1993 to 9.9% in 2002, deposit rate from 280.2% in 1993 to 13.2% in 2002, lending rate from 300.0% in 1993 to 28.4% in 2002 and real interest rate (with respect to the lending rate) 104.0% in 1993 to 16.7% in 2002. There are a couple of issues regarding the interest rate that should be noted here. First, difference between lending and deposit rates is very big in Mongolia. This implies that financial intermediation does not work very well in the economy and financial institutions are concerned with non-performing bonds. Second, real interest rate is much higher than GDP growth rate, which does not make sense theoretically. It seems that high intermediation cost in the finance sector raises lending rate and eventually results in real interest rate, which is much higher than GDP growth rate.

2.2.5. Sovereign Debt

Government debt has continuously increased since 1992. Total debt, debt of central government plus debt of local government, increased from MNT(Monglian tugrik) 11,592 million in 1992 to MNT 979,272 million in 2001. The ratio of total debt with respect to GDP also increased from 24.5% to in 1992, reached its peak (98.2%) in 2000. The ratio decreased in 2001 and 2002 though the amount of the total debt increased during the same period. Apparently, nominal value of the totals debt went up by 83.8 times from 1992 to 2002. This could be attributed to the extremely high interest rate of Mongolia during the period if the loan were domestic or due to the severe depreciation of the Mongolian currency if the loan were from abroad. Actually, the Mongolian government borrowed MNT 11.1 billion from the former Soviet Union. The loan, whose nominal value was MNT 11.1 billion at the time of borrowing, constitutes most of the total government debt.

Table 2-16 Outstanding Debt

(unit: MNT, million, %)

Year	Total Debt	Rate (GDP)	Total Debt (Central Government)	Rate (GDP)	Domestic Debt (Central Government)	Foreign Debt (Central Government)
1992	11,592	24.5	11,575	24.5	1,063	10,512
1993	94,353	56.8	94,353	56.8	233	94,120
1994	196,533	69.4	196,533	69.4	5,281	191,252
1995	242,975	44.2	241,503	43.9	233	241,270
1996	368,823	57.0	365,158	56.5	41,206	323,952
1997	512,488	61.6	509,635	61.2	69,151	440,484
1998	679,008	83.1	676,717	82.8	82,158	594,559
1999	909,116	98.2	906,723	98.0	90,039	816,684
2000	973,635	95.6	959,889	94.2	104,192	855,697
2001	979,272	87.8	961,785	86.2	82,865	878,920

Source: International Monetary Fund, International Financial Statistics, 2002.

2.2.6. Unemployment Rate

Unemployment rate in the Mongolian economy reached its peak in 1997. Table 2-17 shows that unemployment rate of female workers is higher than that of male workers.

Table 2-17 Outstanding Debt

Year	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total	-	-	-	5.5	6.5	7.5	5.8	4.7	4.6	4.6
Male	5.6	7.8	8.1	5.0	6.3	7.3	5.4	4.1	4.1	4.2
Female	7.0	9.4	9.9	6.1	7.2	8.2	6.4	5.3	5.0	5.1

Source: Mongolian Statistical Yearbook 1999 and 2001, p.49 and p.77, National Statistical Office of Mongolia.

What we found in Table 2-18 is as follows:

Employment in the agriculture sector increased from 354.2 thousand in 1995 to 402.4 thousand in 2001. The sector employs almost half of the working population of Mongolia. It can be inferred that per capita output in the agriculture sector decreased from 1995 to 2001 considering that the employment increase and the output increase during the same period. (Table 2-8 and 2-18)

Employment in the mining sector increased from 18.2 thousand in 1995 to 19.9 thousand in 2001. Considering that share of the mining sector in employment (2.4% in 2001) is much lower than that in real GDP (14.6% in 2001), it can be inferred that per capita output in the mining sector is much higher than that in other sectors.

Employment in the manufacturing sector decreased from 67.3 thousand in 1995 to 55.6 thousand in 2001. This is consistent with the output decrease in the manufacturing sector during the same period.

Employment in the commerce sector increased by 39.4% from 64.8 thousand in 1995 to 90.3 thousand in 2001. Considering that employment of the whole economy increased by 8.4% during the same period, employment growth rate of the commerce sector is very high. This explains the output growth rate of the sector, which is much higher than output growth rate of the economy.

Employment in the TSC sector increased from 31.6 thousand in 1995 to 35.1 thousand in 2001. Whereas employment of the sector recorded a 1.8% of average grow rate from 1995 to 2001, average output growth rate of the sector was 11.6%. It can be inferred that per capita output in the TSC sector has significantly increased during the period.

Employment in the finance sector decreased from 8.3 thousand in 1995 to 7.3 thousand in 2001 whereas output in the sector recorded a positive growth. This implies that per capita output of the sector rapidly increased.

Employment in the public sector[4] increased by 20.9% from 79.6 thousand in 1995 to 96.2 thousand in 2001. Employment growth rate of the public sector is much higher than 8.4%, employment growth rate of the whole economy. Moreover, it can be inferred that per capita output of the public sector is much lower than the average per capita output of the economy because share of the sector in real GDP is 6.9% in 2001 whereas that in employment is 11.6%.

Table 2-18 Correlation of Sectoral Growth Rates with Real GDP Growth Rate

(unit: thousand persons)

Division	1995	1999	2000	2001
Agriculture, Hunting and Forestry	354.2	402.6	393.5	402.4
Mining and Quarrying	18.2	19.0	18.6	19.9
Manufacturing	67.3	58.5	54.6	55.6
Electricity, Gas and Water Supply	22.6	21.3	17.8	17.8
Construction	29.5	27.6	23.4	20.4
Whole Sale and Retail Trade; Repair of Motor Vehicle and HH Goods	64.8	83.1	83.9	90.3
Hotel and Restaurants	13.7	16.1	13.3	16.5
Transport, Storage and Communication	31.6	34.9	34.1	35.1
Financial Intermediation	8.3	7.7	6.8	7.3
Real Estate, Renting and Business Activities	6.7	5.0	7.2	6.8
Public Administration and Defense; Compulsory Social Security	31.1	31.5	34.7	41.0
Education	48.5	43.2	54.4	55.2
Health and Social Work	38.1	34.8	33.5	33.0
Other Community, Social and Personal Service Activities	26.6	25.2	29.0	26.9
Other	6.4	3.1	4.2	4.1
Total	767.6	813.6	809.0	832.3

Source: *Mongolian Statistical Yearbook 2001*, p.67, National Statistical Office of Mongolia.

[4] public administration and defense; compulsory social security plus education

As seen in the above Table 2-19 and Table 2-20, school enrollment (rate) has improved through time. However, in a cross sectional domain, the enrollment rate is declining rapidly with respect to schooling years. Education matters for the future of an economy because it determines the future level of human capital in the economy. The current Mongolian education statistics shows that the quality of labor or human capital may not be sufficient to attract FDI and guarantee the fast growth track. Hence, from the long-term perspective, the Mongolian government should establish a reform plan in national education program in order to universalize secondary education and increase opportunities for higher education. It is commonly observed that there is a strong positive correlation between economic growth rate and higher education institution enrollment rate.

Table 2-19 School Enrollment, thousand persons

Year	1995	1999	2000	2001
Grades 1 through 4	216.6	253.3	250	241.3
Grades 5 through 8	146	179.3	195.5	212.4
Grades 9 and 10	39.9	37.3	49.1	56.6
Total	403.8	470	494.6	510.3

Source: *Mongolian Statistical Yearbook 2001*, p.231, National Statistical Office of Mongolia.

Table 2-20 Enrollment Rate (%)

Year	1995	1999	2000	2001
8 to 15 Years Olds	81.5	87.2	89.7	94.5
16 to 17 Years Olds	40.3	35.7	45.8	48.8
Total	74.0	80.2	81.9	85.6

Source: *Mongolian Statistical Yearbook 2001*, p.231, National Statistical Office of Mongolia.

2.3. Implication

In this chapter, we started discussion by identifying the characteristics that distinguishes the Mongolian economy from other economies: transition economy, vulnerability to natural phenomena and international economic circumstances, landlocked territory and dependence on China and Russia. By identifying these characteristics, we were able to recognize risk factors of the Mongolian economy as follows: i) natural disasters such as drought and cold winter, ii) exchange rate and dollar price of export goods, iii) political and socio-economic relationships with neighboring countries, iv) economic system in transition to a market economy.

As we discussed in the first chapter, it is hard to hedge against these risk factors under the current structure of the Mongolian economy. Desertification of inland area will have a continuous negative effect on the agriculture sector of Mongolia and relative price of the country’s main export goods (raw material or semi-processed goods) will go down further in the future. This implies that the Mongolian economy will continue to be vulnerable to the first two risk factors as far as the economy remains based upon agriculture and mining.

However, close relations with China and Russia will work favorable toward the Mongolian economy if Mongolia will focus on economic cooperation with the two countries, whose economies are anticipated to become very large in the near future. The transition to a market economy will succeed if the Mongolian government continues to reform her economic system. That is, controlling these factors is highly dependent on how the government deals with the risk factors.

One might say that industrialization is a very effective way to minimize the susceptibility of the Mongolian economy to the risk factors, but we must consider that there are adverse conditions to industrializing the Mongolian economy. The conditions are i) low level of human capital, ii) lack of domestic capital, iii) high transportation cost, iv) small population.

First, Table 2-21 and Table 2-22 show that low school enrollment rate in Mongolia results in low level of human capital. It prevents the country from industrializing her economy because poorly- educated workers in the agriculture sector will have difficulty in moving to industry sectors such as manufacturing or service. Second, the country does not have sufficient capital for industrialization. Lack of domestic capital can also work as an obstacle to industrializing the Mongolian economy. Moreover, low quality of labor, high transportation cost and small population with low density will make it difficult to attract foreign direct investment. Lastly, Mongolia’s landlocked territory and under-investment in social overhead capital results in high transportation cost, which will obstruct the country’s international trade. At the same time, the country’s small population with low density puts constraint on the size of the domestic market. This is why industrialization doesn’t sound like a good solution for the economy’s vulnerability to the risk factors at least in the short run. The Mongolian government will have to deliberate on how to work out a long-term strategy for economic growth.

We suggest that Mongolia insure her economy from macroeconomic shocks through policy measures. Our discussion in the last section tells that the Mongolian government heavily relied on monetary policy when the economy experienced hyperinflation in 1990. Therefore, we are going to explore how the government should use fiscal policy in the advent of another economic shock. To exhibit how the various sources of potential risk factors may affect the whole economy, we raise an issue of dissolving NPLs within the fiscal system of Mongolia, which happens to be the main theme of the whole project. The issue is especially interesting because the banking sector is a transmission channel of most risk factors to the whole economy in a form of credit crunch or credit crisis. Furthermore, the current feeble structure of financial sector in Mongolia may amplify the magnitude of delivered shocks. Thus, a cure for a symptom like the explosion of NPLs does not merely lie in installing a new financial regulatory system but also in raising the shock absorption abilities of other sectors, especially that of the public sector.

CHAPTER 3

Financial Sector

3.1. Overview of Mongolia's Financial Sector Development

Since the collapse of the former Soviet Union Mongolia's financial system has undergone substantial change. Prior to 1991, the country had a single bank, Bank of Mongolia (BOM), which acted as the sole provider of financial services to the entire nation. In 1991, the banking system started to develop, but not without problems. Financial transformation and economic development has had a significant impact on the financial system, both negatively and positively. A number of banks failed and were closed in the early days of the transition. Fragile economic situations, limited banking skills and frequent government interference had contributed to the crisis that broke in December 1996 (See Table 3-1 for chronology of banking sector before the 1996 crisis). The failure of banks, without clear compensation for depositors and, accordingly, inadequate protection of small depositors had meant that there was a general mistrust of the banks among the Mongolian public.

Table 3-1 Chronology of Banking Sector before the 1996 Crisis

December 1990	Investment and Technological Innovation (ITI) and Trade and Investment (T&D) Bank separated from the State Bank of Mongolia.
April 1991	Banking law passed establishing the central bank (Mongol bank); by year-end, People's, Insurance, Agricultural, and Cooperative banks were formed.
1992	Nine new small banks established Mongol Post, Export-Import, Industrial, Business, Central Asia, Mercury, Selenge, Autoroad, Bayanbogd Banks.
September 1994	Cooperative and Selenge Banks forced to merge with People's and ITI Banks.
1995	First private bank, Golomt Bank, with foreign equity participation established.
1995	Government announces a halt to directed lending.
May 1996	Central Bank issues decree to stop lending to defaulter; creates bank restructuring unit
June 1996	Third parliamentary elections; opposition coalition parties win 70 percent of the vote.
July 1996	Central Asia Bank closed due to insolvency.
August 1996	Second foreign equity bank, MM Bank, established.
September 1996	People's Bank temporarily put under central bank conservatorship.
October 1996	The Mongolian People's Revolutionary Party won 65 percent of popular vote in local elections.
November 1996	Central bank and revised banking law passed Parliament.
December 1996	People's Bank and Insurance Bank closed; Savings Bank, Reconstruction Bank, and Mongolia Asset Recovery Agency established.

Managing the aftermath of the banking crisis, and fostering a more diverse, stable, and better supervised financial system would not only limit the risks of repeating the crisis, but also spur development by increasing savings and improving intermediation. Government actions were bold, but the low-quality assets of the remaining banks indicated that bank restructuring was far from over. On the one hand, the government set up the Mongolian Asset Recovery Agency (MARA) and successor banks such as the Savings Bank and Reconstruction Bank and injected the public funds by issuing the restructuring bonds. On the other hand, the central bank (Bank of Mongolia: BOM) strengthened bank supervision to prevent recurrence of the banking crisis. Furthermore, the BOM's supervision department was in charge of enforcing the restructuring agreements with the surviving but still ailing banks. Although financial supervision has greatly improved over recent years and the central bank's authority has been boosted by revision of the Banking Law, BOM's supervisory capacity remains limited. Off-site analysis carried out by the supervision department is fragmented and delayed due to lack of accounting standards and weak information infrastructure. On-site examinations are only scheduled on the *ad hoc* basis.

Mongolian commercial banks are unable to provide long-term finance to their borrowers, which is a situation common to many developing countries. Credits are typically less than one year (usually 90 to 180 days) and the rudimentary credit agreements do not document either what the loan will be used for or how it will be paid back. Loans frequently mature before the enterprises can repay them, even though the financial transaction may be proceeded as planned. Thus, the borrowers are subject to the risk of serious maturity mismatch. This is especially true for the projects with longer payback periods, such as construction, plant and equipment investment, and even agriculture. The lack of long-term finance is due to macroeconomic factors limiting the supply side, institutional factors specific to the financial sector, and legal and financial infrastructure weaknesses that constrain term financing.

In what follows, each financial sector will be reviewed to serve readers' understanding as to how the financial intermediation works in Mongolia.

3.2. Banking Sector

3.2.1 Commercial Banking

As the end of the year 2002, according to the statistics of BOM, 16 banks and 66 non-banking financial institutions were operating in Mongolia through 595 units, consisting of 96 branches, 481 settlement units, 18 cash units (see Table 3-2 for details). Currently, total of 470 branches of 13 banks are providing services in the local provinces (aimags and soums), which increases by 30 units from the previous year, and it represents 79 percent of total branches.

Table 3-2 Bank's Branches and Units (as of the End of 2002)

	Ulaanbaatar city		Countryside		Total	
	Number of Branches & Units	Annual Changes	Number of Branches & Units	Annual Changes	Number of Branches & Units	Annual Changes
Agriculture	11	4	352	25	363	29
Trade & Development	8	0	10	-1	18	-1
Savings	32	1	9	0	41	1
Golomt	10	0	2	0	12	0
Post	9	8	62	-1	71	7
Erel	3	0	1	0	4	0
Ulaanbaatar City	16	0	2	0	18	0
Shinechlel	5	3	1	0	6	3
Transport & Development	3	-1	0	0	3	-1
Credit	4	3	1	0	5	3
Zoos	4	0	6	0	10	0
Anod	7	0	3	-1	10	-1
Inter	2	1	1	0	3	1
Capitron	3	2	0	0	3	2
XAS	7	-1	20	8	27	7
Menatep	1	0	0	0	1	0
Total	125	20	470	30	595	50

At the end of 2001, out of 16 banks that are operating in Mongolia, two were fully, four were partially state owned banks, and the remaining ten were private banks (one of which was invested by foreigners). In 2002, however, private banks increased by two more due to the privatization of the two out of four partially state owned banks, leaving the total number of banks unchanged. The privatization of the Agriculture Bank is currently in progress, but still owned by the state. In 2001, 77.9 percent of demand deposits and 58.6 percent of saving deposits were concentrated at the state-owned banks, but in 2002, the above percentage went down dramatically to 22 percent and to 30.3 percent, respectively. This is partially due to the privatization of the Trade and Development Bank, the largest bank in Mongolia, and intense business expansion of the private banks.

It is remarkable to note that banking services have recently expanded to rural areas in a great deal. The failure of numerous banks and the banking crisis had greatly undermined the consumer confidence in the overall financial system even after the recovery from the catastrophic situations. Thanks to the policy to promote activities of banks with relative importance in the branches in the local areas, however, the public confidence in the banking system has been significantly improved. Consequently, the banks were encouraged to establish their branches in the local areas and the amount of demand deposits taken in these areas has grown by MNT 4.2 billion or by 23 percent and the amount of saving deposits by MNT 9.9 billion or by 85.4 percent. The outstanding loans in the rural areas reaches MNT 24.6 billion or increase by 2.8 times from the previous year, and their income amounted to MNT 7.3 billion, which represents 40 percent of the total income of the commercial banks before tax. The number of demand deposit holders increased twice and borrowers increased 2.8 times. Compared to the 2001, the liquidity and profitability of the Agriculture Bank has significantly improved, and the percentage of its asset growth was 1.8 times more than the percentage of the asset growth of the sector. Moreover, the Agriculture Bank has become one of the three largest banks in terms of its scope of operations.

In order to expand their market share, the sixteen commercial banks are competing for funds by offering attractive interest rates, which in consequence, hinder deposit rates to decline to an appropriate level. On the other hand, as it is creating risks from the commercial banks' point of view, the tendency to introduce new financial services and products becomes widespread in the banking sector: creation of active and broad cooperation with the banks of the main trade partner countries, issuance of payment cards in accordance to customers' demand and preference, and internet banking services can be mentioned as some of the examples. The Golomt Bank and the Trade and Development Bank were issuing only internationally usable Visa and Master Cards previously, however, they have started issuance of domestic cards from the beginning of 2002.

3.2.2. Main Indicators of Banking Sector

As a consequence of improvement of banks liquidity, public confidence in the banking system has increased and there have been several positive changes such as an increase of the total asset of the banking system by 48.2 percent, demand deposit by 50.0 percent, saving deposits by 62.2 percent, banks capital by 29.9 percent, and a decline of percentage of non-performing loans in total loans.

During 2002, the amount of all banks' assets has gone up and the ratio of money supply or M2 relative to GDP, the main indicator of financial intermediation, has increased to 38.2 percent by 8.5 percentage points from the previous year. Thus, the financial sector continues to deepen ever since the banking crisis. The loans have exploded for the last three years. The ratio of loan to GDP was about ten percent at the time of the banking crisis, but it shrank down to 6.8 percent in 2000. The regained market confidence after the financial sector restructuring strengthened, however, fed more money in the banking sector and propelled the demand for funds channeling. As the end of 2002, this ratio reaches to 18.8 percent, which is almost three fold to the number two years ago. Behind the rapid increase in the loan provision, the asset of the banking sector has increased quite dramatically. The ratio of total banks assets to GDP soared from 2000 and hovers above 40 percent in 2002.

Table 3-3 Main Indicators of Banking Sector

	1996	1997	1998	1999	2000	2001	2002
M2/GDP	19.9	20.4	20.5	25.2	26.4	29.7	38.2
Loan/GDP	10.2	6.1	11.6	9.4	6.8	12.1	18.8
Capital/GDP	-2.1	2.0	0.9	2.2	3.1	4.2	5.0
Total Assets/GDP	21.3	23.6	22.0	22.9	23.1	29.8	40.1
Currency Outside Banks/GDP	6.5	6.0	6.9	10.0	10.3	9.7	9.8
(M2-Currency)/GDP	13.4	14.4	13.6	15.2	16.1	19.6	28.4

3.2.3. Financial Status of Commercial Banks

(1) Assets

In 2002, the total assets of the banking system increased by MNT 160.3 billion or 48.2 percent, reaching 40 percent of GDP. The rapid growth of assets became realizable mainly due to an increase of MNT 43.7 billion in demand deposits, MNT 83.8 billion in saving deposits, and MNT 14.1 billion in the banks' capital.

45.2 percent of the total assets in the banking sector are net loans and 14.3 percent are foreign assets. The Central Bank Bills (CBB), bank reserves and claims on the government take up 12.3, 11.1, 6.2 percent out the total banks assets, respectively. Compared to the pervious year, the percentage share of each asset in total assets except net loans and bank reserves has decreased. However, if we consider the changes in amount of each asset, bank reserves have increased by 57.5 percent, claims on domestic banks and the CBB by 30.0 percent, outstanding net loans by 73.7 percent, other securities by 5.5 times, fixed assets by 22.9 percent, securities purchased through repurchase agreement by 2.8 times, and other assets by 34.6 percent. In other words, net claims on the government and other real estates owned have decreased while net balance of the securities other than net loans, CBB and government bond have had a rapid growth.

(2) Liabilities and Capital

As of the end of 2002, the total liabilities in the banking sector amount to MNT 231.7 billion. For the 2002, they have increased by 51.2 percent or MNT 146.1 billion, which includes an increase of individual and enterprise deposits by 57.4 percent, demand deposit by 30 percent, and foreign liabilities by 5.3 percent. The composition of bank's liabilities has been relatively stable compared to the previous year. 50.6 percent of the total liabilities come from the saving deposits of the households and enterprise, 30.3 percent from the demand deposits. Only 6.9 percent is government deposit, and 3.2 percent is other liabilities.

The majority of resources mobilized by the demand and saving deposits and capital has been allocated mostly to industries in the form of loans. Increased fund intermediation is, on the one hand, directly related to the increased public confidence in the banking system, and, on the other, to the improved financial capacity of the borrowers. In addition to the increase in the amounts of net loans, the percentage share of the net loans out of the total assets has also risen by 6.7 points, reaching 45.2 percent. In contrast, the percentage of all assets other than net loans in total assets has declined. One of the reasons for the higher share of the loans to the total assets is initiation of the measures to utilize excess reserves of the banks for loans. According to the framework of the "Main Guideline of the State Monetary Policy," the weighted average lending rate of local currency loans decreased by 8.0 points, and that of foreign currency loan by 2.4 points from the previous year. As a result, the net loan share has increased.

In 2002, the total loans of MNT 469.9 billion have been made, which is 81.3 percent higher than the previous year. The ratio of loans provided to the industrial sector out of the total loans has declined by 10.4 points from 2001, falling to 41.5 percent, while 58.5 percent of total loans are made to the non-industrial sector. Of the non-industrial sector loans, the amount of loans granted to wholesales and retail businesses, tourism, hotel, transportation and communication sectors have increased significantly. The loans to these sectors have increased by 120.4 percent compared to the last year.

Under the Banking Law, the Bank of Mongolia has set the minimum amount of the bank's equity capital to be MNT 4 billion and obliged the banks to increase their equity capital above this floor amount within the first quarter of 2004. Consequently, we observe the tendency of capitalization in the recent years. At the end of 2002, bank capital position has been reinforced with a growth in the equity capital and income. The banks capital reached to MNT 43.1 billion with an increase of MNT 14.1 billion or 29.9 percent from the same period of the previous year.

Table 3-4 Changes in the Loan, Deposits and Currency Outside Banks

(unit: millions of MNT)

	1996	1997	1998	1999	2000	2001	2002
Total Loan Outstanding	65,860.9	50,763.0	94,614.1	82,000.0	67,000.0	135,270.0	231,729.8
Change	-0.7	-22.9	86.4	-13.3	-18.3	101.9	71.3
Non-Performing Loans	33,048.0	14,544.8	32,638.9	30,504.0	15,718.0	10,821.6	16,690.1
Change	145.1	-56.0	124.4	-6.5	-48.5	-31.2	54.2
Deposits	45,917.8	58,469.4	59,308.7	69,978.2	92,686.2	134,607.4	218,359.6
Change	-2.4	27.3	1.4	18.0	32.5	45.2	62.2
Currency Outside Banks	14,704.4	49,768.3	56,445.8	87,281.3	100,933.4	109,160.7	120,783.6
Change	63.0	19.3	13.4	54.6	15.6	8.2	10.6

Table 3-5 Bank Loans by Sector

(unit: billions of MNT)

				Dec. 31, 2002.
	Beginning of the Year	Loan Insurance	Loan Payment	Outstanding
Total Loan	135.1	469.7	374.3	231.3
Manufacturing	77.0	195.2	156.6	118.0
Agriculture, Hunting, Forestry and Fishing	7.6	13.0	12.1	8.4
Electricity, Gas and Water Supply	4.1	9.1	9.5	3.5
Construction	7.4	18.9	12.1	14.3
Mining and Quarrying	19.9	80.9	65.5	35.6
Processing	38.0	73.3	57.4	56.2
Non-Manufacturing	58.1	274.5	217.7	113.3
Whole and Retail Trade, Repair of Household Goods	38.8	178.7	144.6	72.9
Tourism, Hotel and Restaurants	3.9	8.2	7.0	4.0
Transport, Storage and Communication	2.9	11.8	8.7	6.0
Real Estate, Renting and Business Activities	1.1	4.5	3.3	2.2
Health and Education	1.2	1.6	1.9	1.0
Financial Intermediation	0.5	4.0	3.0	1.1
Others	9.7	65.7	49.2	26.1

(3) Income and Expenses

For the last three years, the commercial banks have become better performed in terms of size of business. The total income of the banking sector is MNT 84.6 billion, which nearly two and half times larger than that two years ago. While both the total income and expense keep increasing, however, the growth of the latter is more striking, which means lower profit level for unit income. The rapid growth in total expenditures was caused by an increase of interest expenditure and an increase in the provision for loan losses. Enhanced competition among the banks is revealed by changes in interest rates offered for their liabilities and assets. Banks have decreased their lending rates and kept deposit rates stable in other to attract more customers. In terms of the profit amounts, however, the performances have been improving continuously for the last three years.

As of 2002, the net profit level before corporate tax is around 20 percent, whereas it was above 30 percent in 2000 and 2001. As a consequence, before tax return on assets (ROA) has decreased by 1.4 points and has fallen to 4.4 percent. Because of the high corporate tax rate, about 40% for corporations of before-tax profits more than MNT 100 million, the average net profit of taxes in the banking sector is only 13 percent out of the unit income. Then the net profit of tax remains 13% out of the unit income in 2002.

Table 3-6 Bank's Income and Expense

(unit: billions of MNT)

	2002		2001		2000		2002 / 2001		2002 / 2000	
	Amount	Share1)	Amount	Share1)	Amount	Share1)	Amount	Share2)	Amount	Share2)
Total income	84.6	100.0	52.1	100.0	36.5	100.0	32.4	62.2	48.1	131.6
Interest	57.9	68.4	35.0	67.1	22.6	61.9	22.9	65.5	35.3	156.1
Trading	12.3	14.5	5.1	9.8	1.2	3.3	7.2	140.4	11.1	927.9
Exchange Revaluation	4.1	4.9	2.5	4.8	5.2	14.4	1.6	64.4	-1.1	-21.2
Fee	7.3	8.6	5.2	10.0	3.8	10.5	2.1	39.6	3.5	91.0
Other	3.0	3.5	4.3	8.3	3.6	10.0	-1.3	-31.1	-0.7	-18.5
Total Expense	66.7	78.9	36.1	69.2	24.6	67.3	30.6	84.8	42.2	171.5
Interest	24.2	28.7	13.4	25.7	8.5	23.4	10.8	80.7	15.7	183.9
Reserves for Risk	5.9	7.0	2.3	4.4	2.1	5.8	3.6	156.7	3.8	177.3
Trading	11.4	13.5	3.7	7.1	0.2	0.5	7.7	207.0	11.2	6664.3
Exchange Revaluation	3.8	4.5	2.5	4.9	5.3	14.5	1.3	51.2	-1.5	-27.5
Personnel	9.5	11.2	5.9	11.3	3.0	8.2	3.6	61.1	6.5	216.0
Depreciation	1.9	2.2	1.2	2.3	0.7	1.9	0.7	55.9	1.2	170.1
Other	9.9	11.8	7.0	13.5	4.2	11.5	2.9	41.8	5.8	137.1
Net Profit before Tax	17.8	21.1	16.0	30.8	11.9	32.7	1.8	11.2	5.9	49.5
Tax	6.8	8.1	6.2	11.8	0.6	1.5	0.7	10.6	6.3	1127.8
Net Profit	11.0	13.0	9.9	18.9	11.4	31.1	1.1	11.5	-0.4	-3.3

Note : 1) share of total income
2) percent of changes

3.2.4. Bank of Mongolia

A Mongolian-Russian joint bank called Trade and Industry Bank of Mongolia (former Bank of Mongolia) was opened to establish a national bank and a monetary-credit system in June 2, 1924 at Altanbulag with a single branch. In 1954, the Mongolian staff of the Bank was increased to 98% as compared to 18% in 1924. On the basis of this extension, the former Soviet Union transferred to Mongolia its own share of capital and stocks to the Bank of

Mongolia in 1954. Since then, the Bank of Mongolia was reorganized as the state bank of Mongolia.

In 1991 a completely new two tier banking system was established in Mongolia: Bank of Mongolia as a central bank, and commercial banks. Since its establishment the Bank of Mongolia has been influencing and contributing real efforts on the economy by maintaining the tight monetary policy aimed at stabilizing the value of the currency and reduction of inflation during the unstable transitional periods.

The Bank of Mongolia's main responsibility is to formulate and conduct monetary policies with the aim of ensuring price stability. To this end, it takes measures to regulate interest rate levels and fine-tune bank liquidity by i) granting assistance to the entire banking system, ii) buying and selling securities, and iii) withdrawing liquidity from credit financial institutions.

The BOM regulates the relations between the Mongolian tugrik and foreign currencies on behalf of the State. To this end, the BOM holds and manages the State's gold and foreign exchange reserves. In the course of these activities, the BOM enters into transaction with commercial banks and other central banks on foreign currency dominated securities and deposits markets as well as on the spot and forward markets. Also, the BOM is a financial supervisory authority in the banking sector. It authorizes banking license and regularly examines banks. The bank supervision activities are conducted by the Supervision Department in the BOM.

3.3. Other Financial Sectors

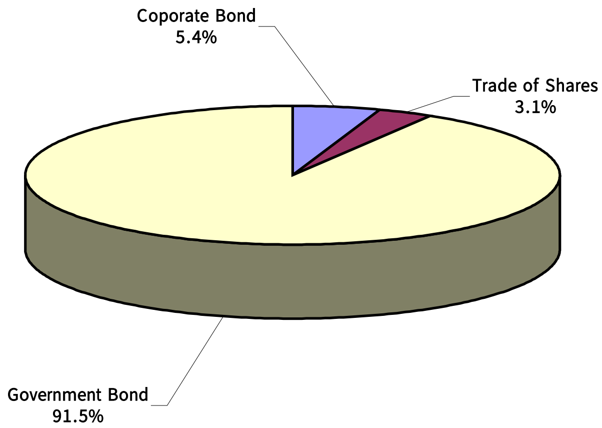
3.3.1. Securities Market

According to statistics of August, 2002 there are 402 companies listed in Mongolian Stock Exchange (MSE), of which 60 are joint stock companies (JSCs) with state shares and the rest 342 ones are JSCs without state shares. Out of registered 349.0 million securities, 184.6 million, 52.9 percent, are owned by the joint stock companies with state shares. Out of total traded securities, government bonds compose 91.5 percent and private companies bonds take up only 5.4 percent. The remaining 3.1 percent are composed by traded shares. All of these numbers reflect on the currently weak state of securities trading in Mongolia (see Figure 3-1).

Table 3-7 Securities Market Indicators

	1998	1999	2000	2001	August 31, 2002
Listed Companies	430	418	410	400	402
JSCs with State Shares	132	84	65	57	60
JSCs without State Shares	298	334	245	343	342
Traded Securities / MNT billion /	10.7	3.2	2.9	1.7	1.3
Volume of Traded Securities / million /	33.1	21.4	35.4	15.9	5.3
Government	-	-	11,132.1	30,750.2	35,597.4
Company	-	-	-	1,204.3	1,721.8
Member Security Companies	41	41	42	42	34
Member Investment Funds	16	16	17	16	2

Figure 3-1 Trading Structure of Stock Exchange



According to the Stock Exchange data, the average share price of the 73 percent listed companies is lower than its face value, or MNT 100. This implies the inefficiency of JSCs. Thus, a lot of JSCs changed the form into a limited liability company, thus dropping out of the list. Also, the concentration of shares reflects on the lack of interest in buying the shares and underestimation of the securities value and the lack of information.

Mongolia is facing with a challenge to upgrade the stock exchanges that are currently underdeveloped. The government, in order to improve the legislation and the legal environment on securities market, submitted a new draft of the law on securities to the Parliament. Furthermore, in order to activate the Stock Exchange, the government is planning to make a step and advertise the advantages of securities as a source of investment. The law contains the clauses to separate the clearing and settlement and depository agencies from the stock exchange and to reorganize the exchange as a separate legal entity, and lastly, to prepare a plan to privatize the Mongolian Stock Exchange.

3.3.2. Insurance

Mongolia is often times faced with infectious and fatal diseases, snow disasters, flood, thunder, cold rain, drought, fire, earthquake and fierce wind in the entire or some part of the country. These risk factors demand for the insurance commodities with which to insure against the huge losses. The Insurance Law in 1997 was established as a legal background to run insurance businesses. It permits an environment to regulate the insurance companies and their activities to the policyholders.

As of the first half of 2002, there are two state property insurance companies and 16 private insurance companies operating. These companies own totally MNT 10.4 billion of fixed and current assets and accumulated MNT 5.3 billion as reserve funds for reimbursing the damage of the insured. The following table shows the summary statistics of insurance premium and reimbursement of insurance companies.

Table 3-8 Premium and Insurance Payment

(unit: billions of MNT)

Year	Premium	Payments	Reimbursement Rate (%)
1997	2.4	1.0	42.4
1998	2.9	1.3	44.6
1999	3.8	0.7	19.9
2000	4.2	1.1	25.2
2001	5.1	1.8	34.2
2002	5.9	2.2	38.0

Currently, the insurance companies are operating 19 types of insurance activities, including 6 types of liability, 8 of property and 5 of life and health. Among these three types of insurance policies, the property insurance is the most popular. In terms of the premium income, its share is 62.2 percent. In 2001, MNT 1.8 billion were granted to reimbursement and 72.8 percent was granted to the insurance of property, 14.7 percent of liability and 12.5 percent life, health and interest. Out of the entire premium income of MNT 5.1 billion in 2001, 78.4 percent accrued from the Mongol Daatgal Company.

Table 3-9 Insurance Premium (by Insurance Types)

(unit: billions of MNT)

	Life, Health and Interests Insurance Premium	Property Insurance Premium	Liability Insurance Premium	Total
1997	0.2	1.6	0.6	2.4
1998	0.3	1.9	0.7	2.9
1999	0.4	2.3	1.1	3.8
2000	0.5	2.7	1.0	4.2
2001	0.5	3.2	1.4	5.1
2002	0.6	3.5	1.8	5.9

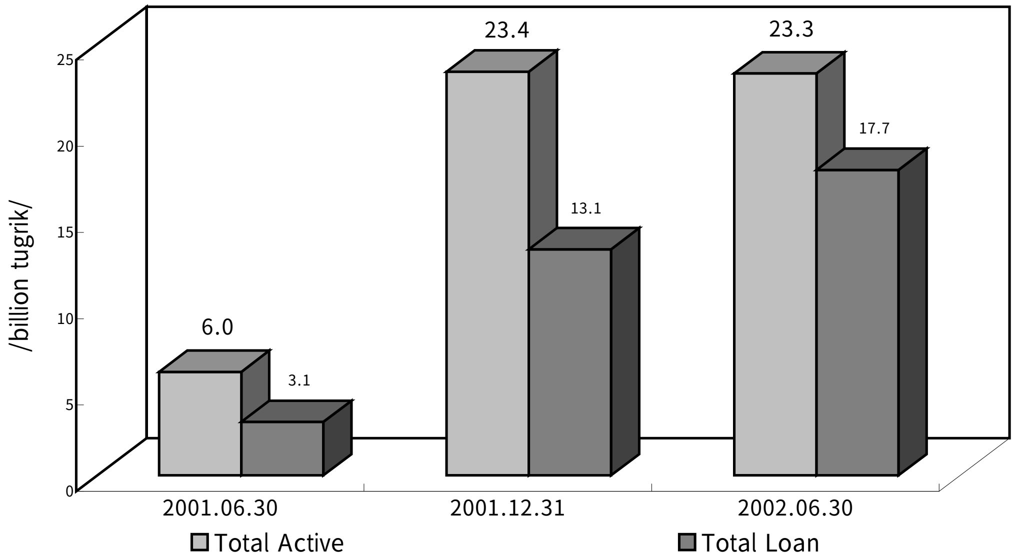
3.3.3. Non-Banking Financial Institutions

Non-banking financial institutions not only expand the financial intermediation but play an important role in reducing the poverty by providing financial services to those who lack the access to banking services.

Table 3-10 Non-banking Financial Institutions Key Indicators

	June, 2001	Dec., 2001	June, 2002
Capital Adequacy Ration /in Percent/	74.9	133.4	101.4
Liquidity Ratio/in Percent/	1.4	1.8	10.9
Loans to Total Assets Ratio/ in Percent/	51.3	55.8	75.8
Non-Performing Loans to Total Loans Ratio /in Percent/	0.8	0.3	0.8
Reserves for Loan Losses to Total Loans Ratio /in Percent/	1.2	1	1.2
Total Assets /in millions of tugrik/	6,031.9	23,391.9	23,323.8
Net profit /in millions of tugrik/	-58.7	131.6	477.9

Figure 3-2 NBFIs Total Assets and Loans



Under the circumstances where the deposits in banking comprises only 20 percent of GDP, which is one fifth in financial deepening relative to the developed countries, the Mongolian government pursued a policy to support the non-banking financial institutions activities and submitted the amendment draft on the Cooperatives Law to the Parliament. In addition, an Asian Development Bank funded project to develop rural finance was initiated with the purpose to establish the savings and credit cooperatives for supplying financial services in the rural areas. Concerning rural areas, particularly in far reaching places, there exists considerable deficiency in the financial intermediation. According to the experiences in the developed countries, non-bank financial and micro finance organizations play a significant role in reducing the poverty in the national economy. One of the most positive changes in the financial sector was the expansion of NBFI activities. Chapter 6 deals with the non-bank financial institutions more in detail.

CHAPTER 4

Resolution of Non-Performing Loans

4.1. Financial Crisis in Mongolia

In 1996, the first banking crisis occurred after the transition to a market economy. Mongolia's largest bank (Ard Bank) and fourth largest bank (Mongol Daatgal Bank) failed and were closed by the Bank of Mongolia (BOM) on December 13. One of the causes of the crisis originated in the bad portfolio that the banks had inherited from the State Bank in the Socialist Era, but continued direct lending by the government deepened the problem. In addition, lack of banking expertise, insider lending to the relevant stakeholders to the banks and inexistence of prudential regulation and supervision aggravated the quality of the banks' assets.

Before the failure of the two banks, Mongolia's overall financial system had already deteriorated. Bank deposits declined by 34.6% in real terms throughout 1996, causing real assets to drop by 21.5%. Total liquid assets such as cash, bank reserves, and BOM bills fell from MNT 13.4 billion in 1995 to MNT 6.9 billion at the end of 1996. Only one commercial bank could maintain adequate reserve in the central bank and other banks had to rely on BOM funding and government deposits, which increased by 40% over 1996. By the fall, Ard Bank could no longer meet its obligations in the interbank payment system.

In November, the government passed the Central Bank and Banking Law that provided grounds for coping with the crisis. Following the restructuring strategy, government closed down the problematic banks and created three successor institutions; the Savings Bank, which inherited retail deposits of the failed banks; the Reconstruction Bank, which retained all the performing loans of the two liquidated banks; and the Mongolian Asset Recovery Agency (MARA), created to recover the non-performing loans that government took out of the banking system.

4.2. The Mongolian Asset Recovery Agency

The MARA was established by the Ministry of Finance and Economy (MOFE) Order No. 17 in January 11, 1997. The main purpose of the MARA was to investigate the bad loans (non-performing loans) and to resolve the debts of the following banks and to bring them into state budget: Ard Bank (People's Bank), Mongol Daatgal Bank (Insurance Bank), which were closed and liquidated, Reconstruction Bank, HOTSH Bank, and Central Asia Bank, which were bankrupted. In 2000, the agency was formed into "Asset Recovery Department" by the 105/76th Government Resolution (Minister of Justice, Minister of Finance and Economy). Furthermore, in June 2002 the structure of the asset recovery department was changed into state-owned enterprise (SOE). Now the main purpose of this SOE is to resolve the debts and bad loans of bankrupted banks, to investigate the lenders and to take all necessary measures such as confiscating properties temporarily and selling any property taken as a collateral for bad loans.

As of June 2003, the MARA employs 110 persons, 68 employees in the main office and 42 in the sixteen provinces (aimags). The number of employees includes police officers and part time workers. Among the workers in the central office, 65% has a bachelor or master degree and 32% high school education. Before joining the MARA, 30% of the employees had worked in the financial sector and 7% were on the legal practice.

Figure 4-1 Organizational Structure of the MARA

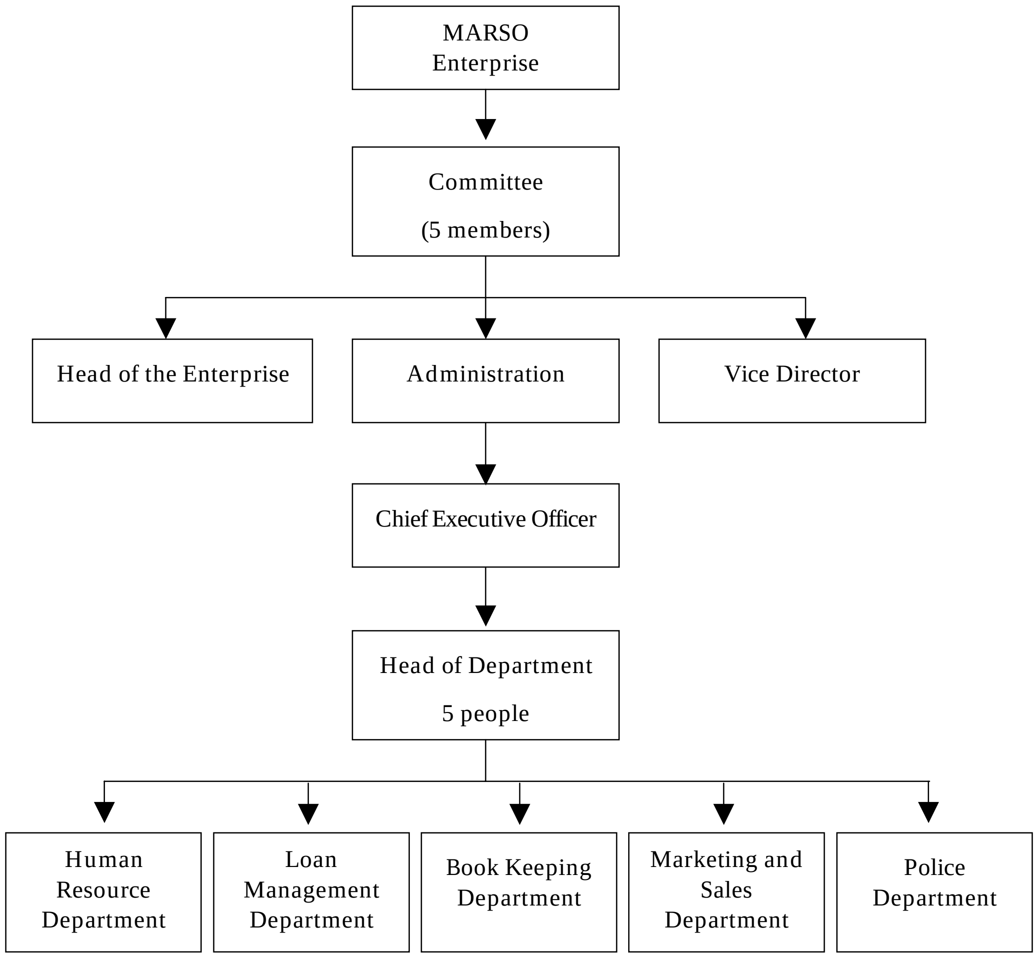


Figure 4-1 displays the organizational structure of the MARA. It consists of five departments, of which the following three departments are directly engaged in the NPL recovery. In the Loan Management Department eighteen employees are working for retrieving the bad loans of which the nominal amount exceeds MNT 10 million. Each employee takes charge of 200 to 250 cases on average. Due to diversity in the difficulty of recovery cases are chosen and distributed to the employees in a random way. The main role of the Marketing and Sales Department is to dispose of the recovered assets in kind as redemption. If the debtors cannot service debts, the collateral may be confiscated forcefully by a court decision or redemption in kind is made based on mutual agreement between the MARA and the debtors. These assets are sold through the MARA owned stores or in the markets by this department. A unique organization in the MARA, compared with other public asset management corporations in the world, is the Police Department. Most of the MARA's assets have been unperformed more than six years and sometimes related to crimes. In addition, many debtors' addresses are not even identified. For these reasons, recovery process can be speeded up with the active involvement of the police. Currently, the MARA makes a contract with the police authority under which some policemen work for asset recovery as a main job and commute to their police station once a week.

4.3. Performance Evaluation of the MARA

The cumulative nominal amount of the transferred assets to the MARA is MNT 47.6 billion against 8,261 delinquent debtors (see Table 4-1). The largest share, 62.6%, is attributable to the NPLs from the liquidated People's Bank and Insurance Bank. Note that these NPLs were just transferred to the MARA, instead of being sold.

Table 4-1 Initially Transferred NPLs to the MARA

(unit: MNT billion)

Banks	Number of Debtors	Loans Outstanding
Liquidated People's Bank and Insurance Bank	6,904	29.8
Bankrupt Central Asian Bank	596	1.1
Loan from the Government of Germany (for Purchasing Equipment)	48	4.9
NPLs Transferred from the ITI Bank	95	4.0
Liquidated Restructuring Bank	360	5.3
NPLs Transferred from the Central Bank's Loan Recovery Division (Those Already Issued Court Decision)	258	2.5
Total Transferred	**8,261**	**47.6**

At the time of the establishment of government expected the MARA to recover most of the NPLs within three years, but despite almost seven years of its operations it has resolved only 26.5% of the NPLs under management, or MNT 12.6 billion out of MNT 47.6 billion (see Table 4-2). Out of the recovered MNT 12.6 billion cash recovery amounts to MNT 6.78 billion (53.8%) and remaining redemption of MNT 5.8 billion is made in kind. In fact, relatively good recovery is due to expansion of redemption methods from paying in cash only to allowing kind payment.

Despite these measures and efforts by the MARA, the performance of distressed assets resolution is judged to be very sluggish. Recalling the time value is extremely important in case of distressed asset disposition, hence, the MARA's slow resolution is unsatisfactory. Like other assets, NPLs are valued as expected present discount sum of all their net cash flows. Since delinquent debtors do not promise to yield predictable payments due to financial distress, the cash flows of NPLs tend to be highly volatile and uncertain in terms of redemption timing, which in turn asks for high risk premium, or discount rate. If the applying discount rate is large and cash inflows come late, the asset should be valued low.

Table 4-2 Recovered NPLs as of the End of June 2003

(Unit: MNT billion)

Year	Recovered NPLs		Total amount of Recovered NPLs Outstanding
	In cash	In kind	
1997	2.7	-	2.7
1998	1.1	-	1.1
1999	0.6	-	0.6
2000	0.5	0.44	1.0
2001	0.7	1.15	1.9
2002	0.6	2.51	3.1
First Half, 2003	0.4	1.7	2.1
Total	**6.78**	**5.8**	**12.6**

For example, suppose that the discount rate is 30% per year and an asset produces no cash inflows for seven years but full recovery in the eighth year. Then, its present discount value is 12.5 cent out for a dollar nominal debt. If the discount rate is 50%, it will be only 3.9 cent for a dollar. Note that, since the average loan interest rate in Mongolia ranges from 30% to 40% per year, the applying discount rate for the NPLs should be no less than 50%. Under these circumstances, the MARA's unresolved NPLs, MNT 35 billion, should have been priced at less than MNT 1.37 billion as of the beginning of its operation in the early 1997.

How must the recovered NPLs of MNT 12.6 billion be valued? Assume that the recovery was completed at the beginning of the year in Table 4-2 in order to have an optimistic bound. Suppose also that the discount rate is 50% per year. Then, redemption in cash and in kind values MNT 4.10 billion and MNT 0.84 billion, respectively, as of 1997. Then total value of redemption is only MNT 4.94 billion as of the beginning of its operation in the early 1997. Note that this estimate is the upper bound since all the redemption is assumed at the beginning of each year. If the redemption is made at the end of each year, the present discounted recovered value as of the beginning of 1997 would be MNT 3.29 billion.

From the estimate, at least two factors should be taken into account for downward adjustment: in-kind redemption for the recovered assets and uncertainties of cash flows for the unrecovered assets. The present discount value of in-kind redemption should be further discounted due to non-liquidity of the commodities as much as by, say, 25%. In the case of the yet recovered assets, it is realistic to price down by at least 75% of the nominal value with the consideration of the recovery history. In hindsight, therefore, the value of the NPLs of nominal amount MNT 47.6 billion should have been no more than MNT 5 billion in the early 1997. That is to say, the average value of the NPLs would have been less than 10.5 cent for a dollar, net of operating costs.

The aforementioned arguments not only illustrate the valuation of the Mongolian NPLs but also highlight the importance of the time value. In most cases, lenders that do not admit the loss from the principal of the NPLs adhere to full payments no matter how long it takes for borrowers to complete redemption. As described above, late payment precipitates the value of recovery, especially at high discount rate so that rigidity in debt rescheduling keeps creditors from maximizing their interests in the not only *ex ante* valuation but also *ex* *post* performance.

One of the serious institutional constraints to collecting debts lies in the lack of authority in the MARA to execute collateral rights. Due to conflicts between the Civil Code and Banking Law, creditors cannot receive the right to dispose of the collateral against the NPLs without court decision. This problem is bypassed in other Asian countries such as Korea, Malaysia, and Thailand by special enactment to bestow the public AMC the discretionary right to efficiently resolve debts. However, the MARA is not established based on an act-level legal framework so that it complies with laws of high priority as in normal time periods.

Once after a decision is made by judges, the MARA steps aside from the loan recovery. Rather, a subsidiary of the Ministry of Justice (MOJ) steps in the process of taking enforcement rights such as confiscating related properties and executing collateral through auction. 90% of the recovered amounts belong to the Ministry of Finance and Economy, the owner of the NPLs after injecting Bank Restructuring Bonds to the failed banks, and 10% is attributed as commissions to the subsidiary agent of the MOJ. This kind of regime may reflect views on pessimistic expectations on successful operations of the MARA at the outset, but obviously should not expect good performances of the MARA nor blame it for slow recovery.

Like many other underdeveloped or developing countries, Mongolia is not equipped with relevant infrastructures for expeditious resolution of distressed assets. Some examples of the lack of infrastructures are as follows. First, it takes a few years for creditors to obtain court decisions for delinquent debt cases. Since the legal system is the final stage of debt collection, efficient and effective insolvency laws and their management by the court are prerequisite to credible credit culture. Provided that debtors recognize the enormous costs and damages that creditors are subject to once they do not service debts, they would exercise strategies not to pay back principal and interests on time. Second, Mongolian capital markets are not well developed in the sense that most normal securities transactions are sparse and sporadic in frequency and small in size, let alone the abnormal securities like NPLs. In that capital markets underdevelopment limits the resolution methods, the MARA cannot help collecting almost all the NPLs under management for itself. It is then not able to utilize the private sector expertise and resources. Weakness in the capital markets is not just a Mongolia-specific problem. It is also found in relatively advanced Asian countries before financial crises such as in Korea, Japan, and Taiwan, as well as in all of the transition economies. Fundamental reasons for improper functioning of capital markets stem from, among other things, weak corporate governance, malpractice in accounting and lack of market principle. In addition, corruption of and cronyism among key stakeholders exacerbate the control of principal-agent problem. Under these circumstances, investors do not take high risks in return for relatively moderate risk adjusted profitability.

4.4. Future Policy Suggestions for Efficient Resolution of NPLs

The policies related to the NPLs resolution in Mongolia are recommended in two dimensions: i) about resolving the currently remaining NPLs and ii) about minimizing the occurrence of potential NPLs in the future.

The MARA has been focusing on the first part, but is still struggling to boost up the recovery of 3% of GDP sized NPLs. Thus the MOFE and the MARA put more emphasis on how to finalize the debts from the past history. According to Table 4-3, however, the MARA's role seems to be quite constrained. About the 64% of the MARA's NPLs court issued decisions so that the MOJ, instead of the MARA, will take initiatives to collect the debts. As for the second largest category of the NPLs, MNT 9.43 billion, the MARA has not identified even addresses of debtors. It still keeps tracing their logistics. There is only a slim possibility, if any, for recovering the NPLs in the other categories. Debts whose borrowers have already passed away, left Mongolia or been in prison are the permanent losses that the MARA should take record of. Debts cancelled by the court are in the same situation. Thus, debts under these criteria, MNT 3.16 billion, should not be counted as recoverable assets.

Table 4-3 Non-Performing Loans Held by the MARA as of the End of June 2003

(unit: MNT billion)

NPLs	No. of Debtors	Amounts
Court Decision Issued	2,207	22.40
Debtors Passed Away	147	0.63
Debtors without Clear Address	4,504	9.44
Debtors Currently Abroad	143	0.65
Debts Cancelled by Court	117	1.60
Debtors in Prison	31	0.28
Total	7,149	35.00

From the MOFE's perspective, the NPLs for which court decisions are made should be considered as a main source to maximize the recovery. In these cases, the information is quite clear and transparent, financially distressed as debtors are. This means that there remains high probability of retrieving at least part of the nominal amounts by exercising collateral rights or disposing of debtors' existing assets. Therefore, the MOFE should put more emphasis on how to recover the NPLs of this category. If the MOFE is not satisfied with the efforts and capacities by the subsidiary of the MOJ to collect debts, it should reconsider adjusting the incentive scheme or entitling the rights to other agency including the MARA.

Table 4-4 Assets and Liabilities Managed by the MARA

(unit: MNT million)

Index	Amount
Asset	
Mobile Asset	
Cash	81
Debt to Be Collected	598
Loan	36,153
Other Mobile Asset	1,155
Total Mobile Assets	**38,367**
Non Mobile Assets	
Fixed Capital	452
Other Assets	5
Government Bond	12,882
Total Non Mobile Assets	**13,339**
Total Assets	**51,705**
Debts and Lenders Property	
Liabilities	
Debt in Cash	17
Government Bond	21,000
Total Debts	**21,017**
Properties	
Loan Fund	26,839
Debt Payment from Countryside	2,555
Confiscated Properties	1,234
Charter Fund	58
Total Owners Property	**30,689**
Total	**51,705**

Still, the MARA has a role of skip-tracing the debtors without clear addresses. As a matter of fact, this is the only job that outsiders recognize as being unique and specific to the MARA. In view of a possibility whether it will perform well in this area, the answer does not seem to be positive. At the time of lending, banks did not record the exact debtors' addresses and they have moved many times without notice to the bank. Since Mongolia is one of the sparsely populated countries in the world, it is too difficult and costly to grasp people's movement. Furthermore, several years have passed after the debtors being delinquent. In this situation, it is quite doubtful for the MARA to contribute to the value added of the NPLs recovery relative to its annual expenses. Table 4-5 summarizes the MARA's income statement after it became a SOE. Its annual expenditure amounts to roughly MNT 226 million in 2002. It is quite small relative to the total NPL holdings, MNT 35 billion, but not negligible compared with the recovery prospects. Thus, without reshuffling the MARA's roles the cost and benefit analysis could conclude the early resolution of the MARA.

Table 4-5 Income Statement of the MARA

(unit: MNT thousand)

Type of Expenditure	Expenditure for 2002		Expenditure for the First Half of 2003	
	Total	Share (%)	Total	Share (%)
Financing of Subsidiaries in Provinces	52,179	23.1	19,551	21.2
Wage Bill of the Main Staff	47,779	21.1	24,421	26.4
Security Expenses (Quarts)	7,282	3.2	3,947	4.27
Social Security Contributions	12,809	5.6	8,065	8.7
Foreign Trips	1,273	0.6		
Benefits			234	0.25
Domestic Trips	2,162	0.95	796	0.86
Gasoline, Fuel	6,979	3	4,158	4,6
Spare Parts	5,729	2.5	3,721	4.03
Heating, Water Supply	5,059	2.25	2,645	2.86
Electricity	2,299	1.02	1,886	2.04
Communication	11,448	5.08	5,148	5.57
Stationary	2,355	1.04	611	0.66
Transportation Cost	143	0.1		
Income Tax			818	0.89
Grants	954	0.43	400	0.43
Training Cost	510	0.22		
Automobile Insurance			387	0.42
Security	1,497	0.76	608	0.66
Inventories	1,460	0.64	965	1.05
Low cost but Easily Sold Goods			162	0.18
Advertisement	38	0.01		
Expenses of National Holiday	3,244	1.4	1,320	1.43
Salary for Contracting Out	4,192	1.85	3,367	3.6
Workshop Expenses			3,067	3.3
Maintenance	18,671	8.3		
Bonus	8,762	3.8	4,615	5
Expenses Occurred according to Bilateral Contracts	17,460	7.8		
Garage Rent	419	0.5		
Investment	3,591	1.6		
Storage Cost of Equipment			1,068	1.15
Charges & Fees Act	5,977	2.7		
Wage Bill for Executive Board Members			189	0.2
Expenses Related to Execution of Court Decision	800	0.36		
Other Costs	96	0.05	206	0.22
Total	**225,652**	**100**	**92,354**	**100**

The MARA's role should be highlighted in the context of minimizing future crisis overcoming costs. As mentioned in the first section, Mongolia is very susceptible and vulnerable to financial and economic crisis due to a number of uncontrollable factors both in and out of the country. Mongolia is then anticipated to inevitably experience a disastrous situation quite frequently, say every several years. Also when crisis breaks out, the depth of damage on the economy as a whole and individual economic agents will be enormous due to lack of relevant infrastructures, weak fiscal positions, and difficulties to coordinate incentive problems. For these reasons, the Mongolian government should prepare contingency plans and measures for the actual occurrence of crisis in order to minimize the damage, if not to prevent it.

The first step to reduce potential crisis costs starts with thorough and careful credit examination of banks at the stage of lending. After loans are provided, the debtors must be monitored periodically. Once symptoms for business distress of debtors are recognized, the loans should be managed under close scrutiny. All of these works must be proceeded by individual banks but systematically guided by regulatory authorities.

As debts become non-performing, banks' health tends to precipitate as well. Since crisis situation is so catastrophic in terms of wealth, welfare and distribution, it must be prevented at any cost. Government attempts to nest the financial uneasiness by providing regulatory forbearance, however, may amplify the adverse effects of bad shocks. This is particularly true in the case of Mongolia where incentive problems and information asymmetry are prevalent. Under these environments, rules are more effective than discretion until the breakout of crisis. For example, prompt corrective action (PCA) as an early warning system is recommended. PCA indicates that regulatory measures are effective when not based on the government's own decision, but on certain already specified criteria such as capital adequacy ratio and / or NPL ratio mechanically. If a bank's NPL ratio touches a certain level, say 5%, supervisory authority ask the bank to reduce the NPLs. If the ratio reaches 10%, recapitalization is automatically ordered. Otherwise, the management should be replaced or the bank should be suspended. The reason why the NPL ratio draws an attention as a criterion of PCA in addition to BIS capital adequacy ratio originates from the experiences that loan losses are the most critical source of the bank failure.

Finally, insolvency reform, accounting system improvement and capital market development are highly recommended. As mentioned earlier, insolvency laws describe the last fate of bad loans. Clear and expected floor value of bad loans is achievable with the credible legal environments and higher floor value feasible with efficient and effective system. In order to resolve NPLs successfully during a crisis, Mongolia should prepare for a market friendly insolvency system. The past experiences after the 1996 crisis should be referred to for insolvency reform. Improvement in accounting system and capital markets is an ingredient of contingency plans for overcoming a crisis as well as a necessary component for an efficient financial system. Transparent accounting is a starting point to valuation of assets and well-developed capital markets supply additional tools and expertise to dispose of bad assets. In that the MARA definitely inherits basic data and views on accounting and valuation of distressed debtors, it should put more efforts to accumulate and systemize past experiences. This seems to be the most important mission that the MARA should take under the current institutional setting and capability.

CHAPTER 5

Deposit Insurance System

5.1. Theoretical Background and Development of Deposit Insurance System

5.1.1. Deposit Insurance System as a Part of Financial Safety Net

Financial safety net system, in general, is comprised of three functional entities: i) supervisory function with focus on prevention of defaulting financial institutions, ii) lender of last resort function fulfilled by central bank to avoid contagion effect and thereby preventing a systemic crisis, and iii) deposit insurance system. In normal times, the existence of each function in effect reduces uncertainties in the financial market, but when problems arise, they assume problem-solving roles. For example, when a problem such as insolvency of a bank occurs, deposit insurance function focuses on ex post activities such as providing payment guarantee and resolving failed banks, but by insuring deposits and easing depositor anxiety, it can reduce potential for bank-runs. Hence, contributing to financial stability in ex ante fashion can occur.

Financial safety nets were adopted by various countries, beginning with the U.S. after the Great Depression of 1930s, in order to maintain financial sector prudence and to avoid contagion effect of shocks from individual financial institution failures. Countries have been developing their respective financial safety nets to enhance their effectiveness by making supplementary improvements to the system. From a historical perspective, financial safety net such as deposit insurance system and lender of last resort are deemed to have been functioning relatively well in terms of resolving financial crisis since the depression era of 1930s, particularly during 1990s, which was fraught with contagion of financial crises. However, financial safety net not only has positive aspects such as prevention of bank-runs and contagion effect, but also has negative facets such as potential of creating instability due to moral hazard problems and adverse selection embodied in the net.

Beginning the mid 1980s, occurrence of financial crisis around the world became more frequent, and systemic problem or instability of the financial market was pointed as the major cause of the crises. Hence, the role of deposit insurance system as an axis of financial safety net in strengthening stability of financial system became more emphasized. Fundamentally, the role of a deposit insurance system is in protecting small depositors in the case that financial institutions become insolvent or bankrupt and prevent instability of financial system that may be caused by contagion of such failures to other financial institutions. If a motive arises for depositors to withdraw their deposits due to failure of depositary institutions and financial instability, a massive bank-run can be caused. In turn, such bank-run may threaten even healthy financial institutions' liquidity. Therefore, to prevent a deposit insurance system, is necessary to prevent such problems from occurring (Diamond and Dybvig [1983]). When deposit insurance system is implemented, the resulting financial stabilization would revitalize the financial intermediation, and in turn, would help boost economic growth. There is also the potentially added benefit of reducing the financial burden when resolving failed banks.

5.1.2. Pros and Cons of Deposit Insurance System

One of the primary positive functions of a deposit insurance system is paying depositors when their depositary institution is unable to meet withdrawal demand due to bankruptcy. It is a function that cannot be undertaken by self-correcting market system or central bank's lender of last resort function alone. In terms of securing credibility with respect to safety of insured deposits, it is generally understood that a public deposit insurance scheme rather than a private insurance company is more effective. Currently, 72 nations have explicit deposit insurance systems, and for many other countries, with the exception of New Zealand, which does not recognize the need for a deposit insurance system, implicit deposit protection is provided (Garcia [1999]). Many countries around the world have adopted deposit insurance systems beginning with the U.S. in 1934 and have various characteristics. However, there is no argument about the usefulness of the systems in terms of maintaining financial stability.

The main purposes of adopting deposit insurance system are the following:

i) To protect small depositors.

ii) To develop appropriate level of incentive system to contribute to stability of financial industry (Garcia [1999]), as deposit insurance system is the most effective means to avoid bank-runs, which can cause meltdown of financial system (Diamond and Dybvig [1983, 1986]). By eliminating depositor anxiety with respect to the safety of their deposits through a deposit insurance system, which can minimize external effect of financial institution failure, the overall integrity and credibility of the financial system would not be damaged even if a financial institution fails.

iii) By providing clear resolution policy regarding failed financial institutions, loss due to insolvency can be reduce, and by applying loss-sharing principle taxpayer's burden can be lightened, thereby supplementing the "lender of last resort" role of the central bank (Mussa [1986]).

iv) Deposit insurance reduces the possibility of s financial crisis. It strengthens market discipline and promotes competitive environment. In other words, it endeavors to provide fair competition conditions to financial institutions of different sizes (Mussa 1986).

However, establishing a deposit insurance system to avoid already expected financial crisis or overcome one that is already in progress can not only distort the "incentive system" which is critical for long-run health of the industry, but may also incur substantially high cost (Garcia [1999]).

Negative side effects of deposit insurance can be seen in various forms from distorted incentive system (structure) among depositor, financial institution, and other relevant participants. Furthermore, effects such as moral hazard, agency problem, and adverse selection may hinder achieving the initial goal.

Moral hazard in a deposit insurance system is that depositors neglect monitoring of their deposit-taking institution as their deposits are insured. Financial institutions would prefer relatively high risk- high return strategy and lower equity stakes or lose sight of appropriate liquidity level because they know, that even if bank-run occurs, deposit insurance system will come to the rescue. The moral hazard problem is more serious in financial industry than other industries because it is highly leveraged and has special characteristics. In the end, it is highly possible that the cost of dealing with financial institution failures to be transferred to the public. The moral hazard problem can be more serious for a marginal bank with high likelihood of failure. So the risk of bankruptcy and eventual loss can rise. Such has actually been shown during the S&L (Savings and Loan Associations) crisis of the U.S. in the 1980s.

Agency problem occurs when agent of principal acts for his own interests rather than those of the principal. It refers to a situation in which supervisory agencies and politicians who should be working for the interest of depositors and taxpayers are focused only in self-interests and thereby threaten financial stability and cause loss to deposit insurance funds and taxpayers. For example, supervisors, after leaving their civil servant duty, may engage in regulatory capture for the interest of the industry in order to secure post-government jobs. Also, industry representative may actually participate in supervisory agency's decision-making entity or process. Politician can engage in political capture, through which they create financial policies or put pressure on supervisors for their self-interest or that of their party. As politicians and supervisors believe that is a disgrace to their reputation if financial institution fails during their tenure. Thus, despite being aware of problems, they may engage in regulatory forbearance by either hoping problems would simply disappear or hide away or delay surfacing of the problems until their tenure expires increasing the eventual cost. Unless roles are clearly understood and information is shared through mutual understanding among financial supervision related organizations, deposit insurance alone may not respond effectively to weakened market discipline (Garcia [2000]). In the long-run similar problems may occur if multiple functions are handled by a single institution, where higher goals (ex: short-term economic stability) supersede lower goals (ex: financial stability) to the extent that the lower goal is sacrificed.

It is critical to adopt incentive compatible systemic mechanisms as deposit insurance system involves many parties with conflicting interest. Many researchers trying to answer have deposited insurance contributing to financial stability, conclude that in an environment where confidence level of the government is low and financial infrastructure is poor, the answer is negative (Demirguc-Kunt and Detragiache [1997], Cull [1998], etc.).

Adverse selection occurs when deposit insurance cannot assess appropriate risk premium to the insured institution based on risk levels. If fixed premium is set based on the average cost, prudent firms may end up supplementing weak or insolvent ones, motivating prudent firms to opt out of insurance coverage. That may initiate a negative cyclical cycle where only the weak would be left to be protected, raising the premium only to hurt them further to the extent of complete destruction of the deposit insurance system.

5.1.3. Development of Deposit Insurance System

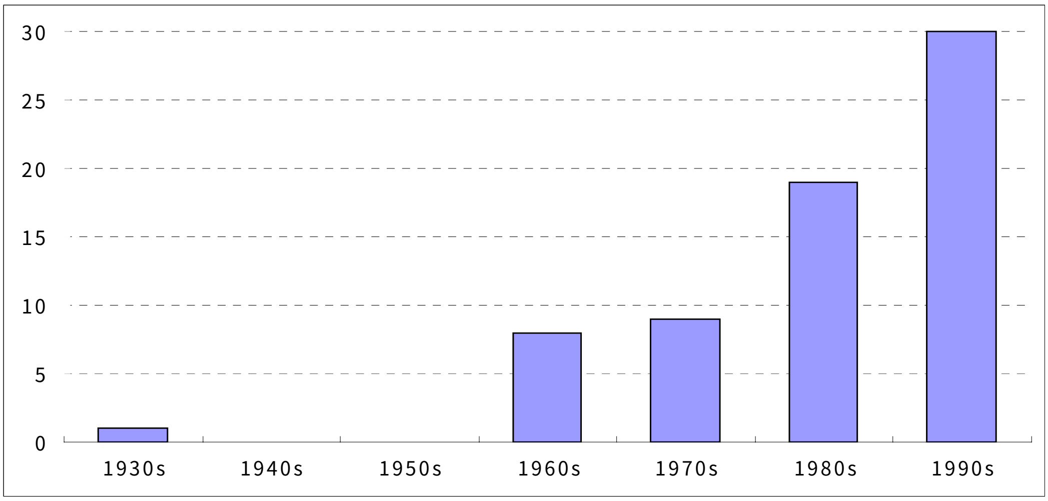
Deposit insurance systems were developed independently based on historical, economical, and cultural background of each country, but in general, the Federal Deposit Insurance Corporation (FDIC) of the U.S. is the fundamental model. In the U.S., deposit insurance system began in the 1830s when a few of the state governments guaranteed bank obligations. In 1933, when the Banking Act was amended to allow the federal government to insured bank deposits directly, the FDIC was established.

In the 19th century, the financial industry did not have a systemic infrastructure in place, and thus, bank failures occurred often and consequently created anxiety, which led to the concept of insuring bank deposits. As economic recession caused repeated bank failures beginning the early 1800s, need for financial reform and guarantee on bank obligations (namely deposits) became prevalent. In 1829, the State of New York came up with a program through which the state government would guarantee bank obligations. This is the first deposit protection scheme that was based on insurance principles. By 1858, five other states adopted similar programs. At that time, protection beneficiaries were bank owners and depositors, but in general bank owners were the main beneficiaries. In the case of bankruptcy, bank owners were paid directly. Subsequently, deposit protection schemes such as deposit protection fund were established in other states, but eventually terminated as the funds were depleted.

In the beginning of the 1930s after the Great Depression, the FDIC was established based on consolidation of many deposit insurance ideas that came out of reorganization of the financial system. The destruction of financial industry due to the Great Depression gave birth to explicit deposit insurance system. Between 1930 and 1933, over 1,000 banks went into bankruptcy. By 1933, 4,000 banks had suspended operations. With the amendment of the Banking Act in 1933, temporary deposit insurance fund was established while it was made mandatory for all banks under the Federal Reserve System to become members of the fund. With the amendment of the Banking Act in 1935, the temporary deposit insurance fund became a permanent one and the FDIC was established to manage the fund.

After the early 1980s, many countries actively adopted explicit deposit insurance systems. By 2000, 72 countries had explicit deposit insurance systems (Garcia [2000]). Prior to early 1960, most of the countries except for the U.S. did not have deposit insurance systems, but 8 countries in 1960s and 9 countries in 1970s adopted deposit insurance systems. After the middle of 1980s many countries experienced financial crisis and in the process of overcoming the crises, they began adopting deposit insurance systems to either supplement or strengthen existing financial safety net such as prudential regulation and supervision, and lender of last resort role of central banks. In 1980s, 19 countries adopted deposit insurance systems. By the 1990s which was fraught with many financial crises among the new economies, 30 countries adopted the system.

Figure 5-1 Adoption of Explicit Deposit Insurance Systems



Source: IMF staff survey

5.2. Design and Management of Deposit Insurance System

5.2.1. Roles and Responsibilities of Deposit Insurance Agency

Recently, deposit insurance systems of many countries have been working to strengthen their respective roles so as to play a leading role in the whole resolution process beginning from the time of financial support injection to recovery in order to minimize the cost associated with resolution of insolvent financial institutions. Of the 67 countries that have explicit and partial deposit insurance systems, deposit insurance agencies of 34 countries have narrow scope of pay-box types in which they collect premiums from financial institutions to deal with insurance triggering events. The rest, or 33 countries have wider scope of functions including effective resolution of failed financial institutions, maximization of recovery, and ex ante prevention of insolvency for minimization of loss to deposit insurance fund besides having a deposit payoff function.

5.2.2. Operator of Deposit Insurance System

Till now, 29 of the 67 countries employ legally independent entities to run their deposit insurance systems in order to secure independence and accountability. For the remaining, deposit insurance agencies are virtually or legally controlled by central banks, finance ministries, or supervisory agencies.

Moreover, 39 deposit insurance agencies are operated directly by their governments, while 12 are managed by private entities and 6 are cooperatively managed by both governments and private firms.

5.2.3. Mobilization and Accumulation of Deposit Insurance Fund

There are two major fund mobilization methods. One is ex ante, in which potential future loss is estimated to assess a certain level of premium to accumulate funds before failures. The other is ex post method in which cost of resolving failure is assessed to various financial institutions. Currently, of the explicit deposit insurance systems, 58 are using fund accumulation method, while 9 are using the ex post method.

The absolute majority, or 66 out of the 67 countries, mobilizes the fund through collection of deposit insurance premiums. Chile is the only country where the government mobilizes the entirety of the fund. Deposit insurance agencies of 55 countries have legal mechanisms available to borrow, issue bonds, or receive official government support in case of mass failures of financial institutions.

On the other hand, of the 58 countries that have ex ante fund accumulation method, 29 employ target fund level[5] systems as ratios of total deposits or insured deposits so as to avoid insolvency of deposit insurance system, or fund deficiency, which could cause delay in taking necessary actions, and maintaining prudence of the funds. However, in most cases actual fund reserves are much lower than their target levels. Only Germany, the U.S., and Poland have funds surpassing their targets.

5.2.4. Insurable Entities, Insurance Membership Type, and Protection Limits

Institutions capable of receiving deposit insurance protection varies by country depending on the respective purpose of adopting deposit insurance systems. For countries

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[5] In the case of the U.S. the target level is 1.25% of insured deposits.

that adopted a deposit insurance system mainly to protect small depositors, all deposit-taking institutions are covered, but for countries whose aim was to stabilize its financial system, commercial banks are covered. Countries that mainly insure commercial banks have a deposit insurance agency for commercial banks and another for deposit-taking institutions. France, Germany, Ireland, and Norway have two deposit insurance agencies while Spain has three. For 40 countries it is, in principle, mandatory for domestic branches of foreign banks to become members of the domestic deposit insurance system. However, for 8 countries it is voluntary, and for Japan and a few other countries, they are excluded from the protection scope.

In terms of membership types, 62 countries require mandatory membership, but for Marshall Islands, Micronesia, Sri Lanka, Switzerland and Dominican Republic, deposit insurance membership is voluntary. As of 1995, about 50% of the countries with explicit deposit insurance system employed mandatory membership, but after experiencing financial crises in the 1990s, many countries made the membership compulsory.

In terms of deposit protection limit, it is desirable to set the limit based on the level at which depositor's moral hazard and stability of financial system would reach a balance for each country. Too high of a protection limit could cause depositor moral hazard, while too low limit could cause bank-runs in risky circumstances and may not be effective in dealing with the instability of its financial system. For such reasons, the IMF recommends one to two times per capita GPD as the appropriate limit level.

5.2.5. Issue of Differential Deposit Insurance Premium

Of the 67 countries with explicit deposit insurance systems, 24 employ risk-based differential insurance premium system in respect of the risk posed by financial institutions. In general, most countries use capital adequacy and supervision assessment rating to measure the level of risk each bank poses on the deposit insurance funds, detailed risk assessment methods differ by country.

Table 5-1 Countries with Differential Insurance Premium Systems

ASIA	EUROPE		AMERICA	
Kazakhstan	Croatia	Norway	Argentina	El Salvador
Marshall Islands	Finland	Poland	Canada	Mexico
Micronesia	France	Portugal	Columbia	Peru
Taiwan	Hungary	Rumania	Ecuador	U.S.
	Italy	Sweden		
	Macedonia	Turkey		

Source: Garcia (2000)

Table 5-2 Recent Trend of Deposit Insurance System

	Explicit DIS			Mandatory Membership		Fund Accumulation Method		Differential Premium System		Operated by					
										Private		Mixed		Government	
	'95	'00	(%)	'95	'00	'95	'00	'95	'00	'95	'00	'95	'00	'95	'00
Total	47	67	43.0	26	62	34	58	4	24	9	13	11	16	21	39

Source: Garcia (2000)

5.3. Deposit Insurance Systems of Major Countries

5.3.1. Overview

Deposit insurance system (DIS), which was first adopted by the U.S. in 1933, was then subsequently adopted and developed by many other countries. In particular, since the mid 1980s, many countries experienced financial crises[6] and in the process of overcoming them, deposit insurance systems were adopted to supplement or strengthen the existing financial safety net role of financial supervision and lender of last resort.

Recent changes observed in deposit insurance system management around the world include i) expansion of explicit and mandatory deposit insurance system, ii) adoption of partial protection limits and differential premium system, iii) focus on prudence (adequacy) of deposit insurance fund, and iv) focus on wide scope deposit insurance function in which prudential regulation would prevent financial institution insolvency, and thereby minimize loss to deposit insurance fund.

These trends are solidifying deposit insurance system's role as an axis of the financial safety net. Furthermore, it can be viewed that deposit insurance systems are in a process of strengthening market discipline and incentive compatible system, which works to prevent moral hazard embodied in deposit insurance system by aiming to protect insured deposits without burden to taxpayers by closely monitoring the financial institutions and assessing risky factors before they become problematic.

Moreover, it is expected that expanding the supervisory operation on top of deposit insurance activities to secure prudence of insured financial institutions and maximization of recovery through effective management of bankrupt financial institutions will be the focal points of concern in the future.

5.3.2. Deposit Insurance System of the U.S.

The U.S. deposit insurance system was established in 1933 with the passage of the Banking Act of 1933, at the height of the Great Depression when many banks were unable to meet their obligations. The basic mandates were i) to provide deposit insurance for the vast majority of banks and savings associations in the U.S., ii) to act as the primary federal regulator for some of the banks (state-chartered banks that are not members of the Federal Reserve System), and iii) to serve as the receiver and liquidator of failed financial institutions.

The Board of Directors is the highest decision-making body of the FDIC. FDIC consists of 7 divisions, 5 offices, 6 regional offices and 2 area offices and the number of officials and employees of the FDIC totaled 5,430 (as of year-end 2002).

Insured Institutions are national banks, federal savings associations, federal savings banks, commercial banks, savings and loan institutions, savings bank and industrial loan companies. Insured Deposits are savings account, check account, certificates of deposit, travellers checks, money orders, certificate drafts of check, foreign currency deposits, inter-bank deposits, etc. The basic coverage limit is $100,000 per depositor per institution.

Deposit Insurance Fund (DIF) is funded by premium assessment (combination of ex-ante and ex-post). The FDIC uses a risk-based premium system that assesses higher rates on those institutions that pose greater risks to the Bank Insurance Fund (BIF) or the Savings Association Insurance Fund (SAIF). In order to assess premiums on individual institutions, the FDIC places each institution in one of nine categories using a two-step process based

[6] In the past twenty years, 112 systemic crises occurred in ninety-three countries, and forty-six countries experienced 51 near crises.

first on capital ratios and then on other relevant information. It should be noted that under the U.S. system, the FDIC is a regulator and supervisor as well as a deposit insurer.

5.3.3. Deposit Insurance System of Canada

Federal government deposit insurance was established in Canada by the Parliament in 1967. DIS was established due to the failure of a number of second-tier financial institutions in the mid-1960s that altered government perspectives on deposit insurance.

The main policy objectives of the DIS are: i) to provide insurance against loss of deposits with member institutions, ii) to promote standards of sound business and financial practices for member institutions, iii) to promote and contribute to the stability of the financial system in Canada, and iv) to pursue the above objects for the benefit of depositors and in such a manner as to minimize the Canada Deposit Insurance Corporation (CDIC)'s exposure to loss.

The CDIC is also governed by a Board of Directors. The CDIC fulfills its mandate through two primary management functions i) Insurance and Risk Management, concerned with assessing, reducing, and managing risks, and ii) Field operations, concerned with managing pay-outs when needed and maximizing the return on the CDIC's claims and recoveries arising from the liquidation of assets of failed member institutions. Insured Institutions are all retail deposit-taking institutions. A CDIC member must be a bank, or a federally or provincially incorporated trust company or loan company. Insured deposits are savings account, chequing account, Certificates of deposit, guaranteed investment certificate, travellers cheques, money orders, certified drafts of cheques, and inter-bank deposits. Basic insurance coverage is CDN $60,000 per depositor per institution.

Deposit Insurance Fund (DIF) is funded by premium assessment (combination of ex-ante and ex-post). CDIC uses a differential premium system that categorizes member institutions into one of four premium categories based on how they are scored according to a series of quantitative and qualitative criteria.

5.3.4. Deposit Insurance System of Korea

Deposit insurance system for non-banking sector existed in the form of funds for each type of financial sector beginning mid 1980s. For banking sector, explicit deposit insurance began with the establishment of the Korea Deposit Insurance Corporation (KDIC) in June 1996 pursuant to the Depositor Protection Act of 1995, which officially began operating on January 1, 1997. After becoming a member of the OECD in 1996, opening of the domestic financial market sped up. Thus, KDIC was established to deal with expected problems resulting from financial instability.

The deposit insurance system, which was adopted with aims to eliminate inefficiency in the Korean financial market through strengthening market discipline and simultaneously improve financial stability, firmly rooted its role as key financial safety net player as a consequence of overcoming the financial crisis that occurred in late 1997. As such, its role and responsibility enhanced substantially. As the financial crisis occurred not even a year into the KDIC’s operation since Jan. 1, 1997, six financial sectors in banking and non-banking sectors (banks, mutual savings banks, merchant banks, credit unions, insurance companies, and securities companies) were consolidated under the Deposit Insurance Fund in April 1998. The consolidation is a result of amalgamation of the financial supervision in Korean, with the Financial Supervisory Commission at the helm, to overcome the financial crisis. In conjunction with the consolidation under the Deposit Insurance Fund, insolvency resolution function (mobilization and injection of public funds) of the KDIC was expanded.

The KDIC currently covers banks, securities companies, insurance companies, merchant banks, and mutual savings banks. Insurance premiums are fixed by each industry. Banks are assessed 0.1% and securities companies are assessed 0.2%, while the others are assessed 0.3% [7]. The blanket coverage system, temporarily adopted right after the financial crisis in 1997, was terminated on December 31, 2000. Beginning January 1, 2001, the system transferred to a limited protection system with 50 million Korean won per person limit. The KDIC began as a pay-box, but in the process of overcoming the financial crisis occurred in late 1997, it has developed into a key instrument for protection of depositors and financial stability. In relation to overcoming the crisis, the deposit insurance system performed important restructuring activities such as risk management of insured financial institutions, holding insolvency related entities accountable for malfeasance, and providing financial support and making recoveries.

In the process of overcoming the crisis, the KDIC, for several years, played key risk management and restructuring roles by injecting public funds (by way of equity participation, contribution, deposit payoff, asset purchase, non-performing loan purchase, etc) to help restore financial stability. The KDIC carried out a key role in financial restructuring, as it has injected 63.8% or 102.3 trillion won of the total 160.4 trillion won of public funds as of the end of May 2003. By effectively utilizing and recovering injected public funds through recovery of public funds, post public fund injection management, bankruptcy estate management, and insolvency culpability investigations, the KDIC has been contributing to firm rooting of market discipline. Through recoveries from equity participation, bankruptcy dividend, and asset sale among others, the KDIC has recovered 19 trillion won of public funds it previously injected by the end of May 2003. By signing the memorandum of understanding with firms that received public fund support, the KDIC has been endeavoring to strictly conduct post public fund injection management and expedite fund recovery. Through the management of bankruptcy estates, the KDIC has been continuously striving to expedite the bankruptcy process and maximize recoveries. To that end, by the end of May 2003, 101 of 424 bankruptcy estates were terminated. In addition, as of the end of May 2003, insolvency accountability investigations with respect to 452 insolvent financial institutions have been conducted. In this regard, damage claim litigations against 5,433 persons totaling 1.5843 trillion won are in progress.

Table 5-3 Insured Financial Institutions in Korea (as of the End of June 2003)

	Banks	Securities Companies	Insurance Companies	Merchant Banks	Mutual Savings Banks	Credit Unions
Number	58	59	42	3	115	1104

[7] Legal limit is 0.5%.

Table 5-4 Financial Restructuring Progress (between December 1997 and December 2002)

Financial Sector	No. of Companies Yearend 1997 (A)	Restructuring Status					Newly Opened	Current Total
		No. of License Revoca- tions	No. of Mergers	No. of Liquida- tions, Transfers to Bridge Banks, and / or Suspen- sions of Operations	Total (B)	Change (B / A, %)		
Banks	33	5	10	-	15	45.5	1	19
Securities Companies	36	5	3	1	9	25.0	17	44
Insurance Companies	50	8	6	2	16	32.0	12	46
Merchant Banks	30	18	6	4	28	93.3	1	3
ITCs	30	6	1	-	7	23.3	8	31
MSBs	231	74	27	26	127	55.0	12	116
Credit Unions	1,666	2	105	335	442	26.5	9	1,233
Lease Companies	25	9	2	-	11	44.0	4	18
Total	2,101	127	160	368	655	31.2	64	1,510

Notes: Includes financial institutions that are not covered by deposit insurance and excludes foreign institutions such as branch offices, etc.

5.4. Deposit Insurance System's Direction of Development

The Financial Stability Forum (FSF), which came into being by a congregation of finance ministers and central bank governors of the G7, established a Working Group to conduct research on ways to strengthen the international financial market by enhancing market functions and preventing systemic risks. The Group pursued research on the deposit insurance system over years and made the following recommendations, titled "International Guidance on Deposit Insurance" in October 2001.

i) **Responsibility and Authority:** A deposit insurance system should be able to handle a variety of functions from a simple pay-box to a wide scope "risk-minimizing" entity with responsibilities and authorities. The deposit insurance system should be given responsibilities and authorities that correspond with the set functions.

ii) **Establishment of Information Sharing System with Financial Supervisor:** In order for a deposit insurance system to effectively perform its functions, it must have timely access to information regarding financial industry so as to accurately evaluate management and insolvency statuses of individual financial institutions.

iii) **Member Institutions:** To prevent adverse selection, in which only the weak or insolvent financial institutions become insured members of deposit insurance system, mandatory membership of all financial institutions including foreign and state-owned banks under deposit insurance system is desirable.

iv) **Protection Limit:** The limit has to be able to adequately restrict moral hazard, and be selected to correspond with policy objectives of the deposit insurance system. It should be determined per depositor and not per account.

v) **Fund Mobilization:** So that insurance claim payments can be made quickly in case of financial institution failure, deposit insurance agency should have fund mobilization infrastructure including government support, deposit insurance premium assessment authority, and loans.

vi) **Resolution of Insolvent Financial Institutions:** Exit strategy of failed financial institution should be one that enhances credibility of the deposit insurance agency, reduces resolution cost and minimize adverse effect of bank failure on the national economy.

vii) **Insurance Claim Payment:** Depositors should be provided with accurate information regarding the payment date and limit. For speedy insurance claim payment process, access to bank information should be available before the failure.

viii) **Recovery:** Marketable performing assets should be disposed as quickly as possible through auctions, private biddings, asset pooling, securitization, consignment to asset management companies, and investment securities, so that deposit insurance fund can be expanded and retaining cost can be reduced to minimize government's involvement.

5.5. Policy Recommendations

After transitioning to a market economy in the beginning of the 1990s, the Mongol Republic experienced a financial crisis in the middle of the same decade. Consequently, its financial system became destabilized and large NPLs were produced, much like the experience of the economies-in-transition in Eastern Europe. As an effort to deal with the structural vulnerability of its financial system and latent instability, the government of Mongol Republic (Central Bank and Ministry of Finance and Economy) is planning to adopt an explicit deposit insurance system to strengthen the existing financial safety net composed of the central bank and supervisory agency.

In general, such policy initiative as adoption of deposit insurance system seems appropriate. However, it seems that the underlying (fundamental) purpose of the policy is unclear, while even the design process of the deposit insurance system also seems not to be organized in certain aspects. We intent to discuss the issues and factors the government of Mongol Republic might need, in order to consider when it actually adopts a deposit insurance system pursuant to the initial draft of the Deposit Protection Act.

It is widely known that deposit insurance system is an axis of the financial safety net along with central bank and supervisory agency. Currently, nearly 70 countries around the world have explicit deposit insurance systems. In particular, many countries that experienced financial crises and economies-in-transition have adopted deposit insurance systems since the beginning of the 1990s. The Mongol Republic, which is a transitioned economy that experienced financial crisis, can be viewed as following suit with such global trends, but a caution is merited as some of the countries that adopted deposit insurance systems in the 1990s without clear purpose and adequate preparation were met with operational inefficiency such as redundancy of tasks among the financial safety net players.

First, the economic and financial environment and the cause (e.g. the structural weaknesses in real economy or vulnerability imbedded in the financial system) of financial crisis and latent financial instability of the Mongol Republic should be comprehensively considered. Also, expected benefits of the adoption should be fully reviewed.

Considering that the primary objective of adopting a deposit insurance system is to enhance macroeconomic and financial stability while preventing financial crisis that could be caused by bank-run and its contagion, the Mongol Republic policymakers should carefully evaluate the current state of its economy and environment, especially on the structural weakness of financial system. In particular, it would be necessary to conduct appropriate assessment as to how latent the cause and characteristics of the financial crisis could be removed or relieved through adopting a deposit insurance system. When reviewing the current state of financial industry and deposit structure of the Mongol Republic, it is not hard to find that compared to the average size of deposits their variance (dispersion) is very large. Moreover, considering the fact that a substantial portion of the financial assets are avoiding the unstable formal sector, adopting a deposit insurance system could contribute to enhancing financial stability by way of achieving stable liquidity through attracting such stationary funds of informal sector to formal sector.

One of the key microeconomic issues that should be considered as importantly as macroeconomic factors in relation to adoption of a deposit insurance system is how to minimize distortion of incentive structure, such as adverse selection and moral hazard that could result from adoption such a system. For this purpose, policymakers should design a deposit insurance system that could serve a neutral function between all relevant market participants (banks, depositors, borrowers). The plan to make deposit insurance membership “mandatory for all deposit taking financial institutions” seems to be an appropriate measure to prevent the adverse selection problem. To prevent moral hazard: i) differentiation of deposit insurance premium rates, and ii) limited protection scope can be considered. Implementing differentiated deposit insurance premium rates from the beginning stages of a deposit insurance system seems inappropriate considering the current state of the Mongol Republic, as it requires certain prerequisites such as accurate risk assessment of insured financial institutions. Therefore, the issue of differentiated deposit insurance premium rates should be considered with caution and patience.

It would be advisable for the policymakers who are currently considering MNT 5 million as the protection limit to make the final decision after a more careful and detailed evaluation of the relevant conditions and expected effects are conducted. In relation to this issue, the policymakers could consider recommendation of international organization, such as the IMF (e.g. one to two times the capita GDP per depositor as the protection limit), or examples of various deposit insurance systems around the world. For instance, if the primary aim of adopting a deposit insurance system purported by the Mongol Republic government lies in enhancing financial stability by inducing the financial assets outside of the formal sector, selecting a high protection limit could be an effective approach. However, if the focus is on typical aim (e.g. stability of financial system from macroeconomic perspective), then the proposed MNT 5 million may be excessively high considering the current economy of the Mongol Republic, as such a high limit could cause distortion of incentive structure and bring about the moral hazard problem.

Accumulating a deposit insurance fund on ex ante basis can be a prudent measure as well. However, it should be decided after carefully considering the appropriate initial size of the fund, its management methods, as well as the state of financial and bond markets in the Mongol Republic. With respect to determination of deposit insurance premium rates, appropriate level of rates should be assessed so as to avoid subsidization of insured financial institutions or unreasonable taxation. A public-funded deposit insurance system should neither subsidize nor tax the banking system.

In order for a deposit insurance system to function effectively, proper monitoring of insured financial institutions and trends of the financial market is necessary. In the case of the Mongol Republic, a deposit insurance system that mitigates the burden of small depositors should be set as the ability to monitor the banks is rather limited compared to the advanced countries where financial systems and information sharing have developed well. As this concern is directly related to the protection limit, setting a protection limit that would induce depositors to monitor their depositary institutions would be advisable.

From a more long-term perspective, it would be prudent to conduct basic research, condition evaluation and solicit consultation to design the deposit insurance system. It would also be useful to go through a sufficient preparation period so that confusion and inefficiency resulting from the adoption of deposit insurance system can be minimized.

<Box Comments on Mongolian Law on Deposit Insurance>

In light of our discussion on the development of deposit insurance system, we would like to remark on the draft of the Mongolian Law on Deposit Insurance (June 2003 version) in the Appendix A.

(1) According to Article 5.1 of the draft, the Deposit Insurance shall insure up to five million tugriks or equivalent amount in foreign currency. First of all, this amount seems too large. MNT 5 million is about $5,000 US dollars, and it is more than ten times the Mongolian per capita GDP, which is estimated at $425. In the case of the U.S., the current deposit protection limit is $100,000, and it is slightly more than three times its per capita GDP; while in the case of Korea, the protection limit is slightly more than four times its per capita GDP of $10,000. As indicated before, if the protection limit is too high, then both depositors and insured financial institutions tend to exhibit moral hazard. That is, depositors tend not to closely monitor the financial situation of the insured financial institutions and the insured financial institutions attracted to higher returns tend to engage in highly risky investment.

Obviously, having such a high protection limit does not seem consistent with one of the major objectives of establishing a deposit insurance system: protection of small depositors. The deposit insurance system is not intended to design or protect large depositors as large depositors have the ability and means to protect themselves. They can monitor the financial status of their financial institutions, and if their financial institutions are distressed, they are able to withdraw their funds and invest them at healthier financial institutions. These actions will induce the managers of financial institutions to be more prudent.

Second, according to Article 5.1 of the draft, the Mongolian deposit insurance system will insure deposits in foreign currency up to about $5,000 US dollars. This will definitely help the larger, wealthier depositors as small depositors in Mongolia would not find it necessary to protect that much funds in foreign currency. Furthermore, this will make the Mongolian deposit insurance system more susceptible to foreign exchange risks. The protection of foreign currency deposits in large quantity tends to have destabilizing effects on the deposit insurance system, which does not seem consistent to one of the two major objectives of having a deposit insurance system.

(2) According to Article 7.1 of the draft, the minimum amount of the deposit insurance

fund shall be five billion tug rugs. Thus, the draft sets the low boundary of the deposit insurance fund. Yet, such a boundary does not seem related to the size of the insurable deposits. Currently, the U.S. has a designated reserve ratio of 1.25 percent. That is, the size of the deposit insurance fund should be 1.25 percent of the total insurable deposits. Such a setup seems more flexible and does not need to go through the State Great Khural when the level of deposit insurance fund needs to be adjusted. A better way of indicating the proper size of the deposit insurance fund is to establish a lower bound and higher bound for such a reserve ratio so that if the size of the fund is within bounds, no action is required. If it is either above the upper bound or below the lower bound, then an appropriate action should be taken.

Actually, according to Article 21, the draft has a mechanism to reduce its fund when the deposit insurance fund exceeds 40 percent of total insured deposits. Yet, it does not indicate what to do when the fund is depleted below the minimum level, say due to a financial crisis. More specifically, the law needs to specify how fast the fund needs to recover once its level is below the required minimum. For example, the law could indicate that the deposit insurance system has a mandate from the Parliament to set a special deposit insurance duty to recover the insurance laws. Furthermore, when the fund is depleted below the minimum level, the law should indicate a loss-sharing rule among the relevant parties, the banking sector and the public.

(3) Article 9 needs to specify the qualifications for the members of deposit insurance national board. Setting up governance system is important. It indicates whether the deposit system is a part of the Ministry of Finance or is given appropriate responsibility and authorities so as to perform its function properly.

(4) Article 12 needs to specify what types of commercial bank deposits are eligible for deposit insurance since it is common that not all the bank deposits are insured.

(5) The law should indicate some principles concerning when the government or the deposit insurance system should intervene a failing financial institution if its financial situation is expected to continue to deteriorate. For example, it needs something compatible to prompt corrective action, when a failing financial institution needs help from the government or the deposit insurance system. The law also needs to indicate how fast the deposit insurance system can resolve failed banks. This is needed to prevent forbearance problems.

(6) Finally, the law needs to specify an establishment of an official mechanism that enhances communication with the financial supervisor. An efficient day-to-day information sharing with the financial supervisor is necessary to effectively evaluate management and the insolvency status of member financial institutions.

CHAPTER 6
Supervision on Non-Bank Financial Institutions

6.1. Savings and Credit Cooperatives in Mongolia

6.1.1. Financial Intermediation in Mongolia

Banking institutions and non-bank financial institutions account for most of the financial intermediation in Mongolia. The Bank of Mongolia has started issuing licenses for performing specified bank activities to individuals and institutions in order to increase financial intermediation. Forty-one NBFIs have been licensed in 2002. The State Great Hural (SGH) and the government of Mongolia have approved the "Concept of Regional Development of Mongolia" and have been taking various measures to accomplish equal social and economic development. Within the framework of those measures, the Bank of Mongolia has expanded opportunities of deepening financial intermediation in rural areas through the establishment of different minimum capital requirement in urban and rural areas.

Out of sixty-six licensed NBFIs, sixty NBFIs operated in Ulaanbatar, three NBFIs were located in Darkhan, and the remaining three NBFIs were located in Tov, Arkhangai, and Zavhan aimags in 2002. The number of operating NBFIs has been increased to about ninety at the end of July 2003. Approval of the "Non-bank financial activity law" by the SGH is considered to promote the expansion of NBFI business activities.

Most of those NBFIs have been licensed to perform loan businesses while a few of them were authorized to perform such businesses as money transfer, financial leasing, and factoring. NBFIs are not allowed to accept deposits from the public. The influence of NBFIs in the financial market is rather limited and the number of NBFI customers is small.

The total assets of NBFIs has increased by 88.5 percent in 2002. It amounts to 8.9 percent of total assets of the banking sector[8].

Mongolia's financial sector has recently witnessed the expansion of savings and credit cooperatives. Savings and credit cooperatives are expected to play a greater role as effective providers of small credit.

In line with development of these savings and credit cooperatives, we study how the Mongolian government could improve supervisory and regulatory oversight of these cooperatives.

6.1.2. Development of Savings and Credit Cooperatives (SCCs)

(1) Amendment of the Cooperative Law

The law to amend the Cooperative Law was passed in December 2002. The amendment adds Chapter 6 that regulates activities of savings and credit cooperatives. The Chapter 6 sets requirements for the savings and credit cooperatives and the composition of equity

[8] The Bank of Mongolia, Annual Report 2002, p. 74.

stocks. Savings and credit cooperatives should comply with prudential regulations and the requirement of minimum risk positions set by the Bank of Mongolia (BOM). (see Appendix 1)

(2) Licensing

The National Tax Office (NTO) issues licenses to savings and credit cooperatives in Mongolia, but the NTO does not supervise them. The minimum number of member requirement of savings and credit cooperatives has been increased to twenty from nine by the amended Law.

The total number of licensed cooperatives amounts to approximately 900. There are about 500 savings and credit cooperatives in Mongolia. About 90 percent of those savings and credit cooperatives have been established since the early 2002.

(3) Business Activities of SCCs

Savings and credit cooperatives are allowed to accept deposits only from members and to extend loans to their members. They are not allowed to extend loans to anyone who is not a member of savings and credit cooperatives.

Only two hundred and seventy savings and credit cooperatives are known to perform businesses. Other savings and credit cooperatives, whose number amounts to approximately two hundred, seem to stop their businesses. Problems occur at those savings and credit cooperatives.

(4) The Association of Savings and Credit Cooperatives (SCCs)

There are two associations of savings and credit cooperatives in Mongolia. The membership of the associations of savings and credit cooperatives is voluntary. Each of these two associations has about ten staff members at the headquarter office.

6.1.3. Prudential Regulation and Supervision of SCCs

Savings and credit cooperatives are currently not supervised by any regulator in Mongolia. Neither the Bank of Mongolia nor any government agency in Mongolia has the responsibility of regulating and supervising savings and credit cooperatives.

Prior to July 1999 the Bank of Mongolia had supervisory and regulatory responsibilities for savings and credit cooperatives. With an amendment to the Banking Law in July 1999, savings and credit cooperatives were no longer subject to the Banking Law.

The Law on Cooperatives became the new legal framework for the cooperatives after the revision of the Banking Law. The recent surge in the number of savings and credit cooperatives seems to be partly a result of this change. The change in the licensing system for establishing savings and credit cooperatives and less restrictive application of regulation on them may have brought about a significant increase in the number of savings and credit cooperatives.

Unregulated savings and credit cooperatives, however, might cause severe social and political as well as economic problems if and when the Mongolian economy suffers from an external shock, a terms-of trade shock, or a slowdown of the economic activities in Mongolia.

A sudden increase in non-performing loans of savings and credit cooperatives would cause many of them to fall into default. Depositors whose deposits are not properly protected under the current system would ask the government to help them to recover their deposits in one way or another.

In line with development of these savings and credit cooperatives, the Mongolian government should improve supervisory and regulatory oversight of these cooperatives.

The Bank of Mongolia has accumulated experiences in prudential regulation and supervision of banks and NBFIs.

Parliamentarians thought that savings and credit cooperatives are different from other general cooperatives and therefore they should be treated differently from other general cooperatives. In the amended Law on Cooperatives, a new chapter on general regulation of savings and credit cooperatives has been added.

The amended Law stipulates that the Bank of Mongolia should set the prudential regulation of savings and credit cooperatives. According to the amended Law, the Bank of Mongolia has recently set a standard of prudential regulation of savings and credit cooperatives. (see Appendix B)

6.1.4. ADB's Recommendation

ADB had technical assistance (TA) available for the banking sector through the end of 2000, and has launched a TA program for implementation of its FSRPL that supports the NBFI component of the Mongolian government's financial sector reform program.

ADB, the Ministry of Finance and Economy, the National Tax Office, and the Bank of Mongolia have discussed ways to establish a Supervision Unit to strengthen prudential regulation and supervision of savings and credit cooperatives in July 2002.

6.1.5. Special Working Group on SCCs

The Ministry of Finance and Economy, the Bank of Mongolia, and the ADB have agreed to establish a special working group at the National Tax Office to study how to establish a regulatory framework of savings and credit cooperatives and to strengthen prudential regulation of them in Mongolia. The special working group is a temporary unit, which is scheduled to operate for about one year.

The special working group consists of three members. The Bank of Mongolia has seconded two bank supervisors of the Supervision Department to the special working group. The National Tax Office, which is under the Ministry of Finance and Economy, has seconded one expert to the special working group.

The special working group started to take administrative steps and to collect information from July 2003. The Special working group plans to submit a recommendation to the government in October 2003.

6.2. Non-Bank Financial Institutions in Korea

In 1972, three laws were enacted authorizing mutual savings and finance companies (MSFCs), credit unions, and investment and finance companies (IFCs). These three new types of non-bank financial institutions were intended to take up the short-term financing activities of the unregulated financial institutions.

6.2.1. Mutual Savings and Finance Companies (Mutual Savings Banks)

The Mutual Savings and Finance Company Act was legislated as a piece of the institutional reform in the wake of "August 3rd Measure". It was to absorb curb market funds into organized money markets. The existing mutual finance companies were reorganized and the new entries were allowed in accordance with the Act.

The main business of MSFCs consisted of providing the traditional Korean savings and loan scheme (*Kye*) and mutual installment savings to small businesses and households. The MSFCs also extend unsecured loans to and discount the bills of their members.

There were 299 such companies registered in 1972. After several waves of insolvencies, mergers, and government-led consolidations, the number of companies was trimmed to 199 by the end of the 1970s.

Despite the decline in number, their total deposits rose noticeably between 1975 and 1978. The growth may have been associated with the takeover of some of MSFCs by large business groups.

It is alleged that the business groups channel some of their idle funds through the MSFCs to take advantage of MSFCs close ties with the unregulated money markets and their relatively high deposit rates.

Under the Mutual Savings and Finance Company Act in March 2001, the name of mutual savings and finance company has been changed to mutual savings bank in March 2003. The scope of their clientele has also been expanded to medium companies.

As of the end of June 2001, a total of 125 mutual savings and finance companies were in operation and their total assets amounted to 22 trillion 799 billion won.

Mutual savings and finance companies faced managerial difficulties due to a surge in the number of small companies going bankrupt following the outbreak of the economic crisis in 1997. As a result, 106 mutual savings and finance companies were liquidated or merged from 1998 to June 2001.

Mutual savings banks handle deposit- taking and lending businesses as do ordinary banks. But they have no role in payment settlement. The scope of their customers is confined to the general public, small and medium companies. They are unable to establish branches, in principle.

Mutual savings banks extend loans to customers using the funds mobilized chiefly from the taking of time deposits. As of the end of June 2001, time deposits accounted for 71.4 percent of total sources of funds. At the end of June 2001, loans accounted for 62.1 percent of the total of their funds and securities made up 10.3 percent.

Figure 6-1 Number of Mutual Savings and Finance Companies

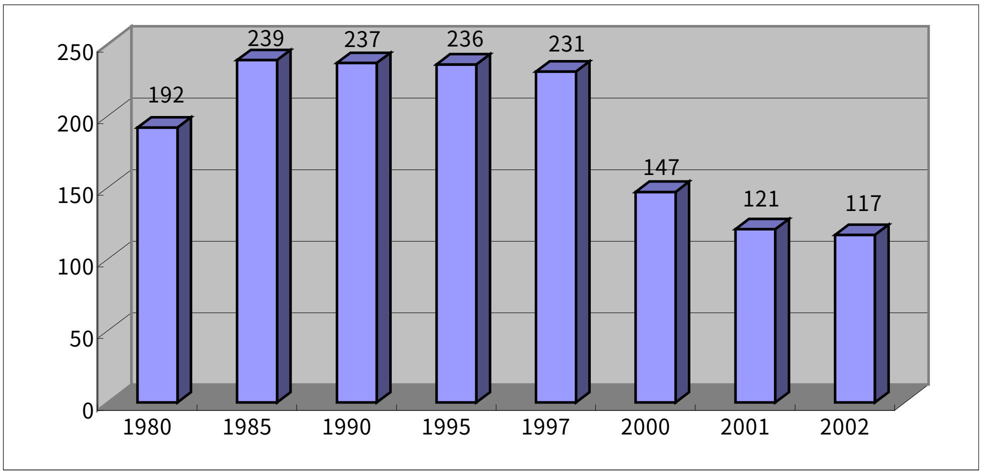


Table 6-1 Sources and Uses of Funds of Mutual Savings and Finance Companies (as of the End of Period)

(unit: billion won)

	1990		1995		2000		2001		2002	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Sources										
Deposits	8,503	74.1	25,682	78.7	18,803	77.7	20,008	82.6	22,555	83.2
(Receipt)	7	0.1	4	0.0	-	-	-	-	-	-
(Installment Receipt)	2,239	19.5	3,638	11.2	503	2.1	N / A	N / A	N / A	N / A
(Time Deposits)1)	5,530	48.2	20,398	62.5	15,900	65.7	18,101	74.8	20,507	75.7
Borrowings from Public2)	438	3.8	-	-	-	-	-	-	-	-
Other Sources	1,179	10.3	2,804	8.6	3,250	13.4	2,632	10.9	3,121	11.5
Capital	1,352	11.8	4,126	12.7	1,644	6.8	1,591	6.6	1,419	5.2
Total	11,471	100	32,612	100	24,196	100	24,230	100	27,095	100
Uses										
Cash and Deposits	837	7.3	3,027	9.3	2,752	11.4	3,135	12.9	2,276	8.4
Securities	284	2.5	986	3.0	1,534	6.3	2,472	10.2	2,384	8.8
Loans and Discounts	9,581	83.5	25,754	79.0	15,701	64.9	15,963	65.9	19,246	71.0
(Installment Loans)	5,519	48.1	16,725	51.3	6,038	25.0	3,357	13.9	2,241	8.3
(Bills Discounted)	2,732	23.8	6,716	20.6	4,043	16.7	N / A	N / A	N / A	N / A
Fixed Assets	548	4.8	1,718	5.3	2,229	9.2	1,681	6.9	1,487	5.5
Other Uses	221	1.9	1,127	3.5	1,981	8.2	980	4.0	1,702	6.3

Note : 1) Data before 1995 are time installment deposits.
2) Abolished in January 1993, and the remaining balance was absorbed by time deposits in 1995.

Sources : The Bank of Korea, *Monthly Bulletin*
Korea Federation of Mutual Savings and Finance Companies, *Monthly Bulletin*

6.2.2. Credit Unions

Credit unions were first organized in the early 1960s in businesses, government agencies, and other public and private organizations to encourage employees to save and to provide them with an opportunity to borrow cheaply. Until 1972, establishment and management of credit unions were left to the unions themselves.

A second piece of legislation that followed the "August 3rd Measure" was the Credit Union Act of August 17th 1972. This Act's jurisdiction covered three different types of financial institutions: credit unions, credit operation of agricultural and fisheries cooperatives, and community credit cooperatives, as a credit arm of the Saemaul (new village) movement.

With the enactment of the Credit Union Act in 1972, they have been placed under government guidance and supervision. Credit unions aim to promote financial assistance to members and seek mutual economic benefit. As of the end of June 2001, 1,280 credit unions were in operation and their combined assets amounted to 22 trillion 98 billion won. As in the case of mutual savings and finance companies, a number of credit unions were liquidated or merged due to an increase in non-performing loans in the wake of the outbreak of the economic crisis in 1997. As of the end of June 2001, deposits at credit unions accounted for 83.4 percent of their total funds raised, and they operated the mobilized funds as loans (46.7%), and cash and deposits (33.5%).

Figure 6-2 Number of Credit Unions

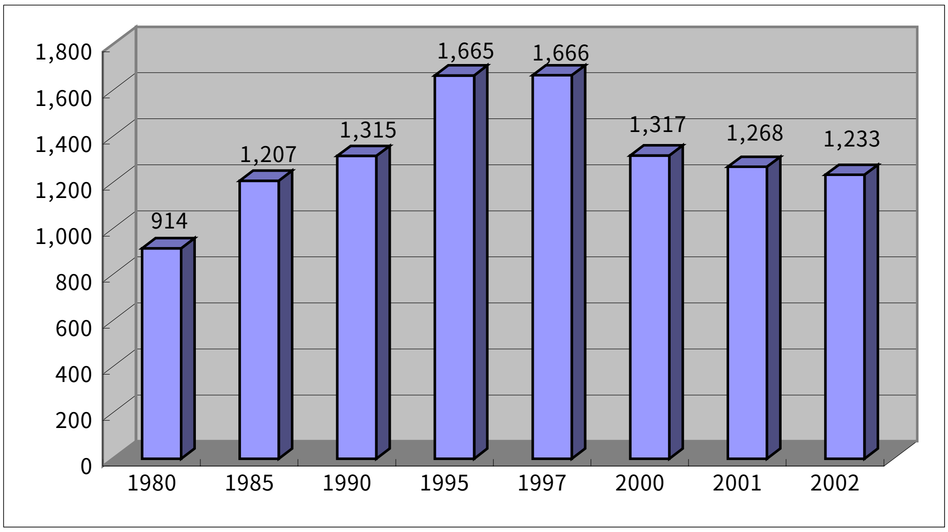


Table 6-2 Sources and Uses of Funds of Credit Unions
(as of the End of Period)

(unit: billion won)

	1990		1995		2000		2001		2002	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Sources										
Deposits	2,658	73.9	10,199	77.2	17,045	81.3	19,377	82.9	16,860	80.3
(Installment Receipt)	909	25.3	2,884	21.8	1,537	7.3	N / A		N / A	
Borrowings	107	3.0	291	2.2	400	1.9	363	1.5	601	2.8
Other Sources	106	2.9	575	4.3	1,171	5.6	1,475	6.3	1,417	6.7
Subscriptions	593	16.5	1,779	13.5	2,162	10.3	2,185	9.3	2,141	10.2
Surplus	134	3.7	372	2.8	181	0.9	7	0	9	0
Total	3,597	100	13,217	100	20,959	100	23,365	100	20,994	100
Uses										
Cash and Deposits	592	16.4	2,612	19.8	6,295	30.0	8,517	36.5	5,717	27.2
Loans	2,687	74.7	8,957	67.8	10,220	48.8	10,599	45.3	10,740	51.1
Securities	98	2.7	666	5.0	2,854	13.6	2,597	11.2	3,026	14.5
Other uses	221	6.1	982	7.4	1,589	7.6	1,652	7.0	1,511	7.2

Source: The Bank of Korea, *Monthly Bulletin*

6.2.3. Community Credit Cooperatives

The community credit cooperatives are a form of credit union whose members usually consist of the residents of a rural village or a *dong*, the smallest administrative unit in urban areas. These community credit cooperatives were first established in 1964 as part of the rural development movement. In the past, they were governed by the Credit Union Act, but they now fall under the Community Credit Cooperatives Act. As of the end of June 2001, the number of community credit cooperatives came to 1,770 and their combined assets reached 37 trillion 575 billion won.

Community credit cooperatives primarily deal with deposit-taking and loans. But they may not handle the discount of commercial bills, which sets them apart from the business of credit unions. As of the end of June 2001, community credit cooperatives secured 85.7 percent of their total funds through deposits and used the mobilized funds mainly in the form of loans (40.3%), cash and deposits (30.8%) and securities (23.9%).

Table 6-3 Number of Community Credit Cooperatives
(as of the End of Period)

1983	1985	1990	1995	1997	2000	2001	2002
11,719	4,090	3,245	2,969	2,743	1,817	1,730	1,701

Source : Korea Federation of Community Credit Cooperatives

Table 6-4 Sources and Uses of Funds of Community Credit Cooperatives
(as of the End of Period)

(unit: billion won)

	1990		1995		2000		2001		2002	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Sources										
Deposits	5,652	78.9	15,616	75.3	30,616	82.6	34,045	84.8	35,792	84.8
Borrowings	125	1.7	873	4.2	800	2.2	632	1.6	795	1.9
Other Sources	197	2.7	696	3.4	1,759	4.7	1,840	4.6	2,082	4.9
Subscriptions	767	10.7	1,930	9.3	2,244	6.1	2,116	5.3	2,128	5.0
Surplus	426	5.9	1,615	7.8	1,642	4.4	1,478	3.7	1,412	3.4
Total	7,167	100	20,729	100	37,061	100	40,126	100	42,230	100
Uses										
Cash and Deposits	1,953	27.2	6,780	32.7	11,450	30.9	11,169	27.8	11,803	28.0
Loans	4,760	66.4	11,492	55.4	14,820	40.0	16,669	41.6	19,614	46.5
Securities	120	1.7	1,073	5.2	8,501	22.9	10,722	26.7	8,556	20.2
Other uses	334	4.7	1,383	6.7	2,290	6.2	1,566	3.9	2,257	5.3

Source: The Bank of Korea, *Monthly Bulletin*

6.2.4. Financial Supervision System in Korea

Among the financial reform bills was the Act on the Consolidation of Financial Supervisory Agencies. In April 1998, a consolidated independent financial supervisory agency, the Financial Supervisory Commission (FSC), was launched under the Prime Minister's Office to ensure an effective supervisory system that was more closely in line with universal banking practices.

The FSC acts as a financial safety device by enforcing prompt corrective action and prudent portfolio management by financial institutions. In addition, the FSC oversees the Financial Supervisory Service (FSS). The FSS was established in January 1999 as a consolidation of four different supervisory institutions. The Securities and Futures Commission (SFC) was also established to oversee market practices, including those connected with securities and exchange-trade derivatives.

Figure 6-3 Financial Supervisory Framework of Mutual Savings & Finance Companies (before December 1997)

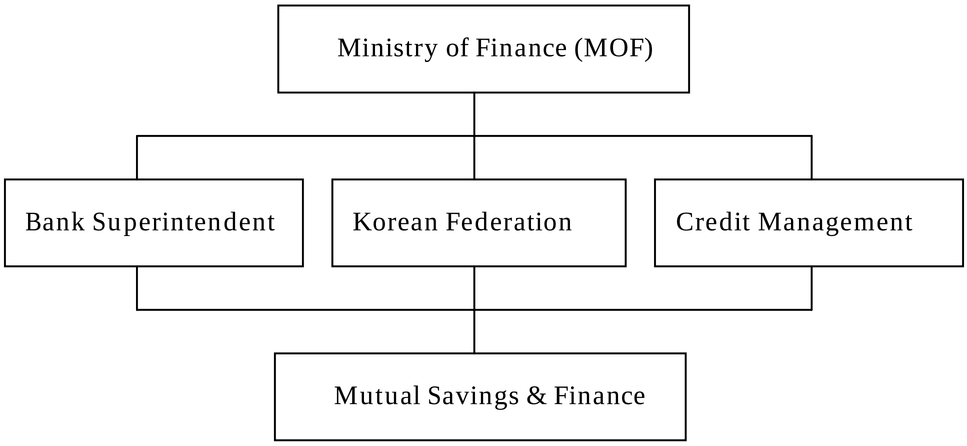


Figure 6-4 Financial Supervisory Framework of Credit Unions (before December 1997)

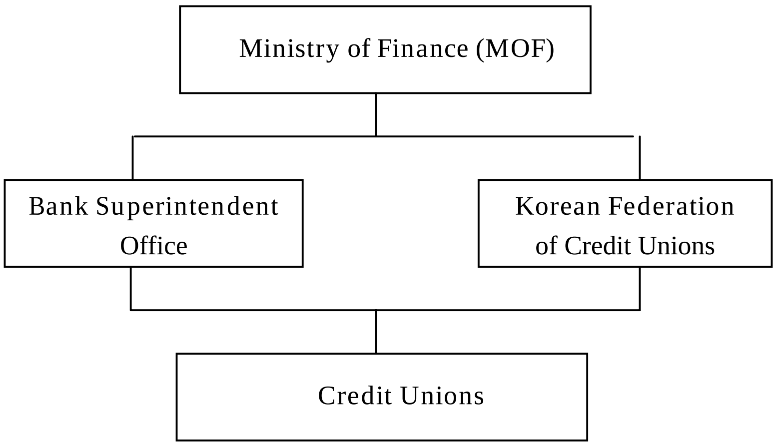


Figure 6-5 Financial Supervisory Framework of Mutual Savings & Finance Companies and Credit Unions (after December 1997)

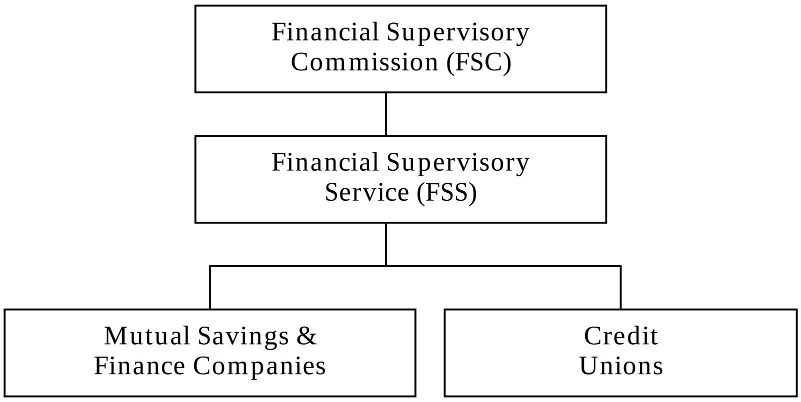


Figure 6-6 Financial Supervisory Framework of Community Credit Cooperatives

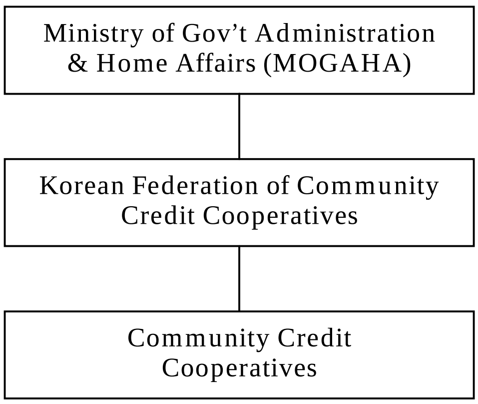


Table 6-5 Current State of Financial Restructuring (1998-2002)

	No. of Institutions as of End of 1997	1998-2001			2002			No. of Institutions as of end of 2002
		License Revoked & Liquidation	Closure Through Merger	Entrance	License Revoked & Liquidation	Closure Through Merger	Entrance	
Banks	33	5	8	-	-	1	-	19
Merchant Banks	30	22	6	-	-	-	-	3
Securities Companies	36	6	1	17	-	2	-	44
Investment Trust Companies	31	6	1	17	-	-	1	31
Life Insurance Companies	31	7	5	-	-	-	1	20
Non-Life Insurance Companies	14	-	1	-	-	-	-	14
Credit-Specialized Financial Companies	68	14	12	11	3	1	8	57
Mutual Savings & Finance companies	231	95	26	12	5	1	-	116
Credit Unions	1,666	305	102	9	33	3	-	1,232
Total	2,140	460	162	57	42	8	11	1,536

6.3. Policy Recommendation for Financial Supervisory Framework in Mongolia

6.3.1. Related Institutions

Mongolia's financial sector has recently witnessed the expansion of savings and credit cooperatives. Savings and credit cooperatives are expected to play a greater role as effective providers of small credits. In line with development of these savings and credit cooperatives, it should be investigated how the Mongolian government could improve supervisory and regulatory oversight of these cooperatives.

(1) Ministry of Finance and Economy

The Ministry of Finance and Economy (MOFE) does not have the responsibility to regulate and supervise any financial institution in Mongolia. Therefore, the MOFE seems to hold that it is not their responsibility to regulate and supervise savings and credit cooperatives. Only the National Tax Office (NTO) and the Mongolian Asset Recovery Agency (MARA) are placed under MOFE.

(2) Bank of Mongolia (BOM)

The Bank of Mongolia is an independent central bank, which is under the Parliament of Mongolia. There are three divisions - Supervision Division, Banking Division, and Policy Regulation Division – under the Supervision Department of the Bank of Mongolia. There are forty-five bank supervisors, which include one Department Director, and three Division Directors, at the Supervision Department of the BOM. They supervise sixteen commercial banks and about ninety NBFIs.

The Bank of Mongolia does not have a responsibility for supervising savings and credit cooperatives. However, the Bank of Mongolia seems to be a good candidate that is able to regulate and supervise savings and credit cooperatives in Mongolia.

ADB, IMF, and the Government of Mongolia have wanted the Bank of Mongolia to be a regulator of savings and credit cooperatives. However, the Bank of Mongolia does not want to regulate, or to supervise savings and credit cooperatives.

If the Bank of Mongolia and the government are to compromise, in one way or another, to establish the Supervision Unit of savings and credit cooperatives at the Bank of Mongolia, then the Bank had better set up a new Savings and Credit Cooperatives Supervision Department.

(3) Association of Savings and Credit Cooperatives

Chairmen of two associations of savings and credit cooperatives are known to express their willingness to take responsibilities to supervise savings and credit cooperatives. According to the amended Law, the associations of savings and credit cooperatives are supposed to supervise savings and credit cooperatives in Mongolia. However, these two associations are not prepared and able to supervise savings and credit cooperatives at present.

The government of Mongolia might consider the option of permitting the association of savings and credit cooperatives, as a self regulatory organization (SRO), to take responsibilities of supervising member savings and credit cooperatives in Mongolia. In order to take responsibilities for supervising member savings and credit cooperatives, those two associations should be merged into one nation-wide association, which has branches in all of 21 provinces in Mongolia. Then the new association of savings and credit cooperatives might be permitted to take responsibilities of supervising member savings and credit cooperatives in Mongolia. But the association should report to the government agency, or the Bank of Mongolia, who can become a major regulator of savings and credit cooperatives. Also, the association should be regulated by the major regulator.

(4) National Tax Office

The National Tax Office is a special agency under the Ministry of Finance and Economy. Local tax offices collect information from savings and credit cooperatives only for tax purposes. Local tax offices are small administrative units. Currently, the National Tax Office does not supervise savings and credit cooperatives. The special working group on savings and credit cooperatives has recently been established as a temporary unit under the National Tax Office.

(5) Professional State Financial Supervision Committee

The government of Mongolia has recently established the Professional State Financial Supervision Committee under the Prime Minister's Office. The Financial Supervision Agency has also been merged into the Professional State Financial Supervision Committee. Insurance supervision office is placed under the Professional State Financial Supervision Committee. However, the Securities and Exchange Committee is not placed under the Professional State Financial Supervision Committee. It is a separate government agency. The government of Mongolia might consider other options of establishing the new Savings and Credit Cooperatives Supervision Agency under the Professional State Financial Supervision Committee.

6.3.2. Recommendation of Financial Supervisory Framework

(1) Option A

The major regulator of savings and credit cooperatives is the Bank of Mongolia. The daily regulatory and supervisory responsibilities will be delegated to and performed by the Association of Savings and Credit Cooperatives (ASCC). The ASCC will be regulated and supervised by the Bank of Mongolia. SRO responsibilities of the ASCC should be legally defined.

The Bank of Mongolia will have the power to intervene and take over direct supervision, if necessary, over any savings and credit cooperative, for any reason.

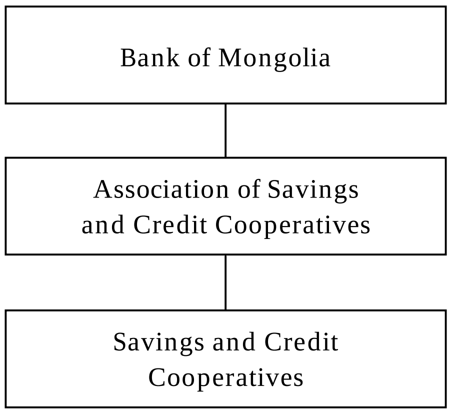
After ensuring appropriate reserve levels and payment of limited dividends on permanent equity capital remains, the surplus rising out of the operations of the savings and credit cooperatives should belong to and benefit all members with no single member or one group of members benefiting to the detriment of others. The surplus may be distributed among members proportional to their transactions with the savings and credit cooperatives as interest or patronage refunds, or directed to improved and/or additional services as required by members.

A prime concern of the savings and credit cooperatives should be to build financial strength, including adequate reserves and internal controls that will ensure continued quality services to their members. Member-oriented services and consistent targeting to a niche market would strengthen member participation.

Management consulting, political advocacy and examination should be the major functions of the ASCC. On behalf of its member savings and credit cooperatives, the ASCC should raise various issues of advocacy and negotiate with regulators of the Bank of Mongolia. The Association should also provide the necessary regulation and guidelines to meet the needs of the savings and credit cooperatives. When the Cooperative Law and any regulation on the savings and credit cooperatives are amended, the ASCC should revise internal rules and guidelines to distribute references for the savings and credit cooperatives to follow the changes of legislation.

The ASCC should also provide a wide range of management consultation, which would enable the savings and credit cooperatives to compete with other financial institutions, as well as in the counseling of legal matters.

Figure 6-7 Financial Supervisory Framework of Savings and Credit Cooperatives

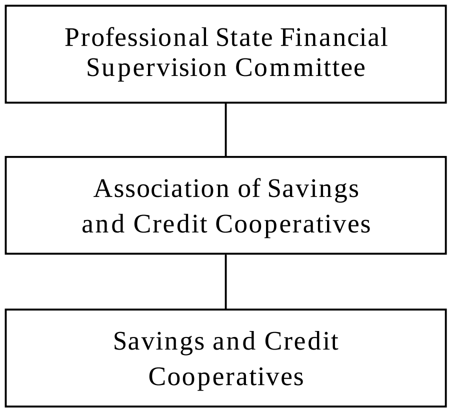


(2) Option B

The major regulator of savings and credit cooperatives is the Professional State Financial Supervision Committee. The daily regulatory and supervisory responsibilities will be delegated to and performed by the Association of Savings and Credit Cooperatives. The ASCC will be regulated and supervised by the Professional State Financial Supervision Committee. SRO responsibilities of the ASCC should be legally defined.

The Professional State Financial Supervision Committee will have the power to intervene and take over direct supervision, if necessary, over any savings and credit cooperative, for any reason.

Figure 6-8 Financial Supervisory Framework of Savings and Credit Cooperatives



CHAPTER 7

Fiscal Sustainability of Mongolia

7.1. Fiscal Sustainability

In Chapter 2, we discuss the vulnerability of Mongolian economy affected by various risk factors ranging from natural disaster to international relationships with neighbor countries. In such circumstances surrounded by the uncontrollable risk factors, the anticipated roles of the government would be to provide the stabilization of the economy through economic growth.

Basically, Mongolian government has two options- monetary policy and fiscal policy. However, as mentioned earlier, due to the recent experience of hyperinflation and the presence of the not-so-stable banking sector, a well-designed fiscal management program may be more appropriate. In our prior knowledge, the Mongolian government has already launched her first Medium Term Expenditure Framework program (MTEF). This we believe, is a right direction to take if it is accompanied with time consistency.

7.1.1. Measures for Fiscal Sustainability

Most commonly used measures for fiscal sustainability are ratios of government debts / GDP and fiscal deficit / GDP. Since the integration of fiscal deficit over time is equal to government deficit, these two ratios encompass the same amount of information mathematically.

According to the definitions by IMF, the government debt is defined as follows:

Government Debt = Central Government Liabilities + Local Government Liabilities
- Local Liabilities to the Central Government

The above definition of the government debt does not include de facto government liabilities such as contingent ones. A true indicator of the government debts should be the sum of the above IMF definition and the following:

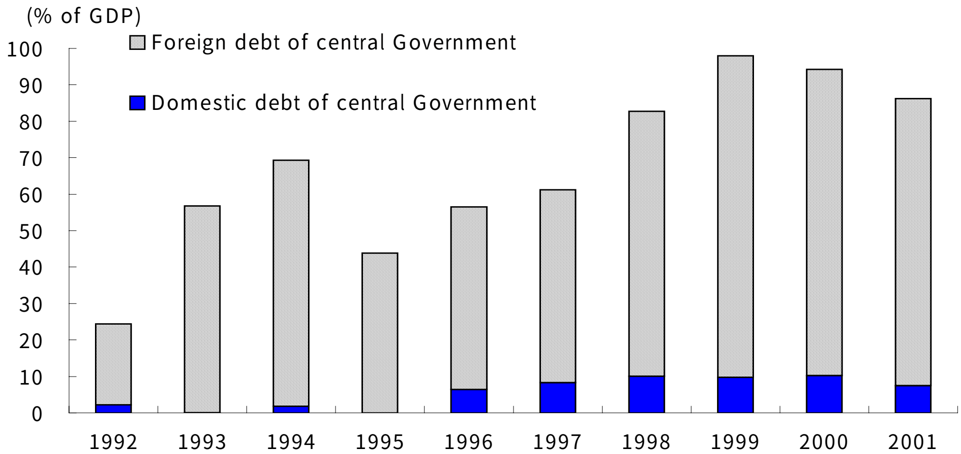
Non-Government Debt = Guarantee of Payment + Central Bank Debt
+ State Owned Companies + Public Pension

National budget accounting system varies from a county to another. Accordingly, it is very difficult to maintain comparability among the data provided by the governments. For the reason, the IMF measure of government debt is widely used for cross-country comparison, though it may underestimate the reality.

7.1.2. Recent Trends

The current Mongolian fiscal system is characterized by the following two points: high growth rate (24.5% (1992) to 86.2% (2001)) of the government debt ratio and heavy dependence (more than 90%) on foreign borrowings.

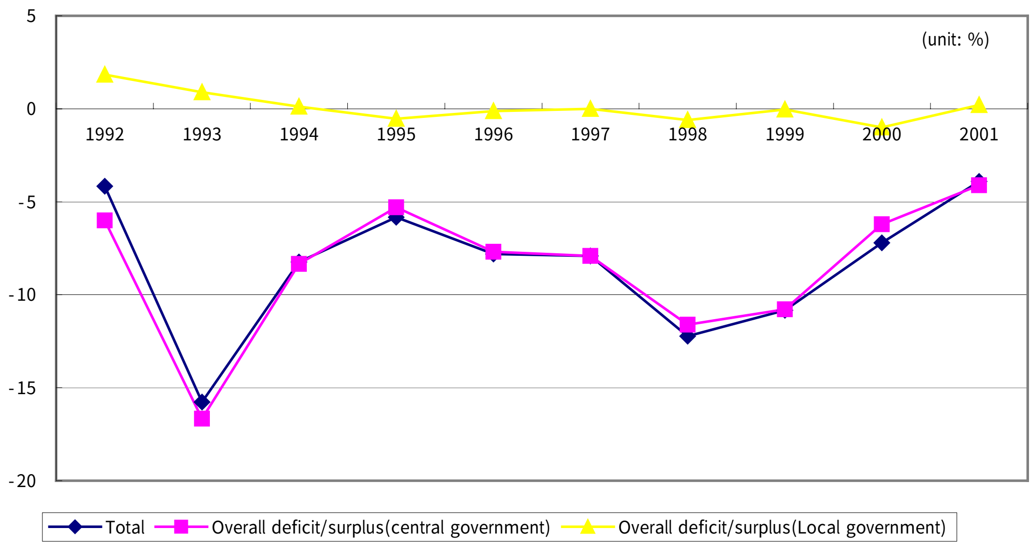
Figure 7-1 Government Debt as a Percentage of Nominal GDP



The above figure displays that the government debt/GDP ratio has been shrinking slightly in recent years. However, the current level (86.2% in 2001) is still high, compared with the OECD average of 70% (1999). In addition, the proportion of foreign borrowings takes almost 90% of the total amount.

The huge fiscal deficits in the early and the late 1990s coincide with the rapidly increasing trend in government debts. Even though the recently declining overall deficit is an inspiring phenomenon, it is hard to tell whether the trend will persist in the long run.

Figure 7-2 Fiscal Deficit as a Percentage of Nominal GDP



Matched with the shrinking government debt/GDP ratios, fiscal deficit/GDP is also shrinking. However, for the same reason we cannot ascertain that the pattern will persist in the long run, especially considering many risk factors embedded in the current Mongolian economy.

7.1.3. Overall Evaluation

Looking at the current fiscal status of Mongolia, it sheds some signs of worries, such as high debt-to GDP ratio and the high fiscal deficits.

$g>r$ is commonly known as a condition for guaranteeing the long run sustainability of government debt[9]. Starting from 1991, there has never been a year in which the real growth rate exceeded the real interest rate. The relation tells that the government policy, especially the fiscal policy, should be designed to expedite the economic growth (g). This doesn't mean that the size of public sector matters. Rather it implies that the allocation of public resources by the government can be critical in determining the future path of the Mongolian economy.

7.2. Policy Recommendations

As discussed in the previous sections, the Mongolian economy is very vulnerable to various uncontrollable risks arising from various sources. Thus, it is extremely critical for the Mongolian economy to have a balanced fiscal status. Holding the extra fiscal capacity, Mongolian government can cope with the risks and preserve the stability of the economy.

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[9] Intuitively speaking, the condition requires that the real economic growth rate should exceed the real interest rate. Otherwise, the government debt would blow out.

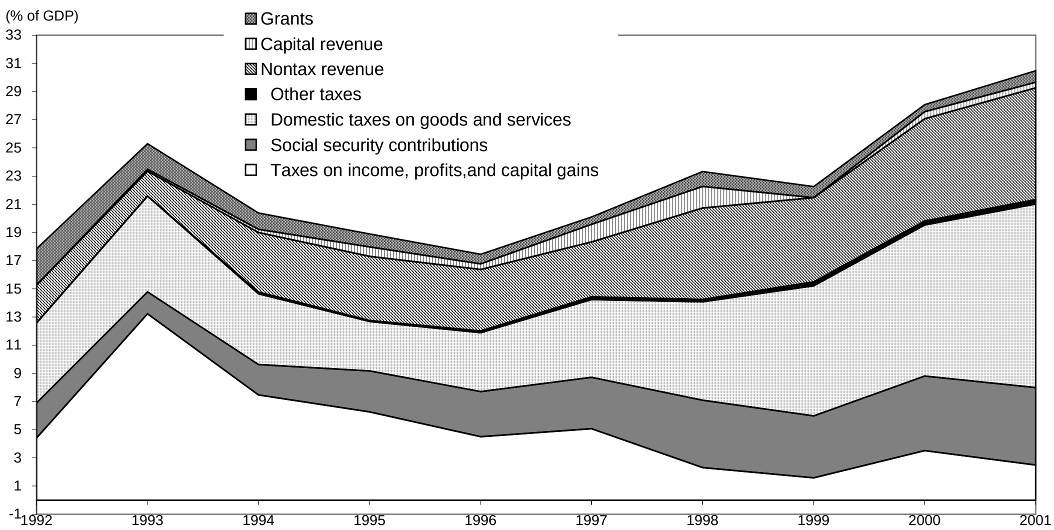
Then, the next question will be how can the Mongolian economy achieve the fiscal sustainability? Basically, there is no royal road to maintaining fiscal sustainability. Only a simple arithmetic relation applies: to increase revenues and reduce spending. Based on the simple arithmetic, we try to deduce policy recommendations for Mongolia in the following sections.

7.2.1. Government Revenues

The next figure shows the compositions of the government revenues for the last 10 years (1992-2001). There are a few notable patterns: First, the shares of income and corporate taxes are declining whereas the share of VAT is increasing. Second, the share of non-tax revenue in comparison with tax revenue is still high. These patterns reflect the shallow tax bases and indicate the need for widening them.

The demographic composition is still far from aging and the deterioration of social security (or pension fund) is not an imminent issue. In contrast, the current level of tax burden (32.8% in 2001) is relatively high. Summing up pros and cons, it is hard to tell whether there is any room for increasing tax revenues. Therefore, the Mongolian government should concentrate on enhancing the efficiency of tax administration service to reduce tax evasion first and then can consider the adjustments of the existing tax schemes and the introduction of new tax items.

Figure 7-3 Government Revenues as a Percentage of Nominal GDP

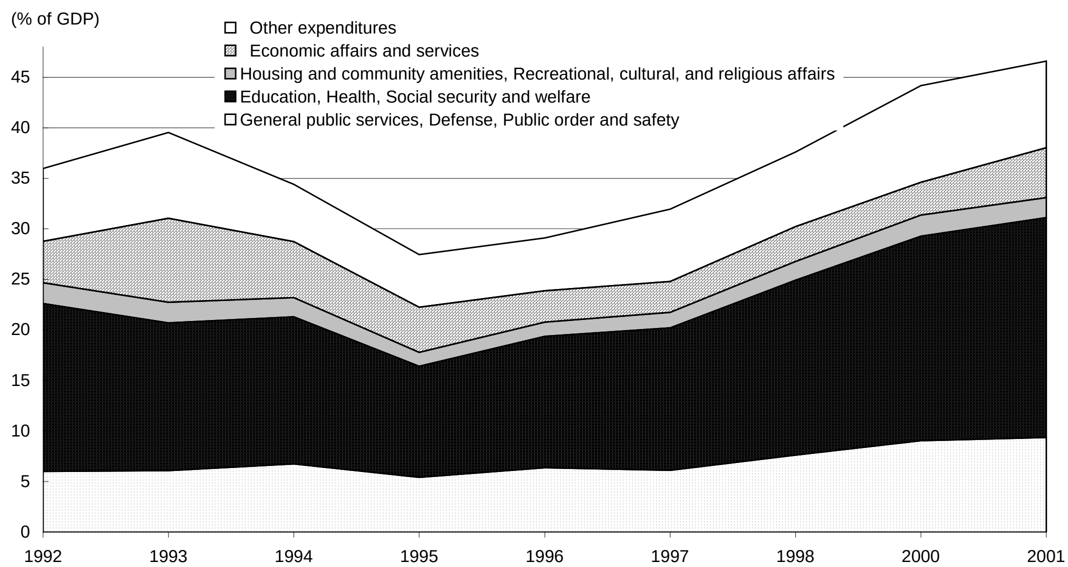


7.2.2. Expenditure

In the expenditure side, the most notable feature is that the share of economic affairs and services has been considerably low, which in turn indicates that under-investment in SOC will persist for a long time. We know that the social infrastructures such as highways and railroads have positive growth effect whereas it usually takes several years to get the benefits from them. Hence, it is recommended that the Mongolian government allocate more resources on building SOCs with consistency.

Another point to mention is the constant high share of budget for education, health, social security and welfare. In some sense, this pattern is a remains of a planned economy. However, these items are still important for the welfare of people even in a market economy system. Furthermore, public investment in education is closely linked with the accumulation of human capital, which eventually will determine the future growth potential of the Mongolian economy. Thus, it is not recommendable to redirect public resources from education, health, social security and welfare to economic affairs and services. Instead, the Mongolian government should expand the share of economic affairs and services, matched with economic growth.

Figure 7-4 Expenditure



7.2.3. The Introduction of Medium Term Expenditure Framework (MTEF)

Mongolia initiated her first MTEF in 2003 following the recommendations from IMF and the World Bank. The following discussion mainly concerns the prerequisites for the successful installation of MTEF in Mongolia, which in turn will improve the fiscal condition of Mongolia.

The MTEF approach stresses that expenditure management is about appropriate policies in the medium term, rather than about cash management in the short term. Where the available cash is the most potent influence on expenditure, management in the normal meaning of the term becomes impossible. MTEF provides more predictable program funding and therefore better management. From the adoption of MTEF, we expect the following outcomes:

i) Improve macro-economic balance by developing a consistent and realistic resource framework;
ii) Improve the allocation of resources to strategic priorities among and within sectors;
iii) Increase the commitment to predictability of both policy and funding so that ministries can plan ahead and programs can be sustained;
iv) Provide line agencies with a hard budget constraint and increased autonomy, and increasing incentives for efficient and effective use of funds.

Implicit in the above are two further gains: to improve the linkage between annual budgeting and medium-term considerations, such as investment plans, borrowing capacity, changing spending policies, and priorities, and to provide information relevant to political decision-makers on the cost implications of expenditure policies.

Much of the necessary changes do not require high-tech solutions, but rather common sense and perseverance. However, we identify seven prerequisites for successfully implementing MTEF in Mongolia.

i) **Good Macro-economic Policies:** Good macro-economic analysis and forecasts are needed as a basis for a MTEF.
ii) **Adaptable Fiscal Policy and Instruments**: The MTEF approach is based on a strong link between macro-economic policy and fiscal policy. Plans for future expenditure must be based on reasonable estimates of prospective resources.
iii) **Reprioritization and Reallocation:** Behind the move to MTEF is a conviction that the annual budget by itself is a poor mechanism for shifting resources from lower-to higher priority use. A major function of an MTEF is to provide better mechanism for aligning budgets with policies.
iv) **Budgetary Discipline:** Budget allocations must be based on a hard aggregate budget constraint derived from what is affordable, and line ministries must live with their budget allocations.
v) **Institutional Conformity and Absence of Bias:** An MTEF requires a supportive institutional base; that is to say, one in which the various actors use the MTEF as a framework within which are taken expenditure decisions. In particular, political decision makers must accept the MTEF as the means by which resources are allocated.
vi) **Appropriate Parameters:** Designing an MTEF requires that its parameters be set. These parameters are the definition of aggregate expenditure to be used, the relationship between the sectoral breakdown and the organizational structure of government, the content of expenditure envelopes, the appropriate price basis for estimating future expenditures, the mechanism for its coordination with the annual budget process, and the degree to which it is to be flexed for different scenarios.
vii) **Transparency:** Fiscal transparency and policy transparency improve the accountability of actors engaged in the MTEF process. Fiscal transparency means being open to the public about the structure and functions of

government, fiscal policy intentions, public sector accounts, and fiscal projections. Policy transparency means being open to the public about what Government intentions are in a particular policy area, which outcomes are to be achieved, and the costs of achieving these outcomes. Also, transparency means reporting actual performance with quality of outputs and results achieved.

A MTEF involves a radical change in the business of budgeting. Consequently, without political commitment, it has little chance of succeeding. Evidence also suggests that a comprehensive approach (all of government) is preferable for introducing an MTEF incrementally, starting with selected sectors and then expanding coverage to all of the government. This is partly a question of data gathering, analysis, and reporting, and partly of people who can both supply and use the information, and the institutional mechanisms for coordinating the efforts of participants.

So far we discussed the rationales for the adoption of MTEF and the conditions for successful working. Thus, most of the claims suggested here are valid for any countries. This section covers “specific” issues regarding the design of MTEF for Mongolia. We emphasize the word “specific” for the following reasons. First, a more detailed description of MTEF system is necessary in the current Mongolian MTEF in practice. Second, country specific factors (Mongolian factors) should be counted.

1) Coverage of MTEF

MTEF should cover the entire consolidated budget in GFS. This means that all the resources under the discretion of government need to be reviewed and prioritized for spending. This comprehensive budget coverage is particularly important considering that MTEF tries to improve resource allocation in line with government priority.

2) Categories of Spendings in MTEF

It is recommended that classification and presentation of budget estimates under MTEF are to be presented in a way to link expenditures to the objectives, outputs and activities clearly. This result-oriented budget structure is, however, not a necessary condition to introduce MTEF. A country may opt to apply existing budget classification and charts of accounts in order for better sectoral allocation. Once this stage of MTEF is internalized, the government can move on to improve budget classification and charts of accounts to produce sufficient information of costing of policy and program, which will further the benefits of efficient resource allocation and financial operation.

MTEF, in its full-fledged form, should provide information as to how much individual program costs and, ultimately, its overall impact. Under this situation, it will be the basis of decision making when programs compete for funding and aggregating of all selected program expenditure will make sectoral budget proposal.

In many countries, including Mongolia, existing budget classification structure, chart of accounts and legal requirement may not allow line ministries to get this information. If so, sectoral ceiling is set first by central budget office using macroeconomic framework, and then line ministries decide how to allocate resources to their programs.

It is recommended that if initial MTEF exercise becomes internalized, the government should consider improving/modifying the budget structure and chart of accounts in order to build a stronger link between resources and priorities.

3) Rules for Selecting a Global Ceiling and Sectoral Ceilings

(1) Who Sets the Ceilings?

Ultimately, overall size of expenditure and sectoral / ministerial limit should be decided / agreed at a ministerial level meeting. What central budget office does is to provide this meeting with medium-term expenditure plan, usually multiple scenarios for different economic and social factors.

It is important to recognize that medium-term expenditure plan, most likely in a multiple number of (contingency) scenarios, which are the technical input into decisions that need to be made at the cabinet meeting on allocation between sectors. Thus the expenditure framework and scenarios are not an end itself, but a tool for improving decision making.

(2) What Factors to Determine Ceilings?

As for the global ceiling, the potential GDP growth rate would be the most reasonable guideline. However, the precise estimation of the potential GDP is not an easy task. Thus, the government revenue forecast is recommended as its proxy. Based on the revenue forecast and the current government debt structure, the Ministry of Planning and Budgeting (MPB) should determine the global ceilings for the next three years.

The determination of the sectoral ceilings is not independent of the factors influencing the global ceiling. In addition to such macro economic factors, the sectoral ceilings should reflect national priorities and the information of the sectoral production efficiency.

(3) Time Consistency of Ceilings-Changeable or Unchangeable?

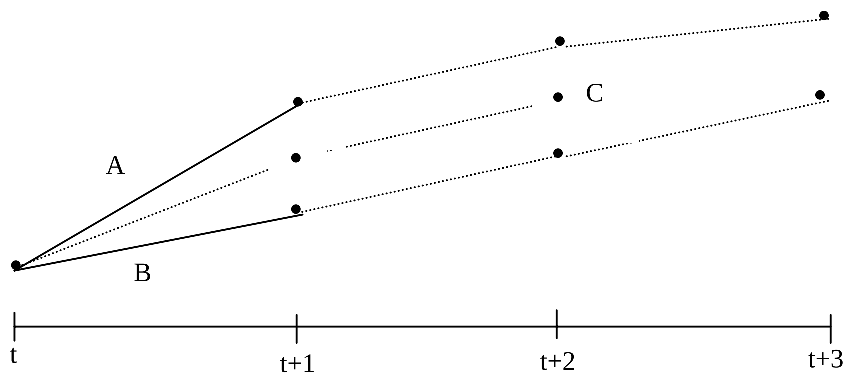
Under the assumption that annual budget is prepared through MTEF process, the previous year's MTEF plan (t) does not necessarily bind the annual budget or the MTEF of this year (*t+1*)[10]. Expenditure perspectives of two or three years included in MTEF should be seen as a guidance. Since the passage of time almost always reveals an unexpected situation, it would be optimal to adjust the original plan following the track of events. For example, the advent of a catastrophy like typhoon would cost a huge amount of unexpected public expenditures.

On the other hand, if a change in the ceilings is permitted frequently and flexibly, the time consistency or the credibility of MTEF will be affected and it will bring about the similar outcome to that of the year-by-year approach.

Figure 7-5 describes the multi-year process of MTEF. C represents the MTEF ceilings determined for the periods (*t*, *t+1*,*t+2*) at *t-1* whereas A and B are the MTEF ceilngs determined for the periods (*t+1*, *t+2*,*t+3*) at *t*. A and B differ by the state of an economy from period *t* to *t+1*. Realization of different paths makes A and B deviate from the original plan C. In order to maintain balance between flexibility and consistency, we have to select the acceptable degree of variation, which sets the boundary of distance between A and C or B and C.

[8] Based on our prior knowledge, Brazil is the only country, which strictly keeps the ceilings set by MTEF for the whole matching time horizon.

Figure 7-5 Cross-Time Procedures of MTEF



In practice, there are several ways to maintaining balance between flexibility and consistency: i) to allow adjustments among the sectoral ceilings while maintaining the global ceiling, ii) to assign different margins of adjustment between the global ceiling and the sectoral ceilings or among the sectoral ceilings, and iii) to decompose the budget items into mandatory spendings and the discretionary spendings and allow different margins of adjustment to them. Each of the above alterations has pros and cons in comparison with others. Hence, it is in the realm of political decision to choose one of them.

7.2.4. General Policy Recommendations

So far we have identified the potential risk factors surrounding the Mongolian economy. Based on this, we addressed why the fiscal consolidation is essential at the current stage of Mongolia. This is because only the balanced fiscal system can insure the national economy against the risks (even partially).

The pursuit of fiscal consolidation is not the only policy goal we suggest. In addition to this, we recommend that Mongolia raise her growth potentials by finding an efficient reallocation of public expenditures since only the stable long run growth of an economy can guarantee the long run fiscal sustainability.

CHAPTER 8

Conclusion

This study is designed to propose ideas for establishing a efficient and sustainable financial system in Mongolia based on the review of her real and financial economic situations and current system.

Prior to the early 1990s, Mongolia had been a centrally planned economy with close ties to the former Soviet Union. In today's modernizing world, the country had remained in a virtually nomadic system with partial industrialization underway in the production of semi-processed raw materials. The economic development was constrained by not only geographic disadvantages but also poor systematic management. This situation began to change in the mid 1990s as the Mongolian became increasingly dissatisfied with the rigidity of the system. After the first elected coalition government took its office in July 1990, it pledged to make a transition to market-oriented economy. Since then, Mongolia embarked upon a comprehensive program of reforms covering the entire spectrum of economic policies, including financial reforming measures such as establishment of two tier banking system, enactment of new laws, and regulations favorable to private participation.

In spite of relative success to other transition economies, Mongolia's recent experiences have been filled with trials and errors. For the four years after the declaration of transition to a market economy, overall macro indices had deteriorated. It was not until 1994 when Mongolia achieved positive growth. In 1996, the Mongolian economy was hit by a succession of adverse developments that reversed some of the previous progress. It was not just bad luck that Mongolia was subject to these adverse shocks that emerged in 1996. As a matter of fact, Mongolia has encountered numerous sources of risks due her geographical location and disadvantageous climate conditions. In addition, Mongolia's heavy dependence on the natural resources and elementary industries like copper mining and cashmere makes her even further exposed to huge uncertainties. These risk factors embed probabilities to ignite a recession or even a crisis at all times so that actual occurrence of the recession in 1996 was not itself a shocking event.

The disrupted growth in the real sector led the crisis in the banking sector. The 1996 Banking Crisis started with the collapse of a private bank and closure of two large banks whose deposits represented about half of the entire deposits, but was rooted by the real economic recession. To overcome the crisis, the government took reform measures such as closing insolvent banks and establishing institutions to manage surviving but still ailing banks and their non-performing loans. The Mongolian Asset Recovery Agency (MARA), for example, is the agency that was to resolve non-performing assets. Up until 2003, MARA's performance has been evaluated to be lower than expected. The asset recovery ratio remains only 26.5 percent out of the entire acquired NPLs as of the end of the first half of 2003 and the recent performance get worse. In fact, it seems difficult for MARA to get recovery from their existing assets because of deficiencies in the infrastructure and incentive schemes related to NPL resolution. Thus, Mongolia should focus on minimizing future crisis overcoming costs rather than making efforts to recover existing NPLs. Institutional strengthening of credit examination and evaluation, controlling of various moral hazards including the ones from the government, and systemic improvement in insolvency and accounting are strongly recommended.

The Mongolian government is trying to modernize its financial system by becoming equipped with financial safety net. One of the examples is introduction of the deposit insurance scheme. Though it is one of the best practices for boosting financial stability, deposit insurance does not come without costs. On the one hand, deposit insurance is an outcome of market failures so that its existence tends to invite the moral hazard problems of commercial banks and government. Even with the explicit deposit insurance scheme, on the other hand, most countries tend to get intervened in the problematic banks with the taxpayers' money because the deposit insurance fund is not usually sufficient to suppress the symptoms of systemic crisis. This is especially true to most developing and underdeveloped countries. Then, the Mongolian government should answer to the question what would be the benefits and costs of the deposit insurance system. Also, many loopholes in the draft of Law on Deposit Insurance should be reconsidered. Otherwise, the deposit insurance scheme will continue contribute to the prevalence of moral hazards of the wealthy individuals under the current environment.

The non-bank financial institutions (NBFIs) are also bringing about uncertainties in the financial intermediation in Mongolia. They have positive influences such as providing financial services with the rural areas. In view of the current operations of the NBFIs that run business mostly in the Ulanbataar area, they do not seem to contribute to the original intention of activating the financial services. Rather, they are utilized as apparatus with which most wealthy individuals take upside profits without taking downside risks. Thus, a thorough supervisory system should be established. Clear and transparent operations of the system are recommended to include identification of the governance and major financial transactions with the related persons.

On top of the aforementioned policy prescriptions for the efficient and effective management in the financial system, Mongolia should be careful to maintain fiscal soundness because all the preemptive preparations for the crisis may not be enough in Mongolia. That means, ultimately the government will inevitably end up engaging in the crisis management processes, which asks for fiscal budgets. The government should play a role as the lender of the last resort to significant risks that cannot be under control by the financial sector.

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Appendix A. Law On Deposit Insurance

CHAPTER ONE
General Provisions

Article 1. Purpose of the Law

1.1 The purpose of this Law is to define the legal framework for conducting Deposit insurance activities in the territory of Mongolia, to describe eligible types of deposit, amount, to establish Deposit Insurance Organization, its management and to regulate relations regarding deposit insurance between depositor, bank and Deposit insurance organization.

Article 2. Laws and Legislation on Deposit Insurance

2.1 Legislation on Deposit insurance shall consist of the Constitution Law of Mongolia, the Civil Code, Law on Insurance and this Law and other legislative acts enacted in conformity with them.

2.2 If the provisions of the international treaties, to which Mongolia is a signatory, are inconsistent with them, then the provisions of the international treaties shall prevail.

Article 3. Definitions of the Law

3.1 Following definitions of this law shall be understood in the below-mentioned meanings:

3.1.1 "**Deposit Insured by Deposit Insurance**" means **-** types and amount of monetary fund described in the Article 5, deposited by citizens with a bank that insured against Deposit insurance.

3.1.2 "**Terms of Deposit**" means period of time, its interest rate amount and regulation to compute currency deposit and liabilities and rights of the parties.

3.1.3 "**Subscribed Currency to Deposit Insurance Organization**" /furthermore referred as "shared capital"/ means bank's monetary contribution to the Charter Fund of Deposit Insurance Organization.

3.1.4 "**Deposit Insurance Duty**"/furthermore referred as "duty"/ is an amount and sequence of currency payment defined in the Article 12 of this law, payable by bank for the insurance services of its deposits to Deposit Insurance Organization.

3.1.5 "**Compensation of Deposit Insurance**" means compensation payment, made to insured, in case of occurrence of such circumstances defined in the Article 17, Section 1 in an amount defined in the Section 2 of the same Article by Deposit Insurance Organization.

3.1.6 "**Insurer**" means Deposit Insurance Organization

3.1.7 "**Insured**" means a bank, member of Deposit Insurance Organization, which has insured its deposits, deposited by citizens, to Deposit Insurance Organization.

Article 4. Deposit Insurance

4.1 Deposit insurance is a social and economic measure in order to secure rights of small deposit owners, banks /further referred as "insured"/ pay duties as per stated in the Article 12 with the intention to establish Deposit insurance Fund and in case the insured became insolvent, bankrupt or dissolved by the decision of relevant Authority, the compensation payment shall be paid in an amount defined in the Article 17 Section 2 of this law.

4.2 Deposit insurance shall be only in compulsory form.

Article 5. Scope and Amount of Deposit Insurance

5.1 Insurer shall insure saving account of citizen of Mongolia, deposited in the bank, in an amount of up to 5 million tug rugs or equivalent amount in foreign currency.

5.2 Accumulated interest on deposit in accordance with terms of Deposit Agreement, shall be included/excluded in/from the restriction amount mentioned in the Section 1 of this Article.

5.3 If the deposit owner has any financial obligation towards bank under Loan and Guarantee Agreement, then such financial obligation shall be deducted from relevant compensation payment.

5.4 In case the deposit is jointly owned, the compensation payment shall be calculated for each owner and must not exceed the restriction amount defined in the Section 1 of this Article.

5.5 The following forms of deposit cannot be insured by deposit insurance:

5.5.1 A deposit saved in the name of the third person and not owned by himself/herself legally.

5.5.2 A deposit, which belongs to a shareholder, who owns more than 5 percent of total Deposit Insurance Fund; a deposit of an auditor appointed by the shareholders meeting; a deposit owned by Chair of National Board, its members, CEO /Chief Executive Officer/ and internal auditors, their relatives.

5.5.3 Certificate of deposit /CD/

5.5.4 Non-negotiable deposit

Article 6. Deposit Insurance Agreement

6.1 Insured must enter with insurer into Deposit Insurance Agreement, in accordance with terms and conditions consistent with this law.

CHAPTER TWO
Deposit Insurance Fund, Its Disbursement

Article 7. Deposit Insurance Fund

7.1 The minimum required amount of the Deposit Insurance Fund shall be 5 billion tugriks. The minimum amount can be adjusted by the State Great Khural /the Parliament/.

7.2 The Deposit Insurance Fund shall comprise from following currency:

7.2.1 Ministry of Finance an Economy, Bank of Mongolia, Banks respective monetary contribution.

7.2.2 Duties paid by insured.

7.2.3 Incomes generated from the operation defined in the Article 8 of this law.

7.2.4 Incomes from sale of assets of the dissolved Insured.

7.2.5 Donations, grants and loans of international institutions and the government.

Article 8. Disbursement of the Deposit Insurance Fund

8.1 Disbursement from the Deposit Insurance Fund shall be made solely on covering principal and interest compensation payment as defined in the Article 17 of this law and the organization's incremental operating costs.

8.2 Up to 60 percent of the outstanding amount of the Deposit Insurance Fund can be invested to the following types of assets:

8.2.1 To purchase the government securities

8.2.2 To open saving account with the Bank of Mongolia

8.2.3 To purchase other financial instruments, comparable to the Bank of Mongolia's and the government's securities.

Article 9. Deposit Insurance Fund's Budget Approval

9.1 Income and expenditure budget of the Deposit Insurance Fund shall be approved by Deposit Insurance National Board /further referred as "National Board"/.

Article 10. Preparing Balance Sheet of Deposit Insurance Fund and Reporting

10.1 Insurer shall book keep by case by case of insured – Deposit owner's paid duties and shared capital based on Deposit Insurance Book and the Certificate.

10.2 The National Board shall approve procedures to raise money to the Deposit Insurance Fund, on its disbursement to record and to report.

Article 11. Tax Exemption

11.1 Deposit Insurance Fund shall be exempt from any taxes.

CHAPTER THREE
Deposit Insurance Duties, Amount of Shared Capital

Article 12. Deposit Insurance Duties, Amount of Shared Capital, Repayment Period

12.1 The bank's contribution to the Charter Fund of the Deposit Insurance Fund shall equal to 0.1 percent of total insured deposits.

12.2 Duties payable quarterly, shall be equivalent up to 0.05 percent. The National Board shall determine duty rate in a given period of time conditional on financial and solvency capacity of Insured in an amount of as per defined in the Article 17, Section 7.2.

12.3 Insured must pay within three working days the membership fee upon entering into Deposit Agreement with Insurer. Insured shall pay penalty in accordance of relevant law for its failure to pay due time.

12.4 Quarterly duty payments shall be made within ten days of the first month of next quarter. For each overdue day Insured shall pay penalty in accordance of relevant law for its failure to pay due time.

Article 13. Procedure on Duty Payment of Deposit Insurance.

13.1 The National Board shall approve Procedure on Duty Payment of Deposit Insurance.

Article 14. Termination of Deposit Insurance Duty, Transfer

14.1 The obligation of insured to pay duty on Deposit Insurance shall be terminated or transferred in the following cases:

14.1.1 Insured has became dissolvent and/or insolvent by the official decision of authorized authority.

14.1.2 Insured has transferred its deposits, deposited by individual citizens to others, or in case insured has zero outstanding deposits.

CHAPTER FOUR
Deposit Insurance Compensation

Article 15. Right to Receive Deposit Insurance Compensation

15.1 Depositors those paying duties in consistency with the relevant provisions and procedures set out in the Deposit Insurance Law, and those holding deposit accounts in banks insured with deposit insurance, shall enjoy the right to receive deposit insurance compensation from the deposit insurance reserve fund.

15.2 Detailed provisional procedure for extending of compensation from deposit insurance reserve fund shall be determined by the National Board.

15.3 Failure in payment of deposit insurance duties due to the fault of insured bank shall not be deemed as a basis for withholding compensations to depositors.

Article 16. Authorization for Compensation Payment.

16.1 The National Board shall issue authorization for insured to execute compensation payment to depositor based on depositor's request and other supporting documents specified by relevant laws and regulations.

16.2 Deposit insurance organization shall, upon receipt of depositor's request for compensation, respond in accordance with provisions agreed in deposit agreement.

Article 17. Provisions, Principles and Amount of Compensation Payment.

17.1 In case if authorities (the Court, Mongolbank, shareholders meeting) announce of insured to become insolvent and make decision on latter's dissolution and receivership, insurer shall execute compensation payment.

17.2. Sum equivalent to 100 percent of currency deposit up to one million tugriks, and 95 percent of currency deposit over one million and up to five million tug rugs respectively, shall be paid as compensation.

17.3. The National Board shall specify methods for calculation of amount of compensation and establish procedures for settlement.

17.4. Insurer shall, within 14 days after issuance of authorization mentioned in Section 17.1 of this Article, execute compensation payment through any commercial bank.

17.5. Amount of insurance compensation for jointly owned deposits shall be calculated by each owner respectively.

17.6. In calculation of insurance compensation for foreign currency deposits, exchange rates of Mongolbank at the given date shall be applied.

17.7. If resources at the deposit insurance reserve fund become insufficient to cover compensation payments, funds shall be raised and payments shall be made in the following manner:

17.7.1 to calculate and collect duties from insured in advance, referring to deposit record of last day of previous month and consequently deduct the appropriate sum from insured's due payables, in the next year,

17.7.2 to increase the amount of quarterly payable duties by not more than 0.5 percent of total amount of deposit,

17.7.3 in case if the funds raised in the manner mentioned in Sections 17.7.1 and 17.7.2 will not be sufficient for compensation payments, in accordance with provisions and procedures under other laws and regulations that regulate activities of the organization, proceed with resolution from the State Great Khural for extension of budget loan.

CHAPTER FIVE
Deposit Insurance Organization

Article 18. Deposit Insurance Organization

18.1 Deposit insurance organization (hereinafter referred to as the "insurer") is a state shared (comprising of shares from the state or the Ministry of Finance and Economy, the Mongolbank and other banks) independent legal body enjoying one's rights and responsibilities.

18.2 Insurer shall run its activities under supervision of the National Board for deposit insurance and shall use seal, stamp and letterhead made according to specified format. Insurer may have its own symbolic device.

18.3 Insurer may establish branch offices. Rules and procedures for branch operation shall be determined by the National Board.

Article 19. Relations between Deposit Insurance Organization and Public Organization.

19.1 The state shall not be attached of duties of deposit insurance organization and deposit insurance organization shall not bear responsibilities of the state.

Article 20. Prohibitions in Activities of Deposit Insurance Organization.

20.1 Deposit insurance organization is prohibited to run commercial activities and to establish business entities.

Article 21. Guidelines for Activities of Insurer.

21.1 Insurer shall be engaged in following main activities:

21.1.1 to apply the amount of fees and duties paid by the insured depositor as specified by the National Board and collect proceeds;

21.1.2 to raise deposit insurance reserve funds through allocating resources in form of assets indicated in Section 8.2;

21.1.3 in case if circumstances described in Article 17 will occur compensation payment for insured deposits shall be executed in order specified by the law, and;

21.1.4 in case if the outstanding amount of deposit insurance reserve fund will exceed the 40 percent of total insured deposits, the extra funds will be returned with respect to the amount of duties paid by insurer to insured.

21.2 Insurer shall open its bank account at the Mongolbank.

21.3 Insurer shall enjoy the right to claim, according to laws and regulations, insured for compensation of losses and damages, after executing compensation payments for depositors.

Article 22. Management of Deposit Insurance Organization.

22.1 The National Board shall be the supreme power to manage deposit insurance organization.

22.2 The National Board shall comprise of 5 members (if considered that participation will be determined by shares all banks involved will have their representatives). Board's membership shall be tied to fund's share structure.

22.2.1 The Minister for Finance and Economy;

22.2.2 The Governor of Mongolbank;

22.2.3 Authorized representative for banks, and;

22.2.4 2 independent members.

22.3 Authorized representative for banks shall be proposed by the Association of Banks, 2 independent members shall be considered as a result of discussions with the Minister for Finance and Economy and the Governor of Mongolbank, and all formally appointed by the State Great Khural respectively.

22.4 Authorized representative(s) for banks and 2 independent members shall be appointed for a period of 3 years.

22.5 The Minister for Finance and Economy and the governor of Mongolbank shall remain members of the Board for the period of their principal appointment.

Article 23. Principles of the National Board Activities

Issues discussed by the National Board shall be considered by vast majority of members. National Board Meeting is valid with 72 percent of attendance.

Article 24. Rights and Responsibilities of National Board

24.1 National Board shall exercise following rights:

24.1.1 To approve organization's long term direction, budget, plan, structure of and number of positions.

24.1.2 To approve procedures on internal rules, regulation and guidelines consistent with the job.

24.1.3 To appoint CEO of the organization for 6 years, to release him / her, to establish remuneration and to monitor.

24.1.4 To determine CEO's power and competence to … and set the responsibilities.

24.1.5 To select the internal auditors group, to set their respective remunerations and to report.

Article 25. Rights and Responsibilities of the Executive Director

25.1 The Executive director shall enjoy and bear following rights and responsibilities:

25.1.1 to manage and coordinate daily activity of the organization;

25.1.2 to appoint and release employees, determine amount of their salaries and wages, grants incentives and impose administrative measures / penalties;

25.1.3 to provide the National Board with quarterly report on organization's activities, and;
25.1.4 to announce and organize extraordinary sessions of the National Board, and initiate proposals for consideration.

Article 26. Requirements for Some of Members of the National Board and the Executive Director

26.1 Authorized representatives for banks, two independent members and the Executive Director shall respond to the following requirements:
26.1.1 possess university degree in banking and financing;
26.1.2 have not less than 5 years of working experience in bank;
26.1.3 shall not be shareholders nor members of board of directors or executive directors of given banks;
26.1.4 not having any overdue debt under any loan and guarantee agreements;
26.1.5 not having experience of executive director of any bankrupted or dissolved bank;

26.2 Authorized representatives for banks and two individual members shall be released from the National Board in the following cases:
26.2.1 Became ineligible/disqualified as per defined in the Section 3, 4 and 6 of this Article.
26.2.2 Committed harmful act against interests of Deposit Insurance Organization (DIO).
26.2.3 Has requested to be released himself/herself by reason of medical condition or for other acceptable motives.
26.2.4 Has fallen under interest contradiction /moral hazard/

Article 27. Releasing the Executive Director from His Duty

27.1 In the following cases the CEO shall be released from his duty:
27.1.1 The completion of his/her term
27.1.2 Has become non-responsive to the requirements defined in the Article 26.

Article 28. Financial Statements of the DIO

28.1 The DIO shall prepare its financial statements on a quarterly basis.

Article 29. Auditing

29.1 The DIO shall have its quarterly financial statements approved by the authorized auditor.

CHAPTER SIX
Consolidated Deposit Database

Article 30. Consolidated Deposit Database

30.1 Data and information on insured's deposit shall be collected and recorded into the DIO's database. Operational procedure for the database shall be approved by the National Board.
30.2 Insured shall provide the database with accurate, reliable and true information on his/her deposit.
30.3 Insurer shall ensure confidentiality of database information.

CHAPTER SEVEN
Supervision, Monitoring and Liabilities

Article 31. Auditing and Monitoring of Insurer's Activities.

31.1 Supervising and Monitoring Committee, appointed by the National Board, shall conduct supervision and monitoring over insurer's activities.

31.2 Insurer shall make its activities in consistency with banking supervision.

31.3 Members of the Supervising and Monitoring Committee shall comprise of officials from the Ministry of Finance and Economy, Mongolbank and other auditing organization.

Article 32. Liabilities for Breach

32.1 In case if any act violating this law is not deemed as a criminal offense, following penalties shall be imposed:

32.1.1 for breach of paragraph ____ of this Article, a fine of _____ tugriks shall be imposed;

32.1.2 for breach of paragraph ____ of this Article, a fine of _____ tugriks shall be imposed;

32.1.3 for breach of paragraph ____ of this Article, a fine of _____ tugriks shall be imposed, and;

32.1.4 for breach of paragraph ____ of this Article, a fine of _____ tugriks shall be imposed.

Appendix B. Non-Banking Financial Operations Law

CHAPTER ONE
General Provisions

Article 1. Purpose of the Law

The purpose of this Law is to establish legal foundations for non-banking financial activities and to regulate relations concerning management, organizational and monitoring structures, licensing and suspension or revocation of licenses of entities conducting non-banking financial activities.

Article 2. Legislation on Non-Banking Financial Activities

2.1. The legislation on non-banking financial activities is comprised of the Civil Code, Company Law, Banking Law, Law on Licensing, this law and relevant legislative acts.

2.2. If an international treaty which Mongolia has joined stipulates otherwise, then the provisions of the international treaty shall prevail.

Article 3. Scope of the Law

3.1. This law shall regulate relations concerning the activities stated in Section 7.1 of this law by the entity which has obtained a license from the Bank of Mongolia.

3.2. Banking, insurance, security business, pension funds, saving and loan cooperatives, pawnshops, project unit, government's special purpose fund shall be regulated by other related laws.

Article 4. Definition of the Terms

4.1. In this law, the following terms shall have interpreted as mentioned below:

4.1.1. "Non-banking financial activities" shall mean services stated in Section 7.1 of this law by the business entity, which has obtained the license from the Bank of Mongolia;

4.1.2. "Factoring" shall mean sale (transfer) by creditor of its right to monetary payment to a third party who thereafter becomes liable for exercise of the right to the payment and for any consequences;

4.1.3. "Financial leasing" shall mean leasing of an equipment, manufactured or purchased in the lessor's or supplier's name upon order or selection by the lessee, on certain conditions, for a certain term and remuneration;

4.1.4. "Issuing a guarantee" shall have the meaning described in Section 457 of Civil Code;

4.1.5. "Electronic payment and remittance service" shall mean wire transferring other's cash through own current account with a bank, or settlement of payments using Internet, automatic equipment or electronic payment means;

4.1.6. "Foreign currency transactions" shall mean sale or purchase of a foreign currency, or issuance of a loan or a guarantee in a foreign currency;

4.1.7. "Trust service" shall mean an arrangement whereby a trustee temporarily controls, uses and manages assets (cash, loan, other assets) of a beneficiary on the basis of an agreement with the beneficiary with the purpose of preserving the value of the assets and earning a profit;

4.1.8. "Investment into short-term financial instruments" shall mean conversion of the funds of an individual or a legal person into investment securities or similar financial instruments with maturity of up to 1 year on the basis of a mutually agreed contract;

4.1.9. "An entity engaging in non-banking financial activities" shall mean a person stated in Section 6.1 of this Law;

4.1.10. "Assets, liabilities and capital of the non-banking financial institution" shall have the meaning described in the accounting regulations approved by the Bank of Mongolia in conformity with international standards.

CHAPTER TWO
Engaging in Non-Banking Financial Activities

Article 5. Incorporation of an Entity Engaging in Non-Banking Financial Activities

5.1. An entity engaging in non-banking financial activities shall be established according to the Company Law.

Article 6. Conducting the Non-Banking Financial Activities

6.1. Non-banking financial activities shall be conducted by a legal person of Mongolia or a foreign legal person authorized by an intergovernmental agreement in accordance with the license issued by the Bank of Mongolia.

6.2. A legal person financed from the state budget, a religious, or political, or nongovernmental organization shall be prohibited from engaging in non-banking financial activities stated in Section 36.2 of Civil Code.

Article 7. The Non-Banking Financial Activities

7.1. The non-banking financial activities shall include the following:

7.1.1. Lending;
7.1.2. Factoring;
7.1.3. Financial lease;
7.1.4. Issuing a guarantee;
7.1.5. Issuing payment instruments;
7.1.6. Electronic payment, remittance service;
7.1.7. Foreign currency exchange;
7.1.8. Trust service;
7.1.9. Investment into short-term financial instruments;
7.1.10. Provision of investment and financial consultancy and / or information services.

Article 8. Application Documents

8.1. Person applying for the license to engage in the activities stated in Section 7.1 of this law, shall file documents stated in Section 11.1 of Law on Licensing as well as the following additional documents:

8.1.1. Charter of the entity engaging in non-banking financial activities and incorporation documents;
8.1.2. Business plan;
8.1.3. Documents confirming availability of the minimum capital determined by the Bank of Mongolia;
8.1.4. Audited financial statements;
8.1.5. Information about personnel, equipment and job descriptions;
8.1.6. Registration of shareholders, number of shares owned [by each shareholder];

8.1.7. Income statement and information about the origin of funds of a shareholder who owns more than 10 percent of the total shares of the entity engaging in non-banking financial activities;

8.1.8. Charter, shareholder registration, the financial documents of the last 3 years and conclusion of an audit institution of a legal person which owns more than 10 percent of the total shares of the entity engaging in non-banking financial activities.

8.2. If the Bank of Mongolia deems the application documents filed in accordance with the Section 8.1 of this law as incomplete or unclear, it can obtain a reference about a founder, a shareholder or management of the entity engaging in non-banking financial activities from relevant organizations.

Article 9. The License to Engage in Non-Banking Financial Activities

9.1. The Bank of Mongolia shall examine the application documents for the license to engage in non-banking financial activities within 30 working days and shall grant the license to engage in non-banking financial activities if each of the following requirements has been met:

9.1.1. Capital of the entity engaging in non-banking financial activities has reached the minimum amount of the capital determined by the Bank of Mongolia;

9.1.2. Strategies and other contributing factors to conduct the non-banking financial activities have been sufficiently stated in the business plan;

9.1.3. Management of the entity engaging in non-banking financial activities has satisfied the criteria stated in Sections 13.5 and 13.6 of this law;

9.1.4. Equipment of non-banking financial institution satisfies safety operation requirements.

9.2. If it is necessary to inspect the filed documents in a more detailed manner, the Bank of Mongolia may prolong the period stated in Section 9.1 of this law by 14 days.

9.3. Certificate of the license shall explicitly indicate a type and duration of the non-banking financial activities to engage in.

9.4. Branch, representative office or other units of the entity engaging in non-banking financial activities shall be established with the permission of the Bank of Mongolia

Article 10. Charter of the Entity Engaging in Non-banking Financial Activities

10.1. Charter of the entity engaging in non-banking financial activities shall include items stated in Section 16.2 of the Company Laws well as the following additional items:

10.1.1. Amount of the owner's equity (capital);

10.1.2. Management and organizational structure of the entity engaging in non-banking financial activities;

10.1.3. Regulation for holding a meeting of shareholders and the board of directors.

10.1.4. Regulation on internal audit.

10.2. Changes or amendments to the charter of the entity engaging in non-banking financial activities shall be registered with the Bank of Mongolia within 10 working days after the decision of such change or amendment has been made.

Article 11. Name of the Non-Banking Financial Institution

11.1. Name of non-banking financial institution shall consist of its own name and the word "The non-banking financial institution" or the abbreviation "NBFI".

11.2. It shall be prohibited for any legal person other than the one with the license to conduct the activities stated in Section 7.1 of this law to use the word "The non-banking financial institution" or the abbreviation "NBFI".

11.3. The non-banking financial institution shall change its name and location with the permission by the Bank of Mongolia.

CHAPTER THREE
Prohibitions and Requirements for the Entity Engaging in Non-Banking Financial Activities

Article 12. Prohibitions for the Entity Engaging in Non-Banking Financial Activities

12.1. The following activities shall be prohibited for the entity engaging in non-banking financial activities:

12.1.1. Conduct activities other than those stated in the license;

12.1.2. Make false or misleading advertisements or statements related to its activities;

12.1.3. Accept deposits or open deposit accounts of individuals and legal persons;

12.1.4. Accept deposits by issuance of payment instruments such as cheque, card, or promissory note;

12.1.5. Use sources of funding that are not reflected in the balance sheets.

12.2. Section 12.1.1 of Current law shall not apply to temporary possession and sale of assets taken as collateral for purposes of recovering a loan.

12.3. The shareholder, the chairman and members of the board of directors, executive director and officers of the non-banking financial institution shall not disclose or use any information which is considered by the non-banking financial institution, its customers, and/or third parties as confidential except in the cases stated in Section 7.2 of the Banking law.

Article 13. Requirements for Non-Banking Financial Activities

13.1. The total amount of loans, assets equivalent to a loan, and guarantees issued to one borrower and related parties by the non-banking financial institution shall not exceed 30 percent of non-banking financial institution's capital.

13.2. The total amount of guarantees issued by the non-banking financial institution shall not exceed 70 percent of the non-banking financial institution's capital.

13.3. The maximum amount of loans, assets equivalent to a loan, and guarantees issued to one shareholder, the chairman or a member of the board of directors, or the executive director, an officer of the non-banking financial institution or a person stated in Section of 3.2.1 of the Banking law shall not exceed 10 percent of the non-banking financial institution's capital and their aggregate sum shall not exceed 25 percent of non-banking financial institution's capital. In addition the provision of the loans, or assets equivalent of loans or guarantees to the above persons shall meet the following requirements:

13.3.1. The loan shall not be collateralized by of the paid capital of the nonblank financial institution;

13.3.2. An individual shall not be permitted to take part in management activities of the non-banking financial institution in any form if the repayment of the loan made by the bank to that person becomes overdue for more than six months.

13.4. Prudential ratios on reserve fund, liquidity, capital adequacy, loan loss provisioning, foreign currency exposure and other criteria shall comply with requirements set by the Bank of Mongolia.

13.5. The chairman, members of the board of directors and the executive director shall meet the following criteria:
13.5.1. No overdue obligations under a loan or guarantee contract;
13.5.2. No criminal records;
13.5.3. Ethical and business reputation shall not adversely affect the management of the non-banking financial institution.
13.6. The executive management of the non-banking financial institution shall have education and work experience in the field of banking and finance.

CHAPTER FOUR
Capital and Financial Statements

Article 14. Capital of the Non-Banking Financial Institution

14.1. The non-banking financial institution shall have own capital. The capital shall be calculated according to accounting regulations approved by the Bank of Mongolia.
14.2. The capital shall consist of cash funds of shareholders of the non-banking financial institution and the minimum amount of the capital shall be determined by the Bank of Mongolia upon consideration of the national economic situation, inflation rate, liquidity and specifics of the type of the activities of the non-banking financial institution.
14.3. The non-banking financial institution shall increase or decrease an amount of capital by profit or loss, or excess or deficiency of the loan loss provisioning.
14.4. The shareholders of the non-banking financial institution shall bear financial liability to the extent of their invested contribution to the capital of the non-banking financial institution.
14.5. The non-banking financial institution shall inform the Bank of Mongolia of any changes in the amount and structure of the capital or composition of the shareholders and receive permission from the Bank of Mongolia.
14.6. The Bank of Mongolia shall issue a regulation concerning an increase or decrease of the capital, issuance of new shares, sale or transfer of shares.

Article 15. Financial Statements and Its Disclosure to the Public

15.1. Financial statements of a nonblank financial institution shall consist of balance sheet, profit and loss statement, cash flow statement, footnotes and clarifications.
15.2. Indicators of the financial statements of the non-banking financial institution shall conform to the accounting standards set by the Bank of Mongolia in accordance with the international standards.
15.3. The non-banking financial institution shall submit its annual and quarterly financial statements to the Bank of Mongolia. The Bank of Mongolia reserves a right to request any additional documents related to the financial statements of the non-banking financial institution.
15.4. The non-banking financial institution shall disclose to the public through the media, the audited financial statements of the previous financial year within the first quarter of the next year.
15.5. The Bank of Mongolia shall require from the non-banking financial institution to correct the financial statements or information which has been disclosed to the public if it was not made in accordance with the relevant regulations, or was incorrect or false.

Article 16. Auditing of the Financial Statements

16.1. The non-banking financial institution shall have its financial statements, other required documents and information audited by an auditing institution /auditor/ at least once a year.

16.2. The auditing institution /auditor/ shall submit its auditing conclusions on the financial statements and other documents to the Board of Directors and Board of Auditors of the non-banking financial institution.

Article 17. Submission of the Auditor's Conclusions to the Bank of Mongolia

17.1. The auditing institution /auditor/ shall submit the original copy of its final conclusions to the audited non-banking financial institution and the Bank of Mongolia.

17.2. The auditing institution /auditor/ shall immediately inform the Bank of Mongolia of its conclusions when the following conclusions are made on the basis of the documents provided by the non-banking financial institution:

17.2.1. If the non-banking financial institution has become insolvent or may experience an exceptionally difficult financial situation in the near future due to possible insolvency;

17.2.2. If it has been considered that a staff of the non-banking financial institution has engaged in unfair or illegal operations, which have had negatively impacted the financial situation of the non-banking financial institution.

Article 18. Conditions for Restructuring and/or Dissolution of the Non-Banking Financial Institution by the Decision of the Shareholder Meeting

18.1. The meeting of the shareholders may decide to dissolve or restructure the non-banking financial institution upon approval by the Bank of Mongolia.

18.2. The following documents shall be submitted to the Bank of Mongolia in order to dissolve or restructure the non-banking financial institution:

18.2.1. Decision of the shareholder meeting to restructure or dissolve the non-banking financial institution;

18.2.2. Documents describing needs, forms, conditions, and schedule of the restructuring or dissolution, restructuring measures, their schedule and stages, relevant financial statements prepared by an auditor and discussed by the shareholders at the meeting and any other necessary information;

18.2.3. Financial forecast of the restructuring of the non-banking financial institution and the startup balance sheet of the restructured non-banking financial institution.

18.3. The Bank of Mongolia shall consider and decide on the application for approval of the dissolution or restructuring of the non-banking financial institution within 30 days after receiving the documents and announce the decision to the public.

18.4. The Bank of Mongolia may decline the application if the decision by the meeting of shareholders to dissolve or restructure the non-banking financial institution is inconsistent with legislation or is likely to negatively affect its customers.

18.5. The dissolution shall be conducted in accordance with legislation upon the approval of the Bank of Mongolia.

CHAPTER FIVE
Supervision of the Non-Banking Financial Activities

Article 19. Supervision of the Non-Banking Financial Activities

19.1. The Bank of Mongolia shall supervise the entity engaging in non-banking financial activities according to this law and other legislation.

19.2. If a breach by a non-banking financial institution of this law or other legislation has been identified in the course of the supervision, the Bank of Mongolia shall take the following sanctions:

19.2.1. Issue admonition in writing and order remedy;

19.2.2. Suspend the license;

19.2.3. Submit a proposal to the Board of Directors of the non-banking financial institution to dismiss the executive director or hold him or her liable;

19.2.4. Revoke the license.

19.3. While undertaking the sanctions mentioned in Section 19.2 of this law, the Bank of Mongolia shall follow the principle of application of the same sanction for similar violations and shall issue a regulation on application of the sanctions.

CHAPTER SIX
Liability

Article 20. Liability Imposed for the Violation of the Legislation

20.1. If a breach of the legislation on the non-banking financial activities does not constitute a criminal offence, the following administrative liability shall be imposed on the guilty person by a supervisor appointed by the Bank of Mongolia:

20.1.1. Opening of a branch of a non-banking financial institution without a license - confiscation of the illegally earned proceeds and a fine of togrogs equal to 20-40 amounts of monthly minimum salary;

20.1.2. Engagement in non-banking financial activities by an entity other than a non-banking financial institution - confiscation of the illegally earned proceeds and a fine of togrogs equal to 20-40 amounts of monthly minimum salary;

20.1.3. Failure to comply with the legislation on non-banking financial activities and the decisions of the Bank of Mongolia designed to implement the legislation - a fine of tugriks equal to 5-10 amounts of monthly minimum salary against an employee or an officer of the non-banking financial institution or equal to 20-40 amounts of monthly minimum salary against the non-banking financial institution;

20.1.4. Intentional impediment to supervisory actions - a fine of tugriks equal to 2-5 amounts of monthly minimum salary against individuals or 5-10 amounts of monthly minimum salary against an employee or an officer of a non-banking financial institution;

20.1.5. Covering up of payment settlement documents or delaying transactions - a fine of tugriks equal to 5-10 amounts of monthly minimum salary against an employee or an officer of a non-banking financial institution or 20-40 amounts of monthly minimum salary against the non-banking financial institution;

20.1.6. Failure to submit reports, balance sheets and other documents to the Bank of Mongolia in accordance with the relevant regulations or to publicly disclose the balance sheets according to Section 15 of this law without valid reasons, the non-banking financial institution shall be fined by tugriks equal to 20-40 amounts of monthly minimum salary f or an employee or an officer of a non-banking financial institution by a fine in tugriks equal to 5-10 amounts of monthly minimum salary;

20.1.7. Failure to comply with requirements described in Section 13 of this law - a fine of tugriks equal to 20-40 amounts of monthly minimum salary against a non-banking financial institution;

20.1.8. If a publicly disclosed report contained untrue or false information, the non-banking financial institution or its executive director who worked at the time of the disclosure shall be fined for tugriks equal to 5-10 amounts of monthly minimum salary.

20.1.9. Disclosure of untrue or false information or advertisement in violation of Section 12.1.2 of this law - a fine of tugriks equal to 20-40 amounts of monthly minimum salary against the non-banking financial institution or 5-10 amounts of monthly minimum salary against the executive director of the non-banking financial institution who worked at the time of disclosing this information.

20.1.10. Engagement in activities prohibited by this law or activities other than those specified in the license - confiscation of the illegally earned proceeds of the non-banking financial institutions and a fine of tugriks equal to 30-40 amounts of monthly minimum salary for the non-banking financial institution, or 15-20 amounts of monthly minimum salary against a non-banking financial institution employee or an officer or 10-15 amounts of monthly minimum salary against a person who released confidential information about the non-banking financial institution or its customers unless such release has been allowed or consented to.

20.2. The fines shall be paid to the State budget.

20.3. Losses and damages resulting from a breach of the legislation on non-banking financial activities shall be compensated in accordance with the Civil Code.

20.4. If the fines imposed in accordance with Section 20.1 of this law are considered to be unfair, an appeal may be lodged with Courts.

Article 21. Entering into Force

21.1. This law shall become effective on the February 1st, 2003.

Appendix C. The Amendment to the Cooperative Law

Article 1. The Chapter six, Article 26, Sections 3.5, 5.2, 8.3, 8.4, 16.7, 27.9, Clauses 8.1.5, 14.1.11, 35.1.5, 49.1.3 shall be added to the Cooperatives Law as set forth below.

1/Chapter Six
CHAPTER SIX.
Saving and lending activity of the Cooperative

Article 48^1. Saving, lending activity.
48^1.1 Savings and Credit Union shall have no less than 20 members' /individuals/.
48^1.2 The following issues shall be reflected in the Charter of Savings and Credit Union.
48^1.2.1 Saving and lending procedure;
48^1.2.2 Rights and Liabilities of the Union and its members
48^1.2.3 Credit fund, Loan loss provision and other fund establishment and its disbursement procedure;
48^1.2.4 Procedure on participation of the Loan Committee and other organizations of the cooperative's structure to saving and lending activity;
48^1.3 Special license stated in the Section 15.2.1 shall not apply to the activity of the Saving and Credit Union.

Article 48^2. Saving activity of the Union
48^2.1 Union may deposit monetary savings from its members.
48^2.2 Union engaged in saving activity shall deposit savings based on entering into written agreement as stated in Articles 454-456 of the Civil Code.
48^2.3 Deposits of the Union shall not consider as of its assets. Deposits can be used solely as source of loan fund /lending purpose/.
48^2.4 Member shall notify to Union in case if his/her deposit has co-owner, prior to entering the Saving Agreement.
48^2.5 Unless otherwise provided in the Charter, procedure on establishing interest rates applicable to deposits and loans shall be approved by all members meetings.
48^2.6 Member of the Union may open deposit account in the name of his/her child. In this case the Agreement shall remain effective until the child reaches adulthood.

Article 48^3. Lending activity of the Union
48^3.1 Credit Union may lend to its members as provided /specified/ in the Charter.
48^3.2 Credit Union shall establish Loan fund and Loan loss provision. Union shall establish Loan Fund through allocating its own assets and deposits of its members.
Unless otherwise provided in the Charter, the amount to be allocated to the Loan Fund shall be determined by all members meeting.
48^3.3 The Credit Union shall lend to its members based on entering into written agreement as stated in Articles 451-453 of the Civil Code.
48^3.4 Repayment of the loan can be guaranteed by member's contribution or it's saving held in the Union.

Article 48^4. Loan Committee, its rights and structure
48^4.1 The Credit Union shall have Loan Committee. Loan Committee shall consist with

no less than three people. Members of Loan Committee shall be elected by confidential voting by all members meeting. Member of the Loan Committee cannot be a Management Board /Presiding/ member or Supervising Board member.

48^4.2 Loan Committee shall exercise the following rights:

48^4.2.1 To examine loan request application from its members

48^4.2.2 Make decision on granting the loan, disbursing loan

48^4.2.3 Ensure loan repayment

48^4.2.4 Initiate all members meeting, if considered necessary

48^4.2.5 Other rights, empowered by Law and by the Union Charter

48^4.3 The Loan Committee meeting shall be effective with the majority attendance. The Charter may set higher percentage of attendance.

48^4.4 In case the Charter does not require higher attendance than stated in the Clause 48^4.3 of this Law, decision of Loan Committee shall be based on the majority vote.

48^4.5 Management Board of the Union shall appoint the Chair of Loan Committee, from Loan Committee's members.

2/ Article 26^1:

Article 26^1. Representatives meeting

26^1.1 The Union with membership over one hundred, may have the Representatives meeting instead of all members meeting, if considered necessary.

26^1.2 Unless otherwise provided in the Charter, clauses relevant to all members meeting, except clauses 23.4.1, 23.4.5, 23.4.10, 23.10, 26^1.3 of this Law, shall apply to Representatives meeting.

26^1.3 Total number of members of the Representatives meeting, their term of office, voting for and vote results as well as number of ordinary members for each Representative to represent shall be determined by all members meeting.
Total number of members of the Representative meeting shall be no less than one fourth /quarter/ of all members with voting power.

26^1.4 Unless otherwise provided in the Charter, all members meeting shall elect the member of the Representative meeting by voting confidentially. The Representative member cannot transfer its rights to other members.

26^1.5 Voting power of each Representative shall be grand total of all voting powers for who he/she represents.

26^1.6 Representative must be a member of the Union."

3/ Section 3.5:

3.5 The Union may conduct a number of activities stated in the Clause 3.4, of this law, at the same time.

4/ Section 5.3:

5.3 Savings and Credit Union shall bear any liability /obligations/ arisen from its activity with its own capital.

5/ Section 8.3:

8.3 Own capital of the Savings and Credit Union shall comprise from contribution of its members, reserve fund, undistributed income, donation, social development fund and net profit of the given financial year.

6/ Section 8.4:

8.4 The Bank of Mongolia shall set criteria and minimum amount of the Loan Loss Provision of the Savings and Credit Union.

7/ Section 16.7:
16.4 Unless otherwise provided in the Charter, the Union must distribute its income within four months after the end of FY /financial year/.

8/ Section 27.8:
27.8 Management Board /Presiding/ members shall set up the loan ceiling.

9/ Clause 8.1.5:
8.1.5 Other properties of the Union.

10/ Clause 14.1.11:
14.1.11 Unless otherwise provided in the Law and Charter, member may be a member of a non rival /competitor/ Cooperation and/or a shareholder of a legal entity.
11/ Clause 35.1.5:
35.1.5 To supervise loan disbursement and repayment of loans as well as the Loan Committee's activity.

12/ Clause 49.1.3:
49.1.3 For depositing savings and/or lending to non member of Saving and Credit Union, posting advertisements on regard to saving and lending activity, the judge or authorized state officer shall confiscate the income from above activity, shall fine the offending person amount from 10000 up to 50000 tugriks and the Union amount from 50,000 up to 250,000 tugriks.

Article 2. Following shall be added to the Cooperative Law of Mongolia:
1. "activity" shall be added after "its type of" in the title of Article 3.
2. "shared/common" after word "democratic" in the Section 3.1
3. "with other cooperatives and legal entities" after word "activities"; "no less than 51 percent of the Joint Cooperative members must be a member of the Cooperative" in the Section 3.2
4. "first staged" before word "cooperative" in the Section 6.1
5. "Loan loss provision" in the Clause 8.1.3
6. "or became a member of a different Cooperative" after word "residence" in clause 15.1.4
7. "admittance and" before the article "the" respectively

Article 3. Following shall be amended in the Cooperative Law of Mongolia:
1. "a cooperative shall be of the following types according to its activity" shall be amended as "cooperative may engage to the following activities" in the Section 3.4.
2. "provided activities in the Charter" in the Clause 3.2.8
3. "no less than two cooperatives" shall be amended as ""no less than two legal entities" in the Section 6.1
4. "Cooperative must have own name and the word "Cooperative" as extension" in Section 7.1.
5. "the mandatory amount of the contribution" shall be amended as "minimum amount of the contribution" in the Clause 9.3.5 respectively.

Article 4. Following shall be deleted from the Cooperative Law of Mongolia:

1. “common ownership” shall be deleted from the Section 3.1.
2. “of the promoters” shall be deleted from the Clause 9.3.2.
3. “personally” shall be deleted from the Clauses 15.1.1 and 17.1.2.

Article 5. Following Sections and Clauses of the Cooperative Law of Mongolia shall be renumbered as follows:

1. Clause 3.2.1 of the Section 3.4 as 3.4.1; Clause 3.2.2 as 3.4.1; Clause 3.2.3 as 3.4.3; Clause 3.2.4 as 3.4.4; Clause 3.2.5 as 3.4.5; Clause 3.2.6 as 3.4.6; Clause 3.2.7 as 3.4.7; Clause 3.2.8 as 3.4.8;
2. Section 11.2 as 11.3; Section 11.3 as 11.4; Section 11.4 as 11.5; Section 11.5 as 11.6;
3. Section 27.2 as 27.5;
4. Clause 35.1.5 as 35.1.6;
5. Section 38.2 as 38.3 respectively

Appendix D. Korean Experiences in Distressed Asset Resolution

D.1. Organization and Operation of Korea Asset Management Corporation

(1) Functions of KAMCO

In a transition economy, state owned banks are a major source of NPL due to directed loans to SOEs and government can use privatization proceeds to compensate for SOE NPLs. In contrast, market economies like Korea and Japan had financial and real estate crisis and credit crunch. NPL is more partial and temporary situation in market economy than in transition economy. That is why the Public Fund, which was once the most popular subject among the Korean people, was raised by KAMCO and the Korea Deposit Insurance Corporation (KDIC) by issuing bonds guaranteed by the government for the purpose of financial restructuring. The Fund was used by KAMCO to acquire NPLs, and also by KDIC to inject capital in financial institutions or to pay off depositors. KAMCO exerted its best efforts to recover all injected Public Fund so that no burden will be laid upon taxpayers.

(2) KAMCO's Organization

A. Business Support Groups

Internal Auditing Department: The internal auditing department inspects all or a part of the work executed by each department and asks for improvement or changes and gives punishment for any kind of illegal activities, in order to realize efficient, transparent and reasonable work procedures. In addition, it is also in charge of inspection and irregular inspection of civil problems.

Corporate Planning Department: The corporate planning department schemes out management strategies along with mid and long term plans and is also in charge of laying out overall business plans and budgeting of KAMCO. While managing KAMCO organization, the corporate planning department is also in charge of controlling and settling the overall businesses of KAMCO. In particular, KAMCO has been undertaking the management and planning of KAMCO's NPA Fund, established for the purpose of Korean financial and corporate restructuring. Further, the corporate planning department takes care of management innovations, management evaluations, and other risk management projects. Externally, it is in charge of any work related with the national assembly and the government.

Legal Office: The legal office does research on any legal matters related to KAMCO act or work of KAMCO. The legal office establishes internal regulations, the working rules of KAMCO business. In addition, the legal office establishes, manages, and interprets working agreements and consulting businesses for overall legal problems, in order to help the rational and efficient work procedures.

Litigation Department: The litigation department undertakes all kinds of lawsuits related to KAMCO. Lawsuits are mainly to extend maturities of the NPLs acquired from financial institutions. And there are various other types of lawsuits including lawsuits between KAMCO and debtors as well as lawsuits among creditors. These lawsuits prevent leakages in the NPA Fund and maximize recovery.

Knowledge Management and Information Department: The knowledge management and information department research important information on finance, real estate, and the NPL market. The knowledge management and information department establishes knowledge management system for the purpose of improved competitiveness and internal innovation. It also is propelling Internet related businesses by building an e-market place.

B. Investment Group

Corporate Restructuring Analysis Department: The corporate restructuring analysis department assumes full charge of NPL acquisition strategies and marketing. Its main work is to make valuations for the NPAs acquired, the main subject of valuation being companies held by KAMCO or companies subject to purchase. Further, it also selects companies that should be restructured and schemes management strategies.

Corporate Loan Disposition Department: The corporate loan disposition department is in charge of individual loan sales for loans that can be more profitable if sold separately. Loans are resolved by selling to a third party or M&A.

Investment Management Department: The investment management department manages 50:50 joint venture NPLs warehousing vehicles. KAMCO used loans from IBRD and ADB to establish joint ventures with Morgan Stanley, Colony Capital, Deutsche Bank, Lehman Brothers. KAMCO can participate in the upside potential, while inducing foreign capital to Korean NPLs.

Disposed Asset Management Department: KAMCO also has financed capital using NPLs as collateral. Actual financing was done by asset backed bonds issued into capital market. As the issuer of bond is only a paper company, KAMCO legally sells NPLs to SPC and manages the collateral for the interest of bond investors by a fee contract after sale. The disposed asset management department is entrusted with the management of those collaterals sold, maximizing its recovery.

C. Corporate Restructuring Group

Corporate Restructuring Department: Korean corporates borrowed excessively from multiple banks. When they defaulted, creditor banks had to reschedule(extend, write-off and convert to equity) the loans as corporate Korea cannot let almost all companies go bankrupt. So creditor banks made creditors' committee and cooperated on restructuring of the client corporate voluntarily, without going to the bankruptcy court. This is so called 'London Approach' or 'Workout'. KAMCO had purchased workout loans of Daewoo Group and several other borrowers so that the corporate restructuring department pushes forward workouts jointly with other creditor financial institutions.

Overseas Loan Management Department: Troubled Daewoo Group had many overseas subsidiaries and borrowed heavily from international banks. Most of the international banks did not want to join the Workout Program. KAMCO had purchased their loans by cash at a discount. This is what KAMCO calls 'Cash Buy Out'. Recently SK Global's international creditors sold their loans to Korea in the second Cash Buy Out. KAMCO newly set up the overseas loan management department on May 1, 2002 for the efficient management and recovery maximization of CBO purchased loans.

D. Ordinary Loan Management Group

Ordinary Loan Management Department: The ordinary loan management department manages and resolves ordinary secured loans. Ordinary Loan means the delinquent loans the borrowers of which are not in Corporate Reorganization by bankruptcy law or Workout.

Restructured Corporate Loan Management Department: The restructured corporate loans management department manages and resolves restructured corporate loans. These are the loans the borrowers of which are under the Korean version of Chapter 11 by Korean bankruptcy court.

Loan Collection Department: Collects unsecured loans acquired from financial institutions, overdue credit card loans, and residual loans after disposing collateralized assets.

E. International Business Group

International Business Department: The international business department researches information, cooperates with global agencies, and engages in PR activities to pave the way for KAMCO's overseas business. The international business department shares information through active exchange of information with NPL resolution agencies abroad, while developing and implementing staff training programs as well as raising profit by marketing NPL resolution methods. Further, the international business department not only researches the foreign NPL market, but also publicizes KAMCO's business and role to international investors and international organizations to improve its international status and induce foreign investors.

Overseas Project and Securitization Department: The overseas project department is making inroads into the foreign NPL market based on KAMCO's accumulated experience and know-how as the sole domestic NPL resolution agency. The overseas project department merchandises its experience of resolving NPLs and advanced resolution methods to China, Vietnam, and South East Asia, as a consulting agency. Particularly, KAMCO was listed as the consulting agency for NPL resolution programs in ADB, gaining public confidence for its consulting work. As such, the overseas project department's main activities is consulting and marketing work on NPLs and expand its business to asset management and investment.

F. Real Estate Trust Service Group

Real Estate Trust Service Department: The real estate trust service department resolves secured loans, unsecured loans, and special loans that have been transferred to KAMCO. In case of secured loans, court auctions are held to sell the collaterized assets. In the absence of an appropriate buyer, assets are transferred to KAMCO by credit bid, and KAMCO resells it through public auctions. Further, public sales of non-business purpose real estate held by financial institutions, public companies and companies targeting to improve their financial structure. In addition, other businesses such as collection of payment and title transfer are conducted in this department.

Real Estate Business Department: The real estate business department disposes of and collects the assets acquired, Real Estate Owned (REO), and assets transferred to KAMCO for management. The real estate trust service department holds real estate road shows for the efficient disposition of various assets. It focuses on aggressive marketing activities such as providing information on real estate and customer services. In addition, it develops assets and act as an intermediary when disposing of assets held by companies showing signs of insolvency or assets of restructured companies. It also engages in consulting services for the management and normalization of companies showing signs of insolvency, and also does research on real estate related businesses such as the collateral trust business.

G. State Property Management Department

KAMCO manages assets that were acquired and commissioned by Ministry of Finance and Economy. Eligible assets are delinquent state taxes, attached real estates and securities.

State Properties: Under the provision of state properties act article 3, clause 1 and its enforcement decree article 1, state properties refer to the assets including real estate, securities, machines and all kinds of rights that were either acquired by the government or attached by the government due to delinquent taxes.

Payment-in-Kind in Case of Attached for Tax Arrears: When individuals or corporations could not pay taxes in cash, they pay taxes in kind such as assets or securities.

H. Tax Delinquent Property Management & Disposition Service Department

The tax delinquent property management mainly engages in public auctions of seized property, which is entrusted by the tax office or local district organization. Public auctions are held for seized property according to the National Tax Collection Act, which are vicarious executions of government public rights.

(3) Loan Sale Methods Used in Korea

A. Outright Sale to Third Party

Outright sale is selling directly to a third party, or outright sale aims to recover loans at the highest price possible.
Individual Sale: The individual sales method can be classified into court auctions, and corporate loan sale. Court auction is used for secured loan sale process. Auctions are held after creditor's request to the court to hold an auction according to foreclosure laws, and the court pays the sale proceeds to creditor. Loans are recovered by selling the collateral properties without title acquisition by creditor. The corporate loan sales method, a method utilized by KAMCO to sell loans separately, can be classified into M&A and Individual Corporate Loan Sales (ICLS). KAMCO's Corporate Disposition

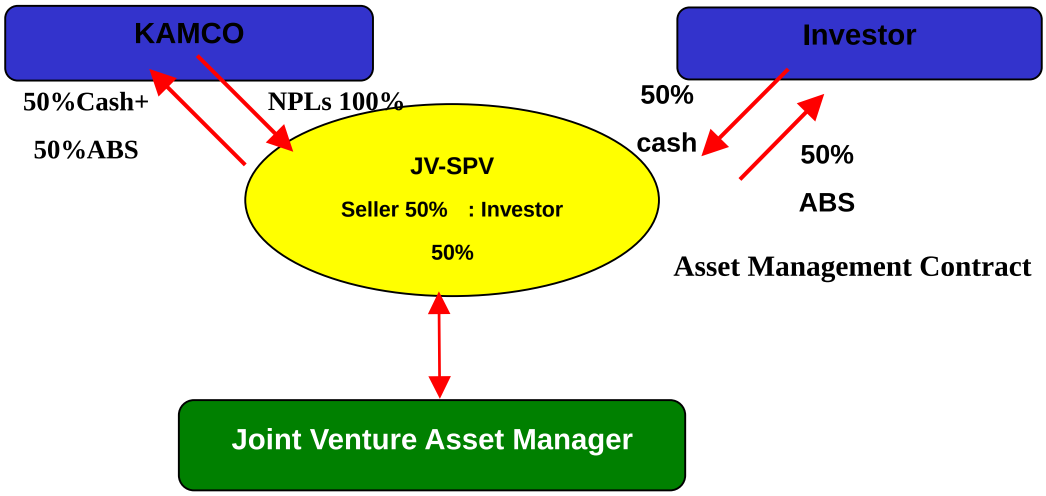
Department performs individual corporate loan sale for borrower companies with high brand value but with liquidity problems or companies with high possibility for recovery.

Bulk Sale: The Bulk sales method is a sales method that involves pooling assets such as NPLs and real estate collateral and selling them to a third party for quick cash. By adapting this sales method, the seller can resolve a massive amount of NPLs through auctions or negotiations. In addition, the seller will be able to enhance balance sheet and buyer achieves better management of assets by economy of size. As buyer might have purchased at discount, he is in a stronger debt negotiation position than originator bank. Further, the seller will be able to sell off even the worse assets by pooling them with the relatively healthy ones.

B. Sale to a Joint Venture SPV

KAMCO and Investor formed a Joint Venture Special Purpose Vehicle to warehouse NPL for future resolution through disposal, restructuring. KAMCO moves NPLs to a SPV and the SPV issues bond and equity. KAMCO and JV Investor equally subscribed to the SPV issued securities. KAMCO pays 100% in NPLs and receives 50% cash and 50% securities issued by SPV. Investor pays 50% in cash and receives 50% in the same securities. KAMCO and Investor also form a JV-Asset Manager to professionally manage the NPLs warehoused. Even though KAMCO has 50% ownership in the Joint Venture SPV, the SPV is legally independent of KAMCO, hence KAMCO can recognize legal and accounting sale on the balance sheet.
The merit of sale to a joint venture SPV, vis-à-vis ourtright sale is that KAMCO can join the upside potential of NPLs value in the future. The gain can be realized as capital gain for the SPV equity owned by KAMCO. However, cash is only half raised at initial sale to SPV.

Figure 1 Joint Venture SPV



C. Asset Backed Financing Backed by NPLs

KAMCO formed a Special Purpose Vehicle to warehouse NPL for future resolution through disposal, restructuring. KAMCO moves NPLs to a SPV at a fair price evaluated by independent accounting firm. The SPV issues bond and equity up to the value of the NPLs acquired. KAMCO subscribes to the SPV issued equity only, and 3rd party investor subcribes to SPV issued bonds. KAMCO pays 100% in NPLs and receives approximately 90% cash and the balance in equity securities. Investor pays in 90% in cash only. The purpose of 10% equity issue is to protect the investor's interest as over-collateral, in case the NPLs' recovery get worse. KAMCO's Disposed Asset Management Department manage the NPLs warehoused as the SPV does not have any capacity to do so. Even though KAMCO has a little ownership in the SPV, the SPV is legally regarded as independent of KAMCO, hence KAMCO can recognize legal and accounting sale on the balance sheet.

The merit of sale to a KAMCO sponsored SPV is that KAMCO is entitled to the whole upside potential of NPLs value in the future. The gain can be realized as capital gain for the SPV equity owned by KAMCO. Also, 90% cash is raised at initial sale to SPV.

D. Debt to Equity Conversion

For Lenders Viewpoints: For lenders, debt to equity conversion has the following advantages; 1) resolution of NPLs, 2) meeting the BIS standards, and 3) normalizing corporate operations and reinforce supervisory function of corporations. But there are the following disadvantages; 1) losing rights (security rights) as a creditor, 2) possibility of leading to corporate insolvency in case of liquidation, and 3) danger to be used as a cover-up for insolvent loans.

For Borrower Corporations: Advantages: Lower debt-to-equity ratio due to converted bonds. Disadvantages: May lose management power due to lower shareholdings

Debt-equity swap should be implemented to improve the financial structure of companies under the restructuring program. For this purpose, the Ministry of Finance and Economy should take care of the following legal hurdles to debt-equity swaps.

D.2. Credit Collection Practices in Korea

(1) Global Collection Industry

The history of the collection industry goes way back about 150 years. In New York Stock Exchange (NYSE), collectors recovered unpaid securities payments for stock brokers. Nowadays, there are about 30 collection associations such as American Collectors Association International (ACA International), International Association of Commercial Collectors (IACC), and European Collectors Association (ECA).

There are over 20,000 collection agencies and law firms specialized in collection in the world. The US is the world's largest credit & collection industry. There are about 6,500 collection agencies and over 2,000 collection law firms. In Europe, England, Germany, and Belgium have big credit and collection markets. There are about 3,000 collection agencies in Europe. In Asia, there are about 300 collection agencies including 75 servicers in Japan.

As of at the end of 2002, there are 26 Credit Information companies in Korea.[11] The Credit Information companies operate 290 local branches and employ 15,000 people. The industry size is $530 million which increased by $100 million or 23% from the previous year.

(2) Related Laws and Regulations

In Korea, the Regulation on Handling and Protection of Credit Information was enacted in 1995 in order to nurture and support the growth of the healthy Credit Information industry. The regulation is to systemically manage and promote proper handling of Credit Information. The Regulation and the related laws of the credit information industry have very strict rules on the protection of private life. Collectors are not allowed to call debtors after 9 at night and before 8 in the morning. Providing incorrect information in regards to debtors' liabilities, threatening debtors in any way, any investigation that is not related to commercial business transactions are all prohibited by the laws.

(3) Standard Collection Practices

A. Specialization

The key to success is specialization. Collection should be done by recovery specialists with experience and expertise in the industry of which the credit debts were issued. Recovery specialists should have working knowledge of industry-specific terminology, laws, and regulations so that they can deal with specific industry-related questions and issues.

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[11] Source: Financial Supervisory Service. As of September 2003, one more company is getting a credit information's license.

B. Timely Approach and Utmost Care

The probability of collecting a delinquent credit debt account drops dramatically with the length of delinquency. Thus, successful collection of past due accounts depends on how fast the credit debts can be followed up as they become delinquent. Successful collection of past due accounts also depends on a carefully constructed and systematic recovery process. Every action toward delinquent account recovery must be on a strict timeframe.

C. Procedure of Collecting

Account Received: The cutting edge technology allows us to seamlessly receive digitalized information of delinquent debts.

Account Analysis: Account research team receives the files and prepares a profile on each customer. Individual recovery specialists receive accounts and note the collection system with any significant information.

Skiptracing: Account research team verifies, locates, or skip traces the address and telephone number of the debtor.

Delinquency Control: The first phone call is made to the debtor within 2 business days from the date of placement. The call representative informs the debtor of the outstanding debt and requests the balance is paid within two business days.

Collections: If payment is not received, a follow-up call will be made to the customer by a recovery specialist. If payment has not been sent or promised, an additional notice will be mailed to the debtor. If there is no legitimate dispute and recovery of the full balance is not possible, due to legitimate financial hardship, this second recovery analyst has the authority to negotiate a short-term payment arrangement. Typical payment arrangements extend no longer than 90 days.

Legal Action: If no recovery is secured within a week from the completion of our most recent follow up, a final demand for payment is generated and mailed to the customer. If the account is not resolved, the recovery specialist and the manager review the account to determine if it should be marked as uncollectible or referred to the litigation team for legal action.