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REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION TO THE EXECUTIVE DIRECTORS ON A PROPOSED CREDIT OF SDR 7.2 MILLION TO MONGOLIA FOR A BANKING AND ENTERPRISE SECTOR ADJUSTMENT CREDIT

March 25, 1997

CURRENCY EQUIVALENTS

(As of February 28, 1997)

Currency Unit	=	Tugrik (Tg)
$1.00	=	Tg 730
Tg 1.00	=	$0.0014

WEIGHTS AND MEASURES

1 meter (m)	= 3.28 feet (ft)	1 ton (t) =	1,000 kg
1 kilometer (km)	= 0.62 miles	=	2,205 pounds
1 square kilometer (km^2)	= 100 ha	1 kilogram (kg) =	2.2 pounds
1 hectare (ha)	= 2.47 acres		
	= 15 mu		

ABBREVIATIONS AND ACRONYMS

ADB	- Asian Development Bank
aimag/som	- county/province
BELTAC	- Banking, Enterprise and Legal Technical Assistance Credit
BESAC	- Banking and Enterprise Sector Adjustment Credit
BIS	- Bank of International Settlement
BOM	- Bank of Mongolia (Central Bank)
CAS	- Country Assistance Strategy
CEM	- Country Economic Memorandum
CIB	- Credit Information Bureau
DUC	- Democratic Union Coalition
DWU	- Debt Workout Units
EDI	- Economic Development Institute
ESAF	- Enhanced Structural Adjustment Facility
FDIC	- Federal Deposit Insurance Corporation (USA)
FSPL	- Financial Sector Program Loan (ADB)
FSTA	- Financial Sector Technical Assistance
GDP	- Gross Domestic Product
GOM	- Government of Mongolia
IDA	- International Development Association
IFIs	- International Financial Institutions
IMF	- International Monetary Fund
ITI	- Investment and Technological Innovation Bank
MARA	- Mongolia Asset Realization Agency
MOF	- Ministry of Finance
MOJ	- Ministry of Justice
MOU	- Memorandum of Understanding
MPRP	- Mongolian People's Revolutionary Party
NDP	- National Democratic Party
PFP	- Policy Framework Paper
PHRD	- Policy and Human Resources Development Fund
SDP	- Social Democratic Party
SDR	- Special Drawing Rights
SPC	- State Property Committee
TA	- Technical Assistance
TAC	- Technical Assistance Credit
T&D	- Trade and Development Bank
USAID	- United States Agency for International Development

FISCAL YEAR

January 1 - December 31

Vice President:	Jean-Michel Severino, EAP
Director:	Nicholas C. Hope, EA2
Division Chief:	Klaus Rohland, EA2CO
Task Manager:	Hongjoo Hahm, EA2CO

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MONGOLIA

BANKING AND ENTERPRISE SECTOR ADJUSTMENT CREDIT

CREDIT AND PROJECT SUMMARY

Borrower:	Mongolia
Implementing Agency:	Ministry of Finance (MOF)
Beneficiary:	MOF, Bank of Mongolia, State Property Committee.
Poverty:	N.A.
Amount:	SDR 7.2 million ($10 million equivalent)
Terms:	Standard IDA terms, with a 40-year maturity.
Commitment Fee:	0.50 percent on undisbursed credit balances, beginning 60 days after signing, less any waiver.
Financing Plan:	Single tranche of $10 million.
Economic Rate of Return:	Not Applicable
Map:	IBRD 26450
Project ID Number:	MN-PE-41741

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REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION TO THE EXECUTIVE DIRECTORS ON A PROPOSED CREDIT TO MONGOLIA FOR A BANKING AND ENTERPRISE SECTOR ADJUSTMENT CREDIT

1. I submit for your approval the following memorandum and recommendation on a proposed development credit to Mongolia for SDR 7.2 million, the equivalent of $10 million on standard IDA terms, with a maturity of 40 years to help finance a Banking and Enterprise Sector Adjustment Credit.

PART I. INTRODUCTION

2. The proposed Banking and Enterprise Sector Adjustment Credit (BESAC) is an adjustment operation designed to support the banking and enterprise reform program of the Government of Mongolia. Reform of these sectors is a key element of the International Development Association (IDA)'s Country Assistance Strategy. In addition, the proposed Credit would help meet external financing requirements and support the budget which will be burdened by the costs of these reforms. The proposed adjustment program would build on and complement the macroeconomic stabilization and structural reform measures, undertaken by the Government and supported by an IMF Enhanced Structural Adjustment Facility Program. It would tackle the main structural problems of the banking and enterprise sectors through an integrated approach that broadly aims to restore the banking system as an efficient and safe intermediator of resources, and to improve the economic and financial performance of select public and recently privatized enterprises. The main elements of the Government's policy reform agenda in the banking sector are to:

(a) stop the flow of bad lending from banks to defaulting borrowers;

(b) restructure individual commercial banks to promote the development of a solvent, viable banking system; and

(c) develop commercial banking skills and aggressively implement loan recovery efforts.

In the enterprise sector, the objectives are to:

(d) privatize remaining public enterprises that were earmarked for cash privatization;

(e) impose hard budget constraints on public enterprises; and

(f) resolve nonperforming loans to enterprises through restructuring and/or liquidation.

3. The institutions responsible for implementing the reform program will be supported by IDA's proposed Banking, Enterprise and Legal Technical Assistance Credit (BELTAC), which is being presented to the Board together with BESAC. BELTAC is designed to promote longer-term institutional and skills development and appropriate legal and regulatory reform so that the programs implemented under the BESAC can be sustained.

PART II. MACROECONOMIC CONTEXT AND FINANCING REQUIREMENTS

A. RECENT ECONOMIC DEVELOPMENTS

4. After suffering through four years of decline, Mongolia achieved a significant turnaround in 1994 with 2.5 percent GDP growth and a further 6.3 percent growth in 1995. Lower copper prices, however, disrupted growth in 1996, and the estimated GDP growth rate for 1996 is 2.6 percent. Inflation, which reached 325 percent in 1993, fell to 53 percent in 1995, and remained at that level in 1996 (see Annex 1, Table 1). During 1996, the Mongolian economy was hit by a succession of adverse developments that reversed some of the progress painstakingly made over the past years. Many of Mongolia's recent economic developments were the result of terms of trade shocks. A 25 percent decline in world copper prices in 1996, a 10 percent fall in cashmere prices, and further increases in world petroleum prices[1], induced a cost to the Mongolian economy equivalent to 10.3 percent of GDP in 1996, compared to a windfall gain of 8 percent in 1995.

5. Mongolia saw a major erosion of public confidence in the banking system in 1996, with the collapse of a small private bank and the closure of two large banks that held approximately 50 percent of total deposits in the country. Moreover, public enterprise defaults to the budget and the banking system have further crippled the banks and have led them to charge unsustainably high interest rates. In April 1996, extensive forest and steppe fires lowered agricultural supplies and exports. While the agriculture exports and the copper, cashmere and petroleum terms of trade problems are likely to self-correct, the problems in the financial and enterprise sectors pose a longer-term threat to stabilization and growth. The 1996 banking crisis poses implications for inflation, financial control, and growth in the real sector. The authorities will have to further resolve the banking crisis and consistently implement strict macroeconomic policies to

[1]The copper sector accounts for a quarter of GDP, half of export earnings, and about a third of overall tax receipts. Cashmere is the second leading export item, accounting for about 15 percent of export receipts. Petroleum and petroleum products account for 20 percent of its imports.

restore stability. Structural reforms are needed to further enhance the credibility of stabilization, and to spur growth by increasing productivity of the real sector.

B. Recent Political Developments

6. The present Government, a coalition of the National Democratic and the Social Democratic Parties, was elected on June 30, 1996.[2] The new Government ran on a platform to further advance market reforms, both in terms of speed and scope. It is committed to accelerating bank restructuring and privatization, and to implementing a comprehensive set of fiscal reforms. The new administration faces formidable challenges. Since 1993, the Government has implemented strict stabilization policies under a three-year Enhanced Structural Adjustment Facility/Policy Framework Paper (ESAF/PFP) Program. The ESAF arrangement expired in June 1996, and a new ESAF Program is planned for 1997-1999. Maintaining a macroeconomic stabilization program, under a new ESAF Program, remains a priority for the authorities.

C. Financing Requirements

7. **Introduction.** The Government and Bank of Mongolia have formulated a medium-term banking and enterprise reform program for the period 1997-99, in close collaboration with the IMF, ADB, and IDA. The Government is negotiating an IMF ESAF Program, which is scheduled for presentation to the Board of the Fund in June 1997. Financial assistance from the Fund under ESAF is in an amount of SDR 33.4 million ($48 million) over three years, equivalent to 90 percent of quota. In support of the Government's banking sector reforms, the Board of Directors of the ADB has approved a $35 million Financial Sector Program Loan (FSPL), and a $3 million Technical Assistance Loan to develop commercial banking skills. The FSPL was presented and approved by the Board of Directors of the ADB on December 18, 1996. The Government is requesting financial assistance from IDA under BESAC in an amount of $10 million, and under BELTAC in an amount of $2 million.

8. The IMF has already negotiated a 1997 financial program for Mongolia with the authorities as part of the proposed ESAF arrangement. The financial program monitors monetary aggregates, net lending levels, and financing options for the budget. The financial program goes into effect on April 1, 1997. On this basis, ADB released the first tranche of its Financial Sector Program Loan in January 1997. An IMF mission is scheduled for late-April/early-May to review the prior actions needed to successfully conclude the ESAF negotiations. The prior actions include, civil service reforms, specific privatization targets for 1997, tax reform and other revenue-enhancing measures, and

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[2]The formerly communist Mongolian People's Revolutionary Party (MPRP), which had dominated the Great Khural (Parliament) since it won 70 out of 76 seats in the first general elections in 1992, was toppled by the Democratic Union Coalition (DUC), a coalition of the National Democratic Party (NDP) and the Social Democratic Party (SDP). DUC obtained 50 of the 76 seats, while the MPRP collected only 25. The one remaining seat belongs to an independent candidate from a conservative party.

submission of an amended 1997 budget by the end of April. In this regard, BESAC is part of a coordinated multi-donor approach to reforming the Mongolian banking and enterprise sectors. In order to achieve a sustainable level of growth, the Government must further resolve the banking crisis, implement broad structural reforms, and consistently implement strict macroeconomic policies. Banking and enterprise reforms will enhance the credibility of stabilization, and macroeconomic stabilization is a pre-requisite to structural reforms. BESAC is thus designed to complement ADB's FSPL, as well as the Government's macroeconomic program that will be supported by ESAF.

9. **External Outlook**. The medium term balance of payments prospects continue to be constrained by Mongolia's narrow export base and the need for substantial investment. The current account deficit is expected to increase to about 11 percent of GDP in 1997 before narrowing to 9 percent of GDP in 1998. Without access to external nonconcessional borrowing, Mongolia will have to rely on continued support from the international donor community. *The external financing gap for 1997 is filled, but is projected to be over $26 million in 1998. The 1997 figures take into account $17 million in disbursement from ADB's FSPL; $10 million in disbursement from IDA's BESAC; and about $10 million in disbursements from IMF's ESAF (a below the line item). The $26 million financial gap for 1998 includes projected ADB/IDA/IMF disbursements. The remaining gap for 1998 is largely expected to be filled with grant funds from bilateral donors* (see Annex 1, Table 2).

10. **Fiscal Outlook.** The fiscal situation is expected to be precarious, and the overall deficit is likely to stay at about 9 percent of GDP in 1997, and drop to about 8.7 percent in 1998. Foreign financing will continue to be required if this deficit is to avoid undue inflationary pressures. Based on current policies, revenues are projected to recover slowly in 1997 and 1998. In contrast, budgetary outlays will need to expand from their present level to pay for the banking and enterprise reform measures. In keeping with the Government's objective of bringing down inflation within single digits by 1999, the budget's recourse to domestic financing is limited, and the 1997 budget deficit will, by and large, be financed from abroad. In view of the country's lack of access to commercial borrowing, much of this foreign financing will need to come in the form of program aid, including the assistance package proposed under BESAC (see Annex 1, Table 3).

11. **Sustainability of Reform**. The Government's medium-term reform program for 1997-99 aims to stabilize the economy and consolidate earlier gains by pressing ahead with structural reforms. The main structural reforms are to harden budget constraints of public enterprises and thereby help improve the soundness of the banking system; to foster development of the private sector; and to increase public sector savings by expanding and diversifying the revenue base, while at the same time rationalizing and curtailing current expenditures in order to release sufficient resources for a well-targeted social safety net. The fiscal impact of the combined reform program is substantial. However, most of the expenditures are one-time injections of funds that fall due in the first year of the program, with smaller outlays in 1998 and beyond. The Government's

1997-98 cash privatization program, and the bank-led enterprise restructuring approach that is being supported by BESAC, will generate cash revenues and reduce budgetary outlays to enterprises, minimizing the fiscal burden of structural reforms in the medium-term. The proposed program of structural reforms should then eliminate the need for large balance of payments assistance over time.

12. **Need for Structural Change.** The financial condition of the banking sector has deteriorated rapidly over the past year. The system faces serious liquidity problems and an erosion of public confidence. The economy cannot continue to develop, let alone grow and thrive, without a healthy financial system. Reforms are needed to ensure that banks are able effectively to fulfill their roles as collectors of savings, allocators of credit, and managers of the payment system. In its present condition, the banking system is not conducive to the development of the private sector nor integral to the savings-investment intermediation process. Banking reforms, however, must be conducted concomitantly with enterprise reforms, as the viability of the system is closely related to the conditions of its clients. Banks are the principal sources of enterprise financing in market economies, and weak enterprise performance will inevitably affect the banking system. The slow pace of enterprise adjustment creates a drag on economic growth, both through efficiency losses and by crowding out the emerging private sector. Structural reforms in both the banking and enterprise sectors are essential for the success of the Government's medium-term reform program.

13. **The Medium-term Reform Program.** As part of a multi-year strategy of reform, the Government has developed, and has begun to initiate, a comprehensive reform strategy that focuses on removing structural bottlenecks to sustained economic growth. Structural reforms embodied in the medium-term reform program are designed to complement and support the Government's short-term stabilization effort on the macroeconomic front. The Government has discussed broad elements of this strategy with IDA in our on-going policy dialogue as well as in the context of the ESAF/PFP discussions. IDA will support the Government's medium-term reform program with a series of single tranche operations, starting with BESAC in FY97, followed by a proposed Private Sector Development Credit in FY98. BESAC will follow the successful negotiation of the IMF ESAF/PFP program so that structural reforms envisaged under the proposed Credit can support the ESAF stabilization objectives. *As a condition of credit effectiveness, the Government will have in place a sound macroeconomic framework, consistent with the objectives of the Program, to the satisfaction of IDA. Successful negotiation of ESAF will be a key monitoring indicator.* In the context of the Government's medium-term reform, IDA will monitor the implementation of these reforms, by examining the levels of non-concessional loans, domestic financing of the budget deficit, net credit to government, and net domestic assets. The broad elements of the medium-term reform program are detailed in the Government's Letter of Development Policy (see Annex 4).

14. **Sequence of Reforms.** The primary focus of the first-year reforms is in the banking sector, followed by intensive reform efforts in the enterprise sector in the second-

year. The authorities will concentrate on stabilizing the banking sector, and aggressively pursue nonperforming loans while imposing strict restrictions on new bank lending to the defaulting enterprises. Restrictions on bank lending to enterprises should initiate further enterprise reforms, especially when supplemented by hard budget constraints from the budget. Reforms in the enterprise sector will be sequenced to follow banking reforms. The Government's privatization program will be launched in the latter half of 1997, supplemented by a pilot public enterprise reform program that will begin in early 1998 under BESAC/BELTAC.

PART III. THE GOVERNMENT BANKING AND ENTERPRISE SECTOR REFORM PROGRAM

15. The Government's banking and enterprise sector reform program has been elaborated and refined jointly by Government agencies and other participating organizations, including BOM, the Ministry of Finance (MOF), the Ministry of Justice (MOJ), the State Property Committee (SPC), and selected commercial banks and enterprises. Important elements of this reform program are already under implementation, and some progress achieved. Additional reform measures will be introduced in the coming months. The full range of policy measures to be undertaken over the next two years is detailed below.

A. BANKING SECTOR REFORMS

16. **Background.** In the past, the main function of the banking system was to transfer Government resources to public enterprises. The monobanking system has since been dismantled, and a commercial banking sector has emerged to engage in lending activities. The ownership structures of these banks are diverse. Enterprises acquired parts of state banks and established new banks in the early transition period. These enterprise-owned banks were then privatized when their owners were privatized. Most banks, however, are deeply troubled and heavily burdened with nonperforming loans. Half of the problem loans are the result of *inherited* loans from the monobanking system and from Government-d*irected* credit to public enterprises[3]; and the remaining half are problem loans made by the banks themselves. The extent of bank-made bad loans is attributable to poor commercial banking skills, weak bank management, and a lack of creditworthy borrowers. The Government has identified and has taken full responsibility for the nonperforming loans inherited from the monobanking system, and for the directed lending that continued after

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[3]*Inherited loans* are defined as loans that were transferred from the previous monobank to newly established commercial banks in 1991 plus accrued interest arrears since transfer until December 31, 1993. *Directed loans* are defined as all loans that were granted by commercial banks on the basis of a Cabinet decision, or extended under Government decrees, resolutions, or letters prior to June 30, 1994. Interest arrears on directed loans are calculated until September 1, 1994 on the basis of a 8/94 BOM decree that stipulates the transfer of past due interest on doubtful/bad loans to off balance sheet accounts.

its breakup. In 1996, BOM issued regulations requiring the five largest banks to separate the portfolio of inherited/directed loans from their balance sheets.

17. The banking system has a poor loan recovery record. This is due to many factors, including a lack of commitment by banks' top management; a shortage of experienced personnel to work out bad debts with defaulting borrowers; insufficient coordination among government agencies concerned; and inadequacies in the legal framework. In September 1996, the Prime Minister issued a decree (No. 102) ordering the repayment of all arrears to commercial banks and state-owned entities. This decree established an inter-ministerial working group, headed by the Minister of Justice. The group is charged with initiating rapid court action against defaulters, seizing collateral, and publishing lists of defaulters in the mass media. Early indications suggest large amounts of outstanding nonperforming loans have been recovered, primarily from small-scale defaulters; but it is unlikely to be effective in recovering arrears from large borrowers.

18. **Current State of the Banking System.** The banking system as a whole is illiquid and has deteriorated to the point of insolvency in 1996 (see Annex 2 for a detailed sector description). Only one bank was able to maintain adequate reserves with BOM; while illiquid banks have had to rely increasingly on BOM funding. Attempts to tackle the crisis in the summer of 1996, by closing one small bank and putting one large bank into conservatorship, ran into difficulties; initially with runs on some of the banks and ultimately with the conservator being withdrawn from the large bank and control restored to the former owners. On December 13, 1996, the Government successfully closed the two large insolvent banks. The closing operation was extensive and complex, but well organized and executed.

19. **IMF/ADB/IDA Support.** The IMF, ADB and IDA have provided sector-specific technical assistance under the auspices of the Government's Financial Sector Technical Assistance (FSTA) Program since 1992. The IMF has been providing extensive advisory assistance in support of macroeconomic and financial sector development. Throughout 1995-96, ADB and IDA have jointly engaged in activities to develop appropriate guidelines for loan classification, to develop specific policies and procedures for resolving the nonperforming loans, and to introduce systematic reviews of commercial banks as a means of determining their viability. IDA undertook reviews and audits of several commercial banks, and a Legal Diagnostic on commercial banking regulations and enforcement procedures. ADB provided assistance to individual commercial banks to develop restructuring and business plans.[4]

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[4]The restructuring plans include: (a) halting dividend payments; (b) downsizing the labor force; (c) reducing wages and bonuses in real terms; (d) downsizing the branch network; (e) introducing management information systems; (f) introducing new credit approval procedures and handbooks; (g) introducing new services and products; and (h) improving loan collection practices.

20. IDA has held discussions with the authorities over the past two years on a strategy to restructure the Mongolian banking system. A draft bank restructuring strategy was developed by IDA in February 1996, in concert with BOM. In May 1996, IDA, ADB and BOM agreed on a coordinated approach. ADB, with its $35 million Financial Sector Program Loan (FSPL), took the lead in financing the bank restructuring/recapitalization plan. ADB also provided some $3 million in loan and $2 million in grant technical assistance to the banking system to develop commercial banking skills and to the central bank to support banking supervision. IDA, on the other hand, will complement ADB's efforts, focusing on restructuring a select group of large defaulting enterprises that most affect commercial bank performance and viability, and continue to provide advice on banking issues.

21. In September 1996, faced with falling public confidence in the banking system, the newly elected Prime Minister called a joint meeting attended by the IMF, ADB and IDA. The Prime Minister requested the coordination of all three international financial institutions in developing a single bank restructuring strategy that can be enacted rapidly. The Government, with the assistance of the IMF, developed a comprehensive bank restructuring strategy in November 1996. This restructuring plan was discussed and agreed upon by the Mongolian authorities and all three IFIs, and the first stages of the plan have been implemented.

22. **Bank Restructuring Strategy.** The bank restructuring strategy developed by the Mongolian authorities entail six steps to ensure that, by the end of 1998, all banks comply with specific capital adequacy ratios.[5] The first four steps of this strategy have already been implemented. First, in December 1996, the two large, insolvent banks (People's Bank and Insurance Bank) were liquidated, and the senior management of these banks replaced. Simultaneously, a *Mongolian Asset Recovery Agency* (MARA) was established, with funding from the Government to purchase the nonperforming assets of the two liquidated banks. Second, the performing assets of these insolvent banks were transferred to two new institutions, a *Savings Bank*, that is permitted to invest only in secure assets, and a *Reconstruction Bank*, that is restricted to providing banking services to enterprises that had deposits in the failed banks. In line with the new Banking Law (1996), all household deposits were fully protected and rapidly transferred to the Savings Bank. Non-household claims were partially protected and transferred to the Reconstruction Bank. Third, all nonperforming inherited and directed loans that were removed from commercial banks' balance sheets were replaced by interest-bearing government bonds. An amount of Tug 16 billion is included in the 1997 budget to meet the estimated interest costs. Fourth, Memoranda of Understanding (MOUs) were signed between the BOM and the owners and senior management of the two other large banks (Agriculture Bank and Investment and Technological Innovation Bank) facing

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[5] Under the ADB FSPL, commercial banks must meet a 2 percent Basle Agreement-based risk-weighted capital adequacy ratio by the end of 1998.

difficulties, which set out actions and conditions for their rehabilitation, and which contain criteria under which progress toward their rehabilitation will be monitored.

23. The two remaining actions will be implemented in the second half of 1997. The first action requires establishing a Credit Information Bureau (CIB) that will register defaulting borrowers. The CIB will help commercial banks to refrain from extending any new credit to defaulting borrowers. To complement this measure, banks will be required to adopt vigorous loan recovery measures. And the second action is to require external audits of each of the three remaining large banks based on international accounting standards. ADB technical assistance will finance these audits. The aim of the audits will be to produce and maintain for each bank a set of true financial statements, including a balance sheet to measure solvency, a statement of income to assess profitability and viability, and a cash flow analysis to appraise liquidity generating capacity. BOM will also introduce general measures to increase confidence in the survivor institutions—such as, enhancing supervisory standards, enforcing prudential requirements, and increasing transparency of banks' financial position. These measures will demonstrate the resolve of the authorities not to see a recurrence of banking problems, and should at once add to public confidence in the banking sector.

24. *Bank Recapitalization.* Bank restructuring generally requires that nonperforming assets be identified and stripped out, that the bank be recapitalized, and that the restructured bank be completely viable. This objective can be met by swapping non-earning assets on the balance sheet with interest-bearing government bonds. This indirectly recapitalizes the bank and provides an earning stream. The Government has taken responsibility for the inherited and directed loans, and has replaced the principal and interest accrued on these loans with government bonds. In addition, the Government has taken over the nonperforming loans of the two failed banks, substituted them with government bonds, and placed them in MARA. By removing the nonperforming loans from the balance sheet of individual banks, the Government immediately and significantly improved the asset quality of the banking system. Funds from ADB's FSPL were used for this purpose.

25. **Constraints and Required Assistance.** Although the closing operation was a success, the extent of restructuring needed in the banking system, including the immediate need to manage successor institutions, would strain even the most experienced financial authorities. In Mongolia, it will test the authorities' capabilities to the utmost. The overriding concern at present is how to nurture a fragile post-restructuring banking system into a sound market-based one capable of mobilizing and allocating resources efficiently for economic growth. The ultimate goal is to see the development of a privately-owned banking system, with foreign participation and competition. This process promises to be lengthy, requiring skills development on a whole host of fronts. The objectives of BESAC are therefore focused on achievable targets that adds value to the long-term transition goals. In this regard, IDA will support the implementation of the overall bank restructuring strategy and focus on commercial bank loan recovery efforts pertaining to enterprises. IDA will also assist in a bank twinning exercise to introduce

international banking practices and eventually foreign bank participation in the sector. ADB will provide support to develop commercial banking skills for all banks and support to BOM in banking supervision.

26. **ADB Financial Sector Program Loan.** ADB's FSPL will finance the recapitalization of the banking sector. ADB assistance to the sector is a bottom-up approach that focuses on developing skills in individual commercial banks. ADB will provide foreign experts for on-the-job training in credit underwriting, loan documentation, syndication, monitoring and recovery, and asset-liability management. ADB will also assist commercial banks to upgrade their computer hardware and software and train their staff in the use of integrated banking computer systems. ADB will provide TA for external audits of banks, and will provide TA to the BOM's banking supervision department. The banking supervisor's on-site examination capacity needs to be further developed so that problem banks are supervised quarterly rather than annually. Banking supervision needs to be extended to more branches to examine and verify data, evaluate asset quality, appraise management, and determine compliance with internal policies. Progress is also warranted in the quality of the reported data to strengthen enforcement and accuracy of the reports.

27. **The Focus of IDA Support in the Banking Sector.** IDA assistance to the banking sector will focus on putting in place the right incentives for banks to initiate debt recovery, and the right institutions and culture that place a premium on repayment and impose strong penalties for non-repayment. Within this context, BESAC has three core components that complement the ADB FSPL. First, BESAC will *support the bank restructuring strategy* agreed between the Government, IMF, ADB, and IDA. Monitorable indicators for this component, such as, *liquidation the two insolvent banks; establishing MARA, the Savings Bank and the Reconstruction Bank; specifically earmarking Tg 16 billion in the 1997 budget to finance the bank restructuring exercise,* are upfront measures that have been implemented prior to Board presentation. Second, BESAC will *support loan recovery efforts by the Government, through MARA, and by commercial banks, through the development of a debt workout unit (DWU) in the Trade and Development Bank.* The DWU program will develop a core group of debt workout specialist in the banks themselves, demonstrate the benefits of bank-led enterprise restructuring, and, by the end of the project period, jump start more wide-spread restructuring in the rest of the economy. BELTAC will also support the development of ancillary services, especially the *collateral regime*, the *bankruptcy/liquidation process*, and *judicial support for debt recovery*. And third, BESAC will assist the authorities in *halting the flow of loans to defaulting borrowers.* These measures are designed to ensure that the surviving banks remain healthy, and will be monitored continuously during the course of project implementation.

28. *(a) Bank Restructuring:* The first stages of the restructuring plan are already under implementation. As noted earlier, the Government successfully closed People's and Insurance Banks, without experiencing immediate depositor runs or significant exchange rate depreciation. The Government has agreed on the financing modalities for

the restructuring exercise, in particular the means of payment of the capitalization of the successor institutions, and has issued Tg 35 billion in bonds to finance the operation. It has submitted a revised 1997 budget to Parliament, with Tg 16 billion allocated for the interest payments on the bank restructuring bonds. Advisory assistance to implement the restructuring program has, and will be provided by IDA, EDI, IMF, ADB, and USAID. IMF and USAID-financed FDIC advisors were in Mongolia to advise and oversee the closing operation. The Government has established the Mongolia Asset Recovery Agency, and has licensed the Savings Bank, and the Reconstruction Bank. ADB will field short and long-term advisors to the Savings Bank, the Reconstruction Bank and BOM to assist this process in early 1997. The IMF will send experts in the field of monetary management and payment system in mid-1997, once the banking system is stabilized.

29. *IDA will support the implementation of the agreed bank restructuring measures. Prior to Board presentation, the Government has already: (a) placed People's Bank and Insurance Bank under receivership, (b) established and licensed the Savings Bank and the Reconstruction Bank, and (c) submitted the 1997 budget to Parliament with Tg 16 billion specifically earmarked to finance the bank restructuring exercise.*

30. *(b) Loan Recovery Efforts: Mongolia Asset Recovery Agency (MARA).* MARA was established as part of the bank restructuring exercise in December 1996. The stated goal of MARA is to recover 90 percent of the nonperforming assets that were transferred to it within the next three years. For now, MARA is concentrating on reviewing piles of loan documents, categorizing each loan (by size, borrower, and origin) and classifying them based on recovery potential. The majority of MARA's assets (about 70 percent) are defaulted small to medium-sized loans to individuals, used primarily for service, trade, and agriculture-related activities. The remaining MARA assets are defaulted loans to enterprises for large investment projects that will require extensive loan workout.

31. MARA has begun its loan recovery operations, with modest success. Future success will depend on support from the judiciary and enforcement agencies to allow MARA effective use of all legal course of action available to it. In the coming months, MARA will consider a Bulk Sales Program for modest-sized loans to expedite the liquidation process and to build a cadre of investors interested in acquiring government-owned bank assets. This program will attempt to sell weak and poor quality loans to investors other than commercial banks at substantial discount. After completion of the Bulk Sales Program, MARA will consider delegating its debt recovery activities to other institutions, especially commercial banks. Contractual servicing arrangements for loan recovery could be considered between the banks and MARA.

32. MARA will have a finite lifespan of three years, after which its functions are expected to be fully integrated into loan workout departments of commercial banks. Through MARA, the Government will also examine ways to develop a secondary market for debt, allowing any bank or institution to purchase the nonperforming loans, and aggressively initiate loan recovery efforts. Emphasis will be placed on assisting MARA

to sell or otherwise transfer the carved out loans back to existing banks, to be handled there through workouts, foreclosures, or liquidations. In the final analysis, commercial bankers are probably better suited to collect problem loans, and scare loan workout and collection expertise should be kept in the banking system. Banks need to collect their own assets and be responsible for their own lending decisions.

33. The Government has already established MARA. It *was agreed during negotiations that, as a condition of Credit Effectiveness, the Government will provide MARA with powers and responsibilities acceptable to IDA.* The charter of MARA will clearly stipulate the mandate and operating principles of MARA. The Government will confirm the full support of the judiciary and enforcement agencies to assist the loan recovery efforts of MARA.

34. *External Factors Related to Loan Recovery.* To aggressively pursue loans, the authorities must address several external factors. These include: A *legal environment* that does provides adequate and impartial enforcement of contractual agreements and support to lenders of seizures and liquidation of collateral duly pledged in support of defaulted loans, and an unwillingness on the part of the banks to use this process. A good *Credit Information System* that can protect banks from extending credit to proven defaulters. An *auditing environment* that allow auditors to test the value of risk assets and force the bank to provide adequate reserves against potential credit losses. A *tax environment* that allows the write-off of loans when no reasonable prospect of recovery exists. And a *prudential supervision system* that monitors the portfolio quality of commercial banks. These measures are being supported by TA from the donor community as well as through IDA's proposed BELTAC.

35. (c) *Debt workout unit in the Trade and Development Bank:* In most market economies, banks play a central role in forcing enterprises to restructure and/or close, either utilizing in-court processes under the insolvency law or out-of-court debt restructuring mechanisms. In many market economies, debt work-out units in banks are the major driving force behind enterprise restructuring/liquidation. The bank-led restructuring example in Poland is an interesting case in point. The objective of the Polish bank conciliation process was to restructure, under the bank's command, a group of financially troubled enterprises. Throughout this process, problem Polish debtors tried to negotiate a reduction in immediate debt service requirements as a means to keep their firm alive. In return, banks insisted upon partial payments, upon equity stakes, or upon fundamental changes in the size and functioning of the firm in order to increase their chances of future repayment of the remaining debt. The Polish bank reconciliation process has received wide acclaim, both in terms of initiating enterprise reform as well as improving the banking system's loan recovery efforts. One of the main objective of the banking component of BESAC is to develop such debt workout capacities in Mongolia.

36. BESAC will assist in the operations of a debt workout unit in the T&D bank. Initially, this unit will focus on the restructuring/liquidation of four private enterprises which are amongst its worst defaulters. These four enterprises, which include three

carpet factories and one textile enterprise, together have loans outstanding of Tg 9 billion, all of which are in arrears.[6] For three of these enterprises, T&D bank is the sole creditor; while the other enterprise has some loans outstanding to the Peoples' bank. These loans amount to 74 percent of T&D bank's total loans outstanding. Successful restructuring /liquidation of these loans will illustrate the benefits of debt work-outs and other forms of passive restructuring. Lessons learnt from this exercise can be used to fine-tune the legal and institutional framework to facilitate future workouts, and the skills acquired can be transmitted both within and outside T&D bank to deal with similar restructuring problems.

37. The T&D bank will exercise its creditor rights on the enterprises to drive the restructuring/liquidation exercise. If any of the four selected enterprises refuse to go through the workout, liquidation proceedings will be initiated against them. Technical assistance will be provided to the T&D bank under BELTAC to carry out viability assessments of the enterprises, and on that basis, draw up restructuring plans for enterprises deemed potentially viable and liquidation plans for those deemed non-viable. The restructuring plans will include financial restructuring and other forms of passive restructuring, such as selling off peripheral assets, which may restore viability and improve cash-flow. Once the passive restructuring plan is drawn up, the T&D bank and the enterprise will have to agree to a financial work-out plan which will stipulate a particular loan repayment schedule. Failure to reach this agreement, or to subsequently meet the debt-service obligations specified in the agreement, will trigger liquidation proceedings against the enterprise. These enterprises will only receive working capital loans from the T&D bank. The budget will only finance the severance payments for any workers retrenched under the agreed passive restructuring plans.

38. *Prior to Board presentation, the Trade & Development Bank has already established a debt workout unit. The newly established DWU will ensure that its operations are overseen by a Director-level manager and supported by four full-time T&D bank staff. As part of the Government's medium-term reform program, by the end of 1997, the DWU in the T&D bank will have completed the viability assessments of the four selected enterprises. Upon completion of the viability assessments, restructuring /liquidation will commence for all four companies by early 1998. In case restructuring/ liquidation is carried out through the courts, some flexibility may be required with respect to the completion dates to enable the judicial process to run its course. Barring any court related delays, the debt workout for the four selected enterprises will be completed by the end of 1998.*

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[6]The four largest defaulters are fully-private enterprises that are incapable or unwilling to service a total of Tg 9 billion in past due loans made to them prior to their privatization. Portions of these loans were on-lent from a government guaranteed foreign commercial bank loan, and thus represent a contingent liability to the government budget. However, much of the nonperforming loans were rolled-over by T&D bank, and new loans issued to the four defaulting borrowers, that distinguishing the government-directed portion from the bank own-made loan has become difficult.

39. *(c) Halting the Flow of Loans to Defaulting Borrowers.* The Government has already stopped all directed lending through the banks. *The cessation of directed lending by commercial banks will be consistently enforced, and monitored through regular commercial bank reports to BOM and through off-site examinations.* If the Government deems it necessary to lend to noncreditworthy public enterprises for policy reasons, such lending will be done from the budget, on commercial terms, and be approved though the regular budget process.

40. *BOM has already taken action to stop all bank lending to defaulting borrowers.*[7] A mechanism for reporting defaulters is already in place at the BOM—commercial banks are required to submit a list of their ten largest defaulter monthly to the BOM. In this connection, BOM has already instructed individual banks to stop lending to defaulters. *Prior to Board presentation, BOM has issued a Central Bank Regulation requiring all commercial banks to report on a monthly basis their ten largest outstanding loans. As a condition for Credit Effectiveness, BOM will establish a Credit Information Bureau consolidating periodic reports from all commercial banks of borrowers in default.* The Credit Information Bureau (CIB) will enable banks to determine if any borrower is in default to a third bank. The CIB will list all defaulters, and banks will be encouraged not to lend to anyone appearing on the list. *As part of the Government's medium-term reform program, by the end of 1998, the CIB located in the BOM will be moved to an organization independent of the BOM, and placed permanently in those quarters.*

41. **Eventual Structure of the Banking System.** The Government has singled out a few select banks for financial and technical assistance. In addition, the Government has established a "safe" bank, primarily collecting household deposits and investing only in safe assets such as government obligations and central bank bills. The bank restructuring strategy aims at establishing a few reliable banks early in the reform process. The two other large banks (Agriculture and ITI banks) have signed agreements with the BOM, specifying actions and conditions for their rehabilitation that will be monitored on a quarterly basis. For the remaining banks, that is, the eight small banks that combined control less than 10 percent of the total deposits and loans of the banking system, the authorities will strictly monitor their performance through prudential norms and regulations, and regular on- and off-site inspections. Banks that fail to adhere to prudential norms and/or rehabilitation conditions will have their licenses revoked, face penalty payments, be forced to change their management, and, in the worse case, face liquidation. The goal is to reduce the banking system to a core set of healthy and financial viable banks through attrition and market-induced mergers and acquisitions. In the interim, the presence of a few reliable institutions and the protection of the payments system from bank failures should help restore public confidence and allow the authorities

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[7] Defaulters are defined on the basis of payment delinquency. Any borrower that has failed to service its principal and interest payment obligations, and is in possession of overdue loans of over 12 months, is defined to be a defaulter.

to remove, or at least reduce, the implicit deposit insurance now provided to the banking system.

42. The bank restructuring program eventually seeks to privatize the large state- and public enterprise-owned banks. However, privatization of large state banks through cash sales has been rare in most transition countries. In Mongolia, privatizing these large banks will be difficult for both political and economic reasons. Political concerns usually complicate the pricing and methods of sales, particularly to foreign buyers. Moreover, foreign banks have shown little interest in acquiring these banks because of difficulties in evaluating their loan portfolios and integrating them with their own system. The potential for cash sales to domestic investors is also limited because local capital markets lack depth and expertise. Given these constraints, the authorities will focus on establishing a few reliable banks early in the transition process, consolidate the number of banks through attrition and market-induced mergers and acquisitions, and initiate bank twinning arrangements to facilitate future entry by foreign commercial banks in the domestic market. The bank restructuring strategy will eventually seeks to privatize all state-owned banks. The ultimate goal is to see the development of a privately-owned banking system, with foreign participation and competition. *As part of the Government's medium-term reform program, by July 1998, the Government will prepare a privatization plan that seeks to privatize all state-owned banks.*

B. Enterprise Sector Reforms

43. Banking reforms will be ineffective and unsustainable without comprehensive reforms in the enterprise sector where most of the important clients of the banks are located. Enterprise reforms should facilitate liquidation of non-viable enterprises, restructuring of potentially viable ones, efficient functioning of existing viable enterprises, and entry of new enterprises. For these goals to be achieved, actions are required on several fronts. These include: (a) privatize and improve governance structures, (b) impose hard budget constraints on enterprises, and (c) restructure or liquidate enterprises that are not financially or economically viable. These reforms will require changes in the legal framework, improvements in the capacity to enforce legal actions, and institutional development in banks and various government agencies.

44. **Background.** Privatization was a key element of the previous Government's economic reform program. Considerable progress was made in transferring assets from public ownership and in fostering the development of a private sector, especially small and medium enterprises. However, privatization of large enterprises in Mongolia has been partial and, in most cases, private participation does not exceed 49 percent. The privately owned shares are held by extremely diffused shareholders scattered throughout the country. Public enterprises are pervasive in Mongolia's economy, despite substantial privatization and new entry of private firms. Some sectors of the economy are completely dominated by public enterprises, while others have significant public enterprise presence. The privatization process has not resulted in improved governance and/or commercially-oriented behavior even for fully privatized firms. Many enterprises

are burdened by old policy-induced distortions—especially inherited/directed loans that they are unable to repay. Public enterprises, on aggregate, earned profits, but the profits were highly concentrated—the top five enterprises accounted for 86 percent of total profits in 1995. Given the weak accounting framework and the inadequate treatment of depreciation in most public enterprises, true overall public enterprise profits are most likely smaller and may even be negative. Public enterprises also absorb a sizable amount of budgetary resources, both explicitly and implicitly.[8]

45. Soft budget constraints have been a major factor inhibiting enterprise reforms in Mongolia. Public enterprises have received substantial amounts of preferential credit from the banking sector. They were the main recipients of the inherited/directed loans from the commercial banking system. Soft budget constraints originate not only from the banking sector, but also from the government budget. Budgetary subsidies to public enterprises are large, growing and becoming less transparent over time. Direct transfers, which had traditionally been the major source of financing for public enterprises, have decreased; however, indirect subsidies, arising from provision of government loans at negligible interest rates and lax enforcement of loan-repayment obligations, have increased substantially in recent years. Capital grants to public enterprises have also increased. The aggregate of direct transfers plus indirect subsidies have risen from 5.3 percent of GDP in 1993 to 7.4 percent of GDP in 1995.[9] The opportunity cost of such subsidies is high. Total subsidies exceed government spending in priority areas, such as education, health or social security and welfare. In addition, public enterprises have tax arrears to the budget that increased from 8 percent of taxes due in 1994 to 40 percent in 1995 (see Annex 3 for a detailed sector description).

46. **The Second-Phase Privatization Program.** In response to these concerns, the new Government has pledged a more comprehensive privatization program which aims to increase both the number of privatized entities and the volume of receipts from the process. The program will include the sale of some of the country's largest and strategic enterprises, such as, Gobi cashmere, gold mines, and major flour mills. *As part of the medium-term reform program, the Government will prepare a privatization program for all state-owned enterprises by July 1, 1997.* This program will also reduce Government ownership share in already privatized entities. In addition, a joint Parliamentary and Government Working Group has been established specifically to deal with the issue of housing privatization.

47. The new cash privatization program, with its more compressed schedule, highlights a number of issues and problems that will need to be addressed quickly to ensure the program meets expectations. Most prominently, these include a lack of

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[8] See World Bank, Mongolia: Public Enterprise Review—Halfway through Reforms. October, 1996.

[9] See World Bank/Danish trust funds-financed consultant report, The Financing of Public Enterprises in Mongolia. August, 1996.

transparency in the existing privatization process and the speed of the new program, both of which increase the possibility of abuse.[10] It is important to ensure that the privatized enterprises acquire a governance structure which is conducive to efficient functioning of these enterprises. A major drawback of the previous mass voucher-based privatization program was that it did not lead to any improvements in the governance structures. The Government should do more to consolidate ownership, to help establish clear lines of authority and accountability of actions, to actively support secondary trading of shares, and to seek foreign participation in the cash privatization process. In addition, there is a need for public education and consultation to ensure stakeholder approval and participation, particularly at the aimag level; for clarification of the legal framework to promote investor confidence, including potential foreign investors; and for improving the process of valuation.

48. The Government needs to improve governance structures in remaining public enterprises. The Government intends to maintain full ownership of about 20 enterprises, including public utilities and infrastructure enterprises. Dealing with the drain on public resources that these enterprises represent is a priority for Government, and strengthening corporate governance is an important first step in reforming these entities. Consideration should be given to corporatizing all remaining public enterprises under the Partnership and Companies Law of 1995. In addition, public enterprise ownership could be separated formally from regulatory authorities and the line ministries. Experience elsewhere suggests that improvements in the infrastructure enterprises require private sector involvement, if not immediately as full owners, then as managers, financiers and concessionaires.

49. **The Focus of IDA Support in the Enterprise Sector.** IDA will support the implementation of enterprise reforms that complement the bank restructuring strategy. BESAC will focus on: (a) the imposition of hard budget constraints on all public enterprises; and (b) the passive restructuring/liquidation of enterprises on three fronts: First, restructuring or liquidation of two large state-owned enterprises to be overseen by the State Property Committee; second, restructuring or liquidation of four private enterprises to be driven by a newly-created debt work-out unit in the T&D bank; and third, initiating liquidation and asset recovery for a large number of enterprises to be carried out by the newly-created MARA.

50. *(a)* *Harden Budget Constraints:* A key element of the Government's banking reform strategy is to exclude defaulting enterprises from further bank lending. To survive without bank lending and the subsidy implicit in the tolerance of default on this lending, these enterprises will be forced to turn to the budget. This is likely to impose a significant burden on the budget—greater than what it can bear—and it is neither

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[10]A well-sequenced enterprise reform strategy corporatizes (to improve accountability) and commercializes (to introduce better governance) state enterprises *prior to and concomitant with* privatization to ensure maximum gains to the state, and, at minimum, is transparent to all parties concerned.

sustainable nor desirable. Soft budget constraints impede enterprise reforms and prevent reforms already undertaken from having their full impact. Imposition of hard budget constraints from budgetary sources on the enterprise sector is thus of paramount importance.

51. The 1997 budget has current expenditures for social sector enterprises (schools, hospitals, etc.), and a separate memorandum item for severance and pension payments to civil servants and retrenched enterprise laborer. Budgetary credit allocations for long term infrastructure projects and lending to the energy sector (electricity and heat) are also included in the 1997 budget under capital expenditures. Subsidies to public enterprises are an explicit line item, and specific to public enterprises in urban transport. Net lending from the budget also specifies the two public enterprise selected as part of the BESAC program. *Prior to Board presentation, the Government, specifically, the Ministry of Finance, has: (a) eliminated subsidies to all types of enterprises, starting from the 1997, with the exception for urban transport enterprises which will be limited to Tg 455 million in 1997, Tg 600 million in 1998, and Tg 700 million in 1999; and (b) stopped all new MOF loans to enterprises starting from the 1997 budget, except to enterprises in electricity and heating. MOF loans to these enterprises will be given at two points below the Central Bank bills rate in 1997. As part of the medium-term reform program, Government loans to enterprises in electricity in heating will be given at the Central Bank bills rate in 1998, and at market rates by 1998. Moreover, the Government will reduce the level of arrears in enterprise loan repayments to the budget to 25 percent of loans outstanding by end of 1997, to 10 percent by end of 1998, and to 0 percent by the end of 1999.*

52. *(b) Enterprise Restructuring:* Many enterprises currently defaulting on their debt-service obligations are potentially viable and may generate sufficient cash flows to service their debts once appropriately restructured. This restructuring may be 'active', involving new investments, or 'passive', involving changes that do not require new investment, such as financial, organizational and management restructuring. Passive restructuring may be sufficient to restore viability in many enterprises; for others, passive restructuring may facilitate financing of active restructuring. Despite its potential benefits, there has been very little restructuring in Mongolian enterprises so far. This is due to a number of factors: (a) lack of modern corporate incentives—inappropriate governance structures; insufficient competition from domestic and foreign sources; soft budget constraints; extremely diffused ownership and "insider" control; and absence of penalties on creditors, such as banks, for making bad loans; (b) lack of technical knowledge—enterprises lack the technical ability to carry out proper viability assessments and draw up restructuring plans; and (c) inadequacies in the legal framework, particularly in the area of bankruptcy. Thus, there is good justification for a program which could jump-start this process in Mongolia. BESAC is designed to passively restructure or liquidate six select enterprises to jump-start more wide-spread restructuring in the rest of the economy.

53. The chief criterion for selection of enterprises is amount of defaults to banks.[11] All selected enterprises, especially the private ones, have significant arrears to the banking system. The two state-owned enterprises also have significant budgetary arrears. The combined defaulted loans of the six selected enterprises account for about a third of all past due loans and about 15 percent of total loans outstanding to the banking system. Arrears of the four private enterprises to T&D bank alone represent 43 percent of T&D bank's total loans outstanding. The total past due debt obligations of these six enterprises amount to more than Tg 12 billion. Table 1 shows the principal and interest past due for the six selected enterprises.

TABLE 1: SELECTED ENTERPRISES AND THEIR LEVEL OF DEFAULTS
(in Tg million)

Bank	Borrower's Name	Outstanding Principal Balance	Past Due Principal	Past Due Interest	Directed/ Inherited Portion	Owner-ship
People's	Bagahangai Meat	1,159.6	1,159.6	0.0	0.0	state
ITI, T&D, Insurance	Darkhan Minimetal	1,828.2	1,828.2	1,096.3	1,828.2	state
Trade & Dev.	Erdenet Carpet Co.	4,526.6	4,526.6	1,092.0	423.9	private
Trade & Dev.	Dornod Carpet Co.	2,068.2	2,068.2	695.6	193.2	private
T&D, People's	UB Carpet Co.	1,744.3	1,744.3	384.1	138.5	private
Trade & Dev.	Eermel Textile Co.	745.5	745.5	0.0	745.5	private
Total		**12,072.4**	**12,072.4**	**3,268.0**	**3,329.3**	

54. *Restructuring/Liquidation of Two State-owned Enterprises*. The SPC, exercising its ownership rights on behalf of the Government, will initiate work-out exercises for two large, state-owned enterprises, the Darkhan Mini-metal plant and the Bagahangai Meat Processing plant. These two enterprises are among the largest defaulters to the banking sector with total loans outstanding of Tg 3 billion, all of which is in arrears. On entry into the restructuring/liquidation program, the enterprises will be isolated from the banking sector and other financiers (such as other enterprises) and the budget will become the sole source of financing. As with the private enterprises to be dealt with by the debt work-out unit of the T&D bank, viability assessments will be carried out of the enterprises and on the basis of these, either a restructuring or a liquidation plan will be drawn up. The restructuring plan will only cover passive restructuring measures, the implementation of which will be financed through the budget. It will be a time-bound

[11] The restructuring program excludes enterprises that are: (a) large joint-ventures with foreign investors (e.g., Erdenet, Mongol Railways, Mongol Telecom); (b) already undergoing restructuring, in some cases through IDA and ADB projects (e.g., Baganuur Coal Mine, Civil Aviation Authority); (c) large utilities and monopolies (e.g., the Central Energy System); and (d) good candidates for privatization without restructuring (e.g., Gobi Cashmere).

program to be completed within 18 months. The enterprise will be expected to achieve a positive operating surplus for two consecutive months within this period, failing which it will be liquidated. If it achieves operating surpluses within this period, it will come out of isolation and go back to commercial sources of financing.

55. The cost of the financial restructuring/liquidation of these enterprises will be borne by the budget which will provide working capital loans during the isolation period, and subsidies to pay for the social costs, mainly severance payments. A total of Tg 2.5 billion will be allocated in the 1997 and 1998 budget for this purpose. The Darkhan Mini-metal plant isolation exercise alone would cost about Tg 2 billion. All other costs including provisions for severance and related social security payments for retrenched workers, amount to about Tg 500 million. These loans will be given subject to successful implementation of restructuring plans, and will not exceed Tug 2.5 billion in 1997 and 1998 combined.

56. *As part of the Government's medium-term reform program, by the end of 1997, viability assessments for Darkhan Minimetal and Bagahangai Meat plans will be completed; by early 1998, the restructuring/liquidation plans of the two enterprises will have been approved; and by the end of 1998, the restructuring/liquidation exercise for the two enterprises will have been completed.*

C. Social Impact of Banking and Enterprise Reform

57. **Bank Restructuring.** The overall bank restructuring exercise will have an impact on society because of the significant role of the banking sector in the economy. Commercial banks provide services to about 30 percent of the total population. All government salaries and government transactions are distributed through the banking system. And pension and welfare benefits to over 300,000 individuals are delivered through the banking system. It is estimated that the consolidation and restructuring of the two large banks will result in a net decrease of about 600 jobs over a three-year period. The proposed program, however, is a corrective measure to restructure a banking system on the verge of collapse. Without the program, over 4,000 jobs in the banking sector, the savings of about 700,000 individual depositors, payment of pensions and social allowances to vulnerable groups, and all government transactions would be at stake. To ensure the social impact of the program remains neutral, the banking system should maintain its presence in the rural *somon* centers to ensure the delivery of social safety net provisions to the rural population. Household depositors should not be adversely affected by the liquidation process as the Government will fully cover their deposits. Throughout the process, the Government must ensure that steps are taken to preserve public confidence in the banking system.

58. **Enterprise Restructuring.** Despite significant retrenchment of labor in recent years, many employees still remain on the books of the enterprises, even if they are not paid. Many employees who are partially or fully paid are underemployed. The restructuring and liquidation of enterprises will lead to job losses as redundant workers

are retrenched. The exact extent of such retrenchment is difficult to quantify since much will depend on the results of the viability assessment of each enterprise. Nonetheless, some estimates of the likely degree of retrenchment can be made based on current levels of employment and under-employment. The six enterprises to be covered by the SPC and T&D bank-driven restructuring programs currently have about 6,000 employees on their rosters, of which barely half are working and being paid. A possible scenario is that the 50 percent who are currently not being paid will be retrenched. This comes to about 3,000 people. Given that many of these employees have not received any payments for several months and that most of them do not enjoy any other facilities from the enterprises, such as housing, the impact and cost of retrenchment will be manageable, especially if it is cushioned with severance payments. BESAC counterpart funds will be used to provide severance payments to workers retrenched through restructuring or liquidation of these six enterprises. Workers losing their jobs under the bank-led liquidation will be covered through the general social safety net provisions of the Government.

59. **IDA Social Sector Assistance**. BESAC follows IDA's FY95 Poverty Alleviation for Vulnerable Groups Project (Credit 2760-MOG). The Poverty Alleviation Project seeks to mitigate the adverse effects of Mongolia's economic transition on the poor segments of the population. Specifically, the Poverty Alleviation project aims to create gainful employment and income-generating opportunities for those adversely affected by the transition, and complements BESAC in addressing the larger social concerns resulting from the transition process. The Bank's Country Assistance Strategy calls for an additional Poverty Alleviation Project in FY98.

D. LEGAL ISSUES PERTAINING TO BANKING AND ENTERPRISE REFORM

60. Achieving sustainable reforms in the banking and enterprise sectors will require resolution of several constraints in the legal and regulatory environment. Banks and enterprises have been seriously hampered by difficulties in such areas as contract enforcement (including loan collection), secured transactions, and the failure of bankruptcy procedures. The Government has embarked on program of legislative reform, including redrafting of existing provisions, and development of new legislation.

61. Through BELTAC, IDA will assist the Government in specific interventions, with a particular emphasis on filling critical legislative gaps and improving the application and enforcement of Mongolia's laws. In this regard, IDA will assist in the establishment and operations of supporting institutions, such as the courts, judiciary, registry and the bailiffs office, to ensure more effective enforcement. Core elements of this legal reform program, aimed specifically at supporting the process of default resolution, asset realization and loan workout, include: (a) strengthening the bailiffs office, (b) training legal professionals in the application of the new bankruptcy law, and (c) establishing a registry for the registration of secured interests in movable property.

62. The BOM's legal authority, including the scale and scope of remedial powers vis-à-vis commercial banks, is detailed in the newly-enacted Central Bank and Banking Law. *As part of the Government's medium-term reform program, the BOM will review the implementation of the Central Bank and Banking Law by mid-1998, with a view to examining its effectiveness.*

63. To facilitate the process of restructuring and liquidation, the Government will present a Draft Insolvency Law to the fall session of Parliament. *As a condition for Credit Effectiveness, the Government will present a Draft Insolvency Law to IDA.*

E. FISCAL IMPLICATIONS OF BANKING AND ENTERPRISE REFORMS

64. For the bank restructuring exercise, the cost to the Government comprises: (a) initial payments to the banks to offset the effect of directed and inherited loans, (b) the capitalization of the MARA, the Savings bank and the Reconstruction bank, (c) the *pari passu* writedown of government deposits in the failed banks, (d) the recapitalization of BOM for losses on its past lending to the failed bank, and (e) any losses incurred by MARA if ultimate realizations are less than estimated at time of closure. The Government issued a total of Tg 35 billion in bonds at a variable coupon rate indexed to the central bank bills rate to finance the bank restructuring. Tg 21 billion in government bonds were first issued to MARA to cover the nonperforming loans of the two failed banks. MARA sold all its bonds to the BOM, which in turn provided Tg 10 billion in bonds to the savings bank, Tg 4.3 billion in bonds to the reconstruction bank. The Government issued an additional Tg 8.9 billion in bonds to BOM, Tg 10.5 billion in bonds directly to the savings bank, Tg 1.3 billion in bonds to the reconstruction bank. This translates to Tg 16 billion in cash expenditures from the 1997 budget, consisting of interest payments on the bonds and direct capitalization of the new banks. In addition, starting from 1997, the Government will make cash payments of Tg 1.6 billion in 1997 to the Agriculture bank for services rendered in distributing pensions and social services. The estimated cost for the bank restructuring exercise in 1997 is shown in Table 2.

65. As part of the bank restructuring strategy, the Government intends to privatize all state-owned banks. Success of the bank privatization will not only determine the growth prospects for the economy, but also the ultimate cost of bank restructuring exercise. These cost are lower now than estimated in December, but they still amount to a whopping 8.7 percent of GDP. Since the Government directly or indirectly owns these banks, strong turnaround in these banks will increase the value of this investment, which will eventually be recovered when the banks are privatized. The cost of the bank restructuring exercise is reduced substantially as proceeds from the privatization is added to government revenues. Moreover, any proceeds made from loan recovery efforts by MARA will augment government revenues. Non-cash expenditures from the budget, that is the government bonds issued for the bank restructuring exercise, are Government equity stakes in state-owned banks, yielding dividends to Government in the interim.

Table 2: Estimated Bank Restructuring Cost to Government in 1997

	(in Tg billions)	(in % of GDP)
Current Expenditures (budgetary items)	**17.6**	2.6
Interest on bonds	16.0	
Service payments to Agriculture Bank	1.6	
Non-cash transactions (excluded from budget)	**40.2**	6.1
Bonds issued:	35.0	
MARA	--	
Savings bank	20.5	
Reconstruction bank	5.6	
BOM	8.9	
Loss of Government deposits	2.5	
Loss of Government equity in failed banks	2.7	
TOTAL COSTS	**57.8**	8.7

66. The total cost of implementing the enterprise restructuring program for the two selected public enterprises is estimated to be about Tg 2.5 billion, comprising working capital and social provisions. These are upfront costs to the 1997 and 1998 budget. This assumes that once under isolation, the two selected enterprises will operate under strict cost control measures. The enterprises will not be allowed to borrow additional funds, other than that of the budget support during the isolation period. The majority of the costs is to finance the working capital of Darkhan mini-metal during isolation. The social safety net estimations are minor in comparison, about Tg 0.3 billion, that includes severance pay to workers retrenched as a part of the isolation program. Most of the working capital outlays are expected to be repaid by the enterprises once they exit the restructuring exercise.[12] For the medium-term, the budgetary provisions for enterprise reforms is marginal, since substantial revenue generation is expected from the Government's cash privatization program and since much of the future enterprise restructuring is expected to be driven by the banks themselves, through their workout units and through the secondary market for debts. The budgetary projections for the bank and enterprise restructuring program combines are shown in Table 3.

[12] A simple assumption is made that Darkhan and Bagahangai plants are both viable and are able to repay Tg 1 billion from 2001 to 2004.

Table 3: Budgetary projections

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Expend. for Bank Restructuring									
(as % of GDP)	2.42%	0.59%	0.52%	0.30%	0.21%	0.14%	0.08%	0.38%	0.00%
(in Tug billion)	(16.0)	(4.6)	(4.6)	(3.0)	(2.4)	(1.8)	(1.2)	(0.6)	(0.0)
Expend. for Enterp. Restructuring									
(as % of GDP)	0.15%	0.19%	0.00%	0.00%	-0.09%	-0.08%	-0.07%	-0.06%	0.00%
(in Tug billion)	(1.0)	(1.5)	(0.0)	(0.0)	(-1.0)	(-1.0)	(-1.0)	(-1.0)	(0.0)
GDP (in Tug billion)	661.7	778.2	882.6	1001.1	1135.5	1281.8	1426.7	1587.9	1767.3
Total Costs									
(as % of GDP)	**2.57%**	**0.78%**	**0.52%**	**0.30%**	**0.12%**	**0.06%**	**0.01%**	**-.03%**	**0.0%**
(in Tug billion)	**(17.0)**	**(6.1)**	**(4.6)**	**(3.0)**	**(1.4)**	**(0.8)**	**(0.2)**	**(-0.4)**	**(0.0)**

67. The fiscal impact of the combined reform program is substantial. Most of the expenditures are one-time injections of funds that fall due in the first year of the program, with smaller outlays in 1998 and beyond to service the interest payments on the government bonds. The budgetary outlay in 1997 is estimated at Tg 17 billion, or about 2.57 percent of GDP; and Tg 6.1 billion in 1998, or about 0.78 percent of GDP. The interest burden of the reform program steadily decreases. Honoring these obligations is important for the credibility of the Government and its reform program.

PART IV. IDA ASSISTANCE STRATEGY

A. COUNTRY ASSISTANCE STRATEGY

68. Since IDA lending to Mongolia began in late 1991, the World Bank Group's country assistance strategy has been to support Mongolia's continued transition to a market-oriented economy. The 1995 CAS sets out the principal criteria which would govern future IDA assistance. In the short term, the strategy is to support the Government's macroeconomic management capability through technical assistance and continued policy dialogue; in the medium-term, the strategy is to support the development of private activities and financial institutions as well as to help implement the Government's poverty alleviation program; and, in the long term, the strategy is to help remove infrastructure bottlenecks for sustainable growth. The CAS also outlines the institutional and structural reform measures that are needed in the country, especially in the banking and enterprise sectors, and these are supported by the proposed BESAC.

69. This strategy was initially implemented through a series of quick-disbursing loans to support institutional and policy reforms (Economic Rehabilitation Credit, Economic Transition Support Credit, Technical Assistance Credit), and investment projects to support the rehabilitation of key infrastructure (Transport Rehabilitation Credit, Coal Mine Rehabilitation Credit). During this period, IDA maintained intensive dialogue with

the Government on required reform measures, especially in the enterprise and banking sectors. IDA's continued dialogue with the authorities, together with its economic and sector work (CEM; Issues on Private Sector Development; Energy Survey; Poverty Assessment; Public Enterprise Review) provides the underpinning for the proposed BESAC.

70. The CAS calls for selective intervention in IDA lending to the country, designed in coordination with the activities of other donors. Effective donor coordination is fundamental to the IDA lending program, and BESAC is a supreme example of this effort. The World Bank co-chairs the annual Tokyo Assistance Group Meeting for Mongolia with the Government of Japan, and actively participates in local donor meetings. In particular, Bank lending is designed to complement the programs of larger donors, notably the ADB and bilateral assistance from Japan and the USA. Cooperation with the IMF has been intense and constructive. IDA participates in all Fund ESAF /Standby Agreement discussions with the Government.

B. LINKS WITH OTHER IDA OPERATIONS

71. The project would be IDA's first operation in Mongolia focusing on the banking and enterprise sectors. It builds on the experience of technical assistance programs in macroeconomic management (Technical Assistance Credit, 2321-MOG), and in financial sector development (Financial Sector TA, PHRD Grant). It is also IDA's first policy-based loan to Mongolia, and its success will be a precondition for a planned follow-up Enterprise and Private Sector Development Credit in FY98. The principal lessons learned from previous IDA credits in Mongolia include the importance of establishing a dedicated project implementation unit and designing a detailed implementation schedule (including policy conditionalities) prior to effectiveness.

C. LESSONS OF EXPERIENCE

72. The success of reforms in the enterprise sector significantly impacts the functioning of commercial banks. IDA experience has shown that bank recapitalization exercises that do not address the poor performance of bank borrowers inevitably lead to a second round of capital infusion for the banks two or three years down the line. In this regard, a number of factors are vital for the success of bank and enterprise restructuring programs. They include: (a) high-level political commitment to the program; (b) a halt to the flow of bad loans; (c) adequate restructuring and downsizing of banks and enterprises; (d) sustainable financing and budgetary provisions for restructuring; (e) a strong legal and regulatory framework to underpin banking and enterprise reform measures; and (f) working-level capacity to implement the proposed reforms. The Government has agreed to take into account the first five factors into BESAC, while the latter two factors provide the rationale for BELTAC.

73. IDA evaluations of adjustment lending, technical assistance and public enterprise reform and privatization operations highlight three areas which have determined project success or failure. These are: *borrower ownership*, reflected in high-level political

commitment, and working-level institutional readiness, *simplicity of project design*, that is, not attempting too ambitious a range of reform measures, and *realistic risk assessment*, as a function of appraisal and project supervision. Where political commitment and implementation capacity are weak, technical assistance is little more than a band-aid solution. IDA experience in adjustment operations also underlines the importance of coordination with other donors to share the burden of reforms, and limit exposure to high-risk situations.

74. The peaceful transfer of power made this summer, and the conclusion of local elections held in October 1996, ensure a stable political climate in Mongolia for the next two years. Presidential elections scheduled for the summer of 1997 should add spark to the process, but Prime Ministerial control over Parliament will likely maintain the speed and momentum of reforms. Moreover, implementation of an IMF Standby Agreement should ensure a stable macroeconomic environment that is necessary for the success of the operation.

75. Political commitment to banking and enterprise reforms in Mongolia remains strong at all levels of Government. At the highest level, the Prime Minister reaffirmed and committed the support of his office and his senior economic advisor to the BESAC project. At the grassroots level, individual enterprise managers, faced with prospects of liquidation, are also committed to restructuring. The implementing agencies, such as the SPC, echo the same view—the need for radical reforms to restore confidence in the system and jump start the economy. On the banking side, MOF has allocated over Tg 16 billion in the 1997 budget to finance the bank restructuring exercise; and BOM is expected to spearhead the restructuring. Parliament has passed an amended central bank and banking law in September to strengthen the powers of BOM to undertake bank restructuring; and the Government has established several working groups under MOJ to enhance loan collection.

76. The Government will initiate most policy actions relating to BESAC upfront. For example, the first four steps in the bank restructuring exercise (e.g. closing down insolvent banks, setting up MARA) have been completed, and the two remaining steps (e.g. setting up the central registrar of defaulting borrowers and external audits of banks) will have been initiated by the time of Board Presentation of BESAC. In addition, all 37 conditions required for the first tranche release of ADB's FSPL have been met.

77. The design of the BESAC is modest in scope. The project consists of targeted interventions to support commercial bank restructuring, debt recovery, and financial restructuring of a few distressed enterprises as a demonstration effect. The policy matrix is structured so that most of the required actions are taken prior to Board presentation. The program of technical assistance proposed under BELTAC has been developed on the basis of extensive consultations with local stakeholders and other donor organizations.

PART V. THE PROPOSED CREDIT

A. CREDIT AMOUNT AND BORROWER

78. The proposed IDA Credit, in the amount of SDR 7.2 million ($10 million equivalent), will be made to the Government of Mongolia on standard IDA terms. The Government will administer the Credit through the MOF, in close collaboration with the BOM. Implementation of the proposed Credit will require close collaboration between all agencies involved, particularly the MOF, BOM, MOJ, and the SPC.

79. The Credit will provide timely and responsive support, in the form of quick-disbursing balance of payments assistance, for efforts being undertaken by the Government to reform the banking and enterprise sectors. This Credit is part of a coordinated donor response to the assistance needs of Mongolia, in particular with the $35 million ADB Financial Sector Program Loan and the IMF ESAF Program.

80. The Government's medium-term reform program is detailed in the Letter of Development Policy and the Matrix of Key Policy Conditions (see Annex 4).

B. DISBURSEMENT ARRANGEMENTS

81. The Government will open and maintain a Deposit Account in BOM. Disbursements will not be linked to specific purchases, and supporting evidence for disbursements is therefore not required. No special procurement arrangements are envisaged, since they are not required by tranche release conditions. Tranche release review, and program supervision, will ensure that the reform programs supported under the BESAC are carried out as agreed, including timely provision of resources by the Borrower to meet the costs of program implementation. Upon tranche release, BOM will submit a simplified withdrawal application to IDA, against which IDA will disburse credit proceeds into the Deposit Account. If credit proceeds are used for ineligible purposes, as defined in the Credit Agreement, IDA will require the Government either to return and reallocate the amount, or to refund it directly to IDA for cancellation.

C. TRANCHE CONDITIONS

82. It is proposed that the credit be disbursed in a single tranche in the amount of $10 million. The tranche conditions are shown in the table below. IMF Board approval of the 1997-1999 ESAF program is a key monitoring indicator for the macroeconomic credit effectiveness condition. The Government's medium-term reform program is detailed in the Letter of Development Policy and the Matrix of Key Policy conditions (see Annex 4).

Actions Already Taken (prior to Board Presentation)	Credit Effectiveness Conditions	Medium-Term Reform Program
Macroeconomic Stabilization	• maintain a sound macroeconomic framework, consistent with the objectives of BESAC.	
Banking Sector • Placed People's Bank and Insurance Bank under receivership. • Established and licensed the Savings Bank and the Reconstruction Bank. • Submitted the 1997 budget to Parliament with Tg 16 billion specifically earmarked to finance the bank restructuring exercise. • Established a debt workout unit in the Trade and Development Bank, with its operations overseen by a Director-level manager and supported by four full-time T&D bank staff. • Issued a Central Bank Regulation, requiring all commercial banks to report on a monthly basis their ten largest loans outstanding.	• Establish MARA, with powers and responsibilities acceptable to IDA. • Establish a Credit Information Bureau, consolidating periodic reports from all commercial banks of borrowers in default.	• By end-1997, the DWU in the T&D bank will have completed the viability assessments of the four selected enterprises. • By early 1998, the DWU in the T&D bank will commence the restructuring or liquidation plans for all four enterprises. • By end-1998, the DWU for the four selected enterprises will be completed. • By end-1998, the Credit Information Bureau located in the BOM will be moved to an independent authority, and placed permanently in those quarters. • By mid-1998, the BOM will review the implementation of the Central Bank and Banking Law, with a view to examining its effectiveness. • By July 1998, the Government will prepare a privatization plan that seeks to privatize all state-owned banks.
Enterprise Sector • Eliminated subsidies to all enterprises, starting from the 1997 budget, with the exception for urban transport enterprises which will be limited to Tg 455 million in 1997, Tg 600 million in 1998, and Tg 700 million in 1999. • Stopped all new MOF loans to enterprises starting from the 1997 budget, except to enterprises in electricity and heating. MOF loans to these enterprises will be given at two points below the Central Bank bills rate in 1997.	• Present a Draft Insolvency Law to IDA.	• By July 1997, the Government will prepare a privatization program for all state-owned enterprises. • By end-1997, the Government will reduce the level of arrears in enterprise loan repayments to the budget to 25 percent of loans outstanding, to 10 percent by end-1998, and to 0 percent by end-1999. • By 1998, MOF loans to enterprises in electricity in heating will be provided at the Central Bank bills rate, and at market rates by 1998. • By end-1997, viability assessments for Darkhan Minimetal and Bagahangai Meat plans will be completed. • By early 1998, the restructuring/liquidation plans of the two enterprises will have been approved. • By end-1998, the restructuring/liquidation exercise for the two enterprises will have been completed.

D. ACCOUNTS AND AUDITS

83. MOF would keep full accounts on credit operations, specifically records of all withdrawals against the Credit. These records would be updated monthly, and quarterly statements of transactions and balances, together with necessary recommendations for disbursements and information on claims in progress, would be forwarded to IDA. MOF would maintain records of all transactions in accordance with sound accounting practices. MOF would also ensure that supporting documents, the basis for statements of expenditure, are properly maintained. IDA reserves the right to audit the Deposit Account.

E. MONITORING ARRANGEMENTS

84. MOF will be responsible for monitoring and implementing the program, and establish a project implementation unit. The proposed unit will collaborate with dedicated officers in the BOM with regard to banking reforms and the MOJ with regard to implementation of legal reforms. IDA will monitor implementation through periodic reviews. Implementation of the bank restructuring plan will be jointly monitored by the IMF, ADB and IDA. At each stage, technical assistance missions will oversee the implementation of the restructuring plan, and review the status of project implementation. IDA supervision missions will be coordinated to overlap with ADB missions to ensure synergy and consistency of program objectives. Staff will advise senior management if significant deviations occur.

F. ENVIRONMENTAL ASSESSMENT REQUIREMENTS

85. In accordance with the Bank's Operational Directive on Environmental Assessment (OD 4.01, Annex E), the proposed operation has been placed in Category C and does not require an environmental assessment.

G. BENEFITS AND RISKS

86. **Benefits.** An economy cannot function, let alone grow and thrive, without a healthy financial system. The proposed measures require urgent implementation to ensure that banks are able to fulfill their roles as efficient collectors of savings, allocators of credit, and managers of the payments system. Anticipated benefits for the banking system of the proposed project are measurable improvements in the quality of commercial bank intermediation, and in the legal and regulatory framework in which banks operate. In the long term, this should enable new private enterprises to obtain financing at competitive rates. The stronger legal and regulatory framework will help instill greater discipline in the commercial banks, protecting their long-term solvency as well as the interests of depositors. This discipline will, in turn, harden budget constraints faced by enterprises. These pressures, if maintained, should foster further enterprise reform. In addition, facilitating the debt recovery process, supported by appropriate legal measures, will create disincentives for nonrepayment, lower transactions costs to both borrowers and lenders, and contribute to the availability of funds for lending.

87. Although it will take some time before Mongolia stimulates as much creditor-led restructuring as in established market economies, the bank-led restructuring exercise is an important start. It will establish a framework for conciliation process that empowers banks to negotiate workout agreements with problem debtors. Moreover, the emergence of banks that have the resources and competence to support a wide range of business activities (e.g. working capital loans to viable enterprises, the use of collateral, letters of credit, export financing) will greatly benefit enterprises.

88. **Risks.** The proposed bank restructuring exercise is by no means easy to implement. It is a bitter pill to swallow, but one that has been accepted by the Mongolian authorities as realistic and overdue. The biggest risk associated with this type of adjustment operation is if the restructuring exercise is unsuccessful, and a core group of viable banks not formed, the process may have to be repeated two or three years down the line, requiring additional capital infusion from Government. The Government is fully committed to these reforms and cannot afford another capitalization exercise. Moreover, conditions in the banking system have reached a point where the cost of inaction clearly outweighs the risk of implementing a difficult restructuring program.

89. BESAC has been designed to focus on a narrow range of policy actions, with an emphasis on upfront conditionality, and disbursements made in a single tranche. IDA has indicated to the Government that any future assistance requested for the banking and enterprise sectors, hinges on the successful outcome of the BESAC. The successful implementation of the bank restructuring plan, and putting in place the right incentives for banks to initiate debt recovery, will require careful monitoring and supervision. IDA, the IMF, and ADB will have to continue close cooperation, delivering timely and effective technical assistance, to prevent and minimize the adverse effects of restructuring, and to establish and assist the successor institutions.

90. The immediate constraint confronting the authorities is its limited human resource pool to implement the financial restructuring program. This poses a formidable challenge. IDA, ADB and bilateral agencies will provide adequate and timely technical assistance to fit the needs and capacity of Mongolian banks. This will include the supply of foreign consultancy services, which are essential given the currently inadequate local capability to provide such services. Foreign consultants will be teamed up with local consultants in order to maximize transfer of skills and knowledge.

91. Experiences in other transition economies have shown the consolidation of bad loans in a government-run collection agency have not been successful (e.g. Hungary), because the new agencies did not have the ability nor the determination to follow-through on collection. In contrast, keeping bad loans in banks and forcing the banks to deal with them has helped build badly-needed institutional capacity in commercial banks (e.g. Poland). BESAC is designed to initiate the bank-led restructuring process. In this regard, there is a risk that T&D bank will be unable to effectively work out outstanding loans from the enterprises, because of bottlenecks in the legal process and the judicial system. This risk is aggravated if the cases are individually settled through the courts. It can be

mitigated by issuance of a Government decree on the functions and responsibilities of the DWU, akin to Resolution No. 102; by enactment of a revised Insolvency Law; and by exploring options for out-of-court settlement and arbitration. The risk will be further mitigated by short-term technical assistance provided under BELTAC in debt workout, training of insolvency practitioners and enforcement of judgments.

92. There may be opposition to the enterprise financial restructuring/loan workout program due to fears about the social costs of restructuring and liquidation. This risk is not too serious in Mongolia, as Mongolian state-owned enterprises are not overly burdened with such social assets as housing, hospitals and kindergartens, compared with other transition economies. However, the risk of a slowdown in the pace of reforms, emanating from the enterprise sector where the social costs of adjustment are most apparent, is real in Mongolia. IDA will maintain continuous dialogue with the Mongolian authorities to ensure the steady and well sequenced implementation of the Government's medium-term reform program.

Recommendation

93. I am satisfied that the proposed Credit would comply with the Articles of Agreement of the Association and recommend that the Executive Directors approve it.

James D. Wolfensohn
President
by: Gautam S. Kaji

Washington, D.C.
March 25, 1997

TABLE A.1: KEY ECONOMIC INDICATORS, 1991-98

(in percent unless otherwise indicated)

	1991	1992	1993	1994	1995	1996/a	1997/b	1998/b
Real GDP Growth	-9.9	-7.6	-1.3	2.3	6.3	2.6	3.5	5.0
Nominal GDP (Tg billion)	18.9	43.1	183.3	283.3	429.2	532.8	661.7	778.2
GDP deflator (period average)	99.1	176.4	262.3	66.6	42.5	21.0	20.0	12.0
Consumer prices (end-period)	208.6	321.0	183.0	66.3	53.1	53.3		
Gross capital formation/GDP	28.9	14.5	19.0	20.9	23.7	22.4	25.9	27.0
Foreign savings/GDP	18.2	5.1	4.9	5.8	4.1	1.4	9.3	7.2
Domestic savings/GDP	10.7	9.4	14.1	15.1	19.6	21.0	16.5	19.8
Budget current revenue/GDP	47.4	30.0	30.2	29.3	31.6	27.8	29.0	29.7
Budget current expenditure/GDP	51.7	31.1	28.3	27.9	23.8	22.7	27.1	26.7
Overall balance/GDP (deficit-)	-9.7	12.7	-17.0	-24.6	-3.7	-7.4	-12.3	-10.1
Change in broad money	53.5	31.7	251.1	81.4	32.9	25.8	20.0	17.4
Income velocity	1.9	3.3	4.0	3.4	3.8	4.1	4.3	4.3
Export volume growth	-	11.0	5.6	-8.4	5.6	10.2	8.9	8.1
Import volume growth	-	-20.2	-12.1	-1.9	21.2	0.8	6.1	6.6
External current account ($ million)	-	-72.3	-38.5	-40.3	-40.2	-13.6	-13.6	-13.6
External debt ($ million)	236.3	341.8	349.0	473.7	504.2	540.7	635.7	680.4
World Bank		27.0	30.0	49.0	59.0	68.5		
External debt/GDP	31.2	31.7	59.5	68.6	52.8	55.3	75.2	75.0
Debt Service (US$ millions)	2.2	68.0	19.0	38.0	46.0	48.9	49.4	35.8
Debt Service/Exports	0.6	17.7	4.8	9.3	8.7	9.2	9.3	6.1

/a Estimates.
/b Projections.

Source: Mongolian authorities, World Bank staff, IMF.

Table A.2: Balance of Payments
(in millions of US dollars)

	1995	1996/a	1997/b	1998/b
Trade balance	**-3.3**	**-80.9**	**-88.4**	**-81.5**
Exports, f.o.b.	485.6	429.9	438.6	476.1
Copper	257.6	190.7	154.4	156.1
Imports, c.i.f.	-488.9	-510.8	-527.1	-557.6
Services, net	**-34.1**	**-32.5**	**-29.9**	**-27.6**
Receipts	50.1	52.7	56.9	61.5
Payments	-84.2	-85.2	-86.8	-89.1
Private unrequited transfers	**-2.8**	**-2.0**	**-2.0**	**-2.0**
Current account deficit (-), excluding official transfers	**-40.2**	**-115.3**	**-120.4**	**-111.1**
Public unrequited transfers, net	**79.1**	**64.1**	**40.4**	**20.0**
Official grants	70.8	56.6	26.1	10.0
Other official transfers, net	8.2	7.5	14.3	10.0
Capital account	**13.5**	**40.8**	**99.6**	**79.8**
Direct investment	9.8	10.0	12.0	14.4
MLT loan disbursements, net	50.9	66.6	115.9	85.1
Disbursements	96.2	105.6	148.3	117.6
Amortizations	-45.3	-39.1	-32.5	-32.5
Short-term capital	-47.2	-35.8	-28.3	-19.7
Errors and omissions	**-28.7**	**-10.2**	**0.0**	**0.0**
Overall balance	**23.8**	**-20.6**	**19.6**	**-11.3**
Financing	**-23.8**	**20.6**	**-19.6**	**-15.0**
Increase in net official reserves (-)	-30.7	17.9	-12.5	-15.0
Use of IMF credit	-8.2	-2.8	20.6	12.2
Increase in gross official reserves (-)	-22.5	20.7	-33.1	-27.2
Financing gap	**0.0**	**0.0**	**0.0**	**26.3**
Memorandum items:				
Exports, f.o.b. (Annual growth)	32.3	-11.5	2.0	8.5
Imports, c.i.f. (Annual growth)	32.0	4.5	3.2	5.8
Current account deficit (-)	4.2	-10.6	-11.2	-9.4
Public transfers, capital account & errors and omissions	63.9	94.7	140.0	99.8
Net official reserves (end-period)	67.9	50.0	62.5	77.5
(In weeks of imports, c.i.f.)	7.2	5.1	6.2	7.2
Short-term foreign liabilities	47.0	44.2	64.8	77.0
o/w: Use of IMF credit	47.0	44.2	64.8	77.0
Gross official reserves (end-period)	114.9	94.2	127.3	154.5
(In weeks of imports, c.i.f.)	12.2	9.6	12.6	14.4
Nominal GDP	954	1,086	1,071	1,176

/a Estimates.
/b Projections.

Sources: Mongolian authorities; IMF.

Table A.3: Budget Summary

	1995	1996	1997*
	(millions of Tugriks)		
Total Revenue and Grants	**144,623**	**158,332**	**212,084**
Current revenue	**135,684**	**151,983**	**191,784**
Taxes, fees and charges	105,510	127,336	163,594
Income taxes	48,537	49,745	52,900
Social security	15,765	21,866	26,800
Domestic sales tax	7,839	9,885	13,493
Excise on petroleum and other	8,580	11,106	13,900
Customs and import sales tax	17,987	24,723	31,500
Other	6,802	10,010	15,000
Nontax revenue	30,174	24,647	28,190
Capital Revenue and Grants	**8,839**	**6,349**	**20,300**
of which: Privatization receipts	3,721	3,000	15,000
Total expenditure	**162,143**	**215,630**	**289,314**
Current expenditure	104,989	124,812	180,957
Wages and salaries	26,758	32,814	47,658
of which: severance payments			7,231
Purchase of goods and services	47,385	54,621	61,000
Subsidies to public enterprises	3,607	0	455
Transfers	21,992	32,277	42,450
Interest payments	5,247	5,100	22,393
of which: bank restructuring bonds			16,000
Capital Expenditure and net lending	57,155	90,818	108,358
Capital expenditure	53,168	84,086	107,608
Net lending and other	3,986	6,732	750
Current balance	**30,695**	**27,171**	**10,827**
Overall balance	**-17,521**	**-57,298**	**-77,231**
Financing	17,521	57,298	77,231
Foreign (net)	29,635	37,688	83,931
Project loans, gross	28,621	58,080	76,087
Foreign cash loans	18,211	0	34,514
less: Amortization	17,197	20,392	26,670
Domestic, net	-12,144	19,610	-6,700
Banking system, net	-20,400	13,906	-6,500
Nonbank, net	8,286	5,704	-200
	(in percent of GDP)		
Total Revenue	33.7	25.6	26.7
Current revenue	31.6	24.6	24.1
Tax revenue	24.6	20.6	20.6
Capital revenue	2.1	1.0	2.6
Total Expenditure	37.8	34.8	36.4
Current expenditure	24.5	20.2	22.8
Capital expenditure and net lending	13.3	14.7	13.6
Current balance	**7.2**	**4.4**	**1.4**
Overall balance	**-4.1**	**-9.3**	**-9.7**
Memorandum: GDP	429,200	618,900	794,400

Source: Ministry of Finance

ANNEX 2: THE BANKING SECTOR

Evolution of the Banking Sector

1. The Mongolian financial system is dominated by commercial banks. Assets of insurance companies and pension funds are minuscule, and a commercial bond market has yet to be developed. Prior to 1990, Mongolia had a monobanking system, administered by the State Bank. The primary responsibilities of the State Bank were to issue currency, to manage foreign exchange, and to provide credit based on the annual production plan. Access to bank credit was restricted to economic units in the material (production) sector and to a few enterprises in the nonmaterial (social and services) sector. The aggregate amount of credit to be extended was centrally determined and extended without collateral.

2. In 1991, Mongolia established a two-tiered banking system, separating the central and commercial banking functions of the State Bank and establishing new commercial banks with private participation. The central bank was formed through reorganization of key departments of the former State Bank. Six banks were launched from the divested portfolio of the former State Bank, and nine were created *de novo* with private participation. The largest, in terms of size, was the People's Bank, accounting for over 35 percent of total assets. The four remaining devolved banks were the Insurance bank, the Investment and Technological Innovation bank (ITI), the Agriculture bank, and the Trade and Development (T&D) bank. These banks have inherited most of the government and state-owned enterprise accounts. The remaining banks are small and combined control less than 10 percent of total deposits and loans of the banking system.

3. Despite its short history, there have been many bank closures to date. In September 1994, the Government, rather than liquidating the assets of two troubled banks, decided to merge the Cooperative bank (a devolved bank) with the People's bank, and the Selenge Bank (a *de novo* bank) with ITI bank. ITI and People's bank both received highly subsidized loans from BOM to cover the cost of the mergers. In the summer of 1996, the Autoroad bank was closed, and the license of the Central Asia bank was suspended due to insolvency. Central Asia Bank was officially closed in July 1996. This action prompted widespread lines of customers until it was announced that depositors would be paid full compensation. BOM provided large volumes of liquidity support to the banks, but confidence in the banking system continued to erode. In December 1996, the Government closed the People's bank and Insurance bank.

CHRONOLOGY

July, 1990	First multi-party elections held; Mongolia People's Revolutionary Party (MPRP) wins 85% of seats in Parliament.
Dec, 1990	Investment & Technological Innovation (ITI) Bank and Trade & Development (T&D) Bank are separated from the State Bank of Mongolia.
April, 1991	Banking Law passed establishing the central bank, Bank of Mongolia, and providing new bank licenses for commercial banks; by year-end, People's, Insurance, Agricultural, and Cooperative Banks were formed.
Dec, 1991	Soviet Union dissolved; trade with Russia collapsed; real GDP declined by 10%.
1992	9 new small banks established -- Mongol Post, Export-Import, Industrial, Business, Central Asia, Mercury, Selenge, Autoroad, Bayanbogd Banks.
June, 1992	Second Parliamentary elections; MPRP wins 93% of seats on 57% of popular vote.
Sept, 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.
June, 1996	Third Parliamentary elections; Opposition Coalition parties win 70% of the popular vote, ending MPRP control of Parliament; New Prime Minister sworn in with mandate to initiate radical reforms.
July, 1996	Central Asia Bank closed due to insolvency.
Aug, 1996	Second foreign equity bank, MM Bank, established.
Sept, 1996	People's Bank temporarily put under central bank conservatorship.
Oct, 1996	MPRP won 65% of popular vote in local elections.
Dec, 1996	People's and Insurance Banks closed; a new Savings Bank, Reconstruction Bank, and Mongolia Asset Recovery Agency established.

The Central Bank

4. The Bank of Mongolia (BOM) has 22 branches in all aimags throughout the country. These branches are involved in activities, such as, clearing operations and settlement of transactions. BOM uses a variety of direct policy instruments, such as administered interest rates and credit ceilings, and indirect instruments, such as refinance facilities and central bank bills to conduct monetary policy.

5. **Administered Interest Rates**. BOM previously set ceilings on loan rates and floors on deposit rates for commercial banks. BOM introduced administered interest rates for a variety of reasons. Floor on deposit rates were instituted early in the transition to expand the banking system's deposit base. Differential ceilings on loan rates were introduced to prevent financial distress from spreading out of control, especially in circumstances where a combination of distress borrowing and evergreening could lead to market instability and skyrocketing real rates of interest if not checked. Loan rates were differentiated based on the strategic importance of the sector and/or the borrower. In other words, commercial banks were directed to provide implicitly subsidized credit to government-picked sectors and activities, and, in turn, were left to cover the cost associated with the subsidized rates by seeking borrowers who were willing to pay higher loan rates. BOM no longer sets any rate ceilings on commercial lending. The current nominal lending rates range from 36 percent to 156 percent per annum. The lending rates are so high that debt servicing is possible only by a small cadre of borrowers, mostly engaged in short term trade transactions.

6. **Credit Ceilings**. BOM imposes tailored-made credit ceilings on all commercial banks to control the growth of net domestic assets and to restrict the size of individual bank lending. The ceilings are determined based on the banks' asset size and lending portfolios. Violations of the credit ceilings, however, have been rampant. BOM has since adopted individual contracts with commercial banks to enforce monetary policy and prudential targets. To date, contracts on credit ceilings and loan to deposit ratios have worked well and formed the basis for bank restructuring.

7. **Central Bank Refinance Facilities**. BOM provides credit to commercial banks to support special economic activities, especially in agriculture (resource deficiency loans), and to meet short-term liquidity needs for payments clearing and settlement (clearing loans). In the past, BOM also provided bank merger loans to clear outstanding balances in the commercial banks' interbank settlement accounts. All preclearing loans have been fully repaid, and this facility is now closed. BOM also guarantees settlement for each clearing through clearing loans. This is basically a short-term credit facility providing liquidity with a one week maturity at a high rate of interest. BOM has limited clearing loans to any one bank to 20 percent of capital with a total facility limit of Tg 750 million. Credit to cover resource deficiency has steadily increased with BOM credit to the banking system exceeding Tg 14 billion, more than 10 percent of total assets during the summer months of 1996. Since then, BOM advances to the banking system were substantially curtailed, and as of end-1996, BOM loans to commercial banks was Tg 1.7 billion. BOM also issued new regulations for using its clearing facility, wherein a predetermined amount of central bank credit is auctioned every week at a maturity of 7 days.

8. **Central Bank Bills**. Central bank (CB) bills were introduced in November 1993 with a Tg 1 billion issuance. Initially, they had a maturity ranging from two weeks to three months, and the interest rates were negotiated between BOM and the commercial banks, usually at about 4 percent per month. In November 1994, a biweekly Dutch

auction system was established, and the maturity of the CB bills was fixed to two weeks. The present interest yield on CB bills is about 3 percent per month. The amount of outstanding CB bills reached Tg 2.2 billion in June 1996, but has since been curtailed. As of end-1996, there were no outstanding CB bills.

9. **Reserve Requirements**. Reserve requirements were unified in August 1993, and at the same time consolidated across branches of commercial banks. Commercial bank deposits with other commercial banks were excluded from the calculations and only cash-in-vault and deposits on current account with the BOM are permitted as reserve requirements. Reserve requirements were increased twice in 1994—from 12 percent to 14 percent in February and again to 17 percent in June—to control excess liquidity. BOM established a reserve money group in November 1994, consisting of directors from the monetary policy, international, and accounting departments, which meets every two weeks, to adjust the reserve ratios.

10. **Payments and Clearing Operations**. BOM started exchanging paper payments orders in 1992, connecting all 21 aimags. At present, inter-aimag payments are made through the UB clearing center once a day. The information is downloaded from computers and transferred to payment orders that are posted and reconciled. There is usually a one day float from outer aimags to Ulaanbaatar commercial banks and a three day float to other parts of the country. Within Ulaanbaatar itself, the UB clearing service operates twice a day—morning and afternoon. In early 1995, BOM established electronic clearing in Ulaanbaatar and has since expanded it to the aimags.

11. Government payments between agencies, as well as other expenditures, are still handled outside the banking system in most places. There is no electronic payment of payroll, even in larger companies. The heavy reliance on cash in the economy has a historical basis, and is compounded by the public's lack of familiarity with noncash instruments. One factor contributing to this lack of trust is the difficulty in making cash withdrawals from banks: delays of days or even weeks in some cases are experienced at the provincial level. BOM has, however, started to implement changes to improve payments, clearing and settlement operations. The approach is multifaceted: improvements in accounts and bookkeeping, computer procedures, data processing at the UB Clearing Center, and monetary policy to insure systemic liquidity for settlement. BOM has centralized commercial bank current accounts (held by BOM offices) at the UB Clearing Center. To speed up interbank clearing, the BOM now requires deposit and related bank information to be reported on daily basis and current account information on a monthly basis. Future plans include BOM efforts to improve interbranch accounting by having only the UB Clearing Center maintain interbranch accounts, introducing interbranch reconciliation on a daily basis, and expanding the BOM network to commercial banks in Ulaanbaatar.

The Banking System

12. As of end-1996, there were 15 commercial banks operating in Mongolia. The five large banks control about 90 percent of total deposits and almost 80 percent of total loans. These banks vary considerably in terms of management competence, financial soundness, and market niches. The small banks, on a combined basis, have a deposit base smaller than that the smallest of the 'five large banks.' Despite their tiny market shares, the small banks on a combined basis are significantly more profitable than the five large banks before provisioning is taken into account. Their superior performance is the result of their relatively high paid-up capital (47 percent of total assets) and lack of competition for good small customers. While the small banks also vary greatly in terms of quality and performance, they represent some element of competition in the banking system and funding for the emerging new enterprise clientele.

13. **Bank Branches in the Aimags**. Mongolia has 19 aimags. Ulaanbaatar and Darkhan, the second largest city, are independent municipalities and do not belong to a specific aimag. Total outer region population is 1,655,000 which is served by 471 banking offices (including 80 branches and 391 sub-branches and retail service centers). Banking offices have population markets of 2,000 to 8,000 per office. The Ulaanbaatar market is a net provider of funding to the outer regions. Total outer region loans is Tg 26.8 billion versus Tg 19.2 billion in deposits. Ulaanbaatar, with 26 percent of the country's population and the vast majority of all enterprises headquarters, is clearly the prime market for any bank, and all banks have their headquarters there. The opportunities to enhance the strength of the banking system through bank rationalization are mainly in the outlying regions, which are generally over-banked.

14. The typical regional banking office has many small accounts with volumes too small to cover costs. Offices average 157 depositors and 23 loans. The average loan size is Tg 2.4 million, and deposit accounts average only Tg 0.3 million. The problems of small customer bases is particularly accentuated by Agricultural Bank's 303 sub-branches in the soums (counties). These offices primarily take deposits, distribute pension checks without compensation, and frequently do not lend. Despite being the only banking facility in these districts, almost all of these offices lose money. Most aimag capitals have few attractive customers, while at least three banks are represented. Elimination of some unprofitable offices can be achieved without leaving any aimag unserved.

15. **Financial Position of the Banking System**. The banking system as a whole is extremely illiquid and has experienced significant deterioration in 1996. Total bank liquid assets (cash, bank reserves, and central bank bills) declined from Tg 13.4 billion at year-end 1995 to Tg 6.9 billion by year-end 1996. A combination of low confidence in the banking system and a sizable unofficial economy has meant that cash represents a large share of the money stock in Mongolia. Currency outside the banking system increased from Tg 25.6 billion in 1995 to Tg 56.1 billion by year-end 1996. This has resulted in decreased liquidity within the banking system, and only one bank has been able to maintain adequate reserves at BOM. The illiquid banks have had to rely

increasing on BOM funding and government deposits, which increased from Tg 7.4 billion at year-end 1995 to Tg 10.9 billion by year-end 1996.

Bank Restructuring Strategy

16. In response to a growing crisis in the banking sector, the Government developed a comprehensive bank restructuring strategy, with input from the IMF, ADB and IDA. The bank restructuring strategy sought to liquidate insolvent banks and to enforce strict measures to improve the liquidity position of the remaining banks. As of end-November 1996, four of the large five banks were in difficulty. Two of these banks, People's bank and Insurance bank, were deeply insolvent, and had no possibility to restore themselves to solvency without very large infusions of new capital. The other two banks, Agriculture bank and ITI bank, appeared to have some scope for rehabilitation on the basis of limited recapitalization if they followed sound banking practices and are intensively monitored. On December 1996, the People's and Insurance banks were liquidated, within the framework of the newly enacted Central Bank Law and Banking law. The Agriculture and ITI banks were required to sign Memorandum of Understanding (MOUs) with the authorities to ensure that they adopt the necessary measures to restore themselves to viability.

17. In the aftermath of the bank closures, the authorities established a Savings bank, a Reconstruction bank, and the Mongolia Asset Recovery Agency (MARA). The Savings bank is restricted to being allowed only to take household deposits, and to invest in safe assets, i.e., government or central bank securities, cash, and deposits at BOM. The Savings bank was licensed by BOM. All household deposits are transferred to the Savings bank together with bonds equivalent to that amount. The Government provided it with the minimum amount of capital required under the law. The existence of the Savings bank provides substantial reassurance to household depositors, especially since there is at present no system of depositor protection, and could have a significant impact in encouraging re-intermediation.

18. Under the Banking Law, household deposits have first priority for payment out of the realizations of a failed bank. The assets of the failed banks were sufficient to provide 100 percent protection to household depositors. However, there was insufficient assets to cover non-household depositors, i.e., deposits of Government and enterprises, in full. The authorities therefore reduced these deposits pari passu to meet the available resources. Non-household deposits in one of the two insolvent banks were written down to 79 percent of their value, and those in the other to 68 percent of their value.

19. The Reconstruction bank retained the performing loans of the two liquidated banks. Although such a bank would be unnecessary in an economy with a properly functioning banking sector, in Mongolia, some of the good enterprises that had deposits in the two liquidated banks found it difficulty to transfer their deposits and loans to another bank. The Reconstruction bank was therefore established as a temporary solution, with the expectation that it would be merged with another bank in the future, once the banking

situation had stabilized. The Government provided capitalization to satisfy the minimum risk-weighted capital assets ratio, to generate resources for the Reconstruction bank to buy the good loans of the two liquidated banks.

20. The objective of MARA is to maximize the recovery from the assets of the banks that were liquidated. MARA is expected to recover the nonperforming loans itself as well as to examine ways in which it could delegate debt recovery to other institutions, including other banks. Staff of MARA is comprised of lawyers, bankers and administrators. MARA will be provided expedited access to the courts, having its cases heard by judges who are specialists in this field of law.

21. The Agriculture and ITI banks have prepared business plans prepared with the assistance of the ADB. These plans will be reviewed to ensure that it provides a credible strategy for the rehabilitation of the bank. Progress will be monitored frequently--at least quarterly, and some key indicators on a monthly basis. MOUs to maintain these business plans have been signed by the owners and senior management the bank and the BOM. The objective is to produce an immediate stop to the flow of losses, and over time to rebuild capital; assuming that this process continues according to plans, there would be limited external recapitalization. Any government recapitalization should be given only if the bank is complying fully with the provisions of the MOUs, and should result in an equivalent increase in the Government's shareholding in the bank.

22. There are at present nine small banks in Mongolia which together comprise around 8 percent of the deposit base. One or two of these seem to be very weak; only a few are clearly strong. In the absence of capacity constraints, there would be a strong argument for placing the weakest banks into receivership with the two large banks. This would give a useful signal to management that all banks will be subject to strong supervisory oversight and remedial action. It would also avoid the risk that further bank closures would be called for in the period immediately after restructuring of the largest banks, thereby undermining the strategy as a whole. The capacity constraints, however, are real. There is a danger that if the Mongolian authorities try to do too much at once, they will be unable to be sufficiently diligent in the parts that really matter, and may run into difficulties that could prove very costly. Any remedial action should therefore have resource constraints very much in mind. In the coming months, BOM will examine the financial position of the small banks and take remedial action as capacity permits.

23. **Asset Quality of Commercial Bank Portfolios.** The quality of loans in the banking system are worse than reported by the banks. At year-end 1996, over 50 percent of total loans outstanding of the banking system were nonperforming. The nonperforming loans are categorized into three groups--inherited, directed and freely decided loans.[1] In

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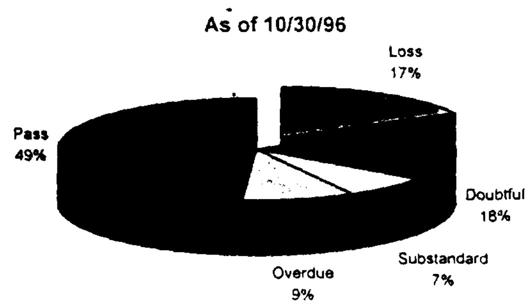
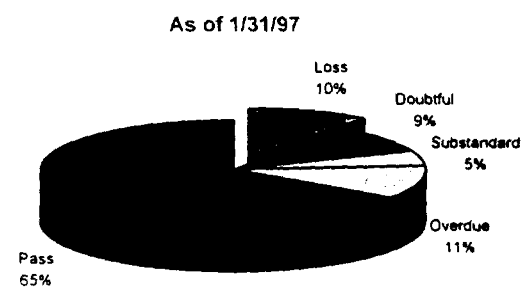
[1] *Inherited loans* are defined as loans that were transferred from the previous state monobank to newly established commercial banks in 1991. *Directed loans* are defined as all loans that were granted by commercial banks on the basis of a Cabinet decision, or extended under government decrees,

all banks which have had on-site inspections, significant problems have been identified, and in all cases, loan loss provisions have to be increased. The banking system also has a poor loan recovery record. This is due to many factors, including a lack of commitment by banks' top management; a shortage of experienced personnel to work out bad debts with defaulting borrowers; insufficient coordination among government agencies concerned; and inadequacies in the legal framework.

24. As part of the bank restructuring exercise, the Government has taken responsibility for the inherited and directed loans, and has replaced the principal and interest accrued on these loans with government bonds. In addition, the Government took over the nonperforming loans of the two failed banks and have placed them in MARA. These actions significantly improved the asset quality[2] and capitalization of the banking system. Total deficit capital of the banking system was reduced from around Tg 4 billion to about Tg 1 billion as a result of bank recapitalization.

Asset quality of the banking system improved as a result of Restructuring





25. **Eventual Structure of the Banking System.** The Government has singled out a few select banks for financial and technical assistance. Surviving large commercial banks will be T&D Bank, ITI Bank and the Reconstruction Bank, comprising a total of approximately 55% of total system deposits. Agricultural Bank (approximately 10% of total deposits) will rationalize its operations while focusing on nationwide deposit

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resolutions, or letters prior to June 30, 1994. Loans granted by commercial banks to borrowers, using their own credit evaluation procedures are categorized as freely decided.

2 Substandard loans are delinquent loans of up to 6 months, requiring 25% loan loss provision; doubtful loans are delinquent up to 12 months, requiring 50% provision; and bad loans are overdue loans of over 12 months, requiring 100% provision.

gathering and agri-business lending. The Savings bank is comprised primarily of the retail deposit base of the closed banks (approximately 27% of total deposits). The Savings bank should help restore confidence, and allow the authorities to remove, or at least reduce, the implicit deposit insurance now provided to the banking system. The nine smaller banks (approximately 8% of total deposits) will compete for primarily Ulaanbaatar based customers, and will probably consolidate into a few sustainable survivors. The authorities will have rationalize the number of small banks in due course, by increasing the minimum paid-in capital for banks for example, to restore confidence and to allow resources to be intermediated by the better banks. Care must also be taken to screen new bank applicants; and to increase transparency, including accounting and disclosure standards, supported by a well-developed auditing profession and enforced by competent banking supervisors.

26. The surviving banking system will comprise three large commercial banks, a specialized savings bank, a specialized agricultural bank and a few smaller commercial banks serving niche markets. This number of institutions is sufficient to preserve competition in Mongolia, and is not too many to be properly supervised by the central bank. What is critical is that the surviving banks are well managed, liquid, appropriately capitalized and adequately supervised. Competition should be preserved, and no single bank should be so large that its failure could not be absorbed by the system.

ANNEX 3: THE ENTERPRISE SECTOR

Introduction

1. The Government's medium-term enterprise reform policy consists of two core elements: imposition of hard budget constraints on public enterprises, and divestiture of around 60 percent of remaining state assets in a three-year cash privatization program. This annex reviews recent developments in and current status of the enterprise sector. This is still dominated by public enterprises, notwithstanding the emergence of new private entities, and the mass privatization of small enterprises and partial privatization of large enterprises in 1991-1994. Regardless of ownership, Mongolia's enterprises face a series of constraints, ranging from difficulties in adjusting to increases in input prices, energy costs and loss of traditional markets, to shortages of credit and specialist skills, and weak governance structures.

Public, Privatized and New Private Enterprises

2. The role of Mongolia's public sector has radically changed since the start of reforms in 1990. In 1989, Mongolia's economy was hard to distinguish from that of an Asian Republic of the Soviet Union, with which it had been closely allied. Virtually all aspects of the economy, including the large pastoral nomadic sector, were centrally planned. Output generated by the public sector was about 95 percent of GDP. By the end of 1995, 64 percent of GDP originated from the private sector, and 44 percent of all assets were privately owned. Government expenditures had fallen to 43.7 percent of GDP, down from 65 percent in the eighties.

3. This remarkable transformation of the economy was largely the result of: (a) the Government's mass voucher privatization program that transferred 44 percent of state-owned assets to private hands between 1991 and 1994; (b) the relaxation of restrictions on private activities that resulted in a proliferation of small shops and proprietorships, and created a whole class of new private enterprises; and (c) the decline in government revenues in line with the transition to a market economy.

4. **Public Enterprises.** Despite the reduced role of the state in the economy, and the emergence of private economic entities, public enterprises remain powerful and active in Mongolia. They are present in numerous sectors of the economy, are the single largest importer of goods, and continue to enjoy monopoly status in a variety of mainly industrial sectors. The Government has retained full ownership of key enterprises in public utilities, transport and mining, majority ownership of many other enterprises, and minority shares in large parts of the newly privatized entities.

5. The extent to which the state plays an active role in enterprises varies considerably. Since August 1996, the Government share in partially privatized or fully state-owned enterprises is represented by the State Property Committee (SPC). In some enterprises, typically smaller and economically less significant ones, the SPC plays a passive role. In other cases, the SPC takes a much more active role through the Board of Directors. Line ministries, in particular the Ministries of Agriculture and Industry and Infrastructure, act as regulators, although they are simultaneously charged with elaboration of sectoral policies. Separation of the ownership, regulatory and management functions of the Government has therefore begun. In practice, however, many public enterprises lack the autonomy necessary to function effectively in a rapidly changing environment. In addition, government directed lending, weak banks, and government subsidies provided enterprises with a soft budget constraint. Enterprises did not have incentives to restructure and improve performance.

6. **Privatized Enterprises.** About 4,500 privatized entities were established on the basis of voucher privatization. The highest concentration of private ownership is in the agricultural, trade and service sectors. However, definition of privatized enterprises, and consequent assessment of their role in the economy, is problematic, given that the size of the residual state share in privatized entities ranges from 10 to 90 percent. Enterprises are classified as private by the State Statistics Office if the residual state share is less than 49 percent. This definitional problem makes it very difficult to estimate the real contribution of privatized entities to GDP. Moreover, the performance of privatized entities has not necessarily differed from that of firms remaining under state control.

7. The performance of small privatized enterprises, particularly in trade and services, including retail, has been relatively successful, and the devolution of operational and strategic decisions appears to have resulted in effective management. In the case of livestock, herding families, rather than central planners, decide herd size and composition, whether to purchase veterinary services, and how to market animals and livestock products. Some problems remain with regard to development of marketing, and with provision of inputs and extension services which were formerly supplied by the government. Privatized farms, conversely, are experiencing visible deterioration of their financial positions and of their asset base. The growth of the trade and service sector has been considerable, reflecting increased managerial autonomy, and has paved the way for the proliferation of new entities.

8. The performance of large enterprises, particularly in manufacturing, has been more problematic. Large enterprises have adjusted to changing external conditions, in particular, diversifying production (for example, several manufacturing industries have started barter trading, import-export or provision of transport services), reducing social benefits and reducing outstanding receivables through changes in trade payment structures. Notwithstanding changes in strategy, enterprises continue to experience considerable difficulties in adjusting to increases in input prices, energy costs, and loss of traditional markets. Furthermore, governance structures of newly-privatized enterprises remain weak, given the diffusion of ownership as a result of mass voucher distribution.

Some enterprises have over 20,000 shareholders scattered throughout the country. As a result, governance remains ineffective, and shareholder authority nominal. For example, it is difficult to determine to what extent shareholders obtain information about enterprise performance, whether dividend payments are made, or to what extent these reflect performance. This diffused ownership structure also prevents outsiders from exercising effective control.

9. In August 1995, secondary trading of shares began at the Mongolian stock exchange.[1] This has helped consolidate ownership somewhat, but major changes in corporate structure have not yet occurred. There is no sign of significant consolidation of ownership through secondary trading. This is attributable largely to shortages of domestic capital, and limited public awareness of the functions and objectives of capital markets. It is also a consequence of inadequate asset valuation, concerns over the accuracy of financial data published by listed companies, and lack of public awareness about shareholder rights and responsibilities. Most significantly, initial market trends show little investor interest in companies in which the state still has a partial share.

10. **New economic entities.** New economic entities have mushroomed in the urban centers of Ulaanbaatar, Darkhan and Erdenet, and in border regions such as Selenge, Orhon and Hovd. Most new entrants have been in the services sector, particularly trading, followed by small-scale mining. Whilst the number of new entrants increased substantially between 1993 and 1996 (by an average of 54 percent nationally, this trend was not sustainable.. Between the first quarter of 1996 and the first quarter of 1997 the total number of new entrants fell by 17 percent. Although exit of new firms is a common phenomenon in market economies, part of the dropout may have been due to the many constraints these enterprises face. The performance of new private enterprises is difficult to assess at this stage, but they face numerous constraints, primarily lack of access to credit.

Size and Structure of the Public Enterprise Sector

11. Public enterprises still have a pervasive presence in Mongolia's economy, despite substantial privatization and new entry of private firms. Some sectors of the economy are completely dominated by public enterprises, with monopoly or near monopoly status. For example, in the industry, mining and energy sectors, 84 percent of value added comes from public enterprises. Moreover, the majority of export earnings are made by Public enterprises. Refined copper from Erdenet Copper Corporation comprises more than half of total merchandise exports ($247.7 million out of $451 million in 1995). The second most important export commodity, cashmere, generates approximately $50 million in

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[1] The Mongolian Stock Exchange was established in 1991, under the institutional control of the State Privatization Commission and regulated by the Securities Commission. The total market capitalization is Tg 72 billion ($159 million). In total, 467 companies, including 247 with state participation are listed on the Stock Exchange.

export earnings. It is mostly produced by the majority state-owned Gobi Cashmere Company—although there are now a number of private producers exporting small amounts. On the imports side, the single largest import item, petroleum products ($69.6 million out of $473 million in 1995), is almost solely imported by the Neft Import Concern (NIC), the majority state-owned petroleum distribution company.

12. Public enterprises usually operate in highly concentrated sectors, in which a few firms, such as the Erdenet copper and Gobi cashmere companies, account for the bulk of production. Table 3A.1 shows the relative importance of the top 10 enterprises in terms of fixed capital, operating surplus, and employment in industry, mining and energy, revealing a high degree of concentration. The top 10 enterprises in terms of fixed asset value account for 81 percent of all public enterprise fixed assets and the top 10 enterprises in terms of sales value account for a similar proportion. The degree of concentration is even greater in terms of operating surpluses. The concentration of employment is less but still high, with the 10 top employers accounting for half of aggregate employment. In most sectors, therefore, a large number of small-to-medium Public enterprises account only for a small proportion of overall activity, while a handful of large state-owned firms are the most relevant in terms of profits and losses, and have the biggest impact on the economy, in terms of flows to and from the budget and the banking sector.

TABLE 3A.1: SIZE DISTRIBUTION OF PUBLIC ENTERPRISES IN INDUSTRY, MINING, AND ENERGY 1995

(million Tugrik, percent, number of employees)

	Fixed capital	Gross sales	Operating surplus	Employment
All public enterprises	68,984	173,648	57,562	54,540
Top 10 public enterprises	56,253	139,415	52,714	27,513
Share of top 10 public	81%	80%	92%	50%
excluding Erdenet	79%	35%	28%	36%

Source: State Statistical Office.

Policy Environment

13. Despite significant progress made in price reforms, deficiencies in pricing policy and administration continue to constrain public enterprise performance. In the energy sector, despite recent reforms, some important prices remain substantially below the cost of supply. Electricity tariffs are currently about 50-60 percent, and heating prices about 30-33 percent of their respective estimated long-run marginal costs.[2] Petroleum prices are currently based on international prices and, on average, are equal to or greater than

[2] World Bank, *Mongolia Energy Sector Review*, November 1995.

economic costs. However, Neft Import Concern is required to price all products uniformly throughout the country, regardless of the distance from distribution points. In railways, as in electricity and heating, tariff adjustments have lagged behind increases in cost.

14. Overstaffing is still an issue in many public enterprises, but afflicts infrastructure and utility companies more severely than others. For example, the Railway Company has 13,000 employees, with few having left despite a substantial reduction in business. Road maintenance and construction companies employ 4,500 persons despite having no projects or budget for much work. However, a number of public enterprises, especially in manufacturing and trade, have been successful in downsizing in recent years. The reduction in labor force of public enterprises had been done in keeping with the Labor Law, and involved payment of three months' severance pay, while other departures have been voluntary. The meat processing plant in Darkhan reduced employment from 1,200 employees in 1990 to 530 in late 1995; and Ulaanbaatar Building Materials reduced its staff over the same period from 1,300 to 420. Employment in trading companies has also fallen dramatically, from 9,500 in 1993 to 2,100 in 1995.

15. Labor costs are influenced by the extensive supplementary services public enterprises provide to employees. The costs of these services are typically 25-35 percent of the wage bill. ;By international standards, these are not excessive, but they are significant because their provision and funding demand management attention. Typically, enterprises provide employees with transport to and from work, subsidized food and medical care, and housing in some cases. For example, at Gobi workers receive an 80 percent discount at a nearby hospital, a 90 percent discount at the staff cafeteria, free transport to and from work in company-owned buses, an 80 percent discount at the company's kindergarten, and a 60 percent discount at the company's vacation/rest and recuperation home. The firm also provides 200 apartments to its employees (at market rent). Gobi's social services represent the most extensive coverage within the public enterprise sector, that is considerably more than 35 percent of the wage bill. Such packages are generally given even by companies that were in serious difficulties, but some, such as the Salkhit Fur Farm has completely or partially discontinued these services.

16. In addition to the provision of social services, public enterprises, particularly food processing industries, are subject to various regulations and restrictions. For instance, public enterprises are frequently required by authorities to provide supplies to other public enterprises or "budgetary organizations" (e.g., schools, hospitals, the military) on a noncommercial basis, often with quantities, prices, and delivery dates specified; or they are sometimes required by local governments to maintain inventories of finished or semi-finished goods greatly in excess of what market conditions might indicate.

Performance of Public Enterprises

17. Public enterprises shared the economic hardships that the entire country endured during 1990-93. Public enterprises, like their private counterparts, faced relative prices at international levels for most of their activities. High levels of inflation combined with remaining price controls squeezed financial performance of public enterprises, notably in utilities and food production. While public enterprises have undertaken some restructuring, it was not sufficient to have a real impact on efficiency. Consequently, they have increasingly become a burden on the budget and the commercial banking system.

18. After years of continuous decline in profits, public enterprises on aggregate returned to profitability in 1994. However, this statistic must be interpreted cautiously, given the weak accounting framework and the inadequate treatment of depreciation in most public enterprises. A survey on net profit rates (net profits/gross sales) in 1994 has shown that most public enterprises exhibit poor financial performance, even with inadequate provision for depreciation.[3] Most enterprises exhibit low net profits/gross sales revenue ratios, with poor performance cutting across sectors. The worst performance appears to be in the agriculture and food processing enterprises, followed by public enterprises in utilities and transportation. Mining enterprises and the flour mills managed to earn only small profit. The notable exceptions are the trading companies and some large firms, such as Erdenet copper corporation and Gobi cashmere factory, all of which performed well.

The Fiscal and Monetary Burden of Public Enterprises

19. Public enterprises constitute an increasing burden on the government budget and the banking system. Aggregate subsidies to public enterprises have risen from 5.3 percent in 1993 to 7.4 percent of GDP in 1995. These subsidies were handed out directly from the budget in the form of current subsides and capital grants, and indirectly from budgetary lending at below market interest rates with lenient repayment conditions.

20. **Current Budgetary Subsidies.** Current budgetary subsidies have traditionally been the major source of budgetary financing for public enterprises, although its relative importance has declined. Current subsidies amounted to 2.1 percent of GDP in 1993. After a 33 percent increase in 1994, current subsidies declined in 1995 to Tg 3.6 billion, or 0.9 percent of GDP. In 1996, the Government stopped all subsidies to public enterprises, and plan only Tg 455 million in subsidies to urban transport enterprises in 1997. Current subsidies are now only provided to some urban transport companies (see Table 3A.2).

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[3] World Bank, *Mongolia: Public Enterprise Review*. June, 1996.

TABLE 3A.2: SUBSIDIES AND GRANTS TO PUBLIC ENTERPRISES
(in Tg millions)

	1993	1994	1995	1996	1997
Current Subsidies	2,258	4,000	3,600	0	455
Capital Grants	1,000	1,900	9,700	6,732	750
Total subsidies and grants	3,258	5,900	13,300	6,732	1,205

Source: MOF

21. **Budgetary Capital Grants.** The 1995 fall in current subsidies was more than offset by a rise in capital grants. Capital grants to public enterprises from the central budget increased in nominal terms from Tg 1.0 billion in 1993 to Tg 9.7 billion in 1995, or from 0.6 percent to 2.5 percent of GDP. Capital grants to public enterprises to Tg 6.7 billion, and Tg 750 million has been allocated in the 1997 budget. The Government provides capital grants under the state investment budget. Some foreign donors also supply earmarked grants to specific public enterprises, although only a few companies have benefited.

22. **Implicit Budgetary Subsidies.** Public enterprises have also benefited from substantial implicit subsidies. Beginning in 1993, the Government started lending to public enterprises from the budget to finance capital expenditures. The total amount of budgetary loans disbursed during 1993-95 was Tg 16.3 billion, or on average about 2 percent of GDP annually. A significant proportion of these loans has gone to a handful of enterprises.[4] Interest was extremely low by Mongolian standards: while market rates hovered around 80-120 percent per year, the budgetary loans carried an interest of 2-5 percent. In addition, loan repayment has been poor. As of November 21, 1995, Tg 3.3 million had been repaid, leaving loans of about Tg 13 billion outstanding. About half of these are in arrears.

23. Public enterprises are estimated to have received a total of about Tg 31 billion in implicit subsidies during 1993-95, or on average about 3.7 percent of GDP annually. Of this, Tg 25.7 billion represents interest rate subsidization, while Tg 5.2 billion is due to nonfulfillment of debt-service obligations. These estimates indicate that *implicit subsidies to public enterprises have not only been substantial in recent years but also larger than explicit subsidies and rising over time.* Implicit subsidies have increased from 2.6 percent of GDP in 1993 to almost 4 percent in 1995. Adding explicit and implicit subsidies, total subsidies to public enterprises have averaged 6.5 percent of GDP

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[4] Although more than 50 enterprises have received loans, almost half (43 percent) has gone to two enterprises: Neft Import Concern (Tg 5.4 billion) and Darkhan Mini-metal (Tg 1.7 billion). Another Tg 4.5 billion has gone to a group of energy plants and a group of public transport organizations. The remaining Tg 4.7 billion (29 percent of the total) has gone to roughly 40 public enterprises.

during 1993-95, with the proportion rising from 5.3 percent in 1993 to 7.4 percent in 1995.

24. **Other subsidies.** Some public enterprises obtain financial support, either as capital grants or government loans, through *aimags* (provincial administrations) and other nonministerial organizations, such as the State Privatization Commission (SPC). The majority of these subsidies are, however, difficult or impossible to document.

The Burden of Public Enterprises on the Banking System

25. Public enterprises have become an increasing burden on commercial banks. They have been the main recipients of government directed loans from the banking system. These loans amount to over Tg 15 billion, or about 4 percent of GDP, including interest accrued. They are mostly unrecoverable, and were assigned to the newly-established Mongolian Asset Recovery Agency (MARA) at the end of 1996.

26. Public enterprises continue to account for a significant part of the banking sector's portfolio—about 16 percent of the total as of June 1995, but down from 43 percent at the beginning of 1993.[5] The share of public enterprises in loan disbursements has also decreased, but at a slower rate, from 46 percent in 1993 to 28 percent in the first half of 1995 (see Table 3A.3). Yet, with one-fourth of new bank loans going to public enterprises, their debt service performance affects the viability of the banking system.

27. Public enterprises fall increasingly short on their debt-service obligations to the banks. While the stock of loans outstanding to public enterprises has decreased over this period, the proportion of principal arrears in total loans outstanding has increased sharply, from 6 percent at the beginning of the year to about 11 percent six months later. Even more alarming is the sharper increase in the incidence of bad loans; from 0.02 percent to 3.4 percent of loans outstanding, and from 0.4 percent to 31.3 percent of arrears.

[5] The data on public enterprises actually refers to the public sector as a whole; separate data for public enterprises were not available. However, nonenterprise loan accounts for less than 4 percent of total loans to the public sector.

TABLE 3A.3: BANK LOANS TO PUBLIC ENTERPRISES, 1993-95

	Loans outstanding at beginning	New loans disbursed during year	Loans repaid during year	Adjustments	Loans outstanding at year-end
Total					
1993	19,018	89,131	85,153	9,918	32,914
1994	32,914	114,599	100,125	8,855	56,243
1995 (first 6 months)	56,243	73,060	63,632	-2,186	63,485
Public enterprises					
1993	8,172	41,409	40,639	3,847	12,789
1994	12,789	41,746	40,109	-1,844	12,582
1995 (first 6 months)	12,582	20,441	23,192	521	10,352
Private enterprises					
1993	10,114	42,554	39,740	5,713	18,641
1994	18,641	64,290	51,944	9,365	40,352
1995 (first 6 months)	40,352	46,222	35,127	-2,531	48,916
Joint ventures					
1993	155	1,078	1,125	3	111
1994	111	1,562	2,004	623	292
1995 (first 6 months)	292	2,440	1,479	51	1,304
Others					
1993	577	4,090	3,649	355	1,373
1994	1,373	6,421	5,466	479	2,807
1995 (first 6 months)	2,807	3,957	3,834	-17	2,913

28. The figures tend to underestimate the true level of arrears and bad loans of public enterprises to the banking sector. It is common practice for public enterprises to roll-over loans, with the banks reclassifying past loans as new. A large part of the new loans to public enterprises, therefore, masks the inability of those firms to repay their past loans. This partly explains why private firms, which usually face stricter repayment conditions, exhibit poorer performance than public enterprises with respect to the level of arrears and bad loans to the banking system.[6]

29. The debt service record of public enterprises varies widely across sectors. Agricultural public enterprises have performed the worst. They received only 12 percent of total loans outstanding as of June 1995, but accounted for 36 percent of total loans in arrears and 70 percent of arrears more than 12 months old. These are mostly inefficient state-run wheat farms that borrow without expectations of repayment. Industrial public enterprises, the largest recipients of bank loans, accounted for almost half of total loans outstanding. Their debt service record is, on average, the best, with only 3 percent of

[6] The poor credit record of the private sector relative to public enterprises is also misleading in that Tg 15 billion in inherited and directed loans to public enterprises, which amounts to over 30 percent of total loans outstanding, are not included in the stock of bad loans.

loans in arrears. Of the loans to public enterprises in infrastructure, 21 percent are in arrears, but only 3 percent of the loans was nonperforming.

Interenterprise Arrears

30. Several enterprises have substantial arrears to other enterprises, creating a chain of loans and arrears which also stretches to the government and the commercial banking sector. These arrears weaken the performance and long-term viability of all enterprises affected, as the network of debt becomes more complicated and less manageable over time.

31. The energy sector, with the Central Energy System (CES) at its core, has the most serious interenterprise arrears. The total amount of arrears in the energy sector is estimated to exceed Tg 9 billion in 1995 (i.e., 2.3 percent of GDP). They include arrears to the state budget, to energy import companies, to coal mines, to energy generating companies, to transportation companies, and others. Examples are many. During the first five months of 1995, a coal company was paid for less than one third of the product it delivered to state-owned power plants. As a result, the coal company was unable to pay Mongolian Railways for the transport of the coal to the power plants.

32. Other key areas with large arrears include the transport and food sectors. In many cases, enterprises are obliged by Government to continue selling to customers even when they do not receive payment. A flour mill is in considerable arrears from bakeries while having to make large interest payments on its own debt to banks. A fuel distribution company is compelled to continue fuel shipments to customers (especially in agriculture and mining) who do not pay.

33. Arrears have several detrimental effects on the economy. The problem is often passed on to the commercial banks, which, in the end, lend at higher rates to cover the arrears. Many enterprises are unable to satisfy other commitments, such as tax payments, government budget loan repayments, pension contributions, utility payments, and staff wages which are often not paid for several months.

Tax Arrears

34. Public enterprises appear to have performed better in meeting their tax payment obligations than they have been in servicing their loans from the Government. Nonetheless, tax arrears are large and appear to be rising. The tax records of 23 important public enterprises show that taxes paid as percent of taxes due fell from 92 percent in 1994 to 60 percent in the first half of 1995. Some of this decline is attributable to seasonal factors, since cash outflows usually exceed inflows in the first half of the year, with the reverse happening in the second half. However, seasonality is only one factor, and the tax-payment record of public enterprises has worsened.

Conclusion and Next Steps

35. Public enterprises are an increasing burden on the economy. Their efficiency and financial performance in a number of sectors. Despite retrenchment since 1990, overstaffing is still an issue, notably in utilities and railways. However, Government has been reluctant to let non-performing public enterprises fail. This reluctance has increasing costs to the budget, the banks and to other enterprises. Non-performing loans from the budget and commercial banks crowd out private enterprises. Moreover, loan defaults have crippled the banks and forced them to charge unsustainably high interest margins on their lending. This has virtually wiped out term lending and investment finance in the economy, and has adversely affected growth.

36. In response to som of the problems in the real sector, the Government has proposed more radical medium-term enterprise reforms, with privatization as the spearhead. The design of what will be a highly ambitious cash privatization program has not been finalized. However, the basic elements include: (a) sale of up to 700 fully and partially privatized public enterprises, primarily through auctions, and (b) privatization of large potentially viable companies, including Neft Import Concern, MIAT, Gobi cashmere co., large gold mines and Mongolian shares in Erdenet Copper Concern (a joint venture with Russia), possibly to foreign investors. The Government intends to retain control over a variety of properties including buildings used by central and local Government organizations, main electric transmission lines, power stations, water supply and sanitation and telecommunication networks, civil aviation and airport terminals, roads, railways and enterprises receiving official development assistance--as stipulated in individual loan/grant agreements. The plan has been developed in the absence of a full inventory of state property. Moreover, revenue expectations are optimistic, some as high as Tug 66 billion by 2000.

37. In refining the privatization program, the Government is likely to evaluate the tradeoffs between speed of transactions, and efficiency of ownership transfer and management. Policymakers are considering the importance of building strong governance structures, and clarifying property rights before privatization. The most important tasks in finalizing the program will be to (a) set objectives beyond the transfer of property alone, (b) adopt realistic timing and revenue objectives, (c) determine, up-front, the appropriate methods and procedures for each transaction, and clearly identify assets and liabilities. Successful private sector development, which goes beyond the scope of the privatization process itself will, however, depend critically on reforms in the financial sector. It will also depend on progress in policy reforms which promote sound governance structures, a competitive environment of secure and flexible transactions, and ensure security of property rights.

GOVERNMENT OF MONGOLIA

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Date March 27, 97 №

Ulaanbaatar-12
State House

LETTER OF DEVELOPMENT POLICY AND MATRIX OF KEY POLICY ACTIONS

Mr. James D. Wolfensohn
President
The World Bank
1818 H Street, NW
Washington, DC 20433

Dear Mr. Wolfensohn:

Subject: Banking and Enterprise Sector Reform Program

My Government, the first non-communist Government elected in 75 years, is committed to deepening the reforms that were started by my predecessors, and establishing an enduring market system. We are committed to a three-year medium-term banking and enterprise sector reform program that will institute macroeconomic stabilization measures and implement fundamental structural reforms, especially the restructuring of our banking and enterprise sectors. To this end, we have formulated a medium-term reform program for the period of 1997-99, in close collaboration with the staffs of the International Development Association (IDA) and the International Monetary Fund (IMF). Within the medium-term reform program, implementation of the Banking and Enterprise Sector Adjustment Credit (BESAC), developed through the successful cooperation between the Mongolian authorities, IDA, IMF, and the Asian Development Bank (ADB), lays the foundation for structural reforms in the banking and enterprise sectors. My Government's medium-term reform program is outlined below.

Macroeconomic Reforms

We recognize that progress toward macroeconomic stabilization and the creation of a stable environment for businesses to invest and grow is essential to the achievement of sustained noninflationary growth. From 1993 to 1995, real GDP, after falling by 3 percent, grew by 2 percent and by over 6 percent in 1995 better than in most other transition economies. The external current account deficit remained between 6 and 7 percent of GDP.

Aid disbursements were strong, and net official international reserves rose more than targeted over the period as a whole. However, inflation at an average of 73 percent in 1994-95 remained well above programmed targets and higher than most other transition economies. Despite these significant achievements, economic performance in 1996 has fallen short of our expectations. GDP growth in 1996 is 2.6 percent, below the target of 5 percent. The budget deficit widened from 4 percent in 1995 to about 8 percent in 1996, reflecting increases in wages and welfare payments in the first half of the year and the revenue impact of sharply weaker copper prices. The current account deficit excluding official transfers widened to about 8.7 percent of GDP in 1996. Growing concerns about problems in the banking system in mid-1996 led to a drain on deposits, and our central bank, the Bank of Mongolia (BOM), responded by providing liquidity support. Inflation dipped briefly to under 30 percent in mid-1996, but quickly rebounded to an annual average rate of 50 percent, in part due to the implementation of long overdue increases in energy prices.

Against this background, my Government has put forth a medium-term reform program that aims to stabilize the economy and consolidate earlier gains by pressing ahead with structural reforms. We are negotiating a new IMF ESAF program for 1997 to 1999, and we expect to finalize negotiations in May for presentation to the Board of Directors of the IMF in June 1997. Our top priority will be the restoration of macroeconomic stability, especially reducing inflation to about 25 percent by end-1997, with further reductions in subsequent years. Fiscal policy will support the overall macroeconomic objectives by substantially tightening traditional current expenditures, especially remaining subsidies to public enterprises. Privatization proceeds, which are projected to peak over the next few years, will provide an important supplement to tax revenues. High levels of exceptional expenditures for bank restructuring will reduce the current budget surplus to 1 1/2 percent of GDP in 1997 and raise the overall budget deficit to 10 percent of GDP. Monetary policy will remain tight throughout the 1997-99 period in order to support a restoration of confidence in the banking sector, strengthening external position, and achieve a sharp reduction in inflation. Broad money growth will be contained to 23 percent, combined with efforts to rebuild the level of gross international reserves to reach 10,5 weeks of imports by end-1997. The growth of total domestic credit will be limited to 5 percent. In real terms, the growth of credit to the private sector is targeted to rise, while lending to public enterprises and government is programmed to decline sharply. Our current account deficit is expected to remain large, reflecting the narrowness of the export base and the need for substantial imports of capital goods. Large investment requirements to develop Mongolia's infrastructure base will require continued foreign financing. The restoration of macroeconomic stability and implementation of structural reforms should contribute to an increase in private sector investment and enable GDP growth to gradually increase to reach 6 percent by 1999.

We believe that private sector development is the key to enhancing Mongolia's medium-term growth prospects, and intend to follow through on our mandate to accelerate the pace of market-oriented reforms. On the structural side, our most urgent priorities will be ensuring that bank restructuring remains on course and that budget constraints on enterprises are hardened. Private initiatives must be freed by creating a stimulating environment for private entrepreneurs and privatized firms to grow. At the same time, the banking system must be strengthened through restructuring and eventual privatization, the enactment of adequate prudential regulations and the enforcement of commercially-oriented lending practices. We believe that sustained growth cannot be achieved without deepening reforms in both the enterprise and financial sectors. We have therefore developed a banking and enterprise sector reform program to be supported by BESAC.

Banking and Financial Sector Reforms

Our long-term objectives in the banking sector are to improve the savings-investment intermediation process through the enforcement of strict credit discipline; to improve the financial performance of individual banks; and to develop skills in loan recovery and debt workout in the banking sector so as to initiate further enterprise restructuring. To achieve these objectives, we will: (a) restructure individual commercial banks to promote the development of a solvent, viable banking system; (b) develop commercial banking skills and aggressively implement loan recovery efforts; and (c) stop the flow of bad lending from banks to defaulting borrowers.

Bank Restructuring. With assistance from the IMF, ADB and IDA, we have developed a comprehensive bank restructuring strategy that seeks to liquidate insolvent banks and to enforce strict measures to improve the liquidity position of the remaining banks. On December 1996, we successfully closed two large insolvent banks, within the framework of our newly enacted Central Bank Law and Banking law. We guaranteed fully household deposits, but limited protection for enterprise deposits. The Parliament has approved a 1997 budget with Tg 16 billion to finance the bank restructuring exercise. In the aftermath of the bank closures, we have established Savings Bank, Reconstruction Bank, and the Mongolia Asset Recovery Agency (MARA). The Reconstruction Bank retains the performing loans of the two liquidated banks, while MARA manages loan recovery efforts. The two other large banks, Agriculture Bank and Investment and Technological Innovation Bank, were required to formulate and implement restructuring plans during 1997. Compliance will be monitored by the BOM and by the ADB, and the banks will be liquidated if there are significant slippages. Our main task in 1997 will be to ensure that the three new institutions successfully carry out their mandates.

The bank restructuring program eventually seeks to privatize all state-owned banks. In this connection, we will initiate bank twinning arrangements to facilitate future entry by foreign commercial banks in the domestic market, and will prepare a privatization plan by July 1, 1998 that seeks to privatize all state-owned banks. The ultimate goal is to see the development of a privately-owned banking system, with foreign participation and competition.

IDA technical assistance will assist in a bank twinning exercise to introduce international banking practices and eventually foreign bank participation in the sector. ADB technical assistance to the sector will focus on developing skills in individual commercial banks. ADB will provide foreign experts for on-the-job training in credit underwriting, loan documentation, syndication, monitoring and recovery, and asset-liability management. ADB will also assist commercial banks to upgrade their computer hardware and software and train their staffs in the use of integrated banking computer systems.

Loan Recovery Efforts. Assuring high levels of loan recoveries is one of the top priorities in our restructuring operation and one of the most difficult aspects to manage. Success is needed both to reduce the budgetary cost and to set an example for the other two banks that are being monitored as an alternative to liquidation. MARA has the main responsibility for managing the loan recoveries of the failed banks and will be staffed accordingly. Through MARA, we will explore the possibility of developing a secondary market for debt, allowing any bank or institution to purchase nonperforming loans and aggressively initiate loan recovery efforts. Emphasis will be placed on selling or otherwise transferring the carved out loans back to existing banks, to be handled there through workouts, foreclosures, or liquidations. We will utilize IDA technical assistance for the strengthening of supporting institutions, such as the courts, registry and the bailiffs office, to ensure more effective enforcement and implementation of our proposed loan recovery measures.

To supplement MARA and to initiate the bank-led enterprise restructuring process, we will strengthen the debt workout unit in the Trade & Development (T&D) bank, with its operations overseen by a Director-level manager and supported by four full-time T&D bank staff. The debt workout unit will launch a pilot program to restructure or liquidate four private enterprises which are amongst the T&D bank's worst defaulters. This pilot program will be implemented either voluntarily in agreement with the shareholders of the selected enterprises, or through bankruptcy procedures initiated by T&D bank, with the full support of my Government. IDA technical assistance will be used to carry out viability assessments of the enterprises. We will ensure that by the end of 1997, the debt workout unit in the T&D bank will have completed the viability assessments of the four selected enterprises; and have completed the restructuring or liquidation of the four selected enterprises by the end of 1998, in accordance to the Law. Lessons learnt from this pilot exercise will be used to fine-tune the legal and institutional framework to facilitate future workouts, and the skills acquired will be transmitted to the rest of the banking system to deal with similar restructuring problems.

Stopping Loans to Defaulters. My Government, in close collaboration with the BOM, has stopped all directed lending through the banks. We intend consistently to enforce the cessation of directed lending by commercial banks, and we will monitor it through regular commercial bank reports to BOM and through off-site examinations. The BOM has already taken action to stop all bank lending to defaulting borrowers. A mechanism for reporting defaulters in already in place at the BOM, and BOM has instructed individual banks to stop lending to defaulters. To monitor continually commercial bank lending practices, the BOM will issue a Central Bank Regulation requiring all banks to report on a monthly basis their ten largest outstanding loans. By mid-1997, BOM will establish a Credit Information Bureau, consolidating periodic reports from all banks of borrowers in default. The Credit Information Bureau will list all defaulters, and is intended to enable banks to determine if any borrower is in default to a third bank. By the end of 1998, we will move the Credit Information Bureau to an organization independent of the central bank.

Enterprise Sector Reforms

We believe that banking sector reforms will be ineffective and unsustainable without comprehensive reforms in the enterprise sector where most of the important clients of the banks are located. Enterprise reforms should facilitate liquidation of non-viable enterprises and development of viable enterprises. Our strategy, which we have begun to implement, is to improve the performance of the enterprise sector by: (a) accelerating privatization and improving governance structures; (b) imposing hard budget constraints on enterprises; (c) restructuring or liquidating enterprises that are not financially or economically viable; and (d) removing obstacles to private sector development.

Privatization. The mass voucher privatization program succeeded in transferring paper ownership to private hands but did not lead to improved governance structures in the newly privatized firms. My Government is actively preparing a privatization program that will be ready by July 1, 1997. This program will seek to privatize most remaining large public enterprises, including profitable enterprises, and sell all remaining state shares in partially privatized manufacturing enterprises in the course of the present term of this administration. In order to provide a clear and strong signal to the private sector of our commitment to privatization, we will sell several public enterprises during 1997. During implementation, we shall pay close attention to improving the governance structures of enterprises to be privatized. The State Property Committee will ensure that privatization yields maximum gains to our economy, and is transparent to all concerned parties. We shall move towards fulfilling the campaign promise of privatizing all residential housing by beginning a nation-wide program in 1997.

Imposition of Hard Budget Constraints. A key element of our banking reform strategy is to exclude defaulting enterprises from further bank lending. This policy will be complemented by ensuring that the budget does not become an alternate source of soft financing. We are committed to phasing out under a time-bound program all remaining transfers and subsidized loans made under the budget to public enterprises. Our 1997 budget has provisions to meet the current expenditures of social sector institutions (schools, hospitals etc.), and expenditures for severance and pension payments to civil servants and retrenched enterprise labor. As part of our effort to harden budget constraints on enterprises, MOF will eliminate subsidies to all types of enterprises, starting from the 1997 budget, with the exception for urban transport enterprises (limited to Tg 455 million in 1997, Tg 600 million in 1998 and Tg 700 million in 1999). Starting from 1997, budgetary loans will be restricted only to public enterprises in electricity and heating, with the exception of loans to two state-owned enterprises included in the State Property Committee-led enterprise restructuring exercise. We will ensure that as of the year 1999 these loans are extended on at market terms. During the interim, we will provide loans at rates linked to the central bank bills rate such that in 1997, the loans will be provided at two points below the central bank bills rate; in 1998, at the central bank bills rate; and in 1999, loans will be provided at market rates of interest. In this connection, we will ensure that household consumers of energy and fuel are appropriately safeguarded. The overall budgetary outlays, both current and capital expenditures, will adhere to the limits as agreed under the ESAF program. As part of the medium-term reform program, the Ministry of Finance (MOF) will reduce the level of arrears in public enterprise loan repayments to the budget to 25 per cent of loans outstanding by end of 1997, to 10 percent by end-1998, and 0 percent by end-1999.

Enterprise Restructuring. Many defaulting enterprises are potentially viable and may generate sufficient cash flows to service their debts once appropriately restructured. With assistance from IDA, the State Property Committee (SPC), exercising its ownership rights on behalf of the Government, will initiate pilot restructuring exercises for two large, state-owned enterprises--the Darkhan Mini-metal plant and the Bagahangai Meat Processing plant. These two enterprises are among the largest defaulters to the banking sector with total Tg 3 billion loans in arrears, and also have Tg 1.7 billion in budgetary arrears. The restructuring program will involve isolation from the banking sector and other financiers (such as other enterprises), a viability assessment which will lead to the drawing up of a restructuring plan if the enterprise is deemed viable, and a liquidation plan otherwise. The restructuring program will be limited to passive restructuring measures and will be time-bound. Enterprises unable to operate independently upon completion of the restructuring exercise will be liquidated. The liquidation decision will be made by the SPC, in consultation with MOF. The restructuring program will be financed by the budget which will provide working capital loans during the isolation period. Tg 2.5 billion has been allocated for the SPC-led restructuring exercise of Darkhan and Bagahangai companies during 1997-1998. By the end of 1997, viability assessments of the two enterprises will be completed, and restructuring or liquidation plans approved. By end-1998, the restructuring (or liquidation) exercise will be completed for the two selected enterprises.

Private Sector Development. We are strongly committed to the development of the private sector and view the private sector as the key to enhancing our country's medium-term growth prospects. The previous government kept many essential sectors under control for too long. This has prevented development of a competitive private sector in areas such as meat storage, flour mills, wheat production, and petroleum products. It is our view that rapid price increases and liberation of these sectors are necessary in order for private competition to develop. In September 1996, we freed the price of most energy products and other commodities, and eliminated measures that prevent the full play of market forces and competition (both domestic and foreign) in the economy, including eliminating policy barriers to entry and exit, and opening the economy to international trade and foreign investment. We are strengthening the economic legal framework, and we are building regulatory capacity in sectors where regulation is appropriate. We intend to present a Draft Insolvency Law to the fall session of Parliament. Our commitment to a liberal trade regime is reflected in accession to the World Trade Organization (WTO) and our removal of the ban on raw cashmere exports. Our economy is perilously dependent on copper export earnings, and new industries and sectors appropriate for an outward competitive economy need to be developed. By eliminating support to obsolete businesses, we will allow resources to be reallocated to these better uses. We are also working to enhance private participation in a few select social sector enterprises (e.g. technical school, pharmaceutical company, hospitals).

Strengthening the Social Safety Net and Poverty Alleviation

Our people need improved social services, such as quality education, reliable health care and adequate pension and unemployment insurance. As we continue our reforms to a market economy, we must take care to protect the most vulnerable groups of society affected by the transition process. Protection of vulnerable groups remains a high priority for my Government. Our goal is to ensure that all citizens have equal opportunity to decent education, adequate health care, and the chance to use their skills to develop and earn in a market environment. But of course not everyone can or does succeed, and particularly during these times of rapid change, many people have been put in jeopardy. With assistance from ongoing projects, such as IDA's Poverty Alleviation for Vulnerable Groups Project under the umbrella of the Government's Poverty Alleviation Program, we aim to make a careful analysis of the extent and causes of poverty in Mongolia, and to design and implement quickly a well-targeted adequate system of support for these people. We will also continue to take measures to reduce child mortality, and to improve the health and education of children.

* * *

The Government of Mongolia welcomes IDA's BESAC supervision team to monitor, jointly with my authorities, the implementation of the Action Plan and all other facets of the medium-term reform program.

Mendsaikhany Enkhsaikhan
Prime Minister of Mongolia

Attachment: Matrix of Key Policy Actions.

Objective	Policy Measure	Institutional Responsibility	Completion Date	Monitoring Indicators
1. Bank Reforms				
1.1 Bank Restructuring	Place People's Bank and Insurance Bank under receivership	BOM	By Board Presentation	Receiver appointed.
	Establish and license the new Savings Bank and the new Reconstruction Bank	BOM	By Board Presentation	Savings bank and Reconstruction bank established/ licensed.
	Submit 1997 budget to Parliament with Tg 16 billion specifically earmarked to finance the bank restructuring exercise	MOF	By Board Presentation	1997 Budget.
	Establish MARA, with powers and responsibilities acceptable to IDA	MOF	Credit Effectiveness	Establish MARA. Charter of MARA submitted to IDA.
	Prepare privatization plans, acceptable to IDA, to privatize all state-owned banks	BOM; SPC	By July 1, 1998	Privatization plans completed.
	Complete a review of the implementation of the banking law since enactment	BOM; MOJ	By July 1, 1998	Report of Banking Law implementation.
1.2 Stopping the flow of bad loans	Issue a Central Bank Regulation, requiring all	BOM	By Board Presentation	BOM Regulation.

Objective	Policy Measure	Institutional Responsibility	Completion Date	Monitoring Indicators
	banks to report on a monthly basis their ten largest loans outstanding			
	Establish a Credit Information Bureau (CIB) consolidating periodic reports from all commercial banks of borrowers in default	BOM	By Credit Effectiveness	CIB established in BOM.
	Move the Credit Information Bureau to an organization independent of BOM	BOM	By December 31, 1998	CIB moved to independent organization.
1.3 Debt Workout	Establish DWU in T&D bank, with functions satisfactory to IDA, and with its operations overseen by a Director-level manager and supported by four full-time T&D bank staff	T&D bank	By Board Presentation	DWU in T&D bank established.
	Complete viability assessments for all four selected enterprises	T&D bank and four selected enterprises	By December 31, 1997	Viability assessments of the four selected enterprises.
	Complete implementation of restructuring/liquidation plans of selected enterprises	T&D bank and selected enterprises	By December 31, 1998	Liquidation/restructuring completed.

Objective	Policy Measure	Institutional Responsibility	Completion Date	Monitoring Indicators
2. Enterprise Reform				
2.1 Hard Budget Constraint	Eliminate all Government subsidies to enterprises, starting from the 1997 budget, with the exception for urban transport enterprises which will be limited to Tg 455 million in 1997, Tg 600 million in 1998, and Tg 700 million in 1999	MOF	By Board Presentation November 31, 1997 November 31, 1998	1997 Budget. 1998 Budget. 1999 Budget.
	Stop all government loans, except to enterprises in electricity and heating, starting from the 1997 budget. MOF loans to these enterprises will be given at 2 point below the CB bills rate in 1997; at the CB rate in 1998; and at market rates by the year 1999	MOF	By Board Presentation November 31, 1997 November 31, 1998	1997 Budget. 1998 Budget. 1999 Budget.
	Reduce the level of arrears in enterprise loan payments to the budget to 25 percent of loans outstanding in 1997; 10 percent in 1998; and 0 percent by 1999	MOF	By December 31, 1997 By December 31, 1998 By December 31, 1999	Loan arrears to budget.

Objective	Policy Measure	Institutional Responsibility	Completion Date	Monitoring Indicators
2.2 Enterprise Restructuring	Complete viability assessments for Darkhan Minimetal and Bagahangai Meat plants	SPC	By December 31, 1997	Restructuring/liquidation plans for Darkhan minimetal and Bagahangai meat company drawn up.
	Approve restructuring/ liquidation plans for Darkhan Minimetal and Bagahangai Meat plants	SPC; MOF	By March 31, 1998	Restructuring /liquidation plans approved.
	Implement restructuring/ liquidation plans for Darkhan Minimetal and Bagahangai Meat plants	SPC	By December 31, 1998	Restructuring/liquidation completed.
	Present Draft Insolvency Law to IDA	MOJ	By Credit Effectiveness	Insolvency Law presented.
	Present Draft Insolvency Law to Parliament, satisfactory to IDA	MOJ	By September 30, 1997	Insolvency Law presented.
	Prepare privatization program for state-owned enterprises, to the satisfaction of IDA	SPC	By July 1, 1997	Privatization program approved.

PROJECT PERFORMANCE INDICATORS[1]

1. Banking Reform

INPUT	OUTPUT	OUTCOME	IMPACT
Commercial Bank Restructuring			
	Two large insolvent banks closed/liquidated; Two other large troubled banks put under strict restructuring contracts.	Savings bank, Reconstruction bank, and Mongolia Asset Recovery Agency established.	Financial deepening as measured by increase in M2/GDP, from 23% in 1996 to 30% by end 1998.
Stopping Loans to Defaulters			
	Reporting mechanism established for monthly monitoring of commercial bank lending.	Lending to defaulters ceases, resulting in reduction in total non-performing loans as a percentage of total loans from 51% in 1996 to 30% by end 1997.	Improved asset quality of individual banks, measured through repayment record of new loans given since 1997 by end 1998.
Recovery of Nonperforming Loans			
Establishment of Debt Workout Unit in T&D Bank. Provision of consultant Services. *(financing: BELTAC)*	Loan repayment/workout scheduled determined for four selected private enterprises.	Recovery of 30 percent of outstanding loans to T&D Bank of the four selected enterprises by end 1998.	Establishment of similar workout exercises in other commercial banks by end 1999.

[1] The matrix of performance indicators reflects the synergy between BESAC and BELTAC, particularly with regard to enterprise reform. Input, process and output indicators for banking reform primarily reflect TA provided by other institutions (ADB, IMF). The output and outcome indicators will be evaluated soon after the program ends, while the impact indicators will be evaluated two to three years thereafter.

2. Enterprise Reform

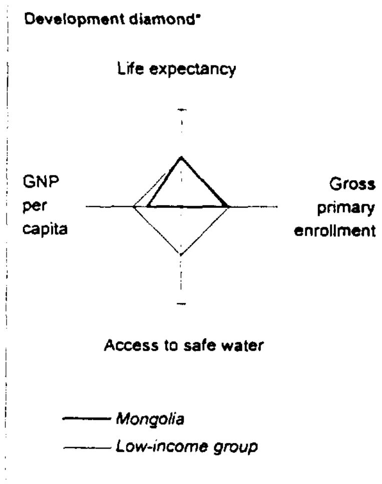
INPUT	OUTPUT	OUTCOME	IMPACT
Public Enterprise Restructuring and Debt Recovery			
Establishment of SPC-led public enterprise restructuring exercise. Provision of consultant services. *(financing: BELTAC)*	Financial restructuring or liquidation and debt service plans prepared for two selected public enterprises.	Implementation schedule for restructuring/liquidation developed for the two selected enterprises by end 1997.	Darkhan Minimetal and Bagahangai Meat plants restructured/liquidated by end 1998.
		Formal insolvency procedures established.	SPC-led restructuring /insolvency model extended to other public enterprises.
Hardening Public Enterprise Budget Constraints			
Passage of 1997 Budget.	Elimination of all subsidies to public enterprises and entities, except urban transport.	Transparency of public expenditures and more effective targeting of budgetary expenditures.	Reduction of budget deficit/GDP ratio from 9% in 1996 to 7.3% in 1999.
	Stop all Government loans except to public enterprises in electricity and heating.	Electricity and heating enterprises receive loans at 2 points below central bank bills rate in 1997.	Electricity and heating enterprises receive loans at central bank bills rate in 1998, and at market rates in 1999.

Mongolia at a glance

3/28/97

POVERTY and SOCIAL

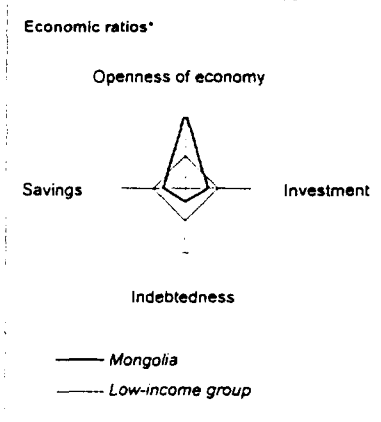
	Mongolia	East Asia	Low-income
Population mid-1995 *(millions)*	2.5	1,706	3,180
GNP per capita 1995 *(US$)*	310	800	440
GNP 1995 *(billions US$)*	0.8	1,365	1,399
Average annual growth, 1990-95			
Population *(%)*	2.1	1.3	1.7
Labor force *(%)*	2.9	1.4	1.7
Most recent estimate *(latest year available since 1989)*			
Poverty: headcount index *(% of population)*	..	..	..
Urban population *(% of total population)*	61	31	29
Life expectancy at birth *(years)*	65	68	63
Infant mortality *(per 1,000 live births)*	55	40	69
Child malnutrition *(% of children under 5)*	10	23	41
Access to safe water *(% of population)*	..	77	67
Illiteracy *(% of population age 15+)*	..	17	34
Gross primary enrollment *(% of school-age population)*	97	117	105
Male	95	120	112
Female	100	116	98



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

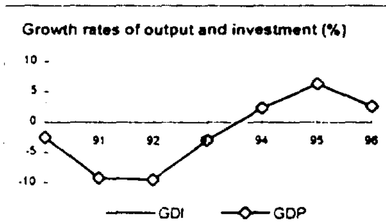
	1975	1985	1995	1996
GDP *(billions US$)*	..	2.5	1.0	1.0
Gross domestic investment/GDP	..	56.4	26.4	22.4
Exports of goods and non-factor services/GDP	..	23.9	54.0	43.5
Gross domestic savings/GDP	..	25.6	28.4	20.2
Gross national savings/GDP	..	..	26.7	.
Current account balance/GDP	..	-32.2	-4.2	-11.9
Interest payments/GDP	..	0.0	0.8	0.9
Total debt/GDP	..	0.1	53.6	54.9
Total debt service/exports	..	0.0	8.7	12.4
Present value of debt/GDP	..	..	34.4	
Present value of debt/exports	..	..	61.4	

	1975-85	1986-96	1995	1996	1997-05
(average annual growth)					
GDP	..	-1.9	6.3	2.6	.
GNP per capita	..	-2.8	6.9	..	.
Exports of goods and nfs	..	..	..	..	.



STRUCTURE of the ECONOMY

	1975	1985	1995	1996
(% of GDP)				
Agriculture	..	14.4	36.7	30.9
Industry	..	36.2	35.1	35.4
Manufacturing	..	..	..	..
Services	..	49.4	28.2	33.7
Private consumption	..	46.8	56.5	63.9
General government consumption	..	27.6	15.1	15.9
Imports of goods and non-factor services	..	54.7	52.0	45.7



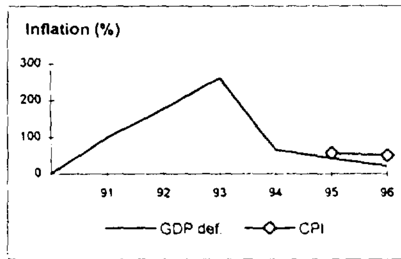
	1975-85	1986-96	1995	1996
(average annual growth)				
Agriculture	..	3.3	5.8	4.7
Industry	..	-3.4	14.8	0.1
Manufacturing	..	..	.	.
Services	..	-1.8	0.8	3.5
Private consumption	..	..	.	
General government consumption	..	..	..	..
Gross domestic investment	..	..		
Imports of goods and non-factor services	..	..	..	..
Gross national product	..	0.0	9.1	2.0

Note: 1996 data are preliminary estimates. Figures in italics are for years other than those specified.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

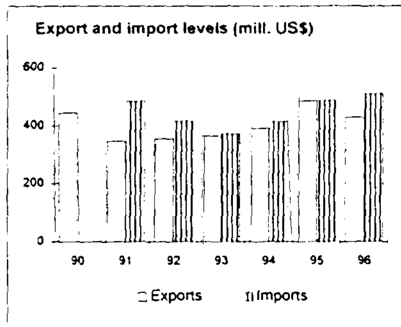
PRICES and GOVERNMENT FINANCE

	1975	1985	1995	1996
Domestic prices				
(% change)				
Consumer prices	..	..	56.8	50.0
Implicit GDP deflator	..	-1.4	42.5	21.0
Government finance				
(% of GDP)				
Current revenue	..	52.5	31.6	24.6
Current budget balance	..	3.1	7.1	4.4
Overall surplus/deficit	..	..	-4.1	-9.3



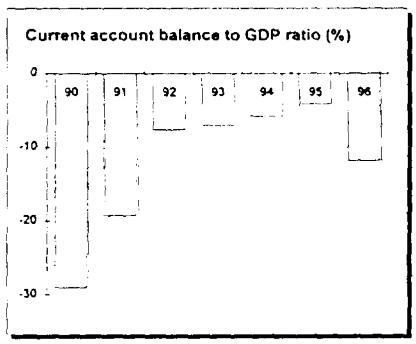
TRADE

	1975	1985	1995	1996
(millions US$)				
Total exports (fob)	..	..	486	430
Copper	..	..	258	191
Meat	..	..	..	..
Manufactures	..	..	..	..
Total imports (cif)	..	..	489	511
Food	..	..	37	..
Fuel and energy	..	..	88	..
Capital goods	..	..	149	..
Export price index *(1987=100)*	..	..	..	..
Import price index *(1987=100)*	..	..	..	..
Terms of trade *(1987=100)*	..	..	..	..



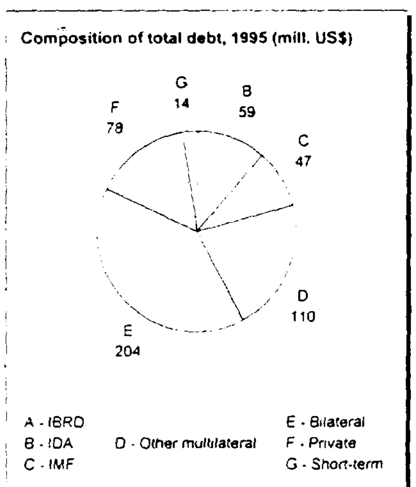
BALANCE of PAYMENTS

	1975	1985	1995	1996
(millions US$)				
Exports of goods and non-factor services	..	639	531	470
Imports of goods and non-factor services	..	1,407	546	589
Resource balance	..	-768	-15	-119
Net factor income	..	-45	-23	6
Net current transfers	..	0	-3	-2
Current account balance, before official transfers	..	-813	-40	-115
Financing items (net)	..	844	71	100
Changes in net reserves	..	-31	-31	16
Memo:				
Reserves including gold (mill. US$)	..	..	123	125
Conversion rate (local/US$)	..	3.7	448.6	548.4



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1994	1995
(millions US$)				
Total debt outstanding and disbursed	..	3	447	512
IBRD	..	0	0	0
IDA	..	0	49	59
Total debt service	..	0	39	47
IBRD	..	0	0	0
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	0	62	74
Official creditors	..	0	58	81
Private creditors	..	3	-22	-14
Foreign direct investment	..	0	10	10
Portfolio equity	..	0	0	0
World Bank program				
Commitments	..	0	30	10
Disbursements	..	0	17	8
Principal repayments	..	0	0	0
Net flows	..	0	17	8
Interest payments	..	0	0	0
Net transfers	..	0	17	8



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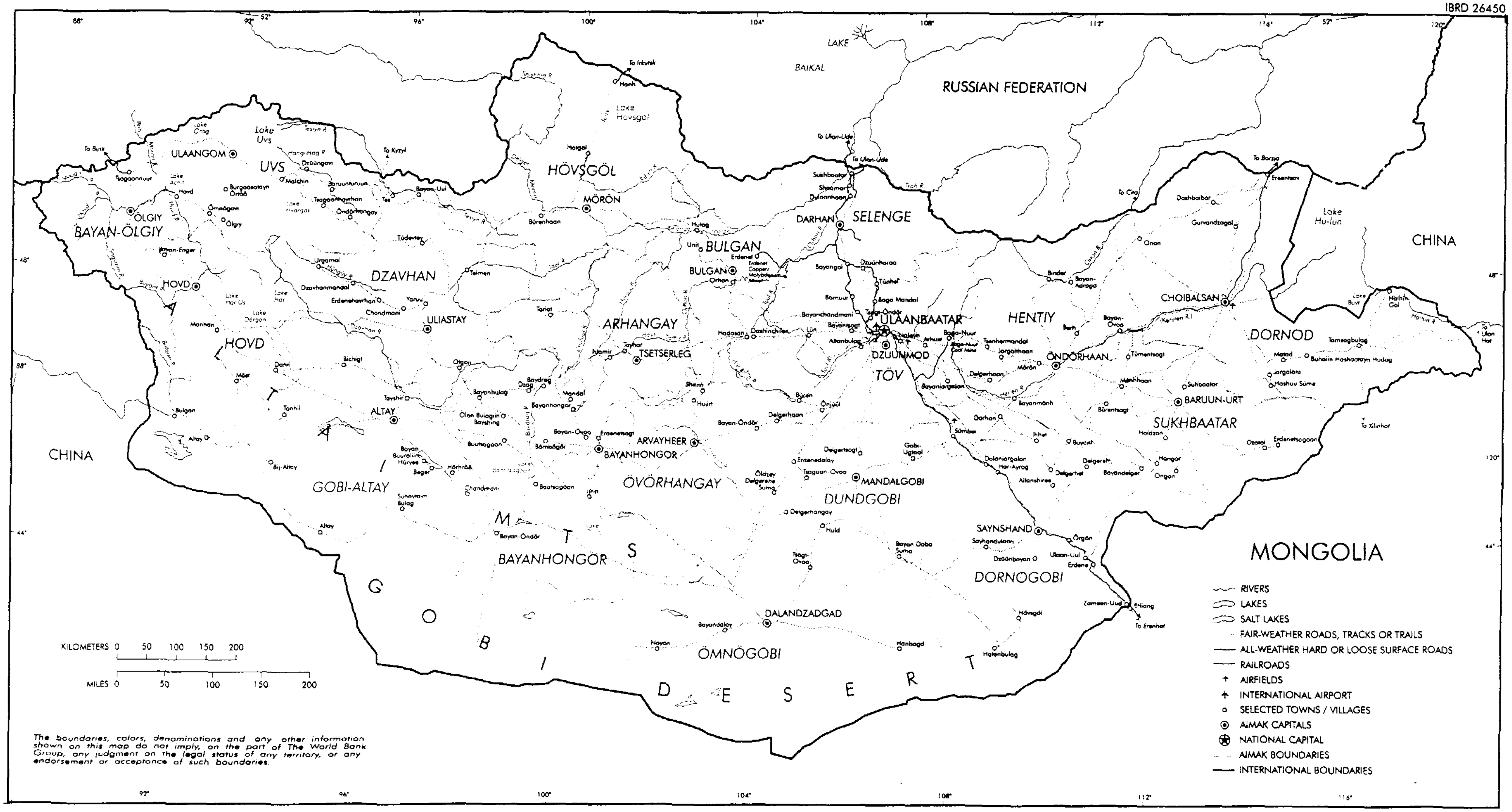

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IMAGING

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