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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 24 MILLION (US$32 MILLION)

TO

MONGOLIA

FOR A

FINANCIAL SECTOR ADJUSTMENT CREDIT

March 29, 2000

Financial Sector Development Unit
East Asia and Pacific Region

CURRENCY EQUIVALENTS
(As of March 28, 2000)

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US$ 1=1090.0 Togrog

FISCAL YEAR
January 1 – December 31

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

AB	Agriculture Bank
ADB	Asian Development Bank
BELTAC	Banking, Enterprise, and Legal TA Credit
BESAC	Banking and Enterprise Sector Adjustment Credit
BOM	Bank of Mongolia (Mongol Bank)
CAR	Capital Adequacy Ratio
CAS	Country Assistance Strategy
CMEA	Council for Mutual Economic Assistance
ESAF	Enhanced Structural Adjustment Facility
FSAC	Financial Sector Adjustment Credit
FSRP	Financial Sector Reform Program Loan (ADB)
GDP	Gross Domestic Product
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (German Technical Corp.)
ICR	Implementation Completion Report
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
ITI	Investment and Technological Innovation Bank
JAICA	(Japan) International Cooperation Agency
MARA	Mongolian Asset Recovery Agency
MPs	Members of Parliament
MPRP	Mongolian People's Revolutionary Party
NGO	Non-Governmental Organization
NIR	Net International Reserves
NPLs	Non-performing loans
OECF	Overseas Economic Cooperation Fund
PRGF	Poverty Reduction and Growth Facility
PSCD	Private Sector Development Credit
RB	Reconstruction Bank
SB	Savings Bank
SOEs	State–Owned Enterprises
TDB	Trade and Development Bank
USAID	US Agency for International Development
VAT	Value-Added Tax

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MONGOLIA

PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT

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PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT

CREDIT AND PROGRAM SUMMARY

Borrower	Mongolia
Amount	SDR 24 million (US$32 million equivalent)
Terms	Standard IDA terms, 40 years including a grace period of 10 years
Objectives	The proposed Financial Sector Adjustment Credit (FSAC) will support the Government's medium-term strategy for financial sector reform and development needed to achieve macroeconomic stability, accelerate private sector-led growth and reduce poverty. The main components of this strategy, which will facilitate the development of a sound and efficient financial system, include: (a) the establishment of basic financial infrastructure (e.g., banking skills, accounting standards, enforcement of financial contracts, and a clear exit policy framework for troubled banks); (b) the consolidation of the banking system; (c) the divestiture of the Government's ownership in Trade and Development Bank; (d) the development of effective regulation and supervision of the financial system; (e) the improvement of the payment system in rural areas; and (f) the confirmation of Government's commitment to honor financial contracts by timely servicing Government bonds.
Description	Proceeds from the credit will be used to close the projected 2000-2002 balance of payments financing gap of US$32 million and to free-up bank credit for private sector development and faster economic growth, by enabling Government to reduce substantially its large stock of net domestic credit from the domestic banking system, and help fund the cost of bank restructuring.
Benefits	The main benefits that the proposed FSAC would generate are a consolidation of macroeconomic stability, more rapid economic growth, and faster and more widespread improvements in living standards. To this end, and in line with the Country Assistance Strategy encompassing FY1999-2001, the financial resources provided under this credit will help Mongolia avoid an excessive transitional decline in consumption and investment, enabling a less costly adjustment to the recent large terms of trade shocks that Mongolia has experienced since 1998 following the decline in the prices of its main exports of primary commodities. The proposed FSAC would also help the Government implement its medium-term strategy for achieving its long-term vision to develop the financial sector. As this vision unfolds, the economy and the population will benefit from the emergence of institutions and markets that will ensure the intermediation of financial resources to viable enterprises, the diversification of risks, and greater access to banking services by firms and households.
Risks	The following are the significant risks to the proposed operation:

- The consensus on specific policy measures supported by the FSAC fails to hold and prevents Parliamentary ratification of the credit.
- The outcome of the June 2000 Parliamentary elections may weaken ownership of the financial sector reform program were it to result in a change in administration.
- The macroeconomic program could be pushed off track by the unusually severe winter and/or policy slippages.
- Limitations in administrative capacity, coupled with opposition from vested interests (e.g., in banks to be liquidated or privatized).
- The high incidence of non-performing loans in the banking system could undermine efforts to restore the sector to health if they remain unresolved.

The proposed operation cannot be fully insulated from the political risks, particularly those emanating from the proximity of the June 2000 elections, but they can be mitigated, as outlined below. At the same time, it should be noted that the timing of the operation yields significant benefits, given the context: the Bank, together with other donors, has engaged the Government in a dialog on financial sector reforms during the last 15 months and an agreement was reached on the program of medium-term policy reforms described above and in the attached policy matrix. However, there is only a limited time window of opportunity for the present Government to implement the agreed measures that the first tranche of the credit would support. Implementing these actions, many of which have already been undertaken, before this window closes, will allow the momentum of financial sector reforms to be maintained without interruption.

To assess whether a sufficiently broad consensus exists not only for the vision and strategy for the development of the financial system but also for the specific actions needed to implement the FSAC, the Government facilitated consultations by the task team with members of Parliament from both the Government Coalition and the opposition party. Feedback from these consultations indicates that the reform program is broadly supported by a wide cross-section of the civil society.

Sustainability is likely to be further enhanced by: (a) the cooperative arrangement between IDA and ADB, in the form of concomitant financial sector operations to support the Government's financial sector reform program, as set out in the common Letter of Development Policy and Policy Matrix; (b) the multi-tranche structure of the proposed operation, with the tranche releases back-loaded so that only US$12 million of the total credit amount (US$32 million) could be disbursed prior to the elections—provided Parliament ratifies the credit and all of the effectiveness conditions have been met; (c) the broad consensus that has been forged as part of the FSAC process among key stakeholders on the Government's Long-Term Vision and Medium-Term Strategy for Financial Sector Development;[1] and (d) close coordination with the IMF to ensure that credit proceeds strengthen fiscal sustainability, in the context of the ongoing IMF Poverty Reduction and Growth Facility (PRGF) Arrangement. These elements will foster reform continuity beyond 2000, regardless of the outcome of the elections.

The Government has a generally good track record on maintaining the reform momentum even under difficult external and internal conditions, as evidenced by its successful completion of the First Review of the Second Year of the Poverty Reduction and Growth Facility (PRGF) in January 2000. Macro indicators still appear to be on track, despite pressures on Government spending and inflation from the severest winter in thirty years (*Zdud*)—which has killed 2 million head of livestock and left 80,000 rural families destitute. Nonetheless, additional measures may be needed to meet the fiscal program targets for 2000 in light of the *Zdud*. Any such measures would be discussed during the upcoming Second Review mission of the Second Year of the PRGF, in which IDA will participate. In addition, the proposed ADB Financial Sector Reform Loan (FSRP) would provide funding to help Mongolia adjust to the macroeconomic effects of the *Zdud*. A new PRGF is planned for October 2000.

At the same time, Government and the Bank of Mongolia have forged ahead with financial sector reforms over the past several months, notwithstanding the huge external and climatic shocks and the proximity of the June Parliamentary elections, initiating liquidation of two deeply insolvent large state banks, doubling the minimum capital requirements for banks, and eliminating almost all arrears on Government bank restructuring bonds. In addition, most of the future actions that would be supported by the proposed FSAC also are in the purview of the Bank of Mongolia, which enjoys considerable autonomy and whose top management has a tenure extending almost until the Closing Date of the credit.

In terms of implementation capacity, Mongolia is generally weak, although the Bank of Mongolia, which will play a salient role in carrying out the reform measures the proposed credit would support, has significantly improved its implementation capacity in recent years. Donors have in place substantial TA to help Mongolia address implementation issues, including in the financial sector.

ADB currently has technical assistance in place for the banking sector through the end of 2000, and is expected to launch a second TA for implementation of its FSRP that will support the NBFI component of the Government's financial sector reform program. IDA is staggering its own

[1]The Government, with the support of the Bank, recently created a Financial Sector Development Performance Group (FSDPG) to forge a broad consensus on (a) the long-term vision and medium-term strategy for the financial sector; (b) the specific measures needed to achieve that vision and on the benchmarks to measure progress; and (c) tracking financial sector development performance over the medium-term, to help ensure reform continuity. The FSDPG includes high-level members of Government policy-making bodies; members of Parliament from both sides of the aisle; and NGO and private sector representatives; and with donors in an advisory role. The FSDPG held a retreat on February 21, 2000 in which these stake-holder's reached a broad consensus on the Government's Long-Term Vision and Medium-Term Strategy for the Reform and Development of the Financial Sector.

proposed TA loan to follow the completion of the ADB-assisted banking TA program to support implementation of the banking sector component of the Government's financial sector reform program beyond 2000. Over the short-term, USAID is providing TA to the Bank of Mongolia to assist it in carrying out several of the reform measures linked to the first tranche of the proposed credit.

Another risk is related to the high level of non-performing loans. Although the NPL ratio is very high (53%), actual NPLs amount to only US$35 million (about 3.5% of GDP) and less than 20% of total banking system assets. Of these bad loans, US$23 million are concentrated in Reconstruction Bank, ITI Bank and Agriculture Bank; the first two banks, which account for US$20 million or 57% of all NPLs are in the process of liquidation, expected to be completed within six months, and the third one is under receivership. The proposed FSAC will also support other measures to further reduce NPLs, such as strengthening MARA, Mongolia's asset management company, and the Credit Information Bureau.

Poverty category Not applicable

Estimated Disbursements

The proposed credit would be a multi-tranche operation designed to release the first tranche of US$12 million equivalent in the second quarter of calendar year 2000. The second tranche of US$12 million equivalent is expected to be released about 18 months thereafter. The proposed FSAC also envisages a floating tranche of US$8 million equivalent tied to the divestiture of the Government's ownership of the Trade and Development Bank (TDB). The closing date will be June 30, 2003.

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

INTRODUCTION

1. During the last 15 months, the Bank has engaged Government, Parliament Members, the private sector, NGOs and other donors in a dialogue on financial sector issues, through a Financial Sector Review. This process has helped Mongolia to develop A Long Term-Vision and Medium-Term Strategy for the Reform and Development of the Financial Sector.

2. The proposed Financial Sector Adjustment Credit (FSAC) would support implementation of the banking sector component of the Government's Medium-term Strategy for Financial Sector Development needed to consolidate macroeconomic stability, create a sound and efficient financial system, accelerate private sector-led growth and reduce poverty. This strategy calls for the establishment of: (a) basic financial infrastructure needed for a sound financial system (e.g., banking skills, accounting standards, enforcement of financial contracts, and a clear exit policy framework for troubled banks); (b) consolidation of the banking system to achieve stronger and more efficient banks; (c) liquidation of insolvent state banks; (d) the divestiture of the Government's ownership of a controlling share holding of Trade and Development Bank to a strategic investor(s) with banking skills recognized to be of international standards; (e) development of more effective regulation and supervision of the financial system; (f) improvement of the payment system in rural areas; (g) the timely servicing of Government bonds including the payment of interest arrears; and (h) the replacement of existing Government bonds held by banks with marketable securities. ADB's planned June 2000 Financial Sector Reform Program Loan (FSRP) would support implementation of the NBFI component of the Medium-Term Financial Sector Development Strategy. The IMF also is supporting the Strategy through its ongoing PRGF, and other donors, including IMF, USAID, GTZ and JAICA, are supporting the implementation of the Strategy through TA.

3. The proposed FSAC also would support implementation of Government's medium-term macroeconomic program. This program, designed to enable Mongolia to adjust efficiently to the huge 1998-99 terms of trade shock, which has persisted in 2000, is backed by the ongoing IMF Poverty Reduction and Growth Facility (PRGF), completion of the First Review of the Second Year of which Mongolia successfully completed on January 24, 2000. The macroeconomic program also is supported by other donors, including ADB, USAID, OECF and GTZ, mainly through project lending. ADB also has an ongoing adjustment loan, to support governance reform as well as the macroeconomic program. ADB has advised that it plans to present a US$15 million Financial Sector Reform Program Loan to its Board around June 2000 to support the NBFI component of the Government's financial sector reform program

4. Proceeds from the proposed FSAC would close the projected 2000-2002 balance of payments financing gaps, of US$32 million, enabling a less costly adjustment to the large terms of trade shock. In 2000, credit proceeds could help finance costs of bank restructuring higher than those programmed in the 2000 budget, if any, up to an amount equivalent to 0.4% of GDP. The first tranche of the proposed FSAC (equivalent to 1.1% of projected 2000 GDP) would enable Government to reduce its large stock of net credit from the domestic banking system, dampening

inflationary pressures stemming from the terms of trade shock (via the 30% depreciation of the exchange rate and more than doubling of petroleum prices over the past year) and freeing-up bank credit for the credit-starved private sector.[2] During 2001-02, proceeds from the proposed FSAC would enable Government to further reduce its large stock of net domestic credit from the domestic banking system, further alleviating inflationary pressures and freeing-up credit to accelerate private sector and overall economic growth.

5. The Government's medium-term macroeconomic program, with the backing of the IMF PRGF Arrangement, is designed to foster a less costly adjustment to the large terms of trade shocks experienced by Mongolia during 1998-99, reduce pressures on inflation and the build-up of debt, and, eventually, accelerate economic growth, by both reducing fiscal and current account imbalances to sustainable levels and spreading-out these adjustments over time. An acceleration of economic growth to 4 to 5% of GDP is projected during 2000-2002 (from an estimated 3.3% in 1999), while inflation is projected to decelerate from 10% in 1999 to 8.5% in 2000.

6. The World Bank's commodity price projections at the beginning of 2000 suggest that the terms of trade shocks will not further intensify in 2000. However, the recent further run-up in petroleum prices, if these higher prices persist, would cancel out the projected 10% improvement during 2000 in the prices of copper, which accounts for about 40% of Mongolia's merchandise exports.

7. The exceptionally severe winter weather *(Zdud)* this year—which killed 2 million head of livestock and left 80,000 rural families destitute, together with the further run-up in oil prices, has placed pressures on Government spending and inflation, as discussed in more detail in the next section. While macro indicators still appear to be broadly on track, additional measures may be needed to meet the fiscal program for 2000 in light of the *Zdud*. Any such measures would be discussed during the upcoming Second Review mission of the Second Year of the PRGF, in which IDA will participate. In addition, the proposed ADB FSRP would provide funding to help Mongolia adjust to the macroeconomic effects of the *Zdud*.

8. The General Government's overall deficit declined from 11.7% of GDP in 1998 to an estimated 8.5% in 1999. The program for 2000 calls for a further reduction of the General Government deficit, to 7.3% of GDP. By 2002, the last year of the proposed FSAC, this deficit would contract to a projected 5% of GDP. The current account balance, which went from a small surplus in 1997 to a deficit of 12.4% of GDP in 1998 as a result mainly of the huge terms of trade shock, is estimated to have declined to 6.2% of GDP in 1999. It is projected to rise to about 10% of GDP in 2000, and contract to about 7% by 2002. (See Annex 3.)

BACKGROUND

9. Mongolia became a member of the World Bank, IDA and IFC in February 1991. In 1998, the country's Gross Domestic Product was US$1 billion. The population totaled 2.4 million people, and per capita income, US$440. Mongolia's economy depends heavily on the exports of a

[2]Under the PRGF for 2000, additional financing associated with bank restructuring and regularization of interest payments on Government bonds up to an amount of 0.4% of GDP could be financed from the domestic banking system in the absence of additional foreign financing. Under the PRGF, any balance of payments financing beyond that assumed in the program through March 31, 2000, would be used to build-up the Bank of Mongolia's net external asset position, and lower the ceiling on the Bank of Mongolia's net domestic assets and the ceiling on net banking system credit to Government. In addition, to meet the quarterly and annual macro targets included in the proposed FSAC to assess the soundness of the macroeconomic framework during 2000, Government would need to utilize the first tranche of the credit to build-up its net external assets and reduce its net domestic credit.

few primary commodities and is highly vulnerable to terms of trade shocks. In 1998, when the value of exports of copper declined by an amount equivalent to 8.4% of GDP due to the depression of world copper prices, copper (39%), non-monetary gold (37%) and cashmere (7%) still accounted for about 83% of the value of Mongolia's merchandise exports.

10. Mongolia has made great progress over the past decade in its transition to a democratic form of government and a market-based economic system. While there has been broad support in the country for implementing a major program of economic liberalization, there have been differences of opinion on the pace of reforms, as well as how to deal with weaknesses in the financial sector.

11. In 1990, Mongolia initiated a peaceful transition to democracy, despite an economic collapse precipitated by the abrupt withdrawal of Soviet assistance (equivalent to about 30% of GDP) and the demise of the CMEA trading system. Free and open parliamentary elections in 1990 and 1992 kept the former communist Mongolian People's Revolutionary Party (MPRP) in power until June 1996. The MPRP initiated the process of economic liberalization, with substantial backing from the international community; however, waning political will and run-up in international copper prices in 1995 witnessed a slow-down in the pace of reforms in the mid-1990s, just as the economy started to recover.

12. In June 1996, the Democratic Coalition was elected on a platform of radical economic change. In the face of a 24% deterioration in the terms of trade that more than reversed the 1995 improvement (13%) and a severe banking crisis, the new Government, with strong support from donors, launched an ambitious program to complete the transition to a private sector-oriented market economy, accelerate economic growth, and reduce poverty. Financial sector restructuring and modernization were key components of the program, which also included measures to reduce inflation; liberalize input and output prices; rationalize the tax regime; downsize the state; create a legal and institutional framework conducive to private sector development; and establish a safety net for the poor.

13. These changes spawned a vigorous private sector response, enabling the overall level of economic activity to recover, despite the progressive shrinkage of activities that dominated the economy under the old regime; agriculture reassumed a dominant place in the economy at 33.5% of GDP, surpassing industry, which currently accounts for 24.1%.

14. Following the initial transition period, when output plummeted, Mongolia achieved a sustained recovery during 1994-98, with real GDP growth averaging 3.6%, exceeding the 1.7% population growth rate.

15. In 1997, Mongolia's terms of trade recovered partially (12%), disbursements of external assistance increased sharply, Government reduced its stock of net credit from the domestic banking system by 3.3% of GDP, and economic growth accelerated to 4% from 2.4% in 1996.

16. The pronounced deterioration in the terms of trade since 1998, however, jeopardizes many of Mongolia's gains. Early efforts to devise a suitable policy response to the huge external shock were thwarted by domestic political turmoil, and the ESAF Arrangement was derailed. Despite this turmoil, however, a credible set of policy measures were adopted beginning in September 1998 by a care-taker Government, and supplemented in May 1999 under the Narantsatsralt Government, enabling Mongolia to get then ESAF (now PRGF) back on track in June 1999. The fourth coalition Prime Minister, Mr. Amarjargal, entered office in July, 1999.

Parliamentary elections are scheduled for June 2000, with Presidential elections scheduled for June 2001.

17. The Country Assistance Strategy (CAS) for Mongolia encompassing FY1999-2001, was discussed by the Board on June 2, 1998 (IDA/R98-38). The primary goal of the CAS is to help Mongolia accelerate its transition to a market-oriented economy, improve living standards, and reduce poverty. The CAS highlights the importance of supporting medium-term macroeconomic stabilization as one of the means of achieving these goals. The proposed Financial Sector Adjustment Credit fully supports the objectives of the CAS by providing balance of payments support to expedite implementation of financial sector reforms that will facilitate macroeconomic stability, contribute to faster economic growth, and speed-up improvements in living standards.

18. In the event of a large terms of trade shock and slower than anticipated GDP growth, the CAS envisages additional IDA lending to support quick disbursing assistance for implementation of the additional policy measures needed to achieve a less costly adjustment to the external shocks. It has been the latter scenario of sharply lower export income, lower than-projected government revenues, disappointing economic growth and a sharp decline in real income that has emerged over the last two years, triggered by marked declines in the international prices of Mongolia's main exports (copper, gold and cashmere), the tripling of oil prices in the past year, and more recently, the disastrous winter weather.

19. On average, Mongolia's export prices dropped almost 31% in 1998, while average import prices declined almost 10%, resulting in a 21% deterioration in the country's terms of trade. This terms of trade shock lowered Mongolia's gross domestic income by almost 13% in 1998, despite a 14% increase in the quantum of exports. The terms of trade deteriorated a further 9% in 1999, resulting in an additional income loss of 4% of GDP. The CAS high case scenario rests on a projected deterioration of the terms of trade of 4.7% per annum. Although economic activity has continued to expand despite these large shocks, GDP growth, 3.5% in 1998 and an estimated 3.3% in 1999, has been significantly below the CAS base case projection (5.1%) and the rates needed to reduce the incidence of poverty, which remained virtually unchanged between 1995 and 1998 (36.3% and 35.6%). In addition, the terms of trade shock has contributed to a severe banking system crisis that would, if not redressed, further depress growth and erode the basis for improved living standards.

20. In 1997, prior to the large, ongoing terms of trade shock, income tax receipts and dividends from the copper sector amounted to almost 11% of the current revenue of the General Government (or 2.9% of GDP). In 1998 Government copper revenues dropped to 0.8% of GDP and in 1999, to 0.5% of GDP. In 1997, government revenues from the gold sector (royalties and VAT) amounted to 4.5% of General Government current revenue, or 1.3% of GDP. In 1998 and 1999 gold sector revenues dropped to 0.7% of GDP due to the decline of international prices.

21. As a result of the terms of trade shock, in 1998 Mongolia's fiscal deficit shot-up to 11.7% of GDP in 1998, from 8.6% in 1997, while the current account balance, went from a small surplus in 1997 to a deficit of 12.4% of GDP. In May 1999, the Government adopted a strong, medium-term program to adjust to the impact of the terms of trade shock, including a package to augment fiscal revenue by 2% of GDP annually and reduce capital spending by about 1% of GDP. These measures, coupled with increases in the VAT (to 13%) and oil excise taxes in September 1998 cut the overall deficit of the General Government to 8.5% of GDP in 1999, compared to a PRFG target of 9.8% of GDP. This substantial adjustment, together with higher net external financing with the support of the PRGF, eliminated the Government's use of net banking system credit in 1999, compared to net banking system credit to the Government of 3.8% of GDP in 1998 and a

PRGF ceiling of 0.9% of GDP in 1999. The full-year effects of these tax measures, together with public administration reform and further privatization, are projected to narrow the general Government's overall deficit to 7.3% of GDP in 2000 and to 5% in 2002.

22. Inflation, which was brought down to 6% in 1998 (from 21% in 1997), rose to 10% year on year at end-1999, due to the impact of lagged relative price adjustments to the external shock and excessive credit extended to the Government in 1998 . Under the PRGF for 2000, inflation was orginally targeted to decelerate to 7%, but is now projected to reach 8.5% due to the effects of the *Zdud.*

23. At the end of 1999, total General Government debt is estimated to have reached 78% of GDP, with General Government external debt amounting to 71% of GDP, compared to 66% and 59%, respectively, in 1998. Mongolia's total external debt is estimated to have reached 88% of GDP in 1999, while total external debt service is estimated to have amounted to only 7.4 % of exports of goods and services in 1999, due to the concessional nature of that debt and the high degree of openness of the economy. Mongolia's total external debt is projected to rise to 89% of GDP in 2000 and 2001, with the debt service ratio declining to 6.7% and 5.4%, respectively.

24. **Recent Economic Developments.** The World Bank's commodity price projections at the beginning of 2000 suggested that the terms of trade shocks that Mongolia suffered in 1998-99 will not further intensify in 2000, although the recent further run-up in petroleum prices, if these higher prices persist, would cancel out the projected improvement of about 10% in copper prices during 2000 (to an average of US$1800 per ton). In December 1999, copper prices were 20% higher than in December 1998, and during February 2000, copper prices rose a further 2%, to US$1800 per ton. The three month forward price in the London Metals exchange during February 2000 averaged US$1836 per ton, and the fifteen month forward price averaged US$1902 per ton. Copper prices have clearly been recovering and the market expects them to continue to recover. These stronger than projected copper prices will provide some measure of relief as Mongolia strives to cope with the macroeconomic effects of sharply higher oil prices and the unusually harsh winter weather.

25. Macroeconomic indicators still appear to be broadly on track, despite the pressures placed on Government spending and inflation by the exceptionally severe winter weather and the further run-up in oil prices,. Total net domestic credit to the General Government amounted to 63.6 billion togrogs at end-February 2000; this compares with a figure of 57.1 billion togrogs in December 1999, and a March 31, 2000 target (ceiling) of 66.1 billion togrogs under the ongoing IMF PRGF arrangement.

26. The net international reserves (NIR) of the Bank of Mongolia amounted to US$73.3 million at end-February compared to US$101.7 in December 1999, and a March 31, 2000 target of US$72.5 million under the PRGF. Mongolia has little room to spare on this indicator, but is still meeting the target. Through March 14, 2000, BOM's stock of NIR rose to about US$77 million.

27. During the year-to-date, Government not only eliminated almost of its remaining interest arrears on its bonds from 1999, but continued to meet interest payments falling due on its bonds, with the exception of a part of the 1999 interest arrears due to the Savings Bank and January-February 15 interest payments due the Savings Bank, which were rescheduled over the February 15-April 2000 period.

28. During the 12 months ending in February 2000, inflation accelerated to 12.3% from 10% in in December 1999, due to the impact of the *Zdud* on meat prices and further increases in fuel prices. In the first half of March 2000, the exchange rate was only about 2.1% higher than in December 1999 and the value of exports rose 25% during the first two months of 2000, compared to the same period of 1999, while the value of imports edged up only 1.5%.

29. Nonetheless, additional measures may be needed to meet the fiscal program targets for 2000 as a result of the *Zdud.* Any such measures would be discussed during the upcoming Second Review mission of the Second Year of the PRGF, in which IDA will participate. In addition, the proposed ADB FSRP would provide funding to help Mongolia adjust to the macroeconomic effects of the *Zdud.*

30. Areas where more attention will be needed to ensure fiscal sustainability and a price environment conducive to faster economic growth include: (i) containing the growth of Government-spending: overall Government spending had been increasing far too fast, until 1999, i.e., by 36% in 1997 and 19% (9% in real terms) in 1998. In 1999, growth in total government spending slowed to 7% (down slightly in real terms); however, total government spending is projected to increase about 15% in 2000 (7% in real terms). This acceleration in spending growth partly reflects the projected costs of bank restructuring; it also reflects an across-the-board 25% hike in government wages. Any future increases in wages need to be structured in such a way as to enhance incentives for managerial and professional personnel and be implemented pari passu with downsizing of the government workforce, so that the total wage bill does not rise relative to GDP; (ii) much less emphasis on increasing tax rates and instituting new taxes, and much more emphasis on improving collection of existing taxes; however, to the extent that raising tax revenue through tax hikes proves indispensable for fiscal sustainability, such tax hikes should only involve increasing taxes that minimize price distortions (e.g., the VAT); remaining export taxes should be phased-out as quickly as progress in reducing the fiscal deficit permits; and (iii) utility prices, which have been kept down over the past year, need to be adjusted both to ensure fiscal sustainability and curb excess demand.

31. To this end, the annual macroeconomic indicators included in the proposed FSAC to assess the soundness of the macroeconomic framework in connection with each tranche release, include: (i) targets on the General Government's overall deficit, total spending and net lending, and its total wage bill; and (ii) targets on transfers from General Government, and net domestic credit, to non-financial state enterprises. In addition, the findings of the upcoming Public Expenditure Review would be factored into the FSAC macroeconomic indicators for the second and floating tranches, and into the new PRGF, expected to commence in October 2000.

STRUCTURE AND RECENT PERFORMANCE OF THE FINANCIAL SYSTEM

32. Mongolia's financial system is still evolving to support a market-based economy. At this point in its transition, it is small and fragile, with recurring insolvencies in the banking system and high vulnerability to shocks and crises. These weaknesses, together with the narrow range of available financial services, are constraining private sector development and economic growth. However, the nature of the financial crisis in Mongolia is not the same as in other crisis countries in Asia. The problems are those more typical of a transition economy. Firm level surveys have confirmed that Mongolia is not affected by systemic corporate distress and thus wide-spread corporate restructuring is not a pre-requisite for financial sector reforms. Nevertheless, as in other transition economies, there is a need to link financial sector reforms with enterprise sector

reforms especially in a small un-diversified economy like Mongolia and this needs to be taken into account in sequencing of reforms.

33. The banking sector is small, with total assets of about less than US$180 million, and heavily over banked. The banking sector is also small relative to the size of the economy--the ratio of claims on the non-government sector to GDP is only 7.2%. Currently, 12 commercial banks are licensed (down from 15 in December 1999 and 18 in June 1998), despite the small size of the economy and BOM's limited supervisory capacity. Four Three banks—TDB, Savings, Golomt -account for 75% of banking system assets. TDB and Savings Bank (SB) are the largest and second largest banks respectively although the assets of SB consist almost exclusively of government bonds. Of the remaining banks, the Reconstruction Bank and Agriculture Bank and Post Bank are of medium-size, each accounting for 4% of bank system assets) but Agricultural Bank is under receivorship. The other banks are tiny in comparison; little intermediation takes place through them. The Government has direct and indirect participation in 6 banks, with the recent liquidation of ITI Bank and Reconstruction Bank. Two of the three largest banks (TDB and Savings) are fully owned by Government; they hold 61% of total assets. Golomt is the largest private bank accounting for 15% of bank assets.

34. Non-bank financial institutions are at an early stage of development. The stock market is small and illiquid, and insurance and leasing businesses are embryonic; however, they should evolve into viable, alternative sources of finance under an appropriate institutional and policy framework. Currently, access to term credit is largely limited to the largest companies that have links with foreign banks and markets.

35. Over the past decade, successive Governments have made important efforts to restructure and develop the financial system to advance Mongolia's transition to a market-based economy. With donor support, Mongolia put in place the legal infrastructure for a commercial banking system. Reforms began with the split-up of the state mono-bank into a central bank, the Bank of Mongolia (BOM), and five commercial banks. In 1991, BOM began licensing private banks and interest rates were liberalized.

36. Despite these serious initial efforts and subsequent initiatives to strengthen and liberalize the financial system, during Mongolia's evolution to a market-base economy, the banking sector has experienced recurring crises and failures, most notably in 1994, 1996 and 1998/1999. The sector appeared to recover substantially after the 1994 and 1996 setbacks, but these recoveries were only transitory.

37. Currently, the banking system is fragile and seriously dysfunctional. There is a severe shortage of banking skills, and a need for improvements in the legal and institutional framework. Real lending interest rates are at high levels that jeopardize economic development. Bank loans are being contracted at annual interest rates of 47%, and banks have been paying 24% for (domestic currency) time deposits, while inflation is in single digits. The spread between lending and deposit rates at about 22.5% is also high. Such real interest rates at these levels are unusually high by any standard, and their economic consequences are having a profound impact on the economy. High rates may also be contributing to disintermediation.

38. The factors conspiring to produce such high real rates include: the high proportion of non-performing assets; increasing perceptions of the riskiness of bank deposits; pressure on the exchange rate from the huge terms of trade shock and expectations of further depreciation; the

shrinking real money supply; the anti-inflationary stance of monetary policy; and the crowding out of the private sector on account of excessive Government demand for credit.[3]

39. In 1996, the Government issued a large amount of bonds as part of the major bank restructuring exercise that was carried out to close two large insolvent state banks and open-up two new state banks (Reconstruction Bank and Savings Bank). These local currency bonds now amount to the equivalent of US$36 million or 20% of total bank assets. Most of these bonds are held by Savings Bank. Until recently, the Government did not service these bonds regularly, nor are their terms clearly defined. The failure of the Government to pay interest on this debt during 1998 and most of 1999 created illiquidity at the banks holding the bonds, forcing them to push up deposit rates to attract new deposits in order to service the demands of existing depositors. This put upward pressure on interest rates throughout the system. The Government's failure to service its bonds also signaled the absence of a credible Government commitment to honor contracts.

40. The payment system in rural areas has also been subject to disruptions in recent years due to both fiscal stringency and to liquidity and solvency problems at Agricultural Bank, the main provider of such services. The bank is currently under receivership. At present, there are few alternative viable mechanisms for providing essential financial services in rural areas, as a result of which there has been an increasing reversion to barter. In the short-term, the priority is to ensure the timely payment of pensions, salaries, and social security payments even as viable alternatives are examined and developed for providing other banking services; micro-finance institutions exist, but are at a nascent stage, having little presence outside the capital, Ulaanbaatar.

41. Government began implementing a new round of financial sector reforms in 1998 with the support of donors, including the IMF and the ADB.[4] At the invitation of the Government, the World Bank carried out a review of the main issues confronting the financial sector during the second half of 1999, to lay the ground work for the proposed FSAC. The Financial Sector Review was discussed and agreed with Government, and discussed with other stake holders, including members of Parliament and other donors. These discussions helped to build a consensus on the diagnosis of the financial sector's problems. Based partly on the findings of the Financial Sector Review, Government has developed a Long-Term Vision and Medium-Term Strategy for the Reform and Development of the Financial Sector.

GOVERNMENT'S LONG-TERM VISION FOR FINANCIAL SECTOR DEVELOPMENT

42. In this Government's Long-Term Vision for the Financial Sector, over the next decade, Mongolia would move to a financial sector in which:

- the Authorities' role is limited to the maintenance of macroeconomic and systemic stability, with intervention only in the event that market forces patently fail to work;
- there is an effective, autonomous central bank and a legal framework which requires good prudential regulation and supervision, and prompt corrective action (i.e. the

[3] An interesting question that can be raised here relates to the link between interest rates and GDP growth: if interest rates are very high (and have been for some time) then how has GDP managed to expand at an average rate of 3.6% in the 1994-98 period? On the assumption that growth is correctly estimated, the explanation appears to lie in the relatively small size of the banking sector in Mongolia and its current dysfunctional state.

[4] The ADB has supported bank restructuring through its Financial Sector Program Loan (US$35 million) and an associated TA loan (US$3 million) over the last three years. The last tranche of the adjustment loan was disbursed in August 1999 and the loan closed in December 1999. The IMF is also supporting financial reforms through the ongoing PRGF arrangement (SDR 33.4 million) approved in July 1997.

closure of banks when the capital adequacy ratio declines below a certain minimum level);

- a relatively small number of domestic and foreign banks, subject to competitive pressures, efficiently provide banking services;
- all commercial banks are eventually owned by the private sector;
- there is a growing number of non-bank financial institutions (e.g., finance and leasing companies, contractual savings institutions, cooperatives, and micro-finance companies) to help meet the demand for savings and investment;
- basic payment and banking services are available to meet demand outside Ulaanbaatar through a variety of channels (e.g., micro-finance institutions, regional cooperatives, private banks);
- there is a cadre of bankers and related personnel who have been trained to international standards; and
- legal and accounting standards are rigorously enforced to uphold public confidence in the soundness of financial institutions.

GOVERNMENT'S MEDIUM-TERM STRATEGY FOR THE DEVELOPMENT OF THE FINANCIAL SECTOR

43. The Government recognizes its long-term vision will take many years to achieve. Consequently, it has devised a medium-term strategy that will lay the foundations necessary for achieving this vision over the longer term. This strategy incorporates important lessons learned during the earlier stages of the reform process, particularly: (a) the importance of having in place the essential building blocks required to support a market based financial system; (b) that well functioning financial markets cannot develop without a credible government commitment to honor contracts and to ensure protection of private property rights; (c) that policy reforms are much more effective when properly sequenced in order to have in place the essential institutions without which markets function much less efficiently; (d) that a pervasive involvement of the state in the allocation of financial resources is incompatible with the development of a market-based financial system; (e) that recapitalization of insolvent state banks leads to greater losses in the future; (f) that liberal entry requirements lead to too many poorly managed banks; and (g) that a sound and effective financial system cannot be built without a legal and institutional framework that encourages debtors to discharge their commitments to creditors.

44. Drawing on the above lessons, the Government's Medium-Term Strategy involves the introduction of reforms that:

- establish the foundations for a market-based financial system, including the development of modern banking skills, the enhancement of auditing and accounting standards, the enforcement of financial contracts and the establishment of an exit policy process for troubled banks;
- signal the government's commitment to uphold private property rights and financial contracts, beginning with the timely servicing of interest payments on government bonds held by banks;
- reduce the pervasive role of the state in the allocation of financial resources. (Government-controlled banks account for 84% of the assets in the banking system);

- facilitate the development of sustainable rural financial institutions to provide payment systems and banking services appropriate to conditions existing in a sparsely populated country such as Mongolia;
- prompt the consolidation of the banking system by doubling the minimum capital requirement to togrog 2 billion (US$1.9 million equivalent);
- strengthen the legal framework for effective supervision and regulation by the central bank including the requirement for prompt corrective action;[5]
- develop a resolution and liquidation framework for failed banks; and
- provide the foundations for the development of a market for government bonds.

POLICY REFORM ACTIONS TO FACILITATE IMPLEMENTATION OF THE GOVERNMENT'S MEDIUM-TERM STRATEGY FOR THE DEVELOPMENT OF THE FINANCIAL SECTOR

45. The Government's Medium-Term Strategy for the Development of the Financial Sector with the support of the proposed credit would be implemented taking into account the following:

- The reform and development of the financial sector needs to be closely coordinated with: (a) a major fiscal correction as part of a macroeconomic reform program (also supported by the IMF) with evidence of sustainability of that program; and (b) an action plan to reduce Mongolia's vulnerability to commodity price shocks;
- an explicit recognition on the part of the Government and its development partners that the reforms will be a long-term process requiring a series of well-coordinated interventions with the focus on institutions and capacity building; while the road to reforms may well be bumpy as political and economic priorities change with changes in Government and international markets, a widely shared consensus behind an articulated and realistic vision of a financial system will reduce the risk of major dislocating changes in the transition to a market based financial system and ensure that the reform process is sustainable;
- a phasing-in of the reforms in the financial sector to achieve the long term vision in the following sequence: (a) completion of the ongoing reforms including liquidation of ITI and Reconstruction Banks, which already has been initiated; (b) adopting a plan to restructure Agricultural Bank in a manner that will provide appropriate governance and ensure its commercial viability; (c) taking the initial steps to implement a medium term-strategy by deepening the reforms to make a decisive break from the status quo over an 18-month period starting in 2000 (as detailed in the bullets below); and (d) reviewing the effectiveness of the strategy after the first 18-24 months to assess the actions that need to be taken over the following 2-3 years to move steadily towards the attainment of the long-term vision;
- a high priority will be given over the next five years to a continuing program of technical assistance aimed at intensive human resource development and the creation of appropriate complementary institutions (including auditing and accounting standards, enforcement of financial contracts, and the development of a clear exit

[5] The Government and Bank of Mongolia's resolve in this area has been demonstrated by the recent revocation of the licenses of two distressed state-owned banks, Reconstruction Bank and Investment and Technological Innovation Bank, and the initiation of their liquidation. All the branches of the two banks have been closed, and it is expected that the process of liquidation, including the collection of outstanding loans will be completed in mid-2000. which are currently under receivership.

policy mechanism for troubled banks) that form the essential financial infrastructure for a market based financial system;

- the development of sustainable rural financial institutions and markets to provide payment systems and banking services appropriate to conditions existing in a sparsely populated country such as Mongolia and which can respond flexibly to on-going structural changes in agriculture and in particular livestock production over the coming decade; in the interim, given the dysfunctional state of existing financial institutions, a high priority needs to be given to maintain minimum financial services (in particular payment services) in rural areas by de-coupling them from the provision of banking services;
- consolidation and establishment of a core banking system to foster systemic soundness and effective competition by (a) encouraging the emergence of a small number of sound banks through a doubling of the minimum capital requirements to togrog 2 billion (about US$ 1.9 million equivalent); and (b) strengthening Savings Bank (SB) by (i) ensuring that the Government has paid its interest arrears on the US$26 million equivalent in restructuring bonds that SB holds as assets and will service these bonds on a timely basis in future, and (ii) implementing a program of technical assistance to improve its banking skills and corporate governance to facilitate the adoption of a time-bound exit strategy from its current status as a state-owned deposit-taking institution investing almost exclusively in Government bonds;
- reduction in the role of the Government in the allocation of financial resources with the divestiture by Government of a controlling share holding in the Trade and Development Bank to a strategic private sector investor(s) with international banking experience; for the sale to be effective the following elements would be essential components of any successful transaction: (a) transparency in the bidding and evaluation process; (b) unambiguous transfer of board and management control to the strategic private sector investor; (c) the tender of not less than 51% of all existing shares; (d) the strategic private investor buyer should have internationally recognized banking skills and have a plan, or an internationally diversified portfolio, to deal with portfolio diversification problems inherent in Mongolia; (e) all legal issues relating to ownership of the bank and its charter will have been addressed prior to the sale; and (f) no new institution will be created as part of the divestiture process; and any assets returned or turned down by the buyer will be disposed off directly or through MARA;[6]
- enhancing the effective regulation and supervision of the financial system by: (a) further tightening of prudential norms to ensure that classification of assets also

[6] Before appraisal, Government had presented to Parliament a bill excluding TDB from the list of properties not to be privatised. Attached to the bill is a proposal for the Government to dispose of 51% of the shares of TDB, which would reduce the Government's stake to 19%. Parliamentary approval of the bill is required before the Government can dispose of its stake in TDB. During appraisal, and confirmed during negotiations, the Government explained that: (a) the bill is limited to requesting Parliament's approval to exclude TDB from the list of firms that cannot be privatised; (b) the paper calls for the divestment of a 51 percent of TDB shares and the Government has indicated that it has the legal powers to decide the amount of shares that it will need to divest to make such a sale possible and that it is not restricted to sell a specific percentage to a strategic private investor; and (c) it is willing to sell a controlling shareholding to a private investor. The attachment to the bill also envisages equity shareholding by ADB or IFC. Involvement of ADB and/or IFC will facilitate the sale as these two institutions have a policy to exit out of such an investment within two years and their shares should be available to the strategic investor. ADB/IFC involvement is likely to help the sale of TDB to a strategic private investor. The ADB supports this approach. The principles and procedures that will guide the privatisation process have been defined consistent with the policy reform actions given in the text.

covers off-balance sheet items and other categories of non-loan assets; and (b) making changes in legislation to: (i) require "Prompt Corrective Action" by BOM when the capital of any bank declines below 75% and 50% of the minimum CAR required); (ii) ensure that other prompt and effective actions by BOM are triggered by objective factors established by the law including legal evidence of fraud, legal evidence of incompetent management or when the bank fails to comply with orders issued by the BOM pursuant to the provisions of the law and pertaining regulations; (iii) provide for a timely and effective failure resolution mechanism to prevent further erosion of troubled bank assets and provide protection to depositors; this resolution mechanism is to be automatically activated whenever the Capital Adequacy Ratio (CAR) of any bank declines below 25% of the minimum required level or the bank suspends payments to liability holders; and (iv) enable the effective liquidation of the residual assets of the troubled bank if the resolution process fails;

- setting the stage for the development of money markets by replacement of the restructuring Bonds held by SB by marketable securities in the next 18 months; and
- enhancing asset recovery and reducing the future incidence of non-performing loans by (a) strengthening the Credit Information Bureau through an agreement on the protocol for sharing information on loan defaulters between the commercial banks sharing the information and the BOM; and (b) strengthening the ability of MARA to collect and dispose of assets.

46. The above actions, if implemented effectively, should have a substantial impact in enhancing the efficiency and soundness of the banking system, reversing disintermediation, and improving the allocation of resources to productive uses. A reduction in non-performing loans, enhanced efficiency afforded by a more efficient banking system and a reduction in the riskiness of the banking system should help to increase bank profitability and lower interest rates by a significant margin. An improvement in the culture of repaying loans will also enhance the availability of credit in the economy. A reduction in the distortions in the financial sector will also facilitate the establishment and sustainability of macroeconomic stability. Actions undertaken with the support of the Bank's Commodity Initiative should also help to reduce the volatility of public finances and the vulnerability of the real economy to terms of trade shocks. Taken together these benefits will facilitate a higher growth path for the economy and help to reduce poverty by making credit and financial services more accessible to small entrepreneurs and the rural economy.

PROJECT RATIONALE

47. The proposed credit will support implementation of the Government's Medium-Term Strategy and thereby contribute to the attainment of a sound and efficient banking system, faster economic growth and enhanced welfare gains.

48. **Role and Importance of Financial Sector Development in the Mongolian Economy.** The small size of banking sector raises two concerns. It could be argued that even if all the reforms proposed under the operation are implemented one can only expect, in the medium term, a limited impact on the economy and living standards and that it will require a long time for the financial sector to reach a stage of development needed to facilitate economic growth. There is

also the question whether corporate restructuring should be a pre-requisite for financial sector reforms.[7] Empirical evidence from recent research helps address these important questions.

49. Over the past decade, a series of papers provide convincing cross-country evidence that there is a causal link between financial development and economic growth, and that the potential growth gains associated with financial sector development are large.[8]

50. In addition, a recent econometric analysis of World Bank loans related to the financial sector from 1985-96 indicates that countries with a low level of financial development such as Mongolia, at the time of loan adoption, experienced the most financial deepening (that is, the most improvement on the standard indicators of financial development).[9]

51. The evidence also suggests that countries at Mongolia's relatively low level of financial development have, on average, experienced nearly a doubling of their financial indicators after World Bank loans focused on the financial sector. That doubling would imply about 1% greater real growth per year according to the econometric specifications in the King/Levine papers mentioned above.

52. **Linkage of reforms to the Enterprise Sector.** In terms of the second question of whether corporate restructuring should be a pre-requisite for financial sector reforms, it should be noted that the nature of the financial crisis in Mongolia is not the same as that in other crisis countries in Asia. In Mongolia there was not a long period of rapid loan growth leading to asset price inflation and excess capacity in the corporate sector; rather, the problems are those more typical of a transition economy where corporate sector reform needs to move hand in hand with financial sector restructuring which is the approach we have been following broadly in Mongolia as mentioned above. Firm level surveys have confirmed that there is not systemic corporate distress is not an issue in Mongolia. Therefore, wide-spread corporate sector restructuring is not a pre-requisite for financial sector reforms.

53. The proposed FSAC builds-on a single tranche adjustment operation focusing on the banking and enterprise sectors of Mongolia supported by IDA, and project and TA lending for private sector development. The Private Sector Development Credit, approved in FY99, comprises a line of credit to support private enterprise development with TA for participating financial intermediaries and the Credit Information Bureau); The Banking and Enterprise Sector Adjustment Credit (BESAC), approved in FY97, was focused on enterprise sector reforms and the issue of NPLs; The Banking, Enterprise and Legal Technical Assistance Credit (BELTAC), approved in FY97, provides assistance in banking, enterprise restructuring and the legal framework for insolvency. (Annex 4 shows the projects funded by IDA.) These three credits feature enterprise reforms and private enterprise development. Hence, the proposed FSAC is part of a sequenced program of assistance to the financial and enterprise sectors, and would promote private enterprise development by facilitating improved financial intermediation. It isanticipated that the proposed FSAC will be complemented by a technical assistance project for supporting the development of basic financial infrastructure.

[7]Ross Levine, in the opening remarks in his 1999 review of the literature on financial development and economic growth, cites the 1952 quote from the economist Joan Robinson that, "where enterprise leads finance follows." The questions raised about the priority of financial sector reforms in Mongolia echo that sentiment. See Levine, Ross, "Financial Development and Economic Growth: Views and Agenda," Journal of Economic Literature, June, 1997, 35(2), pp. 688-726.

[8]For a list of papers by King, Levine and others on this subject, please refer to the source quoted in the previous footnote.

[9]See Robert Cull, Lemma Senbet, and Marco Sorge, "Deposit Insurance and Financial Development," World Bank and University of Maryland, mimeo, March 2000.

54. **Expected Impact on Interest Rates** Under the proposed FSAC, Government would pay market-based interest rates on its outstanding bonds and will make budgetary allowances for this purpose. This will alleviate the liquidity problems faced by Savings Bank and obviate the need for Savings Bank to pay premium interest rates to attract depositors. This will reduce the pressure on economy-wide interest rates.

55. **Choice of FSAC as an Instrument for Reform.** The option of a structural adjustment credit SAC rather than an FSAC was considered but it was concluded that FSAC was better suited for strengthening the financial sector, which by consensus amongst all stakeholders is of the highest priority in Mongolia. However, actions have been included in the FSAC policy matrix (under the macroeconomic framework) to reduce vulnerability to external shocks, one of the major economic problems facing Mongolia. These actions include adoption and implementation of a time-bound action plan to mitigate terms of trade shocks. This action plan will focus on two areas which have a direct impact on the financial system: (a) volatility in public finances; and (b) mitigating commodity price risks. It also will include actions to enhance Mongolia's competitiveness.

56. Mongolia has been selected as an Early Test Case in the Bank's Commodity Initiative, and work on this has commenced. It is anticipated that action plan will include measures initiated under the Commodity Initiative.

57. Fiscal consolidation, privatization and governance are already being addressed by on-going programs of the IMF, USAID, and ADB. At the same time there is a universal consensus among all major stakeholders that the fragility and inefficiency of the financial system is a major impediment to consolidating fiscal sustainability and accelerating economic growth.

58. A second issue relates to the timing and sequencing of the FSAC operation and a proposed TA operation that would complement the FSAC by improving basic financial structure. An alternative to the parallel processing of the two operations is to do a TA first and follow-up with an adjustment operation later.

59. Mongolia urgently needs additional balance of payment support via the proposed FSAC to ensure a less costly adjustment to a large terms of trade shock.Mongolia also will need and has requested a World Bank Financial Sector TA operation. It is expected that such a TA operation would come on stream in 2001, following the completion of the ADB's banking sector TA program, and grant TA that USAID is currently providing to help Government implement key financial sector reforms. Nothing would be gained by delaying the FSAC and much would be lost, as Mongolia would in those circumstances be obliged to undergo a more drastic adjustment to the external shock, with significant negative impacts for firms, the financial sector and individuals.

IDA EXPERIENCE WITH POLICY LENDING IN MONGOLIA

60. The lessons learned from the single tranche BESAC approved in 1997 provides relevant experience for the proposed FSAC. On the banking sector front, BESAC supported the following key objectives: (i) implementation of the 1996-97 bank restructuring exercise; (ii) stepping-up the commercial bank loan recovery effort; and (iii) implementation of enterprise reform that complemented the banking sector strategy.

61. The ICR issued on June 25, 1999, found the outcome of the BESAC, on the whole, to be satisfactory, and that, with few exceptions, the BESAC achieved most of its objectives. The main

lessons learned from this operation, applicable to new operations in the financial sector are as follows:

- *The importance of a multiple-tranche structure in order to ensure continued Government commitment to the project's success.* The strong commitment of the Government was critical in achieving the project's objectives. When the Government's attention phased itself out, implementation performance suffered.
- *Tranche disbursements should be linked to implementation and operational effectiveness.* BESAC envisaged the submission of a draft insolvency law to Parliament prior to credit effectiveness, but no further action was contemplated to implement the law. Similarly, in the case of the Credit Information Bureau, BESAC focused its emphasis on the creation of a new institution, rather than on its operational functioning and achievements.
- *Legal Infrastructures, Banking Reforms, and Credit Structure.* Reform of the banking sector in transitional economies is a very slow process that requires investment and changes in institutions, legal infrastructures, and human capital. Consequently, more attention could have been paid to the structure of the Credit, in the sense that a two-tranche operation would have allowed the Bank to include and monitor certain critical objectives that normally take more time to be achieved.
- *Greater attention should be paid to the fiscal consequences of banking sector reforms,* in order to better assess the short- and long-term costs of the proposed reform program.
- *Institution-Building and Technical Assistance.* When institution building is crucial for a project's objectives, as it is in transitional economies, structural adjustment operations that provide a broad agenda for reforms in particular sectors should be accompanied and supported by technical assistance projects. BESAC and BELTAC constituted a good attempt at implementing this simple principle.

62. The design of the proposed operation has taken into consideration the lessons learned from the BESAC. It has also taken into account lessons learned from other World Bank financial sector operations involving privatization. In particular the relatively successful Argentine bank privatization program highlighted the importance of agreeing with the Government upfront what will constitute an acceptable privatization transaction.

FEATURES OF THE PROPOSED LOAN

63. **Development Objectives.** The proposed FSAC supports legal, institutional and policy reforms aimed at establishing a sound and efficient banking sector needed for macroeconomic stability, faster economic growth, and progressive improvements in living standards.

64. **Policy Actions Supported by the Loan.** A letter of development policy confirming a vision, a medium-term strategy, and an agreed matrix of policy reforms will provide the foundations for this credit. The broad areas of policy reform that would be supported by this loan are summarized above (para. 45 above), and in the Letter of Development Policy (Annex I). The proposed Board, effective and tranche conditions are detailed in the Policy Matrix (Annex 2).

65. **Coordination with Stakeholders.** The Bank has consulted closely with all stakeholders on important aspects of this operation and in particular with respect to the Letter of Development

Policy (LDP) and the Policy Matrix, which includes the vision for financial sector development and the measures needed to implement that vision. The discussion on the vision and strategy for financial sector reforms have taken place in the context of Financial Sector Development Performance Group (FSDPG). The details of this discussion in this forum as well as other interactions with stakeholders are outlined in the section under the risk below.

66. Prior to negotiations, the Bank invited staff of the Asian Development Bank to participate in technical discussions with the Mongolian Delegation on the LDP and the Policy Matrix. The objective of ADB's participation was to set out a coordinating framework between ADB, IDA and the Government of Mongolia regarding the financial sector. Senior staff from the ADB staff attended the technical discussions and provided valuable comments and suggestions on the subject. The tripartite discussions led to agreement on the LDP (which includes the vision for the development of the financial sector and the strategy for achieving that vision) and FSAC policy matrix.

67. Tripartite discussions (Government, ADB, and IDA) were held in Ulaanbataar during March 26-29, 2000 to determine the scope of a coordinated ADB and IDA approach for supporting the Government's financial sector reform program. Agreement was reached in the tripartite discussions that the Government, ADB and IDA will support a common Letter of Development Policy and a common Policy Matrix, without cross conditionalities. ADB, through its planned June 2000 US$15 million FSRP, will support the NBFI component of the Government's Medium-Term Strategy for the Development of the Financial Sector, enhancing sustainability of financial sector reforms.

68. **Borrower and Loan Amount.** The Government of Mongolia will be the borrower. The proposed credit amount is US$32 million (SDR 24 million), corresponding to Mongolia's projected balance of payments financing gaps during 2000-02. The proposed FSAC will be made under standard terms for IDA countries. The Government of Mongolia has formally requested a US$5 million TA credit to be prepared in FY2001 to support implementation of basic financial sector infrastructure as envisaged under the proposed FSAC.

69. **Disbursement and Procurement.** The proposed credit would be a multi-tranche operation designed to release the first tranche (effectiveness) of US$12 million equivalent in the second quarter of 2000. For this purpose, a Deposit Account will be opened at the Bank of Mongolia as is the case for all simplified Structural Adjustment Credits (SACs). The second tranche of US$12 million equivalent is expected to be released about 18 months thereafter. The proposed FSAC also envisages a floating tranche of US$8 million equivalent tied to the divestiture of the Government's ownership (at least 51% of total shares) of the Trade and Development Bank (TDB) to a strategic investor(s) with international banking experience. Given the complexity of the privatization process, this multi-tranche arrangement is designed to allow the reform program to go ahead while giving the Government greater flexibility in meeting its commitment on TDB. Credit proceeds will not be disbursed against expenditures normally excluded from adjustment credits.

70. If any portion of the Credit is used for ineligible purposes as defined by the Credit Agreement, IDA will require the Government either to return that amount to the Deposit Account for use of eligible purposes or refund the amount directly to IDA, in which case IDA will cancel an equivalent undisbursed amount of the Credit. As disbursement will not be linked to specific purchases, evidence to support disbursements will not be required. To secure the release of each tranche, the Government will submit a simplified Withdrawal Application against which IDA will disburse the Credit proceeds into the Deposit Account for the Government's use.

71. **Accounts and Audit.** The Bank of Mongolia, on behalf of the Government, will maintain an appropriate accounting system, in accordance with generally accepted accounting principles, providing all necessary information on the receipt and use of funds channeled through the Deposit Account and will prepare annual financial statements in a format to be agreed at negotiations. The Financial Statements will be audited annually by independent auditors acceptable to IDA under the terms of reference agreed with IDA and in accordance with acceptable international auditing standards. The audited Financial Statements will be submitted within four months of the Government's fiscal year ending December 31 and annually, thereafter.

72. **Environmental Assessment Requirements.** In accordance with the Bank's environmental policies (OP 4.01) sectoral adjustment loans are subject to the Bank's EA requirements. This is a sectoral adjustment credit providing purely balance of payments support to the economy and is not anticipated to have any environmental impacts. For the purposes of environmental rating the proposed FSAC has been categorized as a Category C project. The project is categorized as a C because there are no directly identifiable environmental impacts associated with the proposed policy interventions. To address environmental impacts associated with its future downstream activities, the Agricultural Bank's restructuring plan will include developing and adopting procedures acceptable to IDA for screening, evaluating, and mitigating the potential adverse environmental impacts of its future operations.

RISKS

73. The following are the significant risks to the proposed operation:

- The consensus on specific policy measures supported by the FSAC fails to hold and prevents Parliamentary ratification of the credit.
- The forthcoming elections in June 2000 may weaken ownership of the FSAC reform program due to a change in administration.
- The macroeconomic program could be pushed off track by the unusually severe winter weather and/or policy slippages.
- Limitations in administrative capacity, coupled with opposition from vested interests (e.g., in banks to be liquidated or privatized).
- The high level of non-performing loans in the banking system could undermine efforts to restore the sector to health if they remain unresolved.

74. The proposed operation cannot be fully insulated from the political risks, particularly those emanating from the proximity to the June 2000 elections, but they can be mitigated, as outlined below. At the same time, it should be noted that the timing of the operation yields significant benefits, given the context: The Bank, together with other donors, has engaged the Government in a dialog on financial sector reforms during the last 15 months and an agreement was reached on the program of medium-term policy reforms described above and in the attached policy matrix. However given the proximity of the June 2000 Parliamentary elections, there is only a limited time window of opportunity for the present Government to implement the agreed measures that the first tranche of the credit would support. Implementing these actions, many of which have already been undertaken, before this window closes, will allow the momentum of financial sector reforms to be maintained without interruption.

75. To ensure that a sufficiently broad consensus exists not only for the Government's Long-Term Vision and Strategy for the Development of the Financial System but also for the specific actions needed to implement the proposed FSAC, the task team held extensive consultations with Members of Parliament from both the Government Coalition and the opposition party. Feedback from these consultations indicates that the broad reform program supported by the FSAC has the backing of members of Parliament on both sides of the aisle. This is important because the less than two-thirds majority that the Government has in Parliament ensures that it will not be possible to secure ratification of the credit by Parliament without the support of members of the opposition (because the opposition has sufficient votes to block a quorum and ratification of the credit).

76. The credit will be presented to Parliament for ratification in the current parliamentary session.

77. Sustainability is likely to be enhanced by: (a) the cooperation arrangement between IDA and ADB, in the form of concomitant financial sector operations to support the Government's financial sector reform program, as set out in the common Letter of Development Policy and Policy Matrix; (b) the multi-tranche structure of the proposed operation with the tranche releases back-loaded so that only US$12 million of the total amount (US$32 million) could be disbursed prior to the elections, provided the credit is ratified by Parliament and all effectiveness conditions have been met; (c) the broad consensus that has been forged as part of the FSAC process among key stakeholders on the Long-Term Vision and m Medium- Term Strategy for f Financial Sector Development;[10] and (d) close coordination with the IMF to ensure that credit proceeds strengthen fiscal sustainability, in the context of the ongoing IMF Poverty Reduction and Growth Facility (PRGF). These elements will help foster reform continuity beyond 2000, regardless of who win the elections.

78. The Government has a generally good track record on maintaining the reform momentum even under difficult external and internal conditions, as evidenced by the program it adopted to put the PRGF back on track in May 1999 and its successful completion of the First Review of the Second Year of the Poverty Reduction and Growth Facility in January 2000. Macro indicators still appear to be on track, despite pressures on Government spending and inflation from the severest winter in thirty years. Nonetheless, additional measures may be needed to meet the fiscal program targets for 2000 in light of the *Zdud*. Any such measures would be discussed during the upcoming Second Review mission of the Second Year of the PRGF, in which IDA will participate. In addition, the proposed ADB FSRP would provide funding to help Mongolia adjust to the macroeconomic effects of the *Zdud*.

79. At the same time, Government and the Bank of Mongolia have forged ahead with financial sector reforms over the past several months, notwithstanding the huge external and climatic shocks and the proximity of the June Parliamentary elections, initiating liquidation of two deeply insolvent large state banks, doubling the minimum capital requirements for banks, and eliminating almost all arrears on Government bank restructuring bonds. In addition, most of the future actions that would be supported by the proposed FSAC also are in the purview of the Bank

[10] The Government, with the support of the Bank, recently created a Financial Sector Development Performance Group (FSDPG) to forge a broad consensus on (a) the long-term vision and medium-term strategy for the financial sector; (b) the specific measures needed to achieve that vision and on the benchmarks to measure progress; and (c) tracking financial sector development performance over the medium-term to help ensure reform continuity. The FSDPG includes high-level members of Government policy-making bodies; members of Parliament from both sides of the aisle; and NGO and private sector representatives; and donors, in an advisory role. The FSDPG held a retreat on February 21, 2000 in which these stake-holder's reached a broad consensus on the Government's Long-Term Vision and Medium-Term Strategy for the Reform and Development of the Financial Sector.

of Mongolia, which enjoys considerable autonomy and whose top Authorities current term runs through December 2002, or well beyond the June 2000 Parliamentary elections and almost until the Closing Date of the credit.

80. Mongolia's implementation capacity is generally weak, although the Bank of Mongolia, which will play a salient role in carrying out the reform measures the proposed credit would support, has significantly improved its implementation capacity in recent years. Donors have in place substantial TA to help Mongolia address implementation issues, including in the financial sector.

81. ADB currently has technical assistance in place for the banking sector through end-2000, and will launch a new TA program for implementation of its FSRPL that will support the NBFI component of the Government's financial sector reform program. IDA is staggering its own proposed TA loan to follow the completion of the ADB Banking TA program to support implementation of the banking sector component of the Government's financial sector reform program beyond 2000. Over the short-term, USAID is providing TA to the Bank of Mongolia to assist it in carrying out several of the reform measures linked to the first tranche of the proposed FSAC.

82. Although the non-performing loan (NPL) ratio is very high (53%), actual NPLs amount to only US$35 million (about 3.5% of GDP) and less than 20% of total banking system assets. Of these bad loans, US$23 million are concentrated in Reconstruction Bank, ITI Bank and Agriculture Bank; the first two banks, which account for US$20 million or 57% of all NPLs, are in the process of liquidation, expected to be completed within six months, and the third one is under receivership. The proposed FSAC will support other measures to further reduce NPLs, such as strengthening MARA, Mongolia's asset management company, and strengthening the Credit Information Bureau to pool information on defaulting borrowers.

RECOMMENDATION

83. I am satisfied that this the proposed credit complies with the Articlesof Agreement of the International Development Association and recommend that the Executive Directors approve it.

James D. Wolfensohn
President

by Sven Sandstrom

Washington D.C.
March 29, 2000

Ulaanbatar, March 29, 2000
MONGOLIA

Letter of Development Policy

Long-Term Vision, Medium-Term Strategy and Policies for the Financial Sector Reform Program

Mr. James D. Wolfensohn
President
International Development Association
1818 H. St., N.W.
Washington, D.C. 20433
United States of America

Dear Mr. Wolfensohn :

Subject: Proposed IDA Financial Sector Adjustment Credit for the Financial Sector Reform Program

1. The Government is pleased to request the Asian Development Bank (ADB) and the International Development Association (IDA) to jointly finance the financial sector reform program for Mongolia. We are happy that both institutions are coordinating their efforts to support the program. This is an excellent example of donor coordination and partnership. The comprehensive approach to developing the financial sector that encompasses both banks and non-bank financial intermediaries, involving other donors such as USAID, JICA, GTZ, is an extremely positive development for Mongolia. The fact that we are writing a joint letter attached with a joint policy matrix to the presidents of the two international financial institutions bears testimony that we welcome close donor coordination in the financial sector. We are sending the same letter to President Chino of the ADB.

Background

2. A decade ago this past December 10, 1999, Mongolia embarked on a radical and comprehensive reform path—indeed, the path we choose entailed nothing less than abrupt systemic change encompassing all spheres of the nation's political, economic and social life. If one compares our situation today with that at the end of 1989, one finds that while Mongolia still faces many daunting challenges, we have made great strides in reshaping our lives and our destiny for the better.

3. Today, all citizens of Mongolia have the right and the opportunity to set their own goals, and to choose freely how best to accomplish these goals. Freedom of choice is perhaps the most priceless achievement of this remarkable decade in Mongolian history.

4. In 1990, Mongolia held its first free elections. These were an embodiment of the notion of pluralism and resulted in the formation of a new Cabinet from three different political parties, through which the basis for the ensuing comprehensive reforms of Mongolian society was established. Subsequently, under the 1992 Constitution, Mongolia has held two free and

democratic parliamentary elections, as well as two presidential elections. New political parties have emerged, and the oldest one has evolved into a new democratic force.

5. The transformation of the economy has been equally dramatic. The reforms launched by the first democratic government in 1990-1992, including price liberalization, establishment of a new banking and financial system, and privatization, laid the foundation for the development of a private, market economy in Mongolia. The sweeping transformation of the economy which has taken place in this decade was a direct outcome of those first reforms.

6. The majority of the Mongolian people have come to comprehend in a relatively short period of time the necessity of relying on their own visions, abilities and drive to meet the challenges of the new era. At the same time, this decade has seen the emergence of new social problems such as unemployment and poverty. These were the inevitable result of the withdrawal of the large external subsidies which had previously financed the operations of the entire Mongolian economy and social services to the tune of more than 30% of our GDP, and of the collapse of COMECON trading block. No country could endure or has endured such a dramatic shock without experiencing a period of hardship. It is precisely for this reason that Mongolia has embarked on a path of drastic institutional and structural reforms in all spheres of the economy, and intends to continue on this path in the future. Our national program of institutional, structural and policy reform is aimed at reducing the hardships of the transitional period, overcoming this period in the shortest time possible, and creating a solid foundation for the future development of an efficient economy and the progressive advancement of our society.

7. Substantial progress already has been achieved on the economic front. Mongolia has had five consecutive years of economic growth, and the economy expanded again, by 3.3%, in 1999 despite a further pronounced deterioration in our terms of trade. Inflation has been brought down to single digits. The livestock sector, the backbone of the Mongolian economy, has been privatized, and dynamic private companies also are operating in many other key sectors of the economy. A thriving small business sector is generating jobs and incomes for large numbers of our people. The November 1999 employment report shows that open unemployment has dropped below 6% of the labor force. This is suggestive of the underlying dynamism of our economy—an economy whose structure is on the way to being rebuilt, in the course of a decade.

8. At the same time, many serious challenges remain to be overcome. The external environment has turned extremely unfavorable, leading to excessive trade and budget imbalances and a sharp deterioration in the banking system which must and are being addressed through painful adjustment measures. The need for policies which will achieve more rapid economic growth and improvement in the living standards of the Mongolian people in the face of such a difficult environment is urgent, and that is we why have acted to take the measures needed to both minimize the costs of our adjustment to the huge external shock, and to lay the foundation for more rapid economic growth in the future. And we have done this despite an unfortunate cycle of political turmoil during 1998 and 1999. The banking sector is still very weak and unable to play its proper role in promoting economic growth. Some important sectors of the economy are still predominantly state-owned, and others, although privatized, are still not competitive and generating growth. The Government itself, which must lead the national process of transition to a more productive and efficient society and economy, has undergone relatively less structural change. Mongolia has barely begun to address the question of how to deliver necessary social services to its population without the large external subsidies which had previously financed them.

9. We are very fortunate in that we have many generous and reliable development partners, and as discussed at the Seventh Mongolia Assistance chaired by the World Bank in June 1999, Mongolia needs a transitory increase in donor aid to enable us to carry out the needed measures to adjust to the huge external shock—a shock totaling an estimated 17% of GDP during 1998-99—in a phased manner so as to avoid undue welfare losses. To this end, and to support a series of reforms aimed at creating a sound and efficient financial system needed for faster economic growth, we are requesting a Financial Sector Adjustment Credit from the IDA (the Association), in the amount of US$32 million equivalent, and a Financial Sector Reform Program Loan from the ADB in the amount of US$15 million equivalent to support the projected 2000 to mid-2003 balance of payments financing gap.

Macroeconomic Framework

10. **Terms of Trade Shocks.** The sharp falls in 1998-99 in world prices for copper, gold and cashmere, Mongolia's leading exports, have caused great harm to the Mongolian economy. In 1998, export earnings plunged US$150 million (or by amount equal to about 15% of GDP), due entirely to these price declines. This led to a cumulative depreciation of the exchange rate of 35%, and to a drop in official reserves. The sharp contraction in the value of exports due to the fall in commodity prices reduced Government revenues by almost 4% of GDP in both 1998 and 1999, relative to the level of 1997. Corporate taxes from the copper sector declined from 3% of GDP to nil in 1998, and in 1999.

11. Due to the steep decline in world prices for copper, the Erdenet Copper Concern also has been unable to settle its bills with the Energy Authority, the Oil Importing Company, and electric power stations, making it difficult for the latter to pay money owed to the coal mining companies and to the railways. All of these firms have in turn been unable to pay their expected taxes and dividends to the state budget. This created a cascading of arrears in the economy, causing slowdowns in the activities of these major producers, and a large increase in the Government's budget deficit—from 8.6 to 11.7% of GDP from 1997 to 1998, and in the creation of domestic credit to finance the deficit (to 3% of GDP in 1998). As a result, in 1998, the Government fell into arrears on payments of salaries and pensions. This external shock also contributed to a marked deterioration in financial sector performance, with non-performing loans rising to about 41% of total commercial bank loans.

12. The Government has acted with determination to address the imbalances caused by the terms of trade shock. The Value Added Tax Law was adopted and became effective on July 1, 1998. In September 1998, the VAT was raised from 10 to 13%, a 10% tax of the export of gold was adopted, and the excise tax of imported petroleum and petroleum products was raised by US$7 a ton. In addition, the 1999 budget froze wages and salaries, and reduced outlays on goods and services.

13. **Government's Fiscal Program.** In May 1999, Government adopted a comprehensive, medium-term program to adjust to the impact of the terms of trade shock, including a package of measures to augment fiscal revenue by a further 2% of GDP annually and reduce capital spending and net lending by about 1% of GDP, with the support of the second year of the PRGF Arrangement, approved in June 1999, whose first review we successfully completed in January 2000. These fiscal measures, coupled with the 1998 tax increases, cut the overall deficit of the general Government to 9.9% of GDP in 1999, from 11.7% in 1998. This adjustment, together with higher net external financing with the support of the PRGF, reduced the Government's use of net banking system credit in 1999 to less than 1% of GDP, compared to 3% of GDP in 1998. The full-year effects of these tax measures, together with public administration reform and further

privatization, are projected to narrow the General Government's overall deficit to 7.3% of GDP in 2000, and to 5.3% by 2002, with zero net domestic credit to Government beginning in 2000. Inflation, which was brought down to 6% in 1998 (from 21% in 1997 and 45% in 1996), rose to 10% by the end of 1999 due to the impact of lagged relative price adjustments to the external shock and excessive credit extended to the Government in 1998. It is projected to decelerate to 7% in 2000. At the end of 1999, the total General Government debt reached an estimated 78% of GDP, with external debt amounting to 71% of GDP. External debt service amounted to less than 6% of exports of goods and nonfactor services in 1999, due to the concessional nature of that debt and the high degree of openness of the economy. During 2000-02, the Government's total debt to GDP ratio is projected to increase to 79%, and its external debt, to 73% of GDP. At the same time, economic growth is projected to accelerate to 4-5%.

14. **The Budget for 2000.** The Government budget for 2000 seeks to consolidate fiscal sustainability and free-up resources for the private sector. As mentioned above, the overall deficit is projected to decline to 7.3% in 2000, and net domestic financing, to zero. The 2000 budget is geared to reversing the recent decline Government revenues relative to GDP, while reducing Government spending as a percentage of GDP and improving the prioritization of public spending. Total revenue is slated to rise to 28.4% of GDP, reflecting a slight increase in income taxes and dividends from the copper sector, and the full-year effects of the revenue measures introduced in 1999. Total spending is targeted to fall to 35.7% of GDP, compared to 36.3% in 1999 (and 39% in 1998). The budget makes provisions for the full servicing of public debt, including Government bonds. Outlays on goods and services will be tightly controlled and domestically-financed capital expenditures on lower priority projects will be reduced. The Government also will be undertaking a public expenditure review, with the support of IDA, during 2000. During 2000, the proposed Financial Sector Adjustment Credit would assist to achieve the above macroeconomic targets.

15. **Reducing the Size of the State.** Steps will also be taken to focus Government on core functions, outsourcing other activities, and to increase its efficiency, in the context of the Asian Development Bank (ADB) supported Governance Reform Program. Government also is taking action to improve the governance of state enterprises and curtail their involvement in activities that could be more efficiently carried out by the private sector. To improve pricing decisions, and allow state enterprises to operate on a commercial basis, these enterprises will be granted greater managerial autonomy. Regular financial audits of state enterprises will be instituted. State enterprises will continue to face hard budget constraints (zero net domestic bank credit), and will not receive Government transfers. In addition, the Government has expanded its privatization program, which yielded revenues of about 1.7% of GDP in 1998, to the largest state enterprises. The National Oil Import Concern and the Gobi Cashmere Company are to be privatized, as is the Trade and Development Bank (see also paragraph 38 below).

16. **Exchange Rate and Monetary Policy.** The Bank of Mongolia has continued to pursue the flexible exchange rate policy adopted in 1993 and effectively implemented in the last quarter of 1998 to facilitate the adjustment to the external shock, and will continue to do so in the future. At the end of 1999 the exchange rate was about 25% higher than at the end of the third quarter of 1998, leading to a depreciation of the Togrog of about 4% in real effective terms. International reserves also have substantially recovered from their 1998 decline, and official holdings of external assets reached US$151, or the equivalent of about 14 weeks of imports, compared to less than 12 in 1998. The primary objective of monetary policy is to keep inflation in single digits. With the deceleration of inflation during 1998 and for most of 1999, the yield on central bank bills was progressively lowered, to 10% per annum. As the Government deficit is reduced, banking reforms advance and inflation decelerates during 2000, reductions in commercial bank

lending interest rates should be feasible. Growth in monetary aggregates would reflect increased credit to the private sector (with zero net lending to Government and state enterprises) and the further build-up of net external assets towards an adequate level.

17. **Accelerating Economic Growth and Improving Living Standards.** Real GDP growth over the past few years has grown at a modest pace of 3.5%. With an annual population rate of 2%, per capita GDP has also increased. However, the significant deterioration in the terms of trade since the second-half of 1996 had have a major adverse impact on the purchasing power of exports, which account for about 40% of GDP, and, hence, on income and living standards.

18. **Managing External Shocks.** Managing external shocks has become imperative if Mongolia is going to accelerate economic growth and to be able to translate greater output into higher per capita incomes and declining poverty. Better management of external shocks will lead to higher living standards by reducing fiscal and monetary volatility, reducing uncertainty, enhancing financial sector performance, and mitigating drastic swings in producer and consumer incomes. To this end, under the proposed Financial Sector Adjustment Credit (FSAC), the Government would adopt a time-bound action plan, satisfactory to the Association, to improve management of external shocks. It is envisaged that this action plan will encompass measures to smooth-out fiscal revenues, and measures to manage commodity price risk to shield producer incomes from the full impact of commodity price fluctuations. On the latter, we hope that Mongolia will qualify as an early test case under the World Bank's Commodity Initiative.

Current Situation of the Financial Sector

19. The financial sector in Mongolia is slowly evolving to a market-based system, but is still not able to contribute to the development of the economy, and has instead been a drag on economic development. Consolidated banking sector indicators have improved in the past several months thanks to the implementation of measures taken in connection with the 1996 Financial Sector Program Loan (FSPL) funded by ADB and continued under the Banking Restructuring Action Plan of 1999 and the proposed Financial Sector Adjustment Credit to be funded by the Association. Currently the banking sector also meets the international criteria for capital adequacy (10%) and liquidity (18%). The financial sector, however, remains weak and financial intermediation continues to be severely constrained. Building on ADB's assistance under the FSPL in support of bank restructuring, further restructuring is needed to support the development of viable core private banks.

20. At end-1999, total bank assets amounted to only 18 percent of GDP, while total credit outstanding to the private sector was only about 5 percent of GDP. Four large banks out of 12 currently licensed banks hold 80 percent of total assets of the banking system. The Savings Bank, one of the largest banks, does not perform any financial intermediation functions. The remaining 8 banks have only negligible market shares, have little capacity to compete with the largest 4 banks, and conduct limited financial intermediation activities. The state directly and indirectly owns shares of 6 banks. These include controlling shareholding of 3 banks (Trade and Development Bank, Savings Bank and Agriculture Bank), which together account for 70 percent of total assets of the banking system.

21. Non-bank financial institutions are at an incipient stage of development. The stock market is small and illiquid; and market-based insurance and leasing businesses are only beginning to emerge. Nevertheless, considerable potential exists for development of non-bank financial institutions as a competing force, provided a suitable legal environment is created.

Currently, long-term credit exists only in the following two forms: through project financing from some commercial banks that serve as on-lenders of credit extended to the Government by donors, or through establishing relationships with foreign banks and markets.

22. The financial sector has recently witnessed the expansion of credit cooperatives and micro finance companies. These institutions are expected to play a greater role as effective providers of small credit. Finance companies and financial leasing companies are also beginning to emerge. In line with development of these non-bank financial institutions (NBFIs), the Government is committed to providing a suitable legal environment including improving supervisory and regulatory oversight of these institutions by BOM .

23. During the last 10 years the Government of Mongolia has taken an important series of actions aimed at establishing a market-based banking system, its restructuring and development. Mongolia replaced the one-tier banking system by a two-tier one; put in place the foundations of the legal framework for banking operations; licensed private banks; and liberalized interest rates and capital flows, with the assistance of the donor community. Since 1996, a series of actions have been taken to further modernize banking legislation, strengthen prudential norms and bank supervision, and to restructure the banking sector.

24. Although policies on banking sector reforms, restructuring and liberalization of financial transactions have been broadly moving in the right direction, the banking sector has faced several crises on its transition path (1994, 1996, 1998-1999).

25. Despite these efforts, the banking sector remains small, weak and crisis-prone. It is still necessary to considerably improve banking staff skills and capacity, as well as the legal and operational environment for conducting banking activities.

26. Real lending interest rates are extremely high. Despite the deceleration of inflation to single digits, and subsequent reduction in Central Bank bill rates and deposit rates, lending interest rates remain high in both real and nominal terms. This has adversely impacted financial intermediation and the entire economy. The main reasons for high lending interest rates are: the high level of non-performing loans; expectations of currency devaluation resulting from the terms of trade shock; little competition in the financial sector; weak institutional capacity and failure of the Government to make timely payments on its financial obligations. High lending interest rates in turn contribute to deterioration of loan quality.

27. In 1996, the Government issued bonds in an amount equivalent to 5 percent of GDP to protect deposits of customers of two insolvent banks, within the framework of the banking sector restructuring program. Of these bonds, 60 percent is owned by the Savings Bank, and 40 percent is owned by the Central Bank. The Government has failed to make timely payments of interest on these bonds. Moreover, these bonds have not had clearly defined terms and maturities. The fact that the Government has failed to meet its obligations on its bonds on a timely basis is contributing to deterioration of the financial position and efficient decision-making of bond-holders, and is sending an improper message to the general economy by exercising an unhealthy practice of not meeting contract obligations.

28. The rural payments system has had significant, recurring problems due to strained state and local government budgets and lack of creditworthiness of the Agriculture Bank, virtually the only bank servicing rural areas. This bank is currently operating under the receivership of the Central Bank and is undertaking restructuring actions such as renewal of service fees on a

contract basis, reduction of operational costs and loan recovery efforts. Currently, operations of the bank are restricted to providing payments of pensions and benefits as well as salaries of government employees in rural areas. Micro-lending institutions in rural areas have been established only recently in three Aimags, and have not started operating at the soum level.

29. The capital markets and contractual savings institutions in Mongolia are at a nascent stage of development. The stock market is small and illiquid; and the pension and insurance systems have played a limited role in terms of developing alternative sources of funds to finance economic growth. Despite the smaller size of the capital markets in relation to the banking sector, the Government recognizes the increasing importance of capital markets in developing the financial sector in Mongolia.

30. Market capitalization at the Mongolian Stock Exchange as of December 1999 was $32 million, or 3 percent of GDP, down from $53 million at the end of 1997. Trading activity has declined sharply over the last year, as evidenced by the drop in average daily trading from $50,000 in 1998 to about $10,000 in 1999.

31. The Government recognizes that the small corporate sector and slow progress with regard to the privatization of the remaining 95 SOEs, the largest of which are likely to be sold to strategic investors outside of the MSE, has constrained the supply of better quality stock. On the demand side, limited capacity of MSEC to serve as an effective policymaker and regulator has dampened investor confidence and necessitates considerable institutional strengthening.

32. The Government is aware that the 1997 Insolvency Law has seldom been applied in the resolution of corporate bankruptcies. Under the IDA-assisted Beltac Project and the IDA IDF Grant for the Insolvency Law, the Government is undertaking measures to strengthen the knowledge and application of the Insolvency Law by creditors. These measures will help improve overall corporate governance and accelerate resolution of non-performing loans in the banking sector and debt recovery. With respect to financial governance, Mongolia is unique in that its stock exchange is owned by the Government, and we are strongly committed to its privatization.

33. The capital markets would further benefit from the development of the pension system. The Mongolian pension system is a pay-as-you-go system where current work force pay for the retired workers. Like other transition economies, the pension system has been afflicted by (i) growing unfunded liabilities; (ii) contribution arrears, particularly from state-owned bodies; and (iii) a narrow base of pension contributions relative to recipients.

34. To address these issues, Government pension plan aims to introduce notionally defined individual pension accounts. In this regard, the Law on Individual Pension Accounts was adopted by the Parliament on 11 June 1999, under which workers born after 1 January 1960 will be given individual pension accounts indicating their past pension contributions with effect from 1 January 2000. The annual "returns" to the individual contributions will be determined by the Social Security Insurance General Office. While the new system will enable pension payments to be closely linked to contributions, the pension fund will be unfunded for the foreseeable future, although the Government has plans to invest a part of the contributions of the younger workers in the domestic capital markets. The Government also plans to introduce non-state voluntary pensions in Mongolia, to supplement the current "first pillar" pension provisions. The Government will be preparing draft legislation to allow the development of a voluntary private pension system.

35. While Mongolia has a long history with insurance products, there is a lack of operational and regulatory capacity in the industry. Besides considerable regulatory support, policy and operational assistance is needed to strengthen the sector. Except for minimum capital requirements of Tug. 100 million ($95,000), there are no prudential requirements governing solvency in the industry at present. Investment guidelines for insurance companies need to be strengthened as capital markets gradually develop in the country.

36. Although the recent policy on financial sector restructuring and actions taken to implement this policy have generally been moving in the right direction, it is necessary to take decisive actions to make fundamental changes in the current weak situation, to restore public confidence, and to establish a strong financial sector capable of supporting economic development.

37. With these objectives in mind, the Long-term Vision and the Medium-term Strategy necessary to implement this long-term vision for the development of financial sector is formulated below, and Financial Sector Reform Program Loan. The Government and the Bank of Mongolia and would be implemented with the support of the proposed Financial Sector Adjustment Credit consider that the general policy guidelines and specific actions to be taken to implement the medium-term strategy also should be reflected in the annual Monetary Policy Guidelines that are approved by Parliament at the end of each year, ensuring ownership and consensus on the financial sector reforms as we move forward.

Key Lessons Learned from past efforts to Reform the Financial Sector

38. The following lessons from the experience of last 10 years of financial sector restructuring were taken into consideration in determining the long-term vision and medium term strategy for financial sector development:

- It is necessary to build the infrastructure aimed at supporting a market-based financial system, with strong financial discipline and prudential controls.
- The financial sector will not develop without a state that supports contract enforcement, protection and securitization of private property.
- Financial sector restructuring will not be successful unless the sequence of reforms is determined correctly and a stable political environment exists.
- State intervention in allocation of financial resources hinders development of a market-based financial sector.
- The fact that the state recapitalizes insolvent banks and takes their risks increases potential losses in the future.
- Lax entry requirements result in an excessive number of weak, poorly managed banks.
- A sound financial sector cannot be created without an appropriate legal framework and operational structures aimed at strengthening the repayment culture.
- Capital markets and NBFIs should be developed to complement the banking sector and foster a balanced financial structure.
- Investor confidence is crucially dependent on the existence of sound corporate governance systems and practices in the financial sector.

- The role of the Government in the ownership of financial institutions impairs their rapid growth as viable entities.

Long-Term Vision for Financial Sector Development

39. Based on the above lessons and exchange of views with key stakeholders, including members of Parliament from both sides of the aisle and donors active in the sector, the long-term vision for the financial sector in Mongolia for the next 10 years is envisaged as follows:

- The role of the state will be directed to ensuring macroeconomic and financial sector stability, and the state will intervene only in circumstances where market forces patently fail to work.
- There is an effective, autonomous central bank and a legal framework which requires good prudential regulation, corporate governance, and supervision and prompt corrective action (i.e. the closure of banks when the capital adequacy ratio declines below a certain minimum level);
- A relatively few number of sound and efficient domestic and foreign banks would emerge and would be capable of providing efficient banking services in a competitive environment.
- Ownership of all commercial banks will have been transferred to the private sector.
- Basic payment and banking services are available to meet demand outside Ulaanbaatar through a variety of channels (e.g., micro-finance institutions, regional cooperatives, private banks).
- The financial sector will have a cadre of banking and related personnel trained in best international practices.
- The legal environment for conducting financial activities as well as accounting standards will be rigorously enforced, with the aim of strengthening public confidence in the financial institutions.
- There is a growing number of NBFIs (e.g., finance and leasing companies, contractual savings institutions, cooperatives, and micro-finance companies) to help meet the demand for savings and investment.
- A healthy and well governed capital market will be developed to complement the banking sector.

Medium-term Strategy for Financial Sector Development

40. The Government recognizes its Long-Term Vision will take many years to achieve. Consequently, it has devised a Medium-Term strategy that will lay the foundations necessary for achieving this vision over the longer term. The key elements of the medium term strategy for financial sector development are as follows:

- establish the foundations for a market-based financial system, including the development of modern banking skills, the enhancement of auditing and accounting standards, the enforcement of financial contracts and the establishment of an exit policy process for troubled banks;

- signal the government's commitment to uphold rights and obligations under financial contracts, beginning with the timely servicing of interest payments on government bonds held by banks;
- reduce the pervasive role of the state in the allocation of financial resources—until the revocation of the licenses in December 2000 of the deeply insolvent ITI and RB Bank, government controlled banks accounted for about 90% of the assets in the banking system;
- facilitate the development of sustainable rural financial institutions to provide payment systems and banking services appropriate to conditions existing in a sparsely populated country such as Mongolia;
- prompt the consolidation of the banking system by doubling the minimum capital requirement to T2 billion (about US$1.9 million);
- strengthen the legal framework for effective supervision and regulation by the central bank including the requirement for prompt corrective action;
- develop a resolution and liquidation framework for failed banks;
- provide the foundations for the development of a market for government bonds and an inter-bank market;
- strengthen corporate governance in the financial sector by encouraging banks to move towards international standards such as the guidelines on corporate governance in banking institutions issued by the Bank for International Settlements;
- foster a healthy capital market by carrying out reforms in MSE and MSEC to enhance investor confidence; and
- institute a regulatory mechanism to guide the development of the NBFI sector.

41. The proposed Financial Sector Adjustment Credit and Financial Sector Reform Program would support the implementation of the Governments Medium-Term Strategy for the Reform and Development of the Financial System.

Bank Restructuring and Privatization

42. A largely insolvent state-owned banking system impedes .faster economic growth and improvements in living standards. Heavy banking system losses inflate the public sector deficit and debt, diverting funds from poverty reduction, human resource development and infrastructure.

43. **ITI Bank and Reconstruction Bank.** On December 24, 1999, the Bank of Mongolia revoked the licenses, and initiated a resolution dictating the liquidation of, ITI Bank and Reconstruction Bank. With this unprecedented measure, the size of the state banking sector was reduced by about one-fifth.

44. **Agricultural Bank.** AB is deeply insolvent and incurring operating losses averaging nearly T50 billion per month. At present, AB also operates the largest branch network in Mongolia and only one with a presence down to the county (*soum*) level. The accumulated losses of AB amount to T7 billion (equivalent to about 0.7% of GDP on a yearly basis).The Government plans to recapitalize, restructure and eventually privatize AB, in accordance with a Restructuring

Plan that would be supplemented in consultation with IDA, to strengthen its provisions relating to corporate governance; commercial viability; the actions required to bring it to the point-of-sale; and the revocation of its license if a sound bank cannot be established. Over the medium-term, AB either will have been brought to the point-of-sale (to owners who can provide appropriate governance and ensure financial viability), or, if AB has become insolvent again, BOM will have revoked its license. In the meantime, the Government will begin to implement alternative arrangements for ensuring payment services to the population outside the capital.

45. **Savings Bank.** The Savings Bank was established as a special purpose vehicle to collect and protect household deposits following the banking crisis of 1996. Savings Bank holds about one-third of the banking system's total deposits. The bank has more than 260,000 accounts with an average size of about US$12 equivalent each. The bank functions essentially as a Government agency with an implicit state deposit guarantee and lacks a banking/lending culture. The Government's failure, until recently, to service the bank restructuring bonds that make up virtually all of its assets resulted in a deficit cash flow and operating losses, causing the Savings Bank to maintain higher deposit rates than otherwise would be needed, further pushing-up economy-wide interest rates. Furthermore, Savings Bank's policy of investing all its assets in non-marketable Government bonds prevents one-third of all deposits (representing approximately 75% of all household deposits) from being intermediated.

46. Savings Bank needs to be made financially viable to limit systemic risk, downsized to reduce state exposure and foster financial intermediation, and eventually, turned into a financial intermediary. Therefore, Government is clearing all interest arrears on its bonds, and will service those bonds in future at an interest rate linked to the BOM bill rate. Clearance of interest arrears has enabled Savings Bank to begin lowering its interest rates. Over the medium-term, Government will replace the stock of bank restructuring bonds with marketable securities that will be regularly serviced. In the meantime, Savings Bank will be downsized, by, inter alia, bringing its interest rate structure in line with market rates, and increasing service fees to levels charged by other banks. Over the medium-term, the Government will prepare an action plan for the transformation of Savings Bank into a financial intermediary, including its privatization.

47. **Trade and Development Bank.** The Trade and Development Bank (TDB) is Mongolia's largest bank; however, during 1998 and the first half of 1999, the bank incurred significant loan losses from weak governance and poor lending practices.

48. Scarcity of modern banking skills is severely handicapping development of a banking system, and the fastest way to develop these skills is through the training that a reputable international bank could provide. In addition, much greater private ownership and market allocation of resources in the financial system is needed to accelerate growth.

49. Accordingly, Government submitted a bill to Parliament requesting its approval to privatize TDB on January 28, 2000. Government's intention, once it obtains Parliamentary approval of said bill, is to privatize a controlling share holding of TDB to a private strategic investor with recognized international banking experience via international competitive bidding. The Government is exploring with ADB and IFC the possibility of participating, together with a private strategic investor, in the equity of the privatized TDB.

Corporate Governance in Banking Institutions

50. Corporate governance in banking institutions is generally weak, further undermining market discipline. In many instances, state-owned banks are operated by directors, many of

whom were trained under the old system based on principles of directed lending. To address some of these issues, initial training has been provided under IDA-assisted projects (BELTAC and Private Sector Development Project). On the other hand, certain private investors are, in some instances, interested in establishing small banks not as a sound investment option but as a means to finance their personal business activities. The closed limited-liability nature of banks together with the absence of effective accountability, in many cases, encourages perpetuation of bad management further undermining the development of sound and efficient private banks. In an effort to improve corporate governance and strengthen internal control mechanisms in banks, BOM will, with technical assistance to be provided by ADB, prepare and issues guidelines on best practices in corporate governance in banking institutions, based on international best practices such as the guidelines issued by the Bank for International Settlements.

Loan Collateral

51. It is recognized that the expected approval of provisions in the Civil Code allowing for movable property to be offered as loan collateral will be an important step towards enhancing the supply of loanable funds in the banking system. A second significant step will involve expanding the types of immovable property that can be used as collateral in secured transactions. A plan will be developed by the Government to analyze the feasibility of using other forms of immovable property as collateral. At another level, the Government will address under the Financial Sector Reform Program issues relating to the Office for Immovable Property Registration relating to the relatively high cost of collateral registering and cumbersome administrative procedures that discourage registration.

Banking Supervision and Prudential Regulation

52. Tightening selected prudential norms, together with a stronger failure resolution framework, will help create a sound banking system, reducing resource misallocation and wastage, improving long-run fiscal balance and contributing to faster economic growth and improved welfare.

53. **Minimum Capital Requirements.** Minimum capital requirements have been low relative to the size of the market and the scarcity of banking skills, allowing easy entry into the market and resulting in an excess number of banks—as many as 18 in August 1998 (currently down to 12), most of which have performed weakly or failed. In this way, BOM supervisory resources and Mongolia's scare banking skills have been stretched far too thin. On September 1, 1999 the MCR was raised from T400 million to T1 billion. On January 21, 2000, the Bank of Mongolia issued a resolution that raised the Minimum Capital Requirement (MCR) for commercial banks from T1 billion to T2 billion, effective starting June 30, 2001, except for new candidate banks, for which the increase to T2 billion is effective immediately.

54. With the new increase to T2 billion, the MCR has been raised by a multiple of 5 over the course of the past four months, for new banks, and has been raised by a factor of 5 during the August 1999-June 30, 2001 period, for existing banks. On January 21, 2000, the Togrog (T) exchange rate was T1080 per U.S. dollar, so that, as of that date, the new minimum capital requirement was equivalent to about US$1,850,000. A comparison of the new minimum capital requirement in Mongolia with those in other countries shows that Mongolia's new MCR is relatively stringent.

55. This new doubling in the MCR for banks will encourage a consolidation of existing commercial banks into a smaller number of sounder banks that are capable of competing, and

help ensure that any new entrants into the market meet much more stringent capital requirements. Also, the Bank of Mongolia intends to adjust the MCR as needed, over the medium-term, to maintain its value in real terms.

56. **Asset Classification.** Current regulations on asset classification deal only with loans. Losses, however, may arise from other assets (including cash items; old outstanding "we debit" items due from other banks; poor quality investments, suspense items; unresolved differences; accounts receivable, foreclosed or repossessed assets; and contingent liabilities). In addition, loans are currently considered past due only when principal and/or interest is 90 days in arrears. The BOM is preparing a resolution that will strengthen the definition of past due criteria and require recognition of losses that occur in asset types other than loans.

57. **Prompt Corrective Action.** Prompt corrective action has not been implemented in the banking system, with the result that banks with shaky financial conditions have deteriorated progressively. Only once banks become insolvent, and often then with lengthy delays, have actions been taken to redress the situation, inflicting large losses on Mongolian society.

58. Over the medium-term, Government intends to amend banking legislation to adopt a prompt corrective action, with trigger points at 75% and 50% of the Capital Adequacy Ratio, to make corrective action much more automatic, to depoliticize bank failure resolution, and to encourage banks to maintain higher levels of capital. The Trigger points at 75% and 50% of the minimum capital adequacy ratio (CAR) would automatically activate mandatory recapitalization actions including the development of a capital restoration program, prohibitions on dividends and restrictions on asset growth, capital-raising activities and changes in the mix of risk assets. The final threshold, at 25% of the minimum CAR, is a recognition that corrective actions have been unsuccessful and would culminate in mandatory closure.

59. **Exit Policy.** The Government intends to adopt a modern banking exit policy framework by amending the current banking legislation on conservatorship and receivership, and including a new failure resolution scheme. This new framework will better preserve the asset values of the ongoing concern; increase the rights and choices of the depositors and other parties concerned; reduce moral hazard; accelerate resolution and liquidation, and reduce resolution costs. In addition, at present, an implicit state guarantee of all deposits is perceived to exist. The soundness and efficiency of the financial system would be improved with a stronger exit policy that reduces moral hazard; limits the state's exposure; permits an effective transfer of assets from troubled banks to sound institutions; and prevents contagion and reduces systemic risk.

60. Over the medium-term, Government intends to strengthen the exit policy framework through amendments to the banking legislation. This framework will require that whenever the capital adequacy ratio falls below 25% of the required level, the resolution framework is automatically activated without any further possibility of action by managers and shareholders, in order to protect depositors. Only the residual balance after resolution will need to be sent to liquidation.

61. **Residual Assets.** An improved framework is needed for liquidation of residual assets. With the July 1999 modification of the Banking Law, a receiver can be appointed to restructure or liquidate a bank. However, the authorities do not have all the legal tools needed to liquidate banks in an efficient manner. Further amendments will be introduced to the Banking Law that provide for the process of liquidation of the residual assets of failed bank after the resolution process has taken place.

Strengthening the Regulation of NBFIs

62. In view of the limited outreach of the banking system and problems affecting financial intermediation, finance companies are expected to quickly assume a greater role in Mongolia. Prudential norms for the various categories of NBFIs need to be developed as the existing regulations are short on details. There is also a need to ensure that the Supervision Department of Bank of Mongolia (BOM) is properly organized to ensure effective supervision of NBFIs. Appropriate mechanisms need to be introduced including regulations on licensing requirements, risk-based prudential standards and minimum paid-in capital to ensure a healthy non-bank financial system and avoid the fragility characteristic of the banking system. BOM intends to (i) strengthen NBFI regulations requiring finance companies to comply with risk-based prudential regulations; and (ii) assume oversight responsibility over savings and credit cooperatives through second and higher tier credit associations.

Asset Recovery and Nonperforming Loans

63. **Mongolian Asset Recovery Agency.** The Mongolian Asset Recovery Agency's (MARA) ability to recover nonperforming assets is hampered by its insufficient authority; lack of funding, low salaries; and lengthy court delays. Government plans to strengthen the legal status and powers of MARA to collect and dispose of assets by passage of appropriate legislation. This legislation would provide MARA sufficient flexibility to quickly realize assets, while opening-up asset collection to private agencies, in particular, it would enable MARA to sell recovered assets at a discount and at auction, and to operate on a commercial basis.

64. **Credit Information Bureau.** In order to improve loan repayment rates, the Bank of Mongolia also established a Credit Information Bureau. The information base on loan defaulters and mechanisms to share this information with banks is still in process of development. The BOM intends finalize arrangements to enhance the effectiveness of the Credit Information Bureau by focusing data collection on loan defaulters and developing a protocol for the sharing of this information in consultation with commercial banks. In order to strengthen operations and upgrade the capacity of banks, integrated banking information management system software for treasury management, foreign exchange operations and other activities will be introduced on a pilot basis in TDB and then on a bank-wide basis in Mongolia.

Rationalizing the Payments System

65. Bank restructuring needs to be done in such a way so as to avert a disruption in payments services in rural areas. At present, most payment services (government wages and pensions) in rural areas are performed by the Agricultural Bank. Government attaches a high priority to ensuring that payment services are not disrupted. Government also intends to ensure that these services are provided through least-cost means.

66. The monthly cost of operating an AB bank sub-branch limited to providing payment services at the *soum* level is about T160,000. If half of AB's 282 *soum* level sub-branches were considered essential in that these locations could not be serviced from other *soum or aimag* branches of AB or other banks, the cost of maintaining 141 sub-branches to provide payments services only would about T271 million per annum (about US$245,000). Government plans to keep open those AB subranches needed to ensure continuity of payment services in remote areas. Other potential service providers may bid for supplying this service. To this end, Government will define a strategic network of AB sub-branches that are essential to ensure payment services at the *soum* level; on January 1, 2000 AB signed an agreement with the Social Insurance

Department, whereby the latter will pay for the transaction costs of distributing government wages and pensions throughout the country. Government also intends to remove any remaining impediments to entrance of new institutions in the distribution of these payments.

Public Debt and Development of Financial Markets

67. Creation of a government bond market would provide an alternative source of investment for banks and the public; increase transparency in the management of budget deficits; and aid in the development of a capital market. At present, there is no legal framework on public debt. Government bonds are issued only to meet extraordinary financing needs. This impedes the creation of a market for government bonds and constrains market liquidity. Government plans to submit to Parliament a law on government debt and government debt instruments. Given the close link to this issue, the Bank of Mongolia supports the development of an inter-bank market. An inter-bank market would provide banks in Mongolia a means to improve asset-liability management through the ability to invest surplus funds and reduce the costs of funding liquidity shortfalls. Legal, regulatory and policy considerations will be analyzed by Bank of Mongolia to help create a conducive environment for the eventual development of an inter-bank market.

Development of Human Resources and Financial Infrastructure

68. Developing the essential infrastructure to complement a market-based financial system including banking skills, auditing and accounting standards, enforcement of financial contracts, and better enforcement of prudential norms is a top priority. There is a dearth of banking skills, especially with respect to credit assessment and loan management processes in commercial banks and regulatory processes in the BOM. In some cases laws are not being enforced or are subject to inconsistent interpretation by the courts. The 1993 accounting law required the adoption of international accounting standards. However, nine years into the transition, most financial statements are still prepared on a cash, rather than an accrual, basis. These statements tend to minimize profits to lessen the tax burden and, since they are prepared on a cash basis, do not reflect the true financial condition of the enterprise.

69. There have been and are numerous programs to upgrade financial infrastructure, but these have lacked the strategic basis and overall coordination needed to systematically develop this infrastructure. To that end, Government is preparing a comprehensive Financial Sector Infrastructure Action Plan for development of human resource skills in all facets of the financial sector and other basic building-blocks needed to support a healthy financial sector including banking and supervision skills, accounting and auditing standards, and enforcement of financial contracts. Government has requested World Bank financial assistance to implement this strategy and action plan, in the form of a Financial Sector Technical Assistance Credit.

Development of the Capital Markets

70. The Government recognizes the importance of capital markets to increase domestic resource mobilization and effectively allocate funds to those most productive activities. The development of the capital markets would also increase the supply of long-term funds available in the economy. Over the short-term the Government will support actions that strengthen the operational and regulatory capacity of the MSEC and improve investor confidence in the MSE. In parallel, to increase the supply of quality stocks, the Government will support the issuing of shares of some of the remaining 95 SOEs. In addition, the Government has incorporated under its Guidelines of the Cabinet for Economic and Social Development the submission to Parliament of a Law on Trusts and a Law on Investment Funds in 2000 as part of efforts to establish the legal framework for new investment products. Finally, the Government is committed to the

establishment of MSE, CDS and the securities clearing and settlement system as separate legal entities and subsequent privatization of them; as separate privatized institutions, they will foster the development of a more effective and professional securities exchange.

Consensus-Building on Financial Sector Reform

71. Government recognizes that implementation of its Medium-Term Strategy for Financial Sector Reform and Development requires a broad consensus in Mongolia, as well as the support of our external development partners. To this end, we have created a Financial Sector Development Performance Group (FSDPG as a forum to exchange ideas and reach broad consensus on the long-term vision and medium-term strategy for the financial sector. We expect this forum to monitor progress on a regular basis and determine if there is need to change direction as the program evolves. The FSDPG includes high-level members of Government policy-making bodies (including the Prime Minister's Office, the Ministry of Finance, the Ministry of Justice, the Bank of Mongolia, the Cabinet Secretariat and the State Property Committee); members of Parliament from all parties; NGO and private sector representatives; and donors representatives, including the ADB, GTZ, JICA, IMF, USAID and World Bank.

Ya. Ochirsukh
Minister of Finance
Ministry of Finance

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Governor
Bank of Mongolia

MONGOLIA: FINANCIAL SECTOR REFORM PROGRAM*

POLICY MATRIX

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Condition	Tranche Conditions		
				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	IDA Second Tranche/ *ADB Second Tranche*	IDA Floating Tranche
Macroeconomic Framework						
• Mongolia needs high, sustained labor-intensive growth to steadily raise living standards and reduce the incidence of poverty. Fiscal sustainability is a major challenge facing Mongolia in achieving macroeconomic stability. The high level of interest rates reflect in part the impact of large fiscal deficits.	• Growth averaged 3.5% during1994-98, according to official statistics. Although actual growth has been higher (because national accounts overestimate the impact of declining sectors and underestimate that of expanding ones), the incidence of poverty also remains high, at 35.6% (36.3% in 1995).	• Government's macro-economic policy framework is designed to maintain inflation in single digits, facilitate adjustment to external shocks, build-up holdings of external assets and bring down real interest rates to sustainable levels.		• Maintain a sound macroeconomic framework as determined on the basis of indicators agreed between the Borrower and IDA.	• Maintain a sound macroeconomic framework as determined on the basis of indicators agreed between the Borrower and IDA.	• Maintain a sound macroeconomic framework as determined on the basis of indicators agreed between the Borrower and IDA.
• Mongolia needs to manage external shocks efficiently to significantly raise its long-term growth and welfare gains. Cyclical banking crises are caused in part by term of trade shocks.	• Mongolia has yet to take measures to manage external price shocks. Commodity price fluctuations have led to the classic boom and bust cycle, with low trend growth. Copper prices plunged 42% in 1998, and a further 17% in January-August 1999. Cashmere and gold prices also are depressed; petroleum prices have more than doubled in the past year. Value of terms of trade shock is estimated at about 9% of GDP in 1998, and an additional possible 4% in 1999.	• Government plans to form a Working Group on managing Commodity Risk to consider measures to mitigate external commodity risk and terms of trade shocks including the adoption of risk management systems by the major producers of commodities most vulnerable to price shocks (copper and gold). Mongolia has been selected as early test case in World Bank's commodity initiative and work is expected to start in early 2000.		• Adoption of a time-bound action plan, agreeable to IDA, to mitigate external commodity risk and terms of trade shocks, including work initiated under the World Bank's commodity initiative and the development of non-traditional exports In particular, the plan will focus on efforts to mitigate the impact of volatile commodity prices on the fiscal position of the Government.	• Completion of the said action plan, in a manner satisfactory to IDA.	

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				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	IDA Second Tranche/ *ADB Second Tranche*	IDA Floating Tranche
Financial Sector Development Strategy						
• Create a sound and efficient financial system.	• The financial sector is inefficient, loaded with non-performing loans (NPLs) and is not performing its allocative function satisfactorily.		• The Government, in consultation with donors involved in the financial sector, has adopted a long term vision for the development of the financial sector and a medium term strategy to achieve that vision, satisfactory to IDA			
Corporate Governance in Banking Institutions						
• *Application of corporate governance principles in banking institutions is key to the sustainable development of the banking sector.*	• *Banks are generally poorly managed with limited commercial orientation. Private investors are often interested in banks not as a sound investment option, but as a means to finance their personal business activities. The closed limited-liability nature of banking institutions, together with the absence of effective accountability, encourages perpetuation of bad management practices further undermining the development of sound and efficient private banks.*	• *The Government intends to issue guidelines on best practices in corporate governance for banks, prepare a model charter for banks, and issue guidelines encouraging banks to prepare or amend their charters based on this model.*			• *BOM to prepare and issue guidelines on best practices in corporate governance in banking institutions in Mongolia, including measures to strengthen internal control mechanisms, based on international practices such as the guidelines issued by the Bank for International Settlements.*	

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Improving the efficiency of intermediation: Bank Restructuring, Privatization, Asset Liability Management and Interest Rates						
• The banking system is, in terms of solvency and liquidity, fragile, state-owned and inefficient.	• Heavy banking system losses inflate the public sector deficit and debt, diverting funds from infrastructure, human resource development and poverty reduction. About 90% of banking assets are in state hands.	• Government is implementing a bank restructuring program to strengthen the banking system, reduce fiscal losses, and free resources for priority expenditure.		• Adoption of a plan, satisfactory to IDA, to establish a payment system network to provide payment services to the soum level, which plan may include the use of certain branches and sub-branches of AB or other entities qualified to provide this service.		
• To reverse the current trend towards disintermediation.	• ITI, Reconstruction (RB) and Agricultural Bank (AB) are all illiquid and deeply insolvent.	• Government and BOM plan to liquidate ITI and RB. • BOM has revoked the licenses of ITI bank and RB and issued resolutions to initiate liquidation of ITI bank and RB.				
• *An interbank market would provide banks in Mongolia a means to improve asset liability management by allowing them to invest surplus funds and reduce costs of funding liquidity shortfalls.*	• *There is no functioning interbank market in Mongolia.*	• *The development of financial markets is critical to the development of capital markets . While there are concerns regarding the optimal timing for creating an interbank market, there is an understanding that the monetary authorities have a role in promoting policies conducive to the development of financial markets such as development of an interbank market.*			• *MOF and BOM to prepare a plan acceptable to ADB for development of an interbank market, including establishment of the legal / regulatory and institutional framework.*	

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• To signal Government's commitment to honor financial contracts.				• Government has paid all the interest on its Bank Restructuring Bonds in arrears as of the date of the DCA and issued regulations, satisfactory to IDA, providing for the prompt and timely servicing of all Bank Restructuring Bonds including linkage of their interest rate to those of the Central Bank Bills Rate (CBBR).	• Government has replaced all its outstand-ing bonds with market-able and tradable securities that provide adequate yield, liquidity, and negotiability.	
	• Government plans to recapitalize AB with public and GTZ funds, restructure it, and privatize it. • The cost of providing payment services throughout the country is very low relative to the cost of operating AB as it currently exists. It costs approximately US$160 per month to operate a soum level sub-branch providing only payment services. To operate a full service sub-bank branch costs significantly more due to the expense of personnel, security, equipment, etc. Furthermore, all of AB's current sub-branches are not essential to provide payment services, as some of these locations could be serviced by other soum or aimag branches of AB or other banks.	• Government intends to restructure AB with the objective of creating a viable institution to provide financial services in rural areas.	• Government has adopted for AB a restructuring plan, satisfactory to IDA, that provides appropriate governance, ensures commercial viability, and the actions required to bring it to the point of sale or its closure and revocation of license if a sound financial institution cannot be established.		• Completion of the AB restructuring plan, satisfactory to IDA.	

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• The high level of interest rates encompass monetary and fiscal policy issues, and structural conditions in the banking system.	• Savings Bank (SB) was established as a special purpose state vehicle to collect and protect household deposits It needs to be made financially viable to limit systemic risk. Almost all of SB's assets consist of government bonds which have not been serviced regularly causing liquidity problems for SB. To manage liquidity and meet depositor demand for cash, SB has for significant periods paid higher interest rates than its main competitors. thus raising market rates.	• The Government plans to use technical assistance over the next 18 months, in consultation with IDA, to strengthen Savings Bank in the areas of management, corporate governance, the development of a business plan and staff training consistent.		• Government has issued instructions to SB to adopt and implement an asset-liability management policy, satisfactory to IDA, including prudent management of liquidity and funding needs and payment of interest for deposits at competitive market rates.	• Government has adopted a time-bound action plan, satisfactory to IDA, to privatize SB.	
• Scarcity of modern banking skills is severely handicapping development of a banking system. In addition, much greater private ownership and market allocation of resources in the financial system is needed to accelerate growth.	• Currently, there are no foreign banks operating in Mongolia. In addition, TDB, the largest bank, remains in state hands and its loan portfolio has deteriorated sharply over the past two years.	• Government has presented to Parliament a bill excluding TDB from the list of properties not to be privatized. Attached to the bill is a proposal for the Government to dispose of 51% of the shares of TDB, which would reduce the Government's stake to 19%. Parliamentary approval of the bill is required before the Government can dispose of its stake in TDB. The principles and procedures that will guide the privatization process have not yet been clearly articulated.	• Government has adopted a program, satisfactory to the Association, to bring TDB to the point of sale and transfer a controlling share-holding to a strategic private sector investor with recognized international banking experience. The program includes the principles and procedures that will guide the privatization process.			• A strategic Private Sector investor with recognized international banking experience has acquired a controlling shareholding in TDB.

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Banking Supervision and Prudential Regulation						
• Tightening selected prudential norms will help create a sound banking system, reducing wastage of resources, improving fiscal balance, and contributing to faster economic growth and improved welfare.	• Minimum capital requirements are too low relative to the size of the market and the scarcity of banking skills, allowing easy entry into the market and resulting in an excess number of banks, most of which have performed weakly. Bank supervisory resources also have been stretched too thin. Consolidation of the banking sector will lead to sounder and more efficient banks.	• The minimum capital requirements recently were raised from T400 million to T1 billion; however, since the increase was originally proposed to Parliament, the value of the new minimum capital requirement has declined from the equivalent of about US$1.4 million to US$850 thousand, and from 1.3% of GDP to 0.9% of GDP. The Government plans to phase-in higher minimum capital requirements to further strengthen the banking sector. • The BOM has raised minimum capital require-ments to $2 million equivalent with the increase phased in over 12 months for banks with licenses issued prior to the date of the DCA.				
• Further tightening prudential norms will help strengthen financial discipline and improve banking sector performance.	• Current regulations on asset classification deal only with loans. However, losses may arise from other assets including off-balance sheet items and other categories of non-loan assets. In addition, loans are currently considered past due only when principal and/or interest is 90 days in arrears.	• The BOM intends to strengthen the definition of past due criteria and require recognition of losses that occur in asset types other than loans. • Government plans to tighten regulations with regard to the norms on past due loans.		• BOM has issued a regulation, satisfactory to IDA, providing for: (a) asset classification criteria to include assets other than loans; and (b) Bank licensing criteria .		

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• Prompt corrective action is needed to help ensure the soundness of the banking system.	• Prompt corrective action has not generally been implemented in the banking system, with the result that banks' with shaky financial conditions have tended to deteriorate progressively. Only once banks become insolvent, and often then with lengthy delays, have actions been taken to redress the situation.	• In addition to measures already contained in Article 31 of the Banking Law, the Government intends to adopt the concept of "Prompt Corrective Action," which would require mandatory action by the BOM to when bank capital falls below certain levels with respect to the minimum capital adequacy ratio (CAR). Trigger points at 75% and 50% of the minimum CAR automatically activate mandatory recapitalization actions. If a bank reaches the final threshold, at 25% of the minimum CAR, corrective actions have failed, and resolution becomes mandatory.			• The Banking Law has been amended to provide for mandatory action ("Prompt Corrective Action") to be imposed automatically by BOM whenever the CAR of any bank falls below 75% and 50% of the minimum CAR required level as determined by BOM, including the development and implementation of a capital restoration plan, restrictions on asset growth and on new activities, and implementation of a management improvement plan. • The Banking Law has been amended to provide for prompt and effective intervention by BOM whenever any one of the objective factors expressly stated in the Banking Law occurs, including legal evidence of fraud by the owners and managers of the bank, legal evidence of incompetent management, and lack of compliance with instructions issued by BOM pursuant to law.	

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Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Condition	Tranche Conditions		
				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	IDA Second Tranche/ *ADB Second Tranche*	IDA Floating Tranche
• The soundness and efficiency of the financial system would be improved with a stronger exit policy combined with a system that; protects small depositors' rights while limiting the state's exposure; permits an effective transfer of assets from troubled banks to sound institutions; and prevents contagion and reduces systemic risk.	The existing banking law provisions on conservatorship and receivership need to be strengthened to better preserve the asset values of the ongoing concern; increase the rights and choices of the parties involved; reduce moral hazard; accelerate resolution and liquidation, and reduce resolution costs. In addition, at present, an implicit state guarantee of all deposits is perceived to exist.	• The Government will strengthen the exit policy framework. This framework will require that whenever the capital adequacy ratio falls below 25% of the required level, the resolution framework is automatically activated without any further possibility of action by the private shareholders, in order to protect small depositors.			• The Banking Law has been amended to provide for an effective failure resolution mechanism, including automatic implementation of system to protect depositors and bank assets, whenever the CAR of any bank falls below 25% of the minimum CAR required level as determined by the BOM or when the bank suspends payments to liability holders.	

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Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Condition	Tranche Conditions		
				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	**IDA Second Tranche/ *ADB Second Tranche***	**IDA Floating Tranche**
• An improved framework is needed for liquidation of residual assets.	• With the July 1999 modification of the Law, a receiver can be appointed to restructure or liquidate a bank. However, the authorities do not have all the legal tools needed to liquidate banks in an efficient manner. An amendment of the banking law is needed to provide for the liquidation of the residual assets of failed bank after the resolution process has been completed. A draft bankruptcy law for banks has been prepared but needs revisions. It envisions that depositors will be paid through the liquidation of assets rather than through other failure resolution methodologies, thereby delaying depositors access to their funds and potentially increasing contagion risk and moral hazard.	• The Government plans to amend the banking law to allow for the liquidation of residual assets after resolution. Only the residual asset balance after resolution has to be sent to liquidation.			• The Banking Law has been amended to establish the process of liquidation of banks' residual assets after the completion of the failure resolution mechanism.	

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Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Condition	Tranche Conditions		
				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	IDA Second Tranche/ *ADB Second Tranche*	IDA Floating Tranche
			Loan Collateral			
• *Development of the financial sector requires that the types of property that can be used as loan collateral be expanded.*	• *The types of property that can be used as loan collateral are limited and must be expanded. Procedures for registering property must also be improved to allow for proper registration and valuation of the property.*	• *• The Government recognizes that financial intermediation (i) is constrained by the limited types of property that can be offered as loan collateral and (ii) that the cost of borrowing is higher given the lack of collateral and uncertainty concerning the value of the collateral and the ability to recover the collateral, if necessary. The Government intends to consider means to expand the types of property that can be used as loan collateral.*			• *Government to prepare a plan acceptable to ADB on the expansion of types of property that can be used as loan collateral.*	
			Asset Recovery and reducing the future incidence of non-performing loans			
• A banking system in distress needs an effective vehicle for collecting bad assets accumulated form insolvent financial institutions. At the same time mechanisms need to be put in place to enhance the incentives for repaying future loans.	• The Mongolian Asset Recovery Agency's (MARA) ability to recover nonperforming assets is hampered by its insufficient authority; lack of funding, low salaries; lengthy court delays; and uncooperative debtors.	• Government intends to strengthen the ability of MARA to collect and dispose of assets, including its privatization.			• MARA has been legally empowered to sell recovered assets at discounts, including through auctions , and to operate on a commercial basis.	

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Development Objectives/Key Issues	**Diagnosis**	**Government Strategy/ Actions**	**IDA Board Condition**	**Tranche Conditions**		
				IDA First Tranche/ Condition of effectiveness; ***ADB Board Consideration / First Tranche***	**IDA Second Tranche/** ***ADB Second Tranche***	**IDA Floating Tranche**
	• A credit information bureau has been established at the BOM. However, the information base on loan defaulters and mechanisms to share this information with banks is still in process of development.	• BOM intends to finalize arrangements to enhance the effectiveness of the credit information bureau by focusing the data collection on loan defaulters and developing a protocol for the sharing of this information in consultation with commercial banks.			• BOM has implemented an action plan, satisfactory to IDA, to strengthen its credit information bureau and facilitate sharing of information on loan defaulters among the commercial banks and the BOM.	
			Management Information System			
• *In order to strengthen operations and upgrade the capacity of Mongolian banks, there is a need for banks to adopt an integrated banking management information system.*	• *The existing banking management information systems in banks are rudimentary with limited scope for proper treasury management, foreign exchange operations and other activities.*	• *Integrated banking management information system software should be introduced in Mongolian banks on a pilot basis and then on a bank-wide basis.*			• *Progress acceptable to ADB has been achieved in the implementation of the program to introduce and operationalize integrated banking management information system software in the Mongolian banks participating in such program.*	
			Rationalizing the Payments System			
• Bank restructuring needs to avert a disruption in payments services in rural areas.	• At present, most payment services (government wages and pensions) in rural areas are performed by the Agricultural Bank.	• Government attaches a high priority to ensuring that payment services are not disrupted. Government also intends to ensure that these services are provided through least cost means. • MOF has issued instructions to all budget entities to arrange to pay fees to commercial banks for any payment services said banks provide, such as distributing government wages and pensions throughout				

[*] For ease of reference, ADB and IDA conditions are reflected in this matrix. ADB--assisted components under the Financial Sector Reform Program have been italicized; IDA-assisted components have not been italicized. There is no cross-conditionality.

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Condition	Tranche Conditions		
				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	IDA Second Tranche/ *ADB Second Tranche*	IDA Floating Tranche
		Mongolia.				
Development of Human Resources and Financial Infrastructure						
• Developing the essential infrastructure to complement a market based financial system including banking skills, auditing and accounting standards, the legal framework supporting financial contracts, and enforcement of prudential norms.	• There remains a crippling shortage of banking skills especially with respect to credit assessment and loan management processes in commercial banks and regulatory processes in the BOM. • There is a need to strengthen the legal and associated institutional framework for the development of a robust private sector and contract based financial system. Even where laws have been introduced they are not being enforced or subject to inconsistent interpretation by the courts. • The 1993 accounting law required the adoption of international accounting standards. However, nine years into the transition, most financial statements are still pre-pared on a cash, rather than an accrual, basis. These statements tend to minimize profits to lessen the tax burden and, since they are prepared on a cash basis, do not reflect the true financial condition of the enterprise.	• Government plans to develop a comprehensive strategy for development of human resource skills in all facets of the financial sector. It intends to ask donors for technical assistance to support the strategy. The Government has requested a technical assistance project for capacity building in parallel with FSAC.		• Government has implemented an action plan, satisfactory to IDA, to develop a comprehen-sive program to strength-en the financial sector, including banking and supervision skills, accounting and auditing standards, and enforce-ment of financial con-tracts.	• Government has implemented the said action plan.	

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Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Condition	Tranche Conditions		
				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	IDA Second Tranche/ *ADB Second Tranche*	IDA Floating Tranche
			Development and Strengthening of Non-Bank Financial Institutions			
• *A well functioning financial sector requires that non-bank financial institutions (NBFIs) play an important role in the sector.*	• *NBFIs currently play an insignificant role. This role is, however, expected to increase quickly in view of the limited outreach of the banking system and problems affecting financial intermediation. Existing regulations relating to NBFIs lack detail, and specific measures such as the development of prudential norms for the different categories of NBFIs need to be developed.*	• *BOM intends to (i) strengthen NBFI regulations, including requiring finance companies and financial leasing companies to comply with risk-based prudential regulations; and (ii) assume oversight responsibility over savings and credit cooperatives through second and higher tier credit associations.*		• *BOM to issue risk-based prudential regulations to govern licensing of finance companies for capital adequacy (8 percent), liquidity ratio (10 percent), foreign exchange exposure (20 percent) and single borrower limit (20 percent).* • *BOM to issue guidelines on the calculation of capital adequacy and liquidity ratios and foreign exchange exposure for finance companies.*	• *Enactment of amendments to the Law on Cooperatives and any other necessary legislation to provide for the regulation of second and higher tier credit associations by BOM.*	

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Development Objectives/Key Issues	**Diagnosis**	**Government Strategy/ Actions**	**IDA Board Condition**	**Tranche Conditions**		
				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	**IDA Second Tranche/ *ADB Second Tranche***	**IDA Floating Tranche**
				• *BOM to create an organizational system and procedures acceptable to ADB within the Supervision Department to monitor and enforce prudential regulations of finance companies and financial leasing companies.*		
			Development and Strengthening of the Capital Markets			
• *The capital market must be further developed and strengthened to enhance domestic resource mobilization and improve efficiency in resource allocation.*	• *The capital market is still in a nascent stage of development. For balanced development of the financial sector, it is necessary that the efforts already undertaken to develop the capital market be sustained and strengthened. Further development of the market depends on progress in the privatization of the remaining 95 state-owned enterprises (SOEs). The operational and regulatory capacity of the Mongolian Stock Exchange Commission (MSEC) needs to be strengthened considerably. Market capitalization of the Mongolian Stock Exchange (MSE) has fallen 25 percent over the past two years, partly reflecting the decreasing supply of quality stocks.*	• *New capital market products must be created under a proper legal/regulatory framework. MSEC must be strengthened to ensure the proper operation of the MSE and increase public confidence in and use of the MSE.*		• *MSEC to issue regulations to enhance transparency for all trades in the securities market, mandating that (i) all trades be reported to the MSEC for surveillance purposes on a timely basis, and that (ii) all relevant information about stock prices and quotes be disseminated to the investing public on a frequent and timely basis.*	• *MSE and MSEC to increase the minimum capital requirements for securities brokers and dealers to at least 20 million tugrigs.* • *Government to submit a draft Law on Trusts to Parliament for approval.* • *Government to submit a draft Law on Investment Funds to Parliament for approval.* *Government to establish MSE, CDS and the securities clearing and settlement system as separate legal entities and then privatize them.* • *MSEC in collaboration with MSE to develop a marketing and public awareness campaign to increase public knowledge of equity markets.* • *Government to submit to Parliament for approval a draft amended and restated Securities Law with provisions to improve financial governance.*	

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Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Condition	Tranche Conditions		
				IDA First Tranche/ Condition of effectiveness; *ADB Board Consideration / First Tranche*	IDA Second Tranche/ *ADB Second Tranche*	IDA Floating Tranche
Development and Strengthening of Contractual Savings Institutions – Pension and Insurance Systems						
• *The pensions system needs to be promoted and strengthened as a vehicle for savings and a means to improve the allocative efficiency of investments.*	• *The pensions system needs to be strengthened, so that the transition to partial funding can take place over the medium term. The process and timing of this transition and the associated costs need to be carefully worked out. There is currently no law governing supplementary non-state pensions. Such a law is critical in light of plans by NBFIs to offer voluntary retirement savings products.*	• *Preparation of a plan for introducing partial funding is required. A law on voluntary private pension plans also must be prepared.*			• *Social Security Insurance General Office (SSIGO) to prepare a plan acceptable to ADB for introducing partial funding to the pension system.*	
• *The insurance system needs to be strengthened as a vehicle for savings and a means to improve the allocative efficiency of investments*	• *The operational and regulatory capacity of the insurance industry must be strengthened. Proper regulation is required, as well as policy and operational assistance. Except for minimum capital requirements, there are no other prudential requirements. Investment guidelines for insurance companies need to be strengthened as capital markets gradually develop.*	• *The regulatory framework must be strengthened, and additional investment regulations and guidelines issued.*			• *MOF to draft and submit to Parliament for approval draft amendments to the Law on Insurance to (i) introduce risk-based solvency requirements in the industry; (ii) strengthen the minimum capital requirements; and (iii) increase the percentage of premium incomes that can be invested by the insurance companies.*	

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MONGOLIA: PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT

MONGOLIA: MACROECONOMIC FRAMEWORK, 1995 –2001

Nominal GDP (1998): US$1,026 million
Population (1998): 2.36 million
Quota: SDR 51.1 million

	1995	1996	1997	1998	1999 Projection	2000 Program	2001 Program	2002 *
		(Percent change)						
Real GDP	6.3	2.4	4.0	3.5	3.3	4.3	4.0	
Consumer prices (period average)	56.9	46.9	36.6	9.4	7.6	9.4	6.0	
Consumer prices (end period)	53.3	44.6	20.5	6.0	10.0	7.0	6.0	
		(In Percent of GDP)						
General government revenue	33.7	27.8	29.3	27.4	26.1	28.4	28.2	
General government expenditure	40.4	36.0	37.9	39.1	34.6	35.7	35.3	
Current balance	8.0	4.5	1.8	-0.6	0.6	2.4	2.6	
Overall balance	-6.7	-8.3	-8.6	-11.7	-8.5	-7.3	-7.1	
Domestic bank financing 1/	-4.8	2.1	-3.3	3.8	0.0	0.0	-0.5	
		(Percent change)						
Net foreign assets	87.2	68.9	68.4	-31.6	96.2	16.6	...	
Net domestic assets	12.4	-1.4	-6.3	56.4	-23.3	17.1	...	
Domestic credit	-21.7	133.6	-5.2	60.1	-8.6	-1.5	...	
Credit to enterprises	18.0	23.2	13.2	18.5	-33.2	7.0	...	
Broad money	32.9	25.8	19.8	8.8	31.6	16.8	...	
Reserve money	...	36.2	26.2	13.5	51.8	17.4	...	
Broad money velocity (GDP/BM)	4.5	5.2	5.4	5.4	5.4	5.4	...	
Annual interest rate on BOM bills (percent)	62.4	42.0	35.0	22.5	12.5	...	...	
		(In millions of US dollars)						
Current account balance 2/	-52	-101	13	-129	-60	-96	-87	
(In percent of GDP)	-5.5	-9.4	1.3	-12.4	-6.2	-8.9	-7.6	
Trade balance	-3	-87	30	-120	-48	-79	-72	
(In percent of GDP)	-0.3	-8.2	3.1	-11.5	-4.9	-7.4	-6.2	
Exports, fob	486	423	569	462	423	529	506	
(percentage growth)	32.3	-12.8	34.3	-18.7	-8.4	13.3	8.3	
Imports, cif	489	511	538	582	471	608	578	
(percentage growth)	32.0	4.5	5.4	8.2	-19.1	9.1	2.2	
Capital account balance	19	41	53	116	51	60	70	
(In percent of GDP)	2.0	3.8	5.5	11.1	5.3	5.6	6.0	
Gross official international reserves	115	98	138	123	157	170	198	
(In weeks of imports)	12.2	10.0	13.3	11.0	17.3	14.5	17.8	
Short-term debt (in percent of NIR of the BOM) /3	66.7	69.1	36.3	38.8	19.5	16.9	13.4	
External debt 4/	504	542	605	753	861	952	1,049	
(In percent of GDP)	52.7	50.7	63.0	72.3	88.5	88.6	90.8	
Debt service 5/	64.2	56.6	41.0	39.6	44.3	40.7	35.9	
(In percent of goods & services)	12.1	11.8	6.3	7.3	8.3	6.7	6.1	
Exchange rates and trade prices								
Tugriks per US $ (end of period)	474	694	813	902	1,072	...	...	
Tugriks per US $ (period average)	449	548	790	841	1,023	...	...	
NEER, end-period (Dec. 95=100)	95.9	69.0	63.0	69.0	60.6	...	...	
REER, end-period (Dec 95=100)	108.2	115.7	120.4	139.2	132.7	...	...	
Export prices (US dollar, percent change)	23.7	-21.6	3.7	-28.9	-5.8	7.1	...	
Copper prices (US dollar, percent change)	40.2	-21.8	-0.8	0	-9.3	9.8	...	
Import prices (US dollar, percent change)	9.1	2.6	-7.5	-9.6	4.0	3.4	...	
Terms of Trade (percent change)	13.4	-23.6	12.2	-21.4	-9.3	3.6	...	
Nominal GDP (billion tugriks)	429	587	759	876	995	1,162	1,305	
Nominal GDP (million US dollars)	957	1,070	961	1,042	973	1,075	1,156	

Sources: Mongolian Authorities and IMF staff estimates and projections

Notes:

*Figures for the year 2002 are forthcoming.

1/ For 2000, higher-than-programmed costs of banking system reform and regularization of relations between the government and the BOM, up to an amount of Tog 5 billion, would be financed from the domestic banking system.

2/ Excludes official transfers.

3/ Includes public sector amortization on medium term and long-term debt falling due during the period.

4/ Excludes Russia's unresolved 10.6 billion transferable ruble claim.

5/ Excludes servicing of unresolved Russian medium and long-term claims

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MONGOLIA: BALANCE OF PAYMENTS, 1998-2005

(In millions of US dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
	Estimate				Projections			
Trade balance	-120.1	-48.0	-98.4	-71.9	-72.9	-71.3	-66.2	-72.5
Exports, f.o.b	462.3	423.3	467.5	506.5	546.7	599.4	658.0	706.4
Copper	124.8	111.7	120.0	142.5	156.6	179.8	196.9	215.4
Imports 1/	-582.4	-471.3	-565.9	-578.4	-619.6	-670.7	-724.2	-779.0
Services, net	-11.5	-13.1	-9.9	-10.3	-10.9	-11.6	-12.3	-13.0
Receipts	77.9	75.8	83.3	86.6	91.8	97.3	103.2	109.4
Payments	-89.4	-88.9	-93.2	-96.9	-102.7	-108.9	-115.4	-122.4
Income, net	0.4	-6.6	-8.0	-9.1	-10.6	-11.2	-11.9	-12.4
Official interest payments 2/	-9.2	-9.6	-10.9	-11.3	-12.0	-12.7	-13.2	-13.7
Private unrequited transfers	2.5	7.4	4.0	4.0	4.5	4.5	4.5	4.5
Current account balance, excluding official transfers	**-128.7**	**-60.3**	**-112.2**	**-87.3**	**-89.9**	**-89.6**	**-85.9**	**-93.4**
Public unrequited transfers, net	53.3	61.8	51.0	33.0	33.0	28.0	23.0	21.0
Official grants	45.8	54.9	46.0	30.0	30.0	25.0	20.0	18.0
Other official transfers, net	7.5	6.9	5.0	3.0	3.0	3.0	3.0	3.0
Financial and capital account	116.1	51.3	59.9	69.6	82.3	74.0	73.0	78.9
Direct Investment	18.9	20.0	22.0	24.0	32.0	34.0	35.0	40.0
MLT loan disbursements, net	93.4	85.9	77.0	87.9	84.6	72.7	69.8	70.4
Disbursements	122.5	106.4	94.3	105.0	105.0	96.0	96.0	96.0
Amortization 2/	-29.1	-20.6	-17.3	-17.1	-20.4	-23.3	-26.2	-25.6
Commercial banks, net	40.0	-17.7	-5.0	-4.5	-4.0	-4.0	-3.0	-2.0
Short-term capital	-36.3	-37.0	-34.1	-37.9	-30.3	-28.7	-28.7	-29.5
Errors and Omissions	-69.1	-22.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**-28.5**	**30.5**	**-1.3**	**15.2**	**25.4**	**12.4**	**10.1**	**6.5**
Financing	28.5	-30.5	-10.7	-25.0	-35.0	-12.4	-10.1	-6.5
Increase in net official reserves (-)	15.0	-30.5	2.9	-25.0	-35.0	-15.0	-10.1	-6.5
Use of IMF credit	-1.3	4.3	12.3	5.8	5.7	-8.1	-9.8	-7.0
Increase in gross official reserves	16.3	-34.8	-9.4	-30.8	-40.7	-6.9	-0.3	0.5
Arrears accumulation (+)/payments (-)	13.5	0.1	-13.6	0.0	0.0	0.0	0.0	0.0
Exceptional financing (rescheduling)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing Gap	0.0	0.0	12.0	9.8	9.6	0.0	0.0	0.0
Memorandum items:								
Current account balance, excluding official transfers (in percent of GDP) 1/	-12.4	-6.2	-10.6	-7.6	-7.0	-6.4	-5.6	-5.6
Exports, f.o.b. (annual growth)	-18.7	-8.4	10.4	8.3	7.9	9.6	9.8	7.4
Imports, c.i.f., (annual growth) 1/	8.2	-19.1	20.1	2.2	7.1	8.3	8.0	7.6
Export volume growth	14.3	-7.4	6.4	2.0	5.4	5.0	6.2	5.0
Import volume growth	19.6	-21.4	10.8	6.2	7.1	6.8	6.7	6.4
Trade balance (in percent of GDP)	-11.5	-4.9	-9.3	-6.2	-5.7	-5.1	-4.3	-4.4
Net official reserves (end-period)	74.9	105.4	102.5	127.5	162.5	177.5	187.5	202.5
(In weeks of imports, c.i.f.) 1/	6.7	11.6	9.4	11.5	13.6	13.8	13.5	13.5
Gross official reserves (end-period) 3/	123.2	157.0	166.9	198.3	239.0	246.0	246.3	245.8
(In weeks of imports, c.i.f.) 1/	11.0	17.3	15.3	17.8	20.1	19.1	17.7	16.4
Outstanding arrears (end-period)	13.5	13.6	0.0	0.0	0.0	0.0	0.0	0.0
Debt service (in percent of goods and services) 2/	7.3	8.3	7.6	6.1	6.4	6.4	6.1	5.7
External debt stock 2/	753.1	860.6	948.9	1,049.3	1,145.1	1,213.1	1,279.4	1,333.7
External debt stock (in percent of GDP) 2/	72.3	88.5	90.0	90.8	89.5	86.5	84.0	80.6
NPV of external debt stock (in percent of GDP)	57.2	59.6	57.9	55.7	52.8	50.1	47.9	45.5
GDP (in millions of US dollars)	1,042	973	1,055	1,156	1,279	1,403	1,523	1,654

Sources: Mongolian authorities and IMF staff estimates and projections

Notes:

1/ Includes the import of an aircraft valued at $28.8 million in 1998

2/ Includes payments on CMEA debts that have been converted via formal intergovernmental agreements. Excludes unresolved claims estimated at TR 10.5 billion to former CMEA members.

3/ Includes monetary gold and valuation effects

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MONGOLIA: SUMMARY OPERATIONS OF THE GENERAL GOVERNMENT, 1997-2001

	1997	1998	1999		2000	2001
	Actual	Actual	Program	Est.	Program	
	(In billions of togrogs)					
Total revenues and grants	222.5	240.0	272.5	259.4	329.6	367.6
Total expenditure and net lending	287.6	342.1	370.6	344.4	414.9	460.8
Overall balance (incl. privatization receipts and grants)	-65.1	-102.1	-98.1	-84.9	-85.3	-93.2
Financing	65.1	102.1	98.1	84.9	85.3	93.2
Foreign (net)	92.8	68.6	89.1	85.0	85.3	99.7
Domestic (net) /1	-27.1	33.6	9.0	-0.1	0.0	-6.5
	(In percent of GDP)					
Total revenue and grants	29.3	27.4	27.3	26.1	28.4	28.2
Current revenue	27.1	24.8	24.7	24.2	26.8	26.5
Tax revenue and social security contributions	21.6	17.6	19.4	18.3	21.0	20.1
Income taxes	8.3	4.7	4.3	4.2	4.7	4.8
Social security contributions	2.8	3.0	2.7	3.0	3.2	3.3
Sales tax and VAT	5.0	5.3	7.0	5.9	7.0	6.2
Excise taxes	2.7	2.8	2.9	2.7	3.0	2.5
Customs duties and export taxes	1.2	0.2	0.8	0.9	1.7	1.8
Other taxes	1.7	1.6	1.5	1.6	1.4	1.6
Nontax revenue	5.5	7.2	5.4	5.9	5.8	6.3
Of which: BOM profit transfer)	0.0	0.0	0.0	0.0	0.2	0.2
Capital revenue and grants	2.2	2.6	2.5	1.9	1.5	1.7
Of which: Privatization receipts	1.4	1.7	1.6	1.2	0.9	1.1
Total expenditure and net lending	37.9	39.1	37.1	34.6	35.7	35.3
Current expenditure	25.4	25.4	24.1	23.6	24.5	23.9
Wages and salaries	5.9	6.4	5.9	6.2	6.8	6.7
Purchase of goods and services	11.0	11.4	9.6	9.2	8.7	8.6
Subsidies to public enterprises	0.0	0.0	0.1	0.1	0.0	0.0
Transfers	5.7	6.3	6.3	6.5	6.8	6.8
Interest payments /2	2.8	1.3	2.1	1.8	2.1	1.7
Of which: On bank restructuring bonds 3/	1.8	0.7	0.9	0.6	0.9	0.6
Capital expenditure and net lending	12.5	13.7	13.0	11.0	11.2	11.4
Capital expenditure	3.9	3.9	4.6	3.5	4.1	4.2
Domestically financed 4/	3.9	3.9	3.6	2.6	3.2	3.4
Foreign-financed	-	0.0	1.1	0.9	0.9	0.8
Net lending	8.6	9.8	8.4	7.5	7.2	7.2
Current balance (incl. privatization receipts & grants)	1.8	-0.6	0.7	0.6	2.4	2.6
Overall balance (incl. privatization receipts & grants)	-8.6	-11.7	-9.8	-8.5	-7.3	-7.1
Financing	8.6	11.7	9.8	8.5	7.3	7.1
Foreign (net)	12.2	7.8	8.9	8.5	7.3	7.6
Project loans	8.9	8.4	9.0	7.6	7.8	7.7
Cash loans 5/	5.8	0.9	2.3	2.4	0.9	1.4
Amortization 6/	2.5	1.4	2.4	1.4	1.4	1.4
Domestic (net) 1/	-3.6	3.8	0.9	0.0	0.0	-0.5
Of which: Banking system, net	-3.3	3.8	0.9	0.0	0.0	-0.5
Memorandum items:						
Overall balance (excl. privatization receipts)	-9.9	-13.3	-11.4	-9.7	-8.2	-8.2
Overall balance (excl. grants)	-9.4	-12.6	-10.6	-9.2	-8.0	-7.1
Primary balance (incl. privatization receipts)	-5.8	-10.4	-7.7	-6.8	-5.2	-5.4
Government debt-to-GDP ratio (in percent)	57.9	63.7	75.3	75.7	79.0	81.2
Domestic 7/	7.8	7.4	8.7	7.4	7.9	6.5
Foreign 8/	50.0	56.4	66.6	68.3	71.1	74.6
Social expenditure	17.2	18.1	16.6	17.4	16.6	16.6
Of which: Social security and social assistance	5.6	5.9	5.7	5.8	6.0	6.0
Of which: Education and health	9.9	10.4	9.6	10.0	9.4	9.4
Defense expenditure	2.0	1.8	1.8	1.8	1.8	1.8

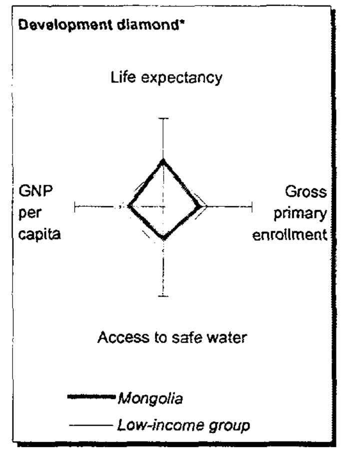
* For ease of reference, ADB and IDA conditions are reflected in this matrix. ADB--assisted components under the Financial Sector Reform Program have been italicized; IDA-assisted components have not been italicized. There is no cross-conditionality.

Sources: Ministry of Finance; and IMF staff estimates and projections.
1/ For 2000, higher than programmed costs of banking sector reform and regularization of the government's relations with the BOM would be financed from the domestic banking system up to an amount of Tog 5 billion.
2/ Includes Tog 2.5 billion in arrears on bank restructuring bonds accumulated in 1998 to be cleared in 1999
3/ For 2000, assumes all restructuring bonds bear a uniform 15 percent interest rate. Provision is made for the carrying costs on additional bond issued for the possible recapitalization/liquidation of Agricultural Bank (Tog 9.6 billion) and the reconstitution of social security and pension fund claims on Reconstruction Bank and ITI bank (Tog 8.5 billion)
4/ Local government domestically financed capital expenditure for 1999 is excluded from program; included in projections.
5/ For 2000, includes ADB governance loan of US$10 million.
6/ The amortization figure in the 1999 projection includes the clearance of arrears (US$11 million) accumulated in 1998.
7/ Bank restructuring bonds are included in the interest payments and debt stock calculations, but their issuance is excluded from domestic deficit financing.
8/ Includes debt serviced by the budget or through the budget by recipients of on-lent funds.

* For ease of reference, ADB and IDA conditions are reflected in this matrix. ADB--assisted components under the Financial Sector Reform Program have been italicized; IDA-assisted components have not been italicized. There is no cross-conditionality.

MONGOLIA AT A GLANCE

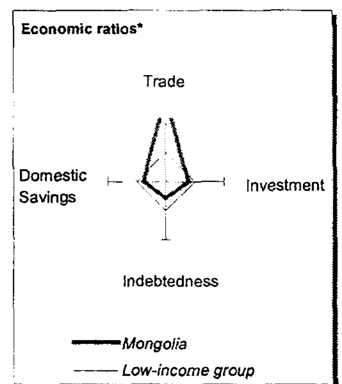
POVERTY and SOCIAL	Mongolia	East Asia & Pacific	Low-income
1998			
Population, mid-year *(millions)*	2.6	1,817	3,515
GNP per capita *(Atlas method, US$)*	400	990	520
GNP *(Atlas method, US$ billions)*	1.0	1,802	1,844
Average annual growth, 1992-98			
Population *(%)*	1.9	1.2	1.7
Labor force *(%)*	2.6	1.6	1.9
Most recent estimate (latest year available, 1992-98)			
Poverty *(% of population below national poverty line)*	36	..	..
Urban population *(% of total population)*	62	35	31
Life expectancy at birth *(years)*	66	69	63
Infant mortality *(per 1,000 live births)*	52	37	69
Child malnutrition *(% of children under 5)*	12	20	..
Access to safe water *(% of population)*	54	77	74
Illiteracy *(% of population age 15+)*	..	15	32
Gross primary enrollment *(% of school-age population)*	88	117	108
Male	86	119	113
Female	91	118	103



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

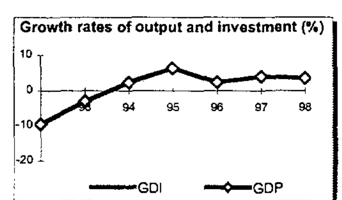
	1977	1987	1997	1998
GDP *(US$ billions)*	..	..	0.96	1.04
Gross domestic investment/GDP	..	45.7	23.0	..
Exports of goods and services/GDP	..	27.5	67.9	50.4
Gross domestic savings/GDP	..	15.2	23.9	..
Gross national savings/GDP	..	..	22.7	..
Current account balance/GDP	..	..	1.3	-11.2
Interest payments/GDP	..	..	2.0	0.7
Total debt/GDP	..	..	74.7	70.9
Total debt service/exports	..	..	9.3	6.2
Present value of debt/GDP	..	..	48.0	..
Present value of debt/exports	..	..	71.1	..

(average annual growth)	1977-87	1988-98	1997	1998	1999-03
GDP	6.5	-0.9	4.0	3.5	..
GNP per capita	3.5	-2.4	1.8	3.2	..
Exports of goods and services	..	..	..	..	..



STRUCTURE of the ECONOMY

(% of GDP)	1977	1987	1997	1998
Agriculture	..	14.4	33.5	32.7
Industry	..	37.9	27.5	27.6
Manufacturing	..	..	..	..
Services	..	47.8	39.0	39.7
Private consumption	..	54.7	60.3	..
General government consumption	..	30.1	15.8	..
Imports of goods and services	..	58.0	67.1	62.0



(average annual growth)	1977-87	1988-98	1997	1998
Agriculture	2.2	1.0	4.8	3.1
Industry	7.6	-2.8	3.9	3.3
Manufacturing	..	..	..	..
Services	7.0	-0.1	3.8	3.8
Private consumption	..	..	..	..
General government consumption	..	..	..	..
Gross domestic investment	..	..	..	..
Imports of goods and services	..	..	..	..
Gross national product	6.5	-0.3	3.6	4.9

Note: 1998 data are preliminary estimates.

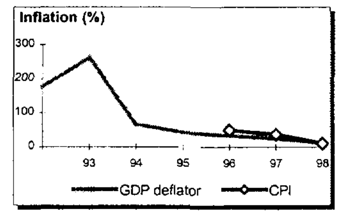
* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond w be incomplete.

* For ease of reference, ADB and IDA conditions are reflected in this matrix. ADB--assisted components under the Financial Sector Reform Program have been italicized; IDA-assisted components have not been italicized. There is no cross-conditionality.

Mongolia

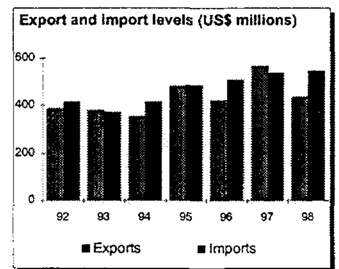
PRICES and GOVERNMENT FINANCE

	1977	1987	1997	1998
Domestic prices				
(% change)				
Consumer prices	..	..	36.7	9.5
Implicit GDP deflator	..	0.8	24.4	11.6
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	46.4	27.3	23.3
Current budget balance	..	-5.5	1.8	-1.2
Overall surplus/deficit	..	-18.7	-8.6	-11.2



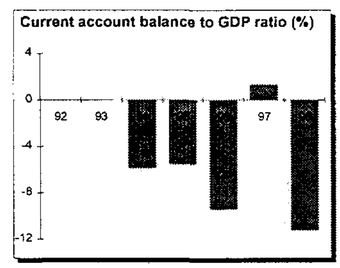
TRADE

	1977	1987	1997	1998
(US$ millions)				
Total exports (fob)	..	718	568	439
n.a.	..	..	..	..
n.a.	..	..	..	..
Manufactures	..	..	..	..
Total imports (cif)	..	1,105	538	548
Food	..	..	..	..
Fuel and energy	..	..	..	..
Capital goods	..	..	..	..
Export price index *(1995=100)*	..	..	..	..
Import price index *(1995=100)*	..	..	..	..
Terms of trade *(1995=100)*	..	..	..	..



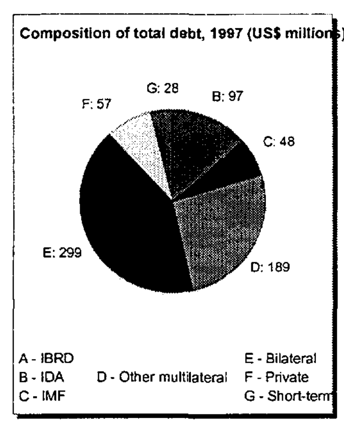
BALANCE of PAYMENTS

	1977	1987	1997	1998
(US$ millions)				
Exports of goods and services	..	908	648	516
Imports of goods and services	..	1,889	626	637
Resource balance	..	-981	23	-121
Net income	..	-11	-14	1
Net current transfers	..	0	4	..
Current account balance	..	-993	13	-117
Financing items (net)	..	1,027	45	89
Changes in net reserves	..	-35	-57	28
Memo:				
Reserves including gold *(US$ millions)*	..	..	200	103
Conversion rate *(DEC, local/US$)*	..	..	790.0	840.8



EXTERNAL DEBT and RESOURCE FLOWS

	1977	1987	1997	1998
(US$ millions)				
Total debt outstanding and disbursed	..	..	718	739
IBRD	..	..	0	0
IDA	..	..	97	118
Total debt service	..	..	60	32
IBRD	..	..	0	0
IDA	..	..	1	1
Composition of net resource flows				
Official grants	..	..	57	..
Official creditors	..	..	209	74
Private creditors	..	..	9	..
Foreign direct investment	..	..	7	..
Portfolio equity	..	..	0	..
World Bank program				
Commitments	..	..	29	..
Disbursements	..	..	34	17
Principal repayments	..	..	0	0
Net flows	..	..	34	17
Interest payments	..	..	1	1
Net transfers	..	..	33	16



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* For ease of reference, ADB and IDA conditions are reflected in this matrix. ADB--assisted components under the Financial Sector Reform Program have been italicized; IDA-assisted components have not been italicized. There is no cross-conditionality.

MONGOLIA: PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT

Mongolia: Status Of Bank Group Operations

Board Date Fiscal Year	Active Projects		Last PSR Supervision Rating b/ Development Objectives	Implementation Progress	Original Amount in US$ Millions IBRD	IDA	Cancel.	Undisb.	Difference Between Expected and Actual Disbursements [a/] Orig.	Frm Rev'd
1994	P004342	TRANSPORT REHABILITA	S	S	0	29.69	0	5.02	4.53	0
1996	P035697	MONGOLIA COAL PROJ.	S	S	0	32.66	0	3.77	4.54	0
1996	P036417	POVERTY ALLEVIATION	S	S	0	8.91	0	3.97	4.32	0
1997	P047683	BANK,ENT,LEG,TA(BELT	S	S	0	2.06	0	0.99	0.65	0
1998	P051855	MN-FISCAL ACCTG TA	S	S	0	5.21	0	4.75	2.79	0
1998	P036052	ULAANBAATAR SERV.IMP	S	U	0	16.87	0	13.16	1.7	0
1999	P049789	MN-PRIV.SEC. DEVT CR	S	S	0	12.21	0	12.21	1.02	0

MONGOLIA: PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT

Statement of IFC's Held and Disbursed Portfolio in Mongolia

As of 8/31/99
(In US Dollars Millions)

		Held				Disbursed			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1997	SEF G&M Leather	1.05	0.2	0	0	1.05	0.2	0	0
	Total Portfolio:	1.05	0.2	0	0	1.05	0.2	0	0