April 2009
IMF Country Report No. 09/130

# Mongolia: Request for Stand-By Arrangement—Staff Report; Staff Supplements; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Mongolia

In the context of request for a Stand-By Arrangement, the following documents have been released and are included in this package:

- The staff report for the Request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on March 7, 2009, with the officials of Mongolia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 18, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff supplement of March 18, 2009, on the joint IMF/World Bank debt sustainability analysis.
- A staff supplement of March 19, 2009, on the assessment of the risks to the Fund and the Fund's liquidity position.
- A staff supplement of March 30, 2009, updating information on recent developments.
- A Press Release summarizing the views of the Executive Board as expressed during its April 1, 2009 discussion of the staff report that completed the review.
- A statement by the Executive Director for Mongolia.

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

Letter of Intent sent to the IMF by the authorities of Mongolia*
Memorandum of Economic Policies by the authorities of Mongolia*
Technical Memorandum of Understanding*
*Also included in Staff Report

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

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**International Monetary Fund**
**Washington, D.C.**

INTERNATIONAL MONETARY FUND

MONGOLIA

**Request for Stand-By Arrangement**

Prepared by the Asia and Pacific Department in Consultation with Other Departments

Approved by Nigel Chalk and Anthony R. Boote

March 18, 2009


**Motivation**: The global financial crisis has had a serious impact on the price of Mongolia's key mineral exports, feeding through to the fiscal accounts, the real economy, the balance of payments and the exchange rate. With one-third of the population in poverty, a disorderly adjustment to this external shock would have devastating social consequences, unwinding the gains that have been made in recent years. The program's main goal is to avoid such an outturn by stabilizing the macroeconomic situation and building confidence.

**Program content**: The proposed Stand-By Arrangement (of 300 percent of quota or SDR153.3 million) would aim to smooth adjustment to the catastrophic terms of trade shock, restore health to the country's fiscal finances, allow for exchange rate flexibility in line with market conditions, address weaknesses in the banking system, and protect the most vulnerable from the burden of the needed adjustment. In addition, the Fund program would outline a clear macroeconomic framework to provide the basis for the authorities to approach the broader international community for financial support. The centerpiece of the program will be a substantial fiscal adjustment. Monetary policy will be calibrated to lower inflation while maintaining a flexible exchange rate and safeguarding international reserves. Financial sector policies have been designed to rebuild confidence in the banking system and improve the framework for supervision and regulation. Finally, the government's program has a concrete timetable to better target the system of social transfers in order to provide greater support to Mongolia's poorest citizens.

**Discussions**: A staff team visited Ulaanbaatar, January 21−February 5 and March 1−7, 2009 consisting of M. Karasulu (Head), T. Feridhanusetyawan, K. Guo (APD), J. J. Hallaert (FAD), J. Hartley (SPR), and B. Jang (Resident Representative). In March, the team overlapped with a mission from MCM on foreign currency operations. Mr. Lee (OED) and I. Song (MCM) joined the January mission, and N. Chalk (APD) participated in discussions in March. The team held discussions with the Prime Minister, Speaker of Parliament, heads of various parliamentary committees, the Finance Minister, the Governor of the Bank of Mongolia, commercial banks, mining companies, and other officials.

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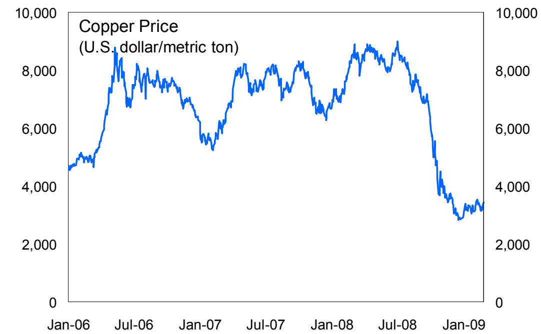
# I. CONTEXT

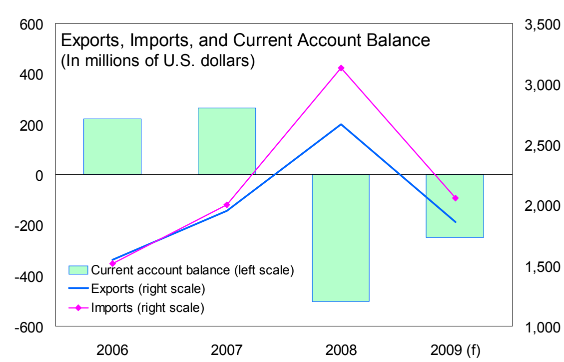
1. **Nature of the shock**. Mongolia has been hit hard by the global financial crisis through a sudden and catastrophic drop in the price of its main export commodities, most notably copper. From its peak in mid 2008, the copper price has fallen by 60 percent creating severe imbalances in both the fiscal and external accounts. Mineral revenues, which accounted for more than one-third of budget revenues at the peak of the commodity boom in 2007, have fallen by 10 percent of GDP and are expected to account for only 12½ percent of total revenues in 2009. Similarly, export proceeds are expected to fall by more than US$800 million this year—almost one-third of total exports—largely a result of lower prices for mineral and textiles exports.



Source: London Mercantile Exchange.

2. **Growth**. The growth outlook has deteriorated markedly in the past several months and is set to fall from 9 percent in 2008 to 2¾ percent this year. There are significant downside risks to even this bleak outlook. The slowdown was initiated by the fall in copper exports and a slowdown in investment flows to both the mineral sector and construction. However, the decline is now spreading to domestic demand and becoming more broad-based, driven by decreasing credit and an end to the large public sector wage increases of recent years.

3. **Inflation**. Inflation peaked at 34 percent in August driven by an overheating economy, high global prices for food and fuel, and the continued boom in copper prices. Inflationary pressures were exacerbated by the authorities' choice to tightly manage the nominal exchange rate, causing a real appreciation of the currency to be realized through domestic wage and price increases. Since then, conditions have changed dramatically. The collapse in the terms of trade is putting downward pressure on the real exchange rate. At the same time, food and fuel prices have been falling rapidly. Inflation which is already falling fast is expected to decline to single digits by year-end.



Sources: Mongolian authorities; and IMF staff estimates.

4. **External sector**. Mongolia's balance of payments worsened during 2008, largely due to a huge increase in imports. Part of this was from higher global food and fuel prices but an overheating domestic economy was also to blame. From 2007 to 2008, there has been a 16 percent of GDP swing in the

current account. These current account imbalances have been further exacerbated since the third quarter of 2008 by a dramatic fall in the terms of trade. Export revenues from minerals and agricultural products are declining precipitously although the slowing domestic economy, lower global food and fuel prices, and a weaker currency should also reduce imports by almost one third during the course of 2009. Despite this, the current account deficit is expected to remain substantial, at around 6½ percent of GDP this year.

5. **Capital flows**. Given the global financial environment, the prospects for private financing of the current account are poor. While FDI flows have been supplanted by greater financing of mineral projects through loans, private capital outflows are still large. As a result, international reserves have been falling at an accelerating pace in the past few months. At the peak in mid-2008, net reserves amounted to more than US$1 billion. By end-February, they had fallen by more than one-half. This loss of reserves is despite an almost 40 percent depreciation in the (informal) nominal exchange rate since November.

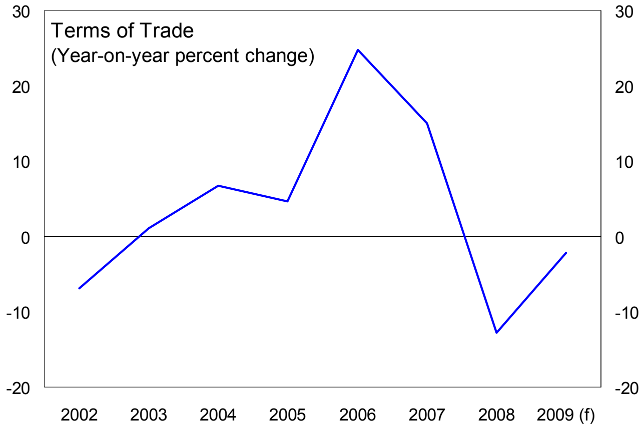
6. **Financial system**. Credit growth over the past two years has been rapid with almost one-half of lending to corporates being denominated in foreign currency. The shock to the economy since mid-2008 has led to a retrenchment of credit; broad money has fallen by 14 percent since mid-2008. The banking system is clearly under pressure. Loan-to-deposit ratios have risen to 140 percent and, in December, there was an isolated bank run on the fourth largest bank (Anod Bank). System-wide capital adequacy ratios—excluding Anod Bank—still average around 14 percent. However, while these capital ratios still appear healthy, they may need to be topped up to provide a cushion against a marked worsening of credit quality.

7. **Politics**. Mongolia is a Parliamentary Republic and the Prime Minister is chosen by the majority party. The ruling Mongolian People's Revolutionary Party won the parliamentary election in June 2008 and, later that year, formed a coalition government with the opposition Democratic Party. There are presidential elections in late May. While the elections will not effect the composition of the parliament, they will, nonetheless, still generate political campaigning in the coming months, potentially straining relations between the two sides of the governing coalition (both parties are expected to field candidates).

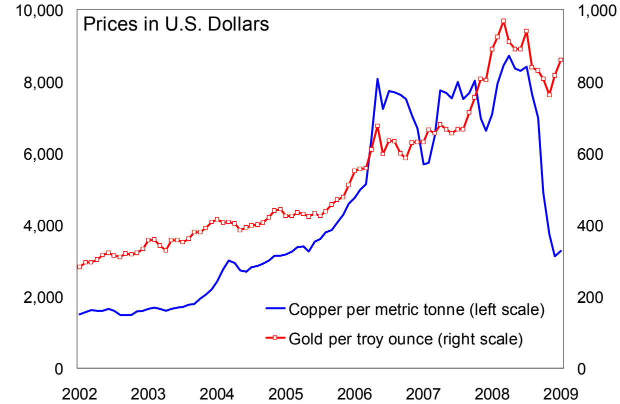
## Figure 1. Macroeconomic Trends

**Main Message:** The real economy has taken a major hit as a result of a shock to Mongolia's terms of trade. Activity is declining and the balance of payments is weaker, putting pressure on the currency.

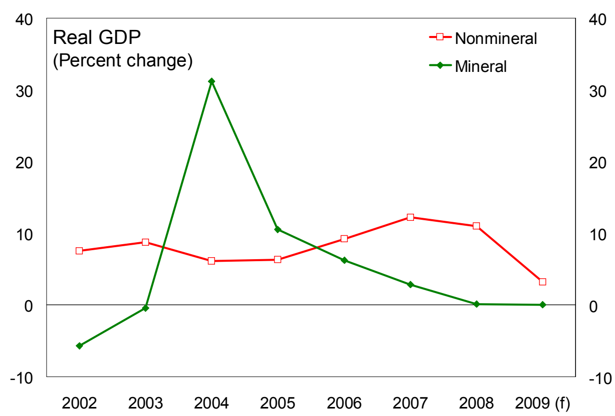
*Following boom years in 2006 and 2007, the terms of trade has witnessed a catastrophic deterioration.*



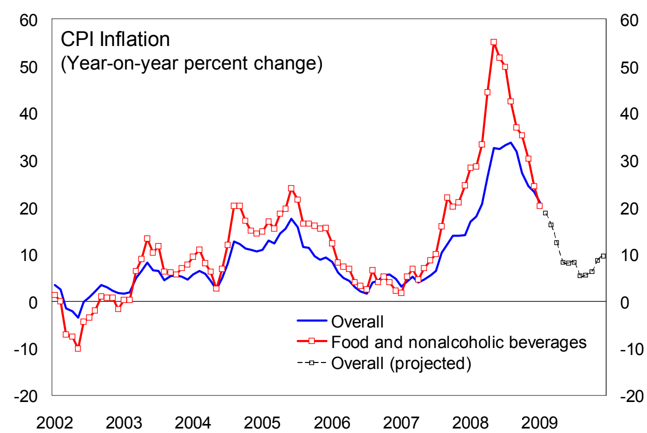

*This has been primarily a result of the precipitous reduction in the global price of key minerals, particularly copper.*



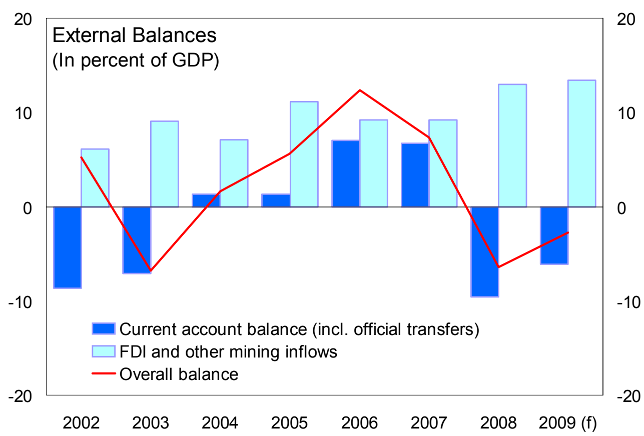

*Activity in the mineral sector has fallen steadily since major projects came on line in 2004.*



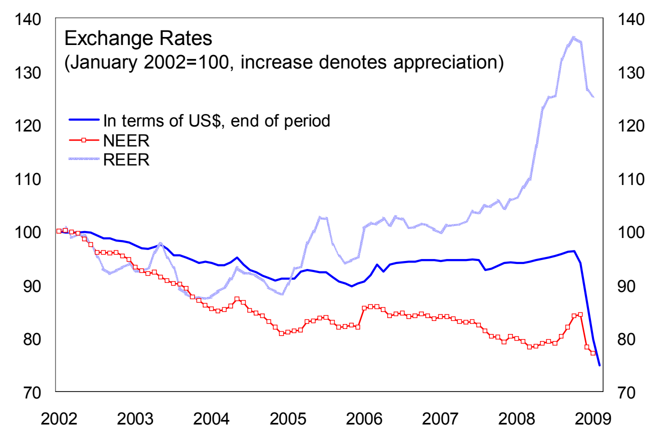

*At the same time, the mineral boom has lead to overheating and a rapid escalation of inflationary pressures. However, the economic downturn should allow inflation to fall rapidly.*




*The current account deficit has widened at a much faster pace than the increase in financing flows.*




*Following a period of significant real appreciation, the currency has depreciated significantly since mid-November 2008.*

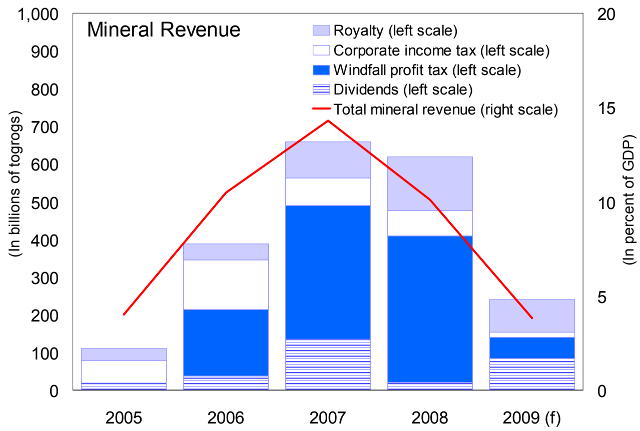



Sources: Mongolian authorities; and IMF staff estimates.

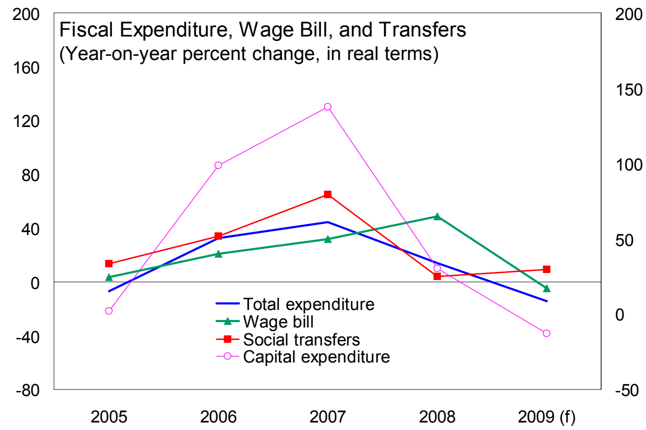
# Figure 2. Policy Developments

**Main Message:** Procyclical policies have led to a weakening of the fiscal position which is now being further exacerbated by a loss of mineral revenues. Monetary policy has been passive in responding, leading to a rapid loss of international reserves.

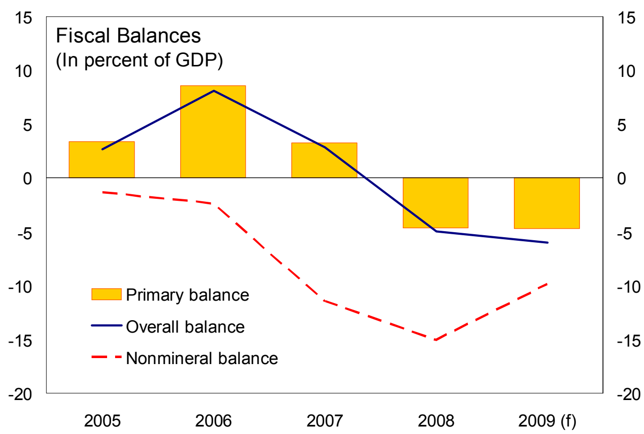
*The loss of mineral revenue has had a significant impact on the fiscal accounts…*



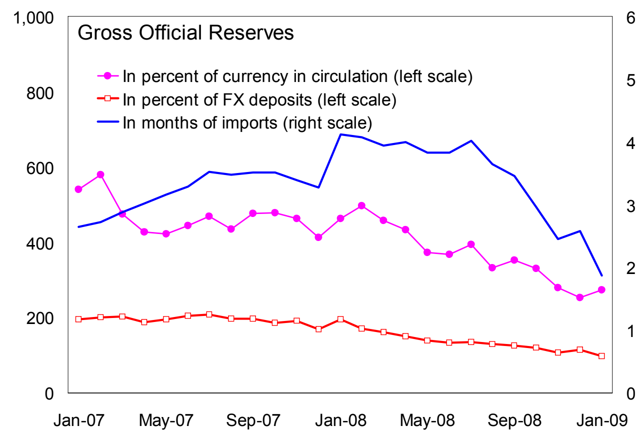

*…and expenditures have been rising rapidly.*



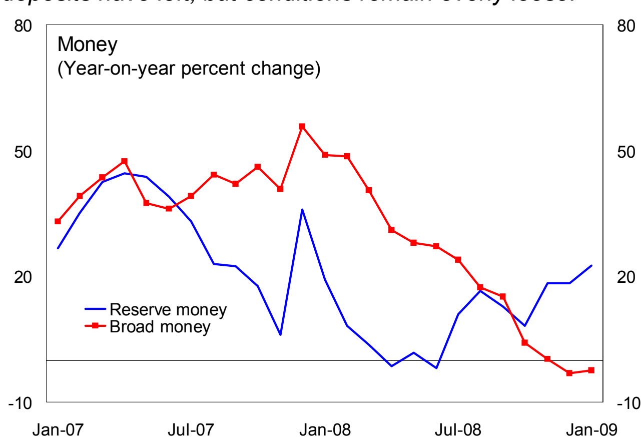

*This has widened imbalances in the fiscal accounts which are now becoming acute.*



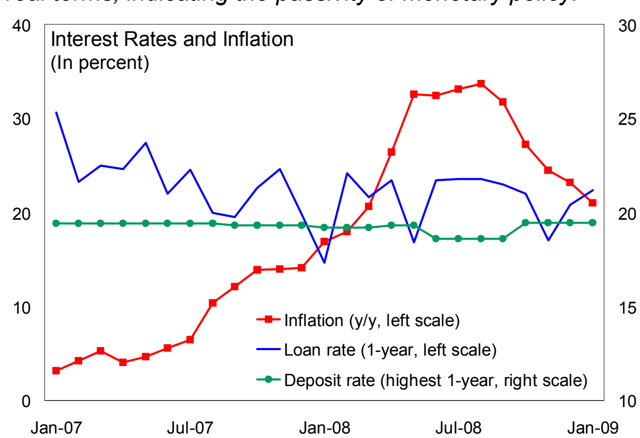

*The central bank has been intervening, initially to prevent depreciation and, since November, to slow its pace.*




*Monetary aggregate growth has contracted sharply, as deposits have left, but conditions remain overly loose.*




*Local interest rates have adjusted little and are negative in real terms, indicating the passivity of monetary policy.*

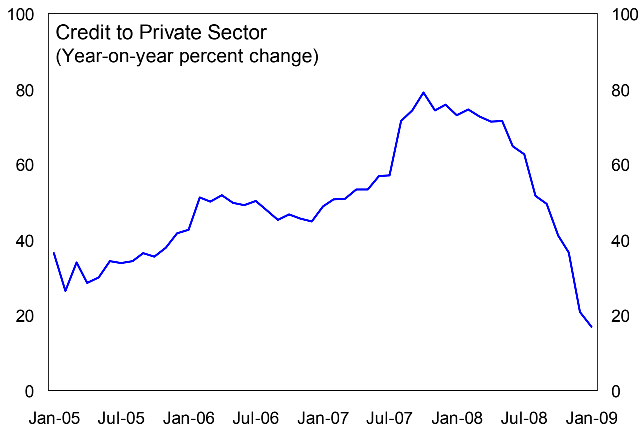



Sources: Mongolian authorities; and IMF staff estimates.

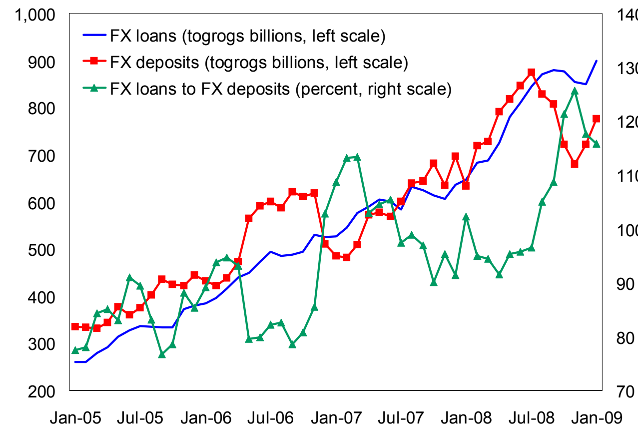
# Figure 3. Financial Developments

**Main Message:** There has been a sudden stop in bank lending and sizeable outflows from the system. The banking system is facing liquidity pressures and is vulnerable to a marked deterioration in asset quality.

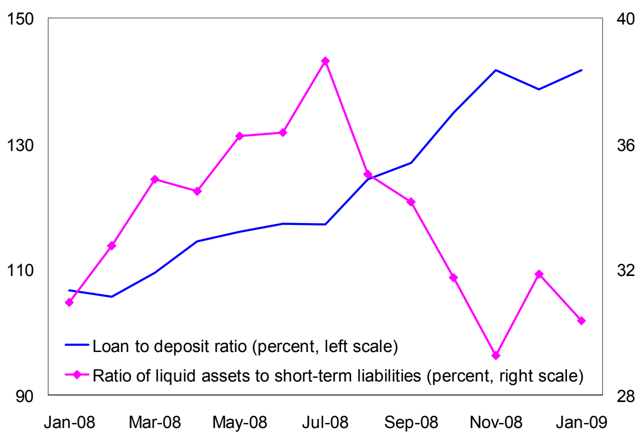
*The rapid loan growth of the past couple of years has dried up. Demand for the local currency has slumped.*



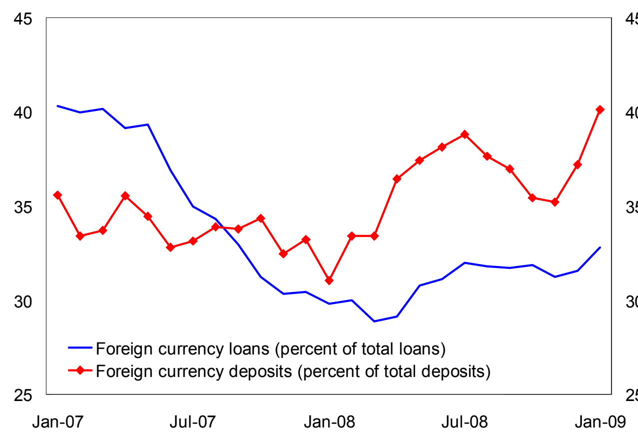

*Deposits have declined, including those in foreign currency, loan-to-deposit ratios are rising rapidly…*



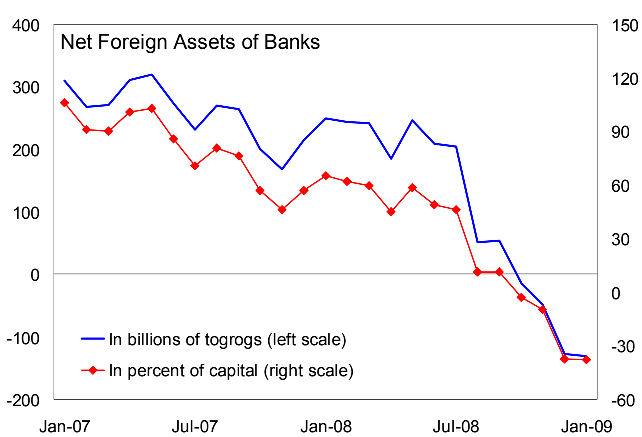

*…and liquidity pressures are increasing.*



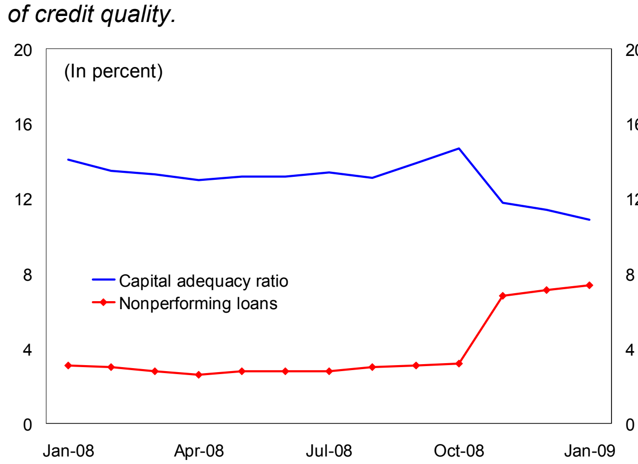

*The financial system remains highly dollarized and FX borrowers do not necessarily have a natural hedge.*




*The banks have exhausted their foreign currency reserves, leaving them exposed to currency depreciation.*




*While capital ratios appear healthy, they may need to be topped up to provide cushion against a marked worsening of credit quality.*

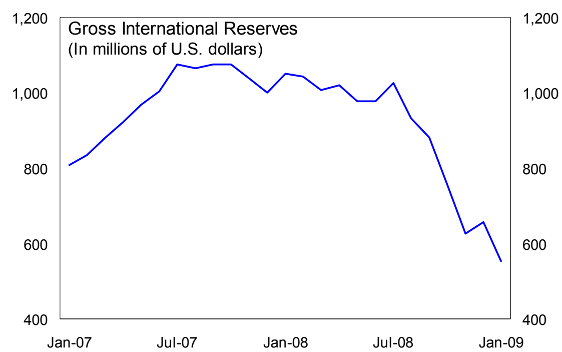



Sources: Mongolian authorities; and IMF staff estimates.

## II. POLICIES

8. **Fiscal policy**. Spending growth has been rapid in recent years. The government gave its employees nominal wage increases of the order of 70 percent in the past two years, adding 2½ percent of GDP to the wage bill in 2008 alone. Similarly, in 2007, transfers to households were raised and new, universal transfers were introduced at an estimated cost of 3½ percent of GDP. Finally, capital expenditures have more than tripled since 2005. It has now become quite clear that the government's plans to increase spending, based upon forecasts of high and increasing mineral revenues, were overly procyclical. The collapse in global mineral prices, has reduced fiscal revenues by 10 percent of GDP since 2007. As a share of GDP, revenues are now back to their 2005 levels, but spending remains almost one-third higher than it was at that time. Without action, the budget deficit will reach over 10 percent of GDP this year.

9. **Monetary policy**. To partly offset the tightening of liquidity conditions in the banking system, the central bank has lowered reserve requirements, directly provided liquidity support to banks, and has injected liquidity through onlending. As a result, monetary conditions remain overly loose. At end-February, local currency deposit rates were under 16 percent (compared to inflation of 17 percent and a rate on foreign currency deposits of 8½ percent). This combination of policies, naturally, has led to a rapid loss of international reserves.



Source: Mongolian authorities.

10. **Exchange rate policy**. After attempting to stabilize the currency through much of 2008, in the latter part of the year the Bank of Mongolia recognized that some adjustment to the collapse in copper prices was inevitable. In November, the central bank began allowing greater movement in the exchange rate which has since steadily depreciated by almost 40 percent versus the U.S. dollar (30 percent in nominal effective terms). However, inflation momentum has meant that the real exchange rate has moved by much less. As a result of the pressures in the exchange market, the Bank of Mongolia has begun rationing foreign currency for essential needs (such as imports of food, fuel, and medicine) and a differential has opened up between the official rate and the rate in the informal market.

11. **Financial sector policies**. Following the bank run in late 2008, the central bank has taken Anod Bank into conservatorship and a substantial fraud in the bank has since been revealed. To guard against further deposit outflows, the government announced a deposit guarantee in November although the guarantee was restricted to only time and savings deposits (and not current accounts).

## III. Program Discussions

12. **Context**. The authorities fully recognize the seriousness of the situation they face. However, they see the current problems as largely transitory in nature. Mongolia has been in negotiations with international mining conglomerates for some time, to develop a large copper and gold deposit at Oyu Tolgoi. Once fully in production, that mine could make Mongolia one of the largest copper producers in the world. In addition, the Tavan Tolgoi deposit, close to the border with China, if developed, would be one of the world's largest coal mines. As a result, the authorities favored a shorter term arrangement to meet their immediate balance of payments needs and allow for a smoother adjustment to the global shock that the country now faces. Over a 3 to 5 year horizon, the authorities believe that development of the country's mineral resources will provide reassurances that there will be sufficient financial resources both to meet Mongolia's flow financing requirements and to repay the Fund.

13. **Fiscal policy**. The government is committed to forcefully addressing the deterioration in the fiscal accounts. The authorities have resubmitted their 2009 budget to parliament, authorizing expenditures that are consistent with the 6 percent of GDP overall deficit (9.9 percent of GDP nonmineral deficit) that underpins the program. Last week, the parliament passed that amended budget. The authorities have made difficult trade-offs and chosen to derive most of the expenditure savings from reducing capital outlays. This will imply a halt to any project that has not yet gotten underway. Additional savings will be generated from a wage and hiring freeze, cuts in bonuses and in some untargeted social allowances, and reductions in other purchases of goods and services. These measures are estimated to reduce noninterest spending by over 4 percent of GDP in 2009. On the revenue side, the measures are limited to increases in excise taxes on petroleum, beer, and tobacco products as well as some increases in customs duties. In total, these measures are expected to increase revenues by around ¼ percent of GDP. Staff would have favored a more balanced adjustment with greater reliance on increases in revenues and an immediate rationalization of existing, nontargeted household transfer programs. Nonetheless, the authorities committed to undertake a comprehensive overhaul of the entire system of social transfers in the coming months (see below). For 2010, the government intends to continue adjusting its fiscal stance and will target a deficit of 4 percent of GDP to bring the fiscal position towards a more sustainable medium-term level. The modalities of the adjustment in 2010 will be discussed in the upcoming reviews of the program and will include overhaul of untargeted social transfer programs and limiting domestically financed capital expenditure growth. In addition, further fiscal adjustment will certainly be needed beyond the horizon of this Stand-By Arrangement.

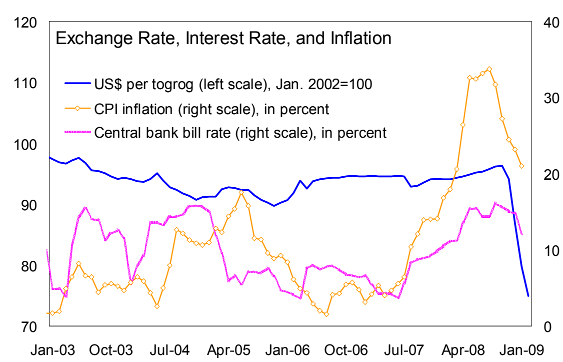
14. **Structural fiscal reform**. Recent events have starkly exposed the risks that pro-cyclical fiscal policies pose to the economy. To prevent the boom-bust fiscal cycle related to world copper prices, the government is committed to putting in place a stronger institutional framework to ensure a greater proportion of windfall copper revenues is saved. In particular, by end-2009, the government will submit to parliament fiscal responsibility

legislation, designed in coordination with Fund and World Bank staff. As part of that legislation, the authorities intend to commit to a structural fiscal rule that would limit expenditure growth and restrain the accumulation of public debt. Spending would be set in reference to a conservative assumption on the medium-term level of copper prices and at a level that guarantees medium-term fiscal sustainability.

15. **Social protection**. With one-third of the population still living below the poverty line, the coming economic downturn will surely have significant, negative social consequences. The authorities agreed it would be essential, therefore, to improve the current system of social transfers and protect such spending from being reduced. Given the complex nature of the current overlapping system of both universal and targeted transfers, the government believed it would take some time to clearly disentangle which programs are truly protecting the poor and to institute a reliable targeting mechanism. Nevertheless, the authorities intend, in cooperation with the Asian Development Bank and the World Bank, to undertake a study of the existing system with a view to rationalizing untargeted social spending in order to direct more resources to the poorest of Mongolia's citizens. This would facilitate an improvement in the structure of transfers in time for the 2010 Budget.

16. **Exchange rate policy**. The authorities recognize that the current pace of reserve loss is entirely unsustainable. The central bank, therefore, intends to quickly introduce a new system of foreign currency auctions in order to have a nondiscriminatory mechanism to sell foreign exchange into the market that would allow for full price discovery. In addition, the central bank will remove the current exchange restrictions by June 1 in order to allow the exchange rate to flexibly adjust to a level that is consistent with economic fundamentals.

17. **Monetary policy**. Monetary policy has been conducted passively for quite some time. The central bank recognizes that the recent loosening of monetary conditions and injection of liquidity have been counterproductive, hastening the pace of reserve loss. A structural break in the conduct of monetary policy is needed. In order to provide support to the exchange rate and eliminate incentives for residents to move out of togrog, the central bank will allow market interest rates to increase to a level that would achieve the path for monetary aggregates described under the program. While this may entail some sharp initial increases in interest rates until the current financial situation has stabilized, it is expected that rates will be able to steadily decline, once the current crisis has been averted. In this, the central bank will need to feel its way, reacting to market conditions as they evolve. The central bank has already begun this process with a step increase in policy interest rates of



Source: Mongolian authorities.

425 basis points (to 14 percent) on March 10. In this regard, it will be important that the entire structure of central bank rates (including on repos, collateralized loans, and refinance facilities) moves up in tandem with the policy rate.

18. **Banking system**. The authorities agreed on the immediate need to restore confidence in the local banking system. It was fully recognized that the banks are vulnerable and nonperforming loans were likely to increase further in the coming months. The authorities are moving quickly to resolve the problems within Anod Bank and have already appointed an international auditing firm to assess the situation at the bank. Once that audit's results are available, the government intends to restructure the bank, as necessary, and pursue vigorously those responsible for any fraudulent transactions discovered at the bank. While the restructuring costs are, as yet, unknown, the government is committed to fully accommodate them as part of the 2010 budget. The central bank has also put in place a program to require banks to raise their capital adequacy to at least 12 percent by end-2009, including through foreign participation. Banks will need to submit their business plans for how this would be achieved by end-April 2009.

19. **Financial supervision**. The events at Anod Bank and last year's FSAP reveal significant weaknesses in the current system of bank supervision. To address these limitations the government intends to increase the number of on-site supervisors, develop a supervisory enforcement plan for weak banks, and strengthen the fit-and-proper review process for new shareholders. The government will also strengthen the prompt corrective action clauses in the Banking Law, improve the bank resolution framework, introduce legal protection for supervisors, and begin consolidated supervision. Finally, over the course of the next several months, the bank supervisors will update on-site supervision of systemically important banks to preemptively assess emerging asset quality problems.

20. **Deposit guarantee**. The government has revised its deposit guarantee system in order to widen its scope and prevent potential abuse. The guarantee will not apply to deposits of related parties or subordinated debt holders. At the same time, the scope of the guarantee will be expanded to current accounts and interbank deposits.

## IV. Program Modalities

21. **Access**. Given the steady depletion of foreign currency reserves, the potential for deposit outflows, and fragile confidence in the local currency, it will be important to substantially increase the resources available to the central bank. A further sharp depreciation of the currency would be extremely damaging to the financial system, given that foreign currency denominated lending makes up around one-half of all corporate lending. In order to bolster reserves, the authorities have requested an 18-month Stand-By Arrangement with

access of 300 percent of quota (SDR 153.3 million or 5½ percent of 2009 GDP). Under existing procedures, this would imply exceptional access. To bolster confidence, the intention is to front-load that access to make one-half of it available in the next six months. Staff forecasts indicate that such a level of access would be sufficient to maintain gross reserves above 3 months of imports throughout the course of the arrangement.

22. **Financing**. Despite the exceptional access levels, the government still has budgetary financing needs of the order of US$205 million in 2009−10. As a result, the authorities have approached donors to request additional support during the course of the Stand-By Arrangement. At a donor conference in Ulaanbaatar on March 14, the Asian Development Bank, the World Bank, and Japan together agreed to provide US$160 million in support over the next two years, US$120 million of which would be available this year. There have also been indications from other donors that, in the coming months, they would be prepared to meet the residual financing need. Staff will reassess the availability of financing at the time of the first review, when there should be greater clarity as to the extent of donor support, and revise program targets, if necessary. The authorities are committed to take corrective measures to address any donor shortfall. In addition, the authorities are exploring the possibility of a sovereign bond issuance, partially guaranteed by the Asian Development Bank. Without such a guarantee, it is unlikely that, given current market conditions, Mongolia could issue nonconcessional debt and still have a fiscal position that is consistent with medium-term debt sustainability. In any case, the authorities are committed that any such issuance would be consistent with debt sustainability and the nonconcesssional borrowing limits under the program. If realized, such borrowing would go towards further building international reserves.

23. **Conditionality**. Conditionality is intended to be parsimonious and focused on the key areas of achieving the programmed fiscal adjustment, restoring stability to the financial system, improving the system of social transfers, and institutionalizing medium-term fiscal responsibility. The quantitative and qualitative conditionality are described in Tables 1 and 2 attached to the government's Memorandum of Economic Policies.

24. **Prior actions**. Given the risks to the program, there are significant prior actions. The authorities have passed an amendment to the budget that is consistent with the fiscal targets under the program. In addition, the parliament has revised the deposit guarantee legislation. Finally, the central bank has already appointed an international auditor to assess the situation in Anod Bank.

25. **Arrears**. The government and the Bank of Mongolia are committed to making good faith efforts to reach collaborative agreements with their creditors. To this end, they have already made contact with creditors to begin the process of resolving outstanding arrears.

26. **Reviews**. Given the near-term uncertainty, and the prospects for a substantial decline in net international reserves in the first half of this year, reviews will be based upon quantitative performance criteria established for end-April and end-June. After that, the program would be assessed on the basis of five quarterly reviews. Until conditions stabilize, there will also be a consultation clause that would be triggered if there were a substantial fall in reserves over a rolling 30-day window.

27. **Exceptional access criteria**. The staff's evaluation of the four exceptional access criteria is as follows:

**Criteria I.** *The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account, resulting in a need for Fund financing that cannot be met within the normal limits*. The balance of payments pressures are currently predominantly on the current account. While data on capital account flows is poor, the pace of recent reserve loss does, however, indicate that pressures on the capital account are mounting. In particular, there is a significant risk that the dwindling level of reserves could catalyze a sudden drop in confidence and precipitate a withdrawal of deposits from the banking system and a conversion of those assets into foreign currency. Preventing these pressures from emerging and to avoid adding to the existing current account pressures are key objectives of the program, justifying the need for exceptional access to replenish the weak international reserve position and bolster confidence in the currency.

**Criteria II.** *A rigorous and systematic analysis indicates that there is a high probability that public debt will remain sustainable in the medium term*. The bulk of the public debt is external and contracted on concessional terms. Debt sustainability analysis completed by staff indicate that, under a baseline scenario, the public debt should peak at below 40 percent of GDP this year—on a present value basis—and decline as a ratio of GDP over the medium term. This assumes that the policies under the program are fully implemented—including the substantial fiscal adjustment discussed earlier—and that large mining projects go forward. Substantial issuance of costly sovereign debt would, however, raise concerns over debt sustainability. The program limits that risk through a ceiling on the contracting of nonconcessional external debt.

**Criteria III.** *The member has good prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding*. So far, Mongolia's access to private capital markets has been limited and the main source of inflows has been through FDI and official financing. However, the prospects for receiving significant private financing, related to the development of its considerable mineral resources, are high.

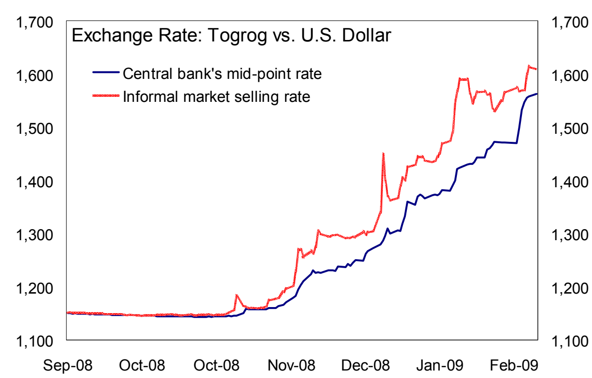
**Criteria IV.** *The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver the adjustment*. There are significant risks to the program. However, steadfast implementation of the broad policy framework outlined above provides the basis for averting the pending economic and social crisis. Parliamentary approval of a revised budget has provided a clear signal of broader political ownership of the proposed fiscal adjustment.

28. **Capacity to repay**. The government is committed to implementing their policy program outlined in the attached Memorandum of Economic Policies. This, combined with the prospects for future development of Mongolia's natural resources (and the accompanying foreign currency earnings and government revenue), give reasonable assurances of capacity to repay the Fund. If purchases are made as scheduled, there will be a peak in repurchases to the Fund in 2013−14. Much will depend, therefore, upon the government's commitment to fiscal prudence over a more medium-term horizon. A steady reduction in the nonmineral fiscal deficit will be essential, even beyond the horizon of the current arrangement. The authorities have expressed their willingness to consider a possible request to transition to a concessional arrangement once the immediate crisis has been averted, which would help bolster fiscal responsibility and facilitate a steady path of structural reform over a longer horizon.

29. **Debt sustainability analysis**. Staff analysis suggests that Mongolia is at low risk of external debt distress. Although the debt ratios will rise significantly over the next two years as a result of front-loaded foreign financing, including from the Fund, the debt outlook is expected to recover and improve over the medium term. Debt sustainability will, nonetheless, depend critically on the future prospects for key commodity prices, notably copper.

30. **Safeguards**. Safeguards assessments of the central bank were completed in March 2002 and November 2003. The second assessment noted good progress in addressing some risks within the central bank's financial safeguards. The process for a new safeguards assessment has already begun and will be undertaken prior to the first review of the program.

31. **Exchange restrictions and multiple currency practices**. The current system of allocating foreign exchange gives rise to multiple currency practices and an exchange restriction. A parallel market has developed quickly at a growing premium from the intervention rate although over the past few weeks, the central bank has adjusted its official rate to narrow the spread with the informal market. There are two key dimensions to this problem:



Source: Bank of Mongolia.

- First, the central bank rations its sales of foreign exchange to only a subset of imports. All other current account transactions are excluded. Residents remain free to purchase foreign exchange from the banks or foreign exchange bureaus and to implement transactions based on their own foreign exchange resources. However, anecdotal evidence suggests that certain current account transactions have failed because of the shortage of foreign currency in the market. This gives rise to an exchange restriction subject to Fund jurisdiction, since by rationing and restricting access to foreign exchange to a limited subset of imports, the government limits the availability of foreign exchange.

- Following from the above, the government's official action to ration and limit access to foreign exchange results in market segmentation and a multiplicity of rates. Foreign exchange purchased from the central bank is available at a better rate than in the foreign exchange market. This is because the central bank rate and the market rate (as measured by the rate transacted at by banks and bureaus) have deviated substantially. The coexistence of two separate exchange markets results in a spread of more than 2 percent between the rates giving rise to a multiple currency practice.

The authorities have made clear that their current practice is a temporary step introduced as a result of the extreme stress on the balance of payments. The authorities have also committed to removing such restrictions before June 1. To that end, with the technical assistance of MCM, the authorities are already working to implement an auction system (as discussed above) to ensure such exchange restrictions are nondiscriminatory.

## V. RISKS

32. There are substantial risks to the program:

- ***Fiscal policy***. The risks to the fiscal position have several components:

  - *Seasonality*. There is a clear seasonal pattern to payments and receipts in Mongolia. As the winter ends and economic activity picks up, government expenditures rise but the revenues associated with those activities arrive only later in the year. Thus the fiscal imbalance is considerably larger in the first half which, this year, will coincide with very tight financing conditions. This makes the fiscal targets in the program very challenging for the first half of the year.

  - *Revenues*. There are certainly risks to the revenue outlook. Most pertinently, the ability of Erdenet—the main copper company which is 51 percent government owned—to pay corporate taxes and dividends is unclear. Loss of that revenue, which is forecast to be 1½ percent of GDP this year, would have damaging consequences for the fiscal position.

- ♦ *Spending*. As has been alluded to earlier, the composition of expenditure reductions is less-than-ideal. If international experience is a guide, this puts at risk the sustainability of the intended adjustment. It will be vital, therefore, that the reduction in spending is maintained in 2010 and that ways are sought in the coming months to improve the quality of the fiscal adjustment.

- ♦ *Gold operations*. Finally, the authorities have, in past years, engaged in lending operations to finance working capital for gold mines in the country. These loans are usually paid out in the second quarter and received back later in the year once the gold is excavated and monetized by the central bank to become part of its foreign reserves. This year, that operation—the size or precise details of which are, as yet, unknown—could put pressure on the fiscal position early on in the year.

Should these risks be realized or donor financing fall short, there is no doubt that further fiscal measures will be needed during the course of this year. Most notably, this would mean advancing the reform of the social transfer system (instead of, as currently planned, as part of the 2010 Budget).

- ***Monetary policy***. Upfront action to constrain liquidity and prevent the continued pace of international reserve loss is required. Such measures are certain to be unpopular. It will require steadfast implementation by the central bank if the program is to succeed. The recently announced interest rate increase is a very positive step in this regard.

- ***Deposit loss***. Given the loss of deposits from the system over the past several months, the program assumes that a process of remonetization will get underway, prompted by higher local currency interest rates, by the credibility of the program, and the availability of substantial Fund and donor resources. However, as in any country, the pace at which banks will be able to attract deposits back into the system is uncertain, which could further constrain the availability of bank-intermediated financing.

- ***Banks***. Stress test results—drawing on a framework put in place at the time of the last FSAP—suggest that banks are exposed to both interest rate and exchange rate risk. The former through maturity mismatches and the latter via the effect a weaker currency will have on the prospects for repayment of foreign currency loans by unhedged borrowers. These effects will be amplified by the impact of a rapidly slowing economy and should they materialize, will need to be handled quickly and carefully.

- ***Global risks***. As is clearly evident, the global economic context is highly uncertain. This translates directly to Mongolia's trade and fiscal revenues through the effect on world mineral prices. Copper prices—which are forecasted based upon the WEO—could well fall further, putting additional pressures on the economy.

- ***Political risks***. Political developments in the run-up to the May presidential elections may distract from policy implementation.

- ***Mining***. Over a longer horizon, there is a risk that Mongolia's mineral wealth will be commercialized at a much slower pace than currently envisaged, perhaps due to increased risk aversion by potential investors or low international prices for these commodities. That would slow growth and have a clear impact on the fiscal balance and balance of payments into the medium term.

## VI. Staff Appraisal

33. **Overview**. Mongolia's economy has been disrupted by a major shock to the price of its main export commodity, in turn a result of the still evolving global financial crisis. This has exacerbated balance of payments and fiscal imbalances that were already present as a result of an overheating economy. While regrettable, the procyclical policies which were in place during more favorable times, now necessitate procyclical policies to avert an impending fiscal, balance of payments, and social crisis. This needs to include a major reduction in budgetary spending, allowing the currency to adjust to the worsening terms of trade while maintaining a restrictive monetary policy, and taking steps to strengthen the banking system.

34. **Program**. The authorities' program tackles the main vulnerabilities currently being faced by the country. The intended upfront adjustment in the fiscal deficit will put Mongolia on a path towards sustainable fiscal finances and passage by the parliament of the government's fiscal plan shows a broad political ownership of the program. The recent movements in interest rates show a clear commitment by the Bank of Mongolia to stem the loss of reserves and begin conducting a more active monetary policy. Finally, the central bank's quick action on Anod Bank shows the authorities' readiness to stand behind the banking system.

35. **Fiscal policy**. The authorities have made difficult and politically unpopular choices in order to rein in budget spending and reduce the nonmineral fiscal deficit by more than 5 percent of GDP, relative to the 2008 outturn. The composition of fiscal adjustment is not that which would have been otherwise advocated by staff. Given the current political constraints, the government will rely more heavily on expenditure measures and, within spending, has chosen to sacrifice capital expenditures and put in place a wage and hiring freeze for the public sector. While perhaps more could have been done to reduce untargeted social transfers and increase transfers to the poor, the authorities' intention to improve targeting of transfers in the near future is a welcome commitment. In addition, the authorities are committed to developing fiscal contingency measures to mitigate risks to the program.

36. **Monetary policy**. It will be essential for the central bank to allow the currency to move flexibly, in line with market conditions. At the same time, to prevent an overshooting of the exchange rate, the central bank will need to tighten monetary policy and constrain the provision of liquidity—to both the government and the financial system—to levels that are consistent with money demand. Staff anticipate that, once confidence has been restored, there should be scope for adjusting the monetary stance. However, given the uncertain economic environment, the central bank will need to stand ready to tighten monetary conditions should there be a more rapid depletion of reserves or a faster depreciation of the currency.

37. **Financial sector policy**. The central bank has dealt expeditiously with the problems that have been revealed in Anod Bank. Enhancing the supervisory and legal framework to ensure such problems are not repeated is essential for the health of the banking system. The central bank will also need to be prepared to act decisively should further problems be revealed in the banking system as a result of the structural shift in monetary conditions.

38. **Risks**. There are indeed substantial risks facing the authorities (as outlined above). This needs to be weighed against the risks of not having the framework of a Fund program in place. Without a program, deposit outflows would likely continue and fiscal pressures would build as wage and pension arrears begin to reveal themselves. With few options, the government would eventually be forced to monetize the deficit while creating distortions through parallel exchange rates and rationing of foreign currency in order to protect reserves. The social consequences would be highly destabilizing. On balance, the Fund program, with all its inherent risks, provides an opportunity to assist the Mongolian government, provide a guide for needed policies, and avert the outcome described above.

39. While risks remain, the government's program is ambitious and merits Fund support. Staff recommends the approval of the requested Stand-By Arrangement.

# Table 1. Mongolia: Selected Economic and Financial Indicators, 2006–10

Nominal GDP (2008): $5,258 million 1/
Population, end-year (2007): 2.64 million
Per capita GDP (2008): $1,981 2/
Poverty incidence (2006): 32.2 percent 3/
Quota: SDR 51.1 million

| | 2006 | 2007 | 2008<br>Prel. | 2009<br>Proj. | 2010<br>Proj. |
|---|---|---|---|---|---|
| | | | (Percent change) | | |
| Real sector | | | | | |
| Real GDP growth | 8.6 | 10.2 | 8.9 | 2.7 | 4.3 |
| Mineral | 6.3 | 2.9 | 0.1 | 0.0 | 1.0 |
| Nonmineral | 9.2 | 12.2 | 11.0 | 3.2 | 5.0 |
| Consumer prices (period average) | 4.5 | 8.2 | 26.8 | 10.1 | 7.9 |
| Consumer prices (end-period) | 4.8 | 14.1 | 23.2 | 9.6 | 7.0 |
| GDP deflator | 23.1 | 12.3 | 22.4 | 0.0 | 9.4 |
| | | | (In percent of GDP) | | |
| General government budget | | | | | |
| Revenue and grants | 36.6 | 40.9 | 35.2 | 30.8 | 31.6 |
| Expenditure and net lending | 28.5 | 38.0 | 40.2 | 36.8 | 35.6 |
| Current balance | 14.8 | 14.1 | 6.3 | 1.9 | 4.5 |
| Primary balance | 8.6 | 3.2 | -4.7 | -4.7 | -3.8 |
| Overall balance (including grants) | 8.1 | 2.8 | -5.0 | -6.0 | -4.0 |
| Nonmineral overall balance | -2.4 | -11.5 | -15.1 | -9.9 | -9.1 |
| | | | (Percent change) | | |
| Money and credit 4/ | | | | | |
| Net foreign assets | 98.4 | 19.1 | -49.8 | 39.1 | 32.5 |
| Net domestic assets | -32.5 | 157.6 | 57.4 | 19.3 | 22.0 |
| Domestic credit | -7.1 | 71.0 | 58.1 | 13.6 | 18.0 |
| Broad money | 31.3 | 55.6 | -3.0 | 25.1 | 25.4 |
| Reserve money | 40.0 | 35.9 | 18.4 | 12.1 | 17.7 |
| Broad money velocity (GDP/BM) | 2.4 | 1.9 | 2.6 | 2.2 | 2.0 |
| Interest rate on central bank bills, end-period (percent) 5/ | 5.1 | 8.4 | 9.8 | … | … |
| | | | (In millions of U.S. dollar) | | |
| Balance of payments | | | | | |
| Current account balance (including official transfers) | 222 | 265 | -503 | -262 | -268 |
| (In percent of GDP) | 7.0 | 6.7 | -9.6 | -6.5 | -6.2 |
| Trade balance | 30 | -54 | -464 | -201 | -245 |
| Exports | 1,545 | 1,949 | 2,667 | 1,858 | 2,211 |
| Imports | -1,516 | -2,003 | -3,131 | -2,059 | -2,457 |
| Foreign direct investment | 290 | 360 | 682 | 317 | 330 |
| Gross official international reserves (end-period) | 718 | 1001 | 657 | 822 | 1075 |
| (In months of next year's imports of goods and services) | 3.6 | 3.2 | 3.0 | 3.3 | 3.7 |
| Trade prices | | | | | |
| Export prices (U.S. dollar, percent change) | 39.9 | 26.0 | 3.9 | -27.0 | 5.5 |
| Import prices (U.S. dollar, percent change) | 12.2 | 9.6 | 19.1 | -25.3 | 4.9 |
| Terms of trade (percent change) | 24.7 | 15.0 | -12.8 | -2.2 | 0.6 |
| | | | (In percent of GDP) | | |
| Public and publicly guaranteed debt | | | | | |
| Total public debt | 45.4 | 39.4 | 33.1 | 46.8 | 47.8 |
| Domestic debt | 1.0 | 0.5 | 0.0 | 0.0 | 0.0 |
| External debt 6/ | 44.3 | 38.9 | 33.1 | 46.8 | 47.8 |
| (In million U.S. dollar) | 1,414 | 1,529 | 1,601 | 1,796 | 2,048 |
| Exchange rate | | | | | |
| Togrogs per U.S. dollar (end-period) | 1,165 | 1,170 | 1,268 | ... | ... |
| Togrogs per U.S. dollar (period average) | 1,177 | 1,170 | 1,166 | ... | ... |
| Nominal effective exchange rate (end-period; percent change) | 1.9 | -4.0 | -2.5 | ... | ... |
| Real effective exchange rate (end-period; percent change) | 5.5 | 6.4 | 19.5 | ... | ... |
| Nominal GDP (billions of togrogs) | 3,715 | 4,600 | 6,130 | 6,294 | 7,180 |

Sources: Mongolian authorities; and Fund staff projections.

1/ Based on period average exchange rate.
2/ Estimate, based on period average exchange rate.
3/ Share of households below national poverty line, based on The Millennium Development Goals Implementation 2007.
4/ For 2009-10, valued at the programmed exchange rate and gold price.
5/ Yield of 14-day bills until 2006 and of 7-day bills from 2007 onward.
6/ Includes prospective Fund credit under the SBA.

Table 2. Mongolia: Summary Operations of the General Government, 2006–10

| | 2006 | 2007 | 2008 Prel. | 2009 Prog. | 2010 Proj. |
|---|---|---|---|---|---|
| | | | (In billions of togrogs) | | |
| Total revenue and grants | 1,360 | 1,880 | 2,156 | 1,936 | 2,269 |
| Total expenditure and net lending | 1,059 | 1,750 | 2,462 | 2,316 | 2,559 |
| Overall balance (incl. grants) | 301 | 131 | -305 | -380 | -290 |
| Nonmineral overall balance | -88 | -527 | -925 | -621 | -653 |
| Financing | -336 | -131 | 305 | 380 | 290 |
| Foreign (net) | 87 | 47 | 43 | 53 | 150 |
| Domestic (net) | -423 | -178 | 262 | 101 | 40 |
| Donor support | 0 | 0 | 0 | 227 | 100 |
| | | | (In percent of GDP) | | |
| Total revenue and grants | 36.6 | 40.9 | 35.2 | 30.8 | 31.6 |
| Current revenue | 36.4 | 40.4 | 34.8 | 30.4 | 31.2 |
| Tax revenue and social security contributions | 30.4 | 32.7 | 30.8 | 25.2 | 26.3 |
| Income taxes | 12.8 | 14.1 | 12.4 | 6.0 | 6.8 |
| Enterprise income tax | 6.0 | 4.8 | 4.1 | 3.5 | 4.0 |
| Personal income tax | 2.1 | 1.6 | 1.9 | 1.6 | 1.6 |
| "Windfall" tax | 4.8 | 7.7 | 6.3 | 0.9 | 1.2 |
| Social security contributions | 3.0 | 3.5 | 3.6 | 3.9 | 3.9 |
| Sales tax and VAT | 6.5 | 5.8 | 5.8 | 6.2 | 6.0 |
| Excise taxes | 2.7 | 2.9 | 2.9 | 3.2 | 3.6 |
| Customs duties and export taxes | 1.9 | 2.2 | 2.5 | 2.5 | 2.4 |
| Other taxes | 3.4 | 4.2 | 3.6 | 3.4 | 3.6 |
| Nontax revenue | 6.1 | 7.7 | 4.0 | 5.2 | 4.9 |
| Capital revenue and grants | 0.2 | 0.5 | 0.3 | 0.4 | 0.4 |
| Total expenditure and net lending | 28.5 | 38.0 | 40.2 | 36.8 | 35.6 |
| Current expenditure | 21.7 | 26.3 | 28.5 | 28.5 | 26.7 |
| Wages and salaries | 5.3 | 6.4 | 8.9 | 9.0 | 9.0 |
| Purchase of goods and services | 8.6 | 8.5 | 8.0 | 5.5 | 5.5 |
| Subsidies to public enterprises | 0.3 | 0.3 | 1.2 | 0.7 | 0.7 |
| Transfers 1/ | 7.0 | 10.6 | 10.2 | 12.0 | 11.2 |
| Interest payments | 0.5 | 0.4 | 0.3 | 1.3 | 0.3 |
| Contingency allocation | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Capital expenditure and net lending | 6.9 | 11.8 | 11.6 | 8.3 | 8.9 |
| Capital expenditure | 4.7 | 10.0 | 10.2 | 6.7 | 6.7 |
| Domestically-financed | 4.5 | 9.5 | 9.9 | 6.2 | 5.9 |
| Foreign-financed | 0.2 | 0.5 | 0.3 | 0.5 | 0.7 |
| Net lending | 2.1 | 1.7 | 1.4 | 1.6 | 2.3 |
| On-lent foreign project loans | 2.4 | 1.6 | 1.1 | 1.9 | 2.6 |
| Domestic lending minus repayments | -0.3 | 0.2 | 0.3 | -0.3 | -0.3 |
| Current balance (excl. privatization receipts) | 14.8 | 14.1 | 6.3 | 1.9 | 4.5 |
| Primary balance | 8.6 | 3.2 | -4.7 | -4.7 | -3.8 |
| Overall balance (incl. grants) | 8.1 | 2.8 | -5.0 | -6.0 | -4.0 |
| Nonmineral overall balance | -2.4 | -11.5 | -15.1 | -9.9 | -9.1 |
| Discrepancy between above and below the line | -1.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Financing | -9.1 | -2.8 | 5.0 | 6.0 | 4.0 |
| Foreign (net) | 2.3 | 1.0 | 0.7 | 0.8 | 2.1 |
| External borrowing (net) | 2.3 | 1.0 | 0.7 | 0.8 | 2.1 |
| Project loans | 2.7 | 2.1 | 1.4 | 2.4 | 3.3 |
| Program loans | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 |
| Amortization | 0.6 | 1.1 | 0.7 | 1.6 | 1.2 |
| Domestic (net) | -11.4 | -3.9 | 4.3 | 1.6 | 0.6 |
| Banking system (net) | -11.8 | -3.8 | 4.2 | 1.3 | 0.6 |
| Nonbank | 0.4 | 0.0 | 0.1 | 0.3 | 0.0 |
| Donor support | 0.0 | 0.0 | 0.0 | 3.6 | 1.4 |
| Memorandum items: | | | | | |
| Mineral revenue | 10.5 | 14.3 | 10.1 | 3.8 | 5.1 |
| *Of which:* tax and royalty | 9.5 | 11.3 | 9.8 | 2.5 | 4.0 |
| Nonmineral revenue | 26.0 | 26.1 | 24.7 | 26.5 | 26.2 |
| Mineral revenue/total revenue and grants (in percent) | 28.6 | 35.0 | 29.2 | 12.5 | 16.0 |
| Nominal GDP (in billions of togrogs) | 3,715 | 4,600 | 6,130 | 6,294 | 7,180 |
| Copper price (US$ per ton) | 6,731 | 7,132 | 6,963 | 3,500 | 3,800 |

Sources: Ministry of Finance; and Fund staff projections.

1/ Includes reclassifications between goods and services and transfers starting in 2009.

## Table 3. Mongolia: Monetary Aggregates, 2006−10

| | 2006 | 2007 | 2008 | 2009 Proj. | 2010 Proj. |
|---|---|---|---|---|---|
| | (In billions of togrog; end of period) | | | | |
| Monetary survey | | | | | |
| Broad Money | 1,537 | 2,391 | 2,319 | 2,900 | 3,637 |
| Currency | 185 | 283 | 329 | 390 | 489 |
| Deposits | 1,351 | 2,108 | 1,990 | 2,510 | 3,148 |
| Net foreign assets 1/ | 1,132 | 1,348 | 677 | 942 | 1,248 |
| Net international reserves | 1,079 | 1,399 | 747 | 1,002 | 1,279 |
| Bank of Mongolia | 801 | 1,137 | 808 | 1,045 | 1,301 |
| Commercial banks | 278 | 261 | -60 | -43 | -22 |
| Other foreign assets, net | 53 | -50 | -70 | -60 | -31 |
| Net domestic assets | 405 | 1,043 | 1,642 | 1,958 | 2,389 |
| Domestic credit | 812 | 1,389 | 2,196 | 2,495 | 2,943 |
| Net credit to government | -435 | -703 | -497 | -416 | -376 |
| Claims on nonbanks | 1,247 | 2,092 | 2,692 | 2,910 | 3,319 |
| Other items, net | -408 | -346 | -554 | -537 | -554 |
| Monetary authorities | | | | | |
| Reserve money | 394 | 535 | 633 | 710 | 836 |
| Net foreign assets 1/ | 798 | 1,134 | 805 | 1,042 | 1,298 |
| Net international reserves | 801 | 1,137 | 808 | 1,045 | 1,301 |
| Other assets, net | -3 | -4 | -3 | -3 | -3 |
| Net domestic assets | -404 | -599 | -172 | -332 | -462 |
| Net credit to government | -335 | -573 | -185 | -74 | -74 |
| Claims on deposit money banks | 18 | 19 | 243 | 165 | 165 |
| Minus: Central bank bills (net) | 71 | 103 | 120 | 303 | 475 |
| Other items, net | -17 | 59 | -110 | -120 | -78 |
| Memorandum items: | (In percent; unless otherwise indicated) | | | | |
| Annual broad money growth | 31.3 | 55.6 | -3.0 | 25.1 | 25.4 |
| Annual growth of credit to nonbanks 2/ | 42.5 | 67.7 | 28.7 | 8.1 | 14.0 |
| Annual reserve money growth | 40.0 | 35.9 | 18.4 | 12.1 | 17.7 |
| Velocity | 2.4 | 1.9 | 2.6 | 2.2 | 2.0 |
| Broad money/reserve money | 3.9 | 4.5 | 3.7 | 4.1 | 4.3 |
| Total loans/deposits 2/ | 92.3 | 99.3 | 135.3 | 116.0 | 105.4 |
| Net international reserve (in millions of US$) 3/ | 660 | 938 | 520 | 575 | 739 |
| Net international reserve (in millions of US$) 4/ | 687 | 972 | 637 | 670 | 834 |

Sources: Mongolian authorities; and Fund staff projections.

1/ Valued at the programmed exchange rate and gold price.
2/ Includes claims on nonbank financial corporations, other financial corporations, and nonperforming loans.
3/ Does not include commercial bank foreign currency deposits and foreign currency current accounts held at the Bank of Mongolia.
4/ Includes commercial bank foreign currency deposits and foreign currency current accounts held at the Bank of Mongolia.

Table 4. Mongolia: Balance of Payments, 2006–2010

(In millions of U.S. dollars, unless indicated otherwise)

| | 2006 | 2007 | 2008<br>Prel. | 2009<br>Proj. | 2010<br>Proj. |
|---|---|---|---|---|---|
| Current account balance (including official grants) | 222 | 265 | -503 | -262 | -268 |
| Trade balance | 30 | -54 | -464 | -201 | -245 |
| Exports | 1,545 | 1,949 | 2,667 | 1,858 | 2,211 |
| *Of which* : copper concentrate | 635 | 812 | 836 | 430 | 478 |
| *Of which:* gold | 270 | 235 | 600 | 575 | 727 |
| Imports 1/ | -1,516 | -2,003 | -3,131 | -2,059 | -2,457 |
| *Of which:* oil imports | -423 | -560 | -966 | -388 | -542 |
| *Of which:* food imports | -180 | -266 | -391 | -273 | -329 |
| Services, net | 122 | 161 | -152 | -266 | -230 |
| Receipts | 486 | 574 | 469 | 319 | 343 |
| Income, net | -144 | -79 | -91 | -124 | -135 |
| Current transfers | 215 | 237 | 205 | 329 | 342 |
| General government | 112 | 133 | 74 | 240 | 230 |
| Other sectors | 103 | 104 | 131 | 89 | 112 |
| *Of which:* workers remittances | 77 | 84 | 100 | 50 | 72 |
| Capital and financial account | 100 | 236 | 396 | 150 | 373 |
| Direct investment 2/ | 290 | 360 | 682 | 317 | 330 |
| Portfolio investment | 1 | 75 | -13 | 1 | 1 |
| Trade credits, net | 28 | -13 | 72 | -53 | -37 |
| Currency and deposits, net | -244 | -268 | -293 | -259 | -245 |
| Loans, net 2/ | 37 | 45 | 114 | 377 | 441 |
| Other, net | -11 | 37 | -167 | -233 | -118 |
| Errors and omissions | 68 | -212 | -231 | 0 | 0 |
| Overall balance | 389 | 288 | -338 | -112 | 104 |
| Increase in gross official reserves (-) | -385 | -283 | 343 | -165 | -253 |
| Use of IMF credit (+) | -4 | -5 | -5 | -6 | -5 |
| Increase in net official reserves (-) | -389 | -288 | 338 | -33 | -164 |
| Financing need | 0 | 0 | 0 | 284 | 153 |
| Expected sources of financing | | | | | |
| Donors support | 0 | 0 | 0 | 145 | 60 |
| IMF: Prospective SBA | 0 | 0 | 0 | 139 | 93 |
| Memoranda items: | | | | | |
| Current account balance (in percent of GDP) | | | | | |
| Including official grants | 7.0 | 6.7 | -9.6 | -6.5 | -6.2 |
| Excluding official grants | 3.5 | 3.3 | -11.0 | -12.4 | -11.5 |
| Gross official reserves (end-period) | 718 | 1,001 | 657 | 822 | 1,075 |
| (In months of imports of goods and services) | 3.6 | 3.2 | 3.0 | 3.3 | 3.7 |
| (In months of nonmining imports) 3/ | 4.2 | 3.9 | 3.4 | 3.7 | 4.2 |
| Copper price (in US$ per ton) | 6,731 | 7,132 | 6,963 | 3,500 | 3,800 |
| Oil price (in US$ per barrel) | 64 | 71 | 97 | 44 | 52 |
| Gold price (in US$ per troy oz.) | 604 | 697 | 872 | 880 | 890 |

Sources: Mongolian authorities; and Fund staff projections.

1/ As of 2007 includes valuation adjustment from c.i.f. value to f.o.b.

2/ Includes the assumed financing of Oyu Tolgoi project of about $4 billion, financed by FDI and loans during 2008–2013. The project can be exploited in two stages: open pit section commencing in 2012 and a larger underground reserve in 2015.

3/ Nonmining imports of goods and services are approximated by total imports minus foreign direct investment.

## Table 5. Mongolia: Medium-Term Macroeconomic Framework, 2006–14

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|
| | | | Prel. | | | Proj. | | | |
| **Real sector** | | | | | | | | | |
| Nominal GDP (in billions of togrogs) | 3,715 | 4,600 | 6,130 | 6,294 | 7,180 | 8,097 | 9,571 | 11,453 | 12,721 |
| Per capita GDP (in U.S. dollars) 1/ | 1,224 | 1,503 | 1,981 | 1,498 | 1,584 | 1,729 | 1,984 | 2,305 | 2,487 |
| Real GDP (percent change) | 8.6 | 10.2 | 8.9 | 2.7 | 4.3 | 6.0 | 11.3 | 13.0 | 6.0 |
| GDP deflator (percent change) | 23.1 | 12.3 | 22.4 | 0.0 | 9.4 | 6.4 | 6.2 | 5.9 | 4.8 |
| Consumer prices (end-period; percent change) | 4.8 | 14.1 | 23.2 | 9.6 | 7.0 | 5.5 | 5.5 | 5.0 | 5.0 |
| **General government accounts** | | | | | | | | | |
| Total revenue and grants (percent of GDP) | 36.6 | 40.9 | 35.2 | 30.8 | 31.6 | 33.1 | 33.1 | 34.6 | 35.8 |
| Total expenditure and net lending (percent of GDP) | 28.5 | 38.0 | 40.2 | 36.8 | 35.6 | 36.3 | 35.5 | 34.4 | 34.0 |
| Current balance (percent of GDP) | 14.8 | 14.1 | 6.3 | 1.9 | 4.5 | 5.9 | 6.3 | 8.0 | 9.1 |
| Primary balance (percent of GDP) | 8.6 | 3.2 | -4.7 | -4.7 | -3.8 | -3.0 | -2.1 | 0.4 | 2.0 |
| Overall balance (percent of GDP) | 8.1 | 2.8 | -5.0 | -6.0 | -4.0 | -3.3 | -2.4 | 0.2 | 1.8 |
| Nonmineral overall balance (percent of GDP) | -2.4 | -11.5 | -15.1 | -9.9 | -9.1 | -8.8 | -8.1 | -8.9 | -8.1 |
| **Monetary sector** | | | | | | | | | |
| Broad money (percent change) | 31.3 | 55.6 | -3.0 | 25.1 | 25.4 | 16.4 | 18.2 | 19.7 | 16.9 |
| Velocity (GDP/M2) | 2.4 | 1.9 | 2.6 | 2.2 | 2.0 | 1.9 | 1.9 | 1.9 | 1.8 |
| **Balance of payments** | | | | | | | | | |
| Exports (percent change) | 44.6 | 26.1 | 36.8 | -30.3 | 19.0 | 9.1 | 35.0 | 57.4 | -6.8 |
| Imports (percent change) | 23.9 | 32.2 | 56.3 | -34.2 | 19.3 | 18.9 | 18.7 | 0.6 | -1.5 |
| Current account balance (including official transfers) | 7.0 | 6.7 | -9.6 | -6.5 | -6.2 | -11.0 | -1.9 | 15.5 | 17.0 |
| Gross official reserves (in millions of U.S. dollars) | 718 | 1001 | 657 | 822 | 1,075 | 1,223 | 1,366 | 1,448 | 1,669 |
| (In months of next year's imports of goods and services) | 3.6 | 3.2 | 3.0 | 3.3 | 3.7 | 3.7 | 4.1 | 4.3 | 4.4 |
| **Debt indicators** | | | | | | | | | |
| Total public debt (percent of GDP) | 45.4 | 39.4 | 33.1 | 46.8 | 47.8 | 46.3 | 41.3 | 35.8 | 33.3 |
| Domestic public debt (percent of GDP) | 1.0 | 0.5 | 0.0 | 0.0 | 0.0 | 0.4 | 0.2 | 0.0 | 0.0 |
| External public debt (percent of GDP) 2/ | 44.3 | 38.9 | 33.1 | 46.8 | 47.8 | 45.9 | 41.1 | 35.8 | 33.3 |
| (In millions of U.S. dollars) | 1,414 | 1,529 | 1,601 | 1,796 | 2,048 | 2,186 | 2,281 | 2,344 | 2,387 |
| **Memorandum items** | | | | | | | | | |
| Copper prices (U.S. dollar per ton) | 6,731 | 7,132 | 6,963 | 3,500 | 3,800 | 4,000 | 4,200 | 4,400 | 4,500 |
| Gold prices (U.S. dollar per ounce) | 604 | 697 | 872 | 880 | 890 | 905 | 925 | 940 | 945 |

Sources: Mongolian authorities; and Fund staff projections.

1/ Based on period average exchange rate.
2/ Includes prospective Fund credit under the SBA.

Table 6. Mongolia: External Financing Requirements and Sources, 2009–2011

(In millions of U.S. dollars)

| | 2009 | 2010 | 2011 |
|---|---|---|---|
| Gross financing requirements | 1,291 | 1,195 | 1,383 |
| External current account deficit (excl. official transfers) | 502 | 499 | 714 |
| Amortization of medium- and long-term debt | 93 | 54 | 127 |
| Repayment of arrears | 0 | 0 | 0 |
| Gross reserves accumulation (increase = +) | 165 | 253 | 147 |
| IMF repurchases and repayments | 6 | 5 | 4 |
| Other net capital outflows 1/ | 524 | 385 | 391 |
| | | | |
| Available financing | 1,007 | 1,042 | 1,383 |
| Grants | 240 | 230 | 186 |
| Disbursements to public sector | 96 | 144 | 197 |
| Disbursements to private sector | 355 | 337 | 600 |
| Foreign direct investment | 317 | 330 | 400 |
| | | | |
| Financing need | 284 | 153 | 0 |
| | | | |
| Financing | 284 | 153 | 0 |
| IMF: Prospective SBA | 139 | 93 | 0 |
| Donor support | 145 | 60 | 0 |

Sources: Mongolia authorities; and Fund staff projections.

1/ Includes all other net financial flows, and errors and omissions.

# Table 7. Mongolia: Indicators of Capacity to Repay the Fund, 2008–15 1/

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| | | Projections | | | | | | |
| Fund obligations based on existing credit (in millions of SDRs) | | | | | | | | |
| Principal | 3.2 | 4.2 | 3.0 | 2.4 | 1.6 | 1.6 | 0.0 | 0.0 |
| Charges and interest | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Fund obligations based on existing and prospective credit (in millions of SDRs) | | | | | | | | |
| Principal | 3.2 | 4.2 | 3.0 | 2.4 | 17.6 | 59.1 | 60.7 | 19.2 |
| Charges and interest | 0.1 | 1.1 | 2.4 | 3.0 | 2.9 | 1.9 | 0.8 | 0.1 |
| Total obligations based on existing and prospective credit | | | | | | | | |
| In millions of SDRs | 3.3 | 5.4 | 5.5 | 5.4 | 20.5 | 61.1 | 61.4 | 19.3 |
| In millions of US$ | 5.0 | 8.1 | 8.3 | 8.2 | 31.3 | 93.6 | 94.6 | 29.7 |
| In percent of gross international reserves | 0.8 | 1.0 | 0.8 | 0.7 | 2.3 | 6.5 | 5.7 | 1.5 |
| In percent of exports of goods and services | 0.2 | 0.4 | 0.3 | 0.3 | 0.8 | 1.7 | 1.8 | 0.4 |
| In percent of debt service 2/ | 4.6 | 8.7 | 10.8 | 9.3 | 21.8 | 51.7 | 50.7 | 20.4 |
| In percent of GDP | 0.1 | 0.2 | 0.2 | 0.2 | 0.6 | 1.4 | 1.3 | 0.4 |
| In percent of quota | 6.4 | 10.5 | 10.7 | 10.5 | 40.1 | 119.5 | 120.2 | 37.7 |
| Outstanding Fund credit | | | | | | | | |
| In millions of SDRs | 13.0 | 100.7 | 159.0 | 156.6 | 139.0 | 79.8 | 19.2 | 0.0 |
| In millions of US$ | 19.7 | 152.1 | 240.8 | 238.0 | 212.2 | 122.4 | 29.5 | 0.0 |
| In percent of gross international reserves | 3.0 | 18.5 | 22.4 | 19.5 | 15.5 | 8.5 | 1.8 | 0.0 |
| In percent of exports of goods and services | 0.6 | 7.0 | 9.4 | 8.5 | 5.7 | 2.2 | 0.6 | 0.0 |
| In percent of debt service 2/ | 18.1 | 163.1 | 315.6 | 270.2 | 148.0 | 67.6 | 15.8 | 0.0 |
| In percent of GDP | 0.4 | 3.8 | 5.6 | 5.0 | 3.8 | 1.9 | 0.4 | 0.0 |
| In percent of quota | 25.4 | 197.1 | 311.2 | 306.4 | 271.9 | 156.2 | 37.5 | 0.0 |
| Net use of Fund credit (in millions of SDRs) | -3.2 | 87.8 | 58.3 | -2.4 | -17.6 | -59.1 | -60.7 | -19.2 |
| Disbursements 3/ | 0.0 | 92.0 | 61.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Repayments and repurchases | 3.2 | 4.2 | 3.0 | 2.4 | 17.6 | 59.1 | 60.7 | 19.2 |
| Memorandum items: | | | | | | | | |
| Exports of goods and services (in millions of US$) | 3,136 | 2,177 | 2,554 | 2,792 | 3,700 | 5,651 | 5,354 | 6,888 |
| Gross international reserves (in millions of US$) | 657 | 822 | 1,075 | 1,223 | 1,366 | 1,448 | 1,669 | 1,968 |
| Debt service (in millions of US$) 2/ | 109 | 93 | 76 | 88 | 143 | 181 | 186 | 146 |
| Quota (millions of SDRs) | 51 | 51 | 51 | 51 | 51 | 51 | 51 | 51 |

Sources: Fund staff estimates and projections.

1/ Includes prospective SBA purchase of SDR 153.3 million (300 percent of quota).

2/ Total public debt service, including IMF repurchases and repayments.

3/ The purchases are assumed to take place on the first day of the following month after each review.

Table 8. Mongolia: Reviews and Disbursements under the Proposed 18-month Stand-By Arrangement

| | Amount of Purchase | | |
|---|---|---|---|
| Date | In percent of quota | In SDRs | Condition |
| [April 1, 2009] | 100 | 51,100,000 | Approved Stand-By Arrangement. |
| June 15, 2009 | 50 | 25,550,000 | Completion of the first review and observance of end-April 2009 performance criteria. |
| September 15, 2009 | 30 | 15,330,000 | Completion of the second review and observance of end-June 2009 performance criteria. |
| December 15, 2009 | 30 | 15,330,000 | Completion of the third review and observance of end-September 2009 performance criteria. |
| March 15, 2010 | 30 | 15,330,000 | Completion of the fourth review and observance of end-December 2009 performance criteria. |
| June 15, 2010 | 30 | 15,330,000 | Completion of the fifth review and observance of end-March 2010 performance criteria. |
| September 15, 2010 | 30 | 15,330,000 | Completion of the sixth review and observance of end-June 2010 performance criteria. |
| Total | 300 | 153,300,000 | |

Table 9. Mongolia: Indicators for Vulnerability and Financial Soundness, 2005–2008

| | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|
| Key economic and market indicators | | | | |
| Real GDP growth (in percent) | 7.3 | 8.6 | 10.2 | 8.9 |
| CPI inflation (end-period; in percent) | 9.2 | 4.8 | 14.1 | 23.2 |
| Short-term interest rate (end-period; in percent) 1/ | 3.7 | 5.1 | 8.4 | 9.8 |
| Exchange rate, Togrog/US$ (end-period) | 1,221 | 1,165 | 1,170 | 1,268 |
| External sector | | | | |
| Exchange rate regime (end-period) | Floating | Pegged | Pegged | Other managed |
| Current account balance (in percent of GDP) 2/ | 1.3 | 7.0 | 6.7 | -9.6 |
| Direct investment (in percent of GDP) | 11.2 | 9.2 | 9.2 | 13.0 |
| Export growth (US$ value, percent change) | 22.9 | 44.6 | 26.1 | 36.8 |
| Real effective exchange rate (end-period; 2000=100) | 100.6 | 106.1 | 111.8 | 133.7 |
| Gross international reserves (in US$ million) | 333 | 718 | 1,001 | 657 |
| Public external debt (in percent of GDP) | 59.7 | 44.3 | 38.9 | 33.1 |
| General government (in percent of GDP) | | | | |
| Overall balance | 2.6 | 8.1 | 2.8 | -5.0 |
| Primary balance | 3.4 | 8.6 | 3.2 | -4.7 |
| Foreign financing (net) | 3.2 | 2.3 | 1.0 | 0.7 |
| Domestic bank financing (net) | -3.3 | -11.8 | -3.8 | 4.2 |
| Financial sector (in percent) | | | | |
| Capital adequacy ratio | | | | |
| Tier I capital ratio | 15.8 | 15.6 | 11.8 | 8.6 |
| Total regulatory capital/risk-weighted assets | 18.2 | 18.1 | 14.2 | 11.4 |
| Total regulatory capital/total assets | 13.6 | 13.6 | 11.2 | 9.3 |
| Asset quality | | | | |
| Foreign exchange loans/total loans | 47.0 | 46.7 | 33.2 | 33.6 |
| NPLs/total loans | 5.6 | 4.7 | 3.2 | 7.1 |
| Provisions/NPLs | 99.2 | 87.8 | 87.1 | 78.2 |
| Earnings and profitability | | | | |
| Return on (average) assets | 2.2 | 2.7 | 2.5 | -1.6 |
| Interest margin/gross income | 30.9 | 27.8 | 28.3 | 26.5 |
| Non-interest expenses/gross income | 54.3 | 55.4 | 46.5 | 74.7 |
| Personnel expenses to non-interest expenses | 28.5 | 15.5 | 20.4 | 11.7 |
| Liquidity | | | | |
| Loans to deposits | 89.7 | 95.6 | 101.3 | 137 |
| Liquid assets/total assets | 36.0 | 37.9 | 28.1 | 21.8 |
| Liquid assets/short-term liabilities 3/ | 37.7 | 38.2 | 37.0 | 31.8 |

Sources: Mongolian authorities; and Fund staff estimates.

1/ Yield of 14-day bills until 2006 and of 7-day bills for 2007.

2/ Including official transfers.

3/ Short-term liabilities are defined as the sum of current account and demand deposits.

## ATTACHMENT I

March 17, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

Mongolia has been buffeted by a dramatic shock to its terms of trade, a direct product of the deepening global economic crisis. Growth has stalled and inflation remains far too high.

To tackle these problems, the government of Mongolia has adopted a robust package of economic policies designed to restore health to the country's fiscal finances, allow for a more flexible exchange rate, and address weaknesses in the banking system. We are cognizant of the particular burden this needed adjustment will have on the poor and the government is committed to putting in place a more effective system of social support to protect those Mongolian citizens that are most vulnerable to the coming economic downturn.

The attached Memorandum of Economic Policies describes the economic policies and objectives of the Government of Mongolia for the remainder of 2009 and for 2010, in support of which the government requests a Stand-By Arrangement with the Fund for a period of 18 months, in the amount of SDR 153.3 million (equivalent to US$224 million or 300 percent of quota). The government has also secured significant support from the international community. The government is considering the possibility of transitioning from this emergency support, once conditions have sufficiently stabilized, to a program supported by the concessional resources of the IMF.

The government believes that the policies described in the memorandum will put Mongolia's economy back on a path of sustainable and equitable growth. Nevertheless, the government stands ready to take all necessary policy measures to ensure the attainment of its economic and social objectives.

During the period of the arrangement, the authorities of Mongolia will maintain the usual close policy dialogue with the Fund. Further, to enhance transparency, the Government has authorized the publication of its Memorandum of Economic Policies.

Sincerely yours,

| | |
|---|---|
| /s/ | /s/ |
| S. Bayartsogt | L. Purevdorj |
| Minister of Finance | Governor of Bank of Mongolia |

Attachments
Memorandum of Economic Policies
Technical Memorandum of Understanding

## MEMORANDUM OF ECONOMIC POLICIES

*Mongolia's recent economic and social progress is under threat from a dramatic worsening in the prices of key exports, a rapid growth slowdown, and emerging strains in the banking system. The current account and fiscal deficits have widened, international reserves have been drawn down, there are increased pressures on the currency, and the banking system has been weakened. Without rapid policy correction, Mongolia faces severe fiscal and balance of payment problems in the very near future.*

*The objective of our program is to build a path back to strong, sustainable and equitable growth with low inflation. The core of our program relies upon four key planks: restoring health to government finances; allowing the exchange rate to adjust flexibly to its natural equilibrium while safeguarding international reserves; bolstering confidence in the banking system; and protecting the poor during this period of economic adjustment. The quantitative targets and structural policies underlying our program are summarized in Tables 1 and 2.*

### I. MACROECONOMIC OUTLOOK

1. **The economic outlook for this year will be challenging**. Growth is projected to slow to 2¾ percent in 2009 reflecting weak exports and falling domestic demand. Inflation should, however, decline rapidly (from 23 percent at end-2008 to 9 percent by end-2009). Prudent policies and a flexible exchange rate should allow the current account deficit to stabilize at around 6 percent of GDP, albeit with a continued decline in exports.

2. **Although we anticipate an economic recovery will begin in early 2010**. Assuming a recovery in global economic conditions and an improvement in mineral prices we expect growth to turn around in 2010, reaching 4¼ percent, with a continued decline in inflation. Given the unusual uncertainty surrounding global economic prospects, there are, however, significant risks to this outlook.

### II. FISCAL POLICY

3. **The large drop in our mineral revenues necessitates bold fiscal measures to bring government finances back to a sustainable level**. The government's aim is to constrain the general government deficit to 6 percent of GDP in 2009. This implies around 5 percent of GDP in adjustment in the nonmineral balance, offsetting much of the loss of mineral revenues that we expect for this year. The process of fiscal adjustment will continue in 2010 and beyond; we expect a further reduction of the fiscal deficit to 4 percent of GDP in 2010.

Key Fiscal Targets
(In percent of GDP)

| | 2008 | 2009 |
|---|---|---|
| Revenue | 35.2 | 30.8 |
| Spending | 40.2 | 36.8 |
| Deficit | -5.0 | -6.0 |
| Nonmineral deficit | -15.1 | -9.9 |

4. **The fiscal adjustment is centered primarily around expenditure restraint**. We have taken tough decisions to prioritize government outlays. The biggest savings will come from postponement of domestically financed capital expenditure plans, but also from lower current expenditure such as cuts in purchases of goods and services, a wage and hiring freeze and the elimination of bonuses, and lower untargeted transfers. These measures are estimated to reduce spending by almost 5 percent of GDP. Parliament will pass a revised budget outlining these changes in spending priorities. In light of the uncertainty about the value of mineral wealth the government has decided to postpone plans to distribute its mineral wealth in cash. Instead, it will look at other options to share Mongolia's mineral wealth among the population that will be geared towards reducing poverty and improving essential infrastructure but will ensure these are fully consistent with a steady reduction of the fiscal deficit over the medium term.

5. **We will take action on the revenue side also**. In particular, we have already increased excise taxes on petroleum, beer and tobacco products as well as some increases in customs duties. In total, these measures are expected to permanently increase revenues by around ¼ percent of GDP per year. In addition, the government will use its voting rights in Erdenet, the main copper exporter, to ensure that all taxes and dividends are collected on schedule. In the unlikely event there are delays in the receipt of these revenues, the government is committed to taking additional steps to offset the shortfall to ensure the 2009 deficit target is fully achieved.

6. **The government is acutely aware of the pressure the current global crisis is placing on Mongolia's most vulnerable citizens**. High inflation and a slowing economy will doubtless be most felt by those that are currently living close to or below the poverty line. The government is committed to supporting these groups. To that end, by end-June 2009 we will design, in collaboration with the Asian Development Bank and the World Bank, a comprehensive overhaul of the existing system of social transfer programs. The goal will be to better target these programs towards the very poor and increase the support that poor households receive. The improved transfer system will be incorporated into the 2010 Budget.

7. **Despite the substantial adjustment in the fiscal position, financing the budget will be difficult, particularly in the first half of 2009**. As a stop-gap measure, we have requested that Parliament approve the use of contingency savings held in the Development Fund, excluding certain allowances for wheat and petroleum reserves. In addition, we have approached the donor community and, as a sign of their confidence in our policy intentions, have secured commitments for an additional US$160 million in budget support over the course of the next two years. We anticipate further pledges from other bilateral donors in the coming months that will secure the financing needed for this year and next. We are committed to take measures to address any donor shortfall and mitigate risks to the program.

8. **To maintain fiscal discipline on a sustained basis we intend to submit to Parliament a draft Fiscal Responsibility Law by end-2009**. The large expansion in fiscal spending during the copper price boom of recent years indicates the need for a stronger institutional framework to guard against painfully procyclical fiscal policy. Our intention is to institute, with advice from Fund staff and the World Bank, a stronger budgetary framework that will guarantee sound fiscal management and constrain this and future governments through a straightforward fiscal rule.

9. **We are in the process of discussing investment agreements for two large mining projects with foreign investors**. We intend to save any prepayments from these agreements to finance any donor financing shortfalls in 2009, for budget financing in 2010 and other potential costs.

## III. Exchange Rate and Monetary Policy

10. **The Bank of Mongolia is committed to maintaining a flexible exchange rate to facilitate the needed adjustment to the large terms of trade shock while safeguarding its international reserves**. Consistent with this objective, the Bank of Mongolia intends to build up its international reserves during the course of the program and will maintain a sufficiently tight monetary policy to prevent any undue overshooting of the exchange rate and to keep inflation on a downward path. We recognize that interest rates would need to rise in the coming months to protect the currency. In the event that net international reserves fall by more than US$30 million during the past 30 days, the authorities will consult with Fund staff on the appropriate policy response.

11. **As part of a managed float exchange rate regime, developing the foreign exchange market will be essential**. The Bank of Mongolia and the government intend to revise the relevant laws to ensure Erdenet—the main copper exporter—begins paying its taxes in local currency. In the meantime, the central bank is working to establish an auction mechanism to allocate foreign exchange, improving price discovery and the transparency of foreign currency sales. All foreign exchange transactions between the central bank and commercial banks will be undertaken through this auction mechanism. Foreign exchange transactions involving all government accounts will be conducted only with the central bank. The central bank will also establish a screen-based system for interbank foreign exchange transactions by end-June 2009 and begin trading foreign currency at the market-determined quotes. Due to recent balance of payments pressures, the central bank has recently begun to ration its foreign exchange sales to critical imports, representing an Article VIII restriction. To the extent the introduction of the auction mechanism gives rise to exchange restrictions or MCPs, we will seek IMF Board approval of these restrictions, as these will be imposed for balance of payments reasons and nondiscriminatory. These restrictions will be lifted by June 1.

12. **The central bank will strengthen and streamline its monetary policy instruments**. The central bank will consolidate the central bank bill issuance at the three-month maturity by end-June 2009. It will also adjust rates on these instruments consistent with monetary policy objectives. To ensure that the central bank's lender of last resort facilities are consistent with its monetary policy and tapped only by illiquid but solvent banks, the central bank will streamline its liquidity facilities.

## IV. Strengthening the Banking System

13. **Restoring the confidence in the banking system is a top priority**. We have already revised and clarified the existing deposit guarantee to cover current accounts, savings accounts, time deposits and interbank deposits. However, in order to prevent abuse and unnecessary fiscal costs, deposits of related persons—as defined in the banking law—and deposits of holders of subordinated debts will be excluded from this guarantee.

14. **We have also prepared a comprehensive plan to strengthen banking supervision and address potential weaknesses in banks**:

- The central bank has asked all banks to increase their risk-weighted capital adequacy ratio (CAR) to 12 percent by end-2009. By end-April 2009 banks will submit capital reinforcement plans under different assumptions about the future deterioration of asset quality.

- The central bank will increase the number of on-site supervisors, complete an updated on-site examination of the five largest banks by June 2009, and intensify off-site monitoring.

- The central bank will identify any problem banks and formulate a supervisory enforcement plan by end-June 2009 to ensure that weaker banks do not threaten financial stability.

- The central bank will strengthen its fit and proper review of shareholders and management and clearly identify beneficial owners in the case of complex bank ownership structures. The government and the central bank will ensure that banks' external auditors are appropriately qualified and experienced.

15. **To further strengthen the legal framework for the banking system, the government, the central bank and the Financial Regulatory Commission will submit a revised Banking Law and other pertinent laws and legislations to the parliament by end-June 2009**. The revisions will include (i) strengthened prompt corrective action clauses, including an increase in penalties for noncompliance; (ii) requiring consolidated supervision; (iii) an improved bank resolution framework that more clearly defines the roles of conservator and liquidator; (iv) legal protection for bank and non-bank supervisors; (v) a

more clear definition of "group of connected parties;" and (vi) reinforced prudential supervision requirements. The government will also improve, with advice from the World Bank, the laws on foreclosure of collateral which overly protect borrowers and impede loan recovery.

## V. Other Policies

16. **Safeguards Assessment**. A safeguards assessment will be completed prior to the first review of the stand-by arrangement. We will authorize the Bank of Mongolia's external auditors to provide Fund staff with all necessary information, including management letters, information related to correspondent banks, and foreign reserves.

17. **Arrears**. The government and the Bank of Mongolia are committed to resolve its remaining bilateral official arrears by seeking an agreement on arrears clearance with creditors. To that end, the government has already made contacts with creditors to begin the process of resolving these arrears.

Table 1. Mongolia: Quantitative Performance Criteria (PC) and Indicative Targets (IT)

| | 12/31/2008 Actual | 4/30/2009 | 6/30/2009 | 9/30/2009 | 12/31/2009 |
|---|---|---|---|---|---|
| Performance criteria 1/ | | | | | |
| Net international reserves (NIR) of the Bank of Mongolia (BOM) (floor, eop stock, in million US$) 2/ | 520 | 335 | 315 | 455 | 575 |
| Net domestic asset (NDA) of the BOM (ceiling, eop stock, in billion togrog) 3/ | -172 | -32 | 14 | -195 | -332 |
| Net-bank credit to general government (NBCGG) from the banking system (ceiling, cummulative from the beginning of the fiscal year, in billion togrog) 3/ | 206 | 105 | 156 | 72 | 81 |
| New nonconcessional external debt maturing in one year or more, contracted or guaranteed by the government or the BOM (ceiling, eop stock, in million US$). | 0 | 200 | 200 | 200 | 200 |
| New nonconcessional external debt maturing in less than one year, contracted or guaranteed by the government or the BOM (ceiling, eop stock, in million US$). | 0 | 0 | 0 | 0 | 0 |
| Accumulation of new external payment arrears (ceiling, eop, in million US$). | … | 0 | 0 | 0 | 0 |
| Accumulation of domestic payment arrears (ceiling, eop, in billion togrog). | 0 | 0 | 0 | 0 | 0 |
| Indicative targets | | | | | |
| General government fiscal deficit (ceiling, cummulative since the beginning of fiscal year, in billion togrog). | 305 | 250 | 325 | 290 | 380 |
| Memorandum items: | | | | | |
| Support from bilateral and multilateral donors excluding IMF (cummulative since the beginning of the year, in million US$) | 0 | 0 | 30 | 80 | 145 |
| Program exchange rate (togrog/U.S. dollar) | 1,268 | 1,560 | 1,560 | 1,560 | 1,560 |
| U.S. dollar per SDR | 1.521 | 1.509 | 1.509 | 1.509 | 1.509 |
| Monetary gold price (U.S. dollar/ounce) | 872 | 880 | 880 | 880 | 880 |

1/ Evaluated at the programmed exchange rate.

2/ The NIR does not include commercial bank foreign currency deposits and foreign currency current accounts held at the Bank of Mongolia. The floor on NIR will be adjusted upward (downward) by the amount of support from bilateral and multilateral donors (excluding IMF) in excess (short) of the programmed level. The floor will also be adjusted upward by the amount of nonconcessional borrowing disbursed during the program period.

3/ The ceiling on NDA and NBCGG, respectively, will be adjusted downward (upward) by the amount of support from bilateral and multilateral donors (excluding IMF) in excess (short) of the programmed level. The ceilings will also be adjusted downward by the amount of nonconcessional debt disbursed during the program period.

Table 2. Mongolia: Prior Actions (PA) and Structural Benchmarks (SB)

| Actions | Type | Date |
|---|---|---|
| The passage by the parliament of the 2009 budget amendment consistent with program targets | PA | |
| Appointment of a reputable external auditor to make diagnostic assessment on the portfolio and off-balance sheet transactions of Anod Bank. | PA | |
| Revision and clarification of blanket deposit guarantee by including current accounts as well as savings accounts, time deposits and interbank deposits; and by excluding all deposits of related persons to the bank as defined in the banking law, and deposits of holders of subordinated debt. | PA | |
| Establishment of a foreign currency auction mechanism at the Bank of Mongolia. | SB | 4/1/2009 |
| Revising relevant laws to require Erdenet to pay taxes in togrog. | SB | 6/30/2009 |
| Establishment of screen-based system for inter-bank foreign exchange transactions. | SB | 6/30/2009 |
| Announcement of a resolution plan for Anod Bank a based on the diagnostic assessment of the external auditor. | SB | 6/30/2009 |
| A comprehensive review of transfer programs resulting in a revision of the relevant laws to streamline transfer programs and safeguard the social safety. | SB | 6/30/2009 |
| Submission to the parliament of a revised banking law and other pertinent laws and legislations that include: (i) strengthened prompt corrective action clauses including an increase in penalties for noncompliance; (ii) requiring consolidated supervision; (iii) an improved bank resolution framework that more clearly defines the roles of the conservator and liquidator; (iv) legal protection for bank and non-bank supervisors; (v) a more clear definition of "group of connected parties;" and (vi) reinforced prudential supervision requirements. | SB | 6/30/2009 |
| The submission to parliament of Fiscal Responsibility Law consistent with recommendations of Fund technical assistance. | SB | 12/31/2009 |

## MONGOLIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. During the period of the arrangement, the authorities of Mongolia will maintain the usual close policy dialogue with the Fund. In this regard, the authorities are committed to take any additional measures that may be needed to ensure that the program remains on track. They will consult with the IMF on the adoption of measures, and in advance of revisions to the policies contained in the MEP, in accordance with the IMF's policies on such consultation. Further, the Government of Mongolia and the Bank of Mongolia will provide the Fund with such information as it requests on policy implementation and achievement of the program objectives.

2. The program will be monitored through quantitative performance criteria, indicative targets, structural benchmarks, and quarterly reviews (Table 1). This memorandum sets out the definitions for quantitative performance criteria and indicative targets under which Mongolia's performance under the program supported under a Stand-by Arrangement (SBA) will be assessed. Monitoring procedures and reporting requirements are also specified. The first review will take place on or after June 15, 2009, and the second review on or after September 15, 2009.

### I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

3. Performance criteria for end-April 2009, end-June 2009, end-September 2009, end-December 2009, end March 2010, and end June-2010 have been established with respect to:

- floors on the level of net international reserves of the Bank of Mongolia (BOM);
- ceilings on the level of net domestic assets of the BOM;
- ceilings on the level of net bank credit to general government;
- ceilings on the contracting and guaranteeing by the central government or the BOM of new medium- and long-term external debt; and
- ceilings on the contracting or guaranteeing by the central government or the BOM of new short-term external debt.

4. Performance criteria that are applicable on a continuous basis have been established with respect to

- ceilings on accumulation of new external payment arrears of the central government and the BOM; and

- ceiling on accumulation of domestic payment arrears of the central government.

5. Indicative targets for end-April 2009, end-June 2009, end-September 2009, end-December 2009, end-March 2010, end-June 2010 have been established with respect to:

- ceilings on the general government fiscal deficit;

## II. Institutional Definitions

6. The general government includes all units of budgetary central government, social security funds, extrabudgetary funds, and local governments.

7. The domestic banking system is defined as the BOM, the existing and newly licensed commercial banks incorporated in Mongolia and their branches.

## III. Monetary Aggregates

8. **Valuation**. Foreign currency-denominated accounts will be valued in togrogs at the program exchange rate between the togrog and the U.S. dollar Tog 1,560 per U.S. dollar. Foreign currency accounts denominated in currencies other than the U.S. dollar, excluding SDRs, will first be valued in U.S. dollars at actual end-of-period exchange rates used by the BOM to calculate the official exchange rates. SDR-denominated accounts will be valued at the program exchange rate of SDR 1=US$1.51. Monetary gold will be valued at US$880 per ounce.

### A. Reserve Money

9. Reserve money consists of currency issued by the BOM (excluding BOM holdings of currency) and commercial banks' deposits held with the BOM.

### B. Net International Reserves of the BOM

10. A floor applies to the level of net international reserves (NIR) of the BOM. The floor on NIR will be adjusted upward (downward) by the amount of support from bilateral and multilateral donors (excluding IMF) in excess (short) of the programmed level. The floor on NIR will also be adjusted upward by the amount of nonconcessional borrowing disbursed during the program period.

11. NIR will be calculated as gross international reserves less international reserve liabilities. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the BOM shall be valued at program exchange rates and gold price as described on paragraph 8 above.

12. **Gross international reserves** of the BOM are defined as the sum of

- monetary gold holdings of the BOM;
- holdings of SDRs;
- Mongolia's reserve position in the IMF; and
- foreign currency assets in convertible currencies held abroad that are under the direct and effective control of the BOM and readily available for intervention in the foreign exchange market or the direct financing of balance of payments imbalances and are of investment grade or held with an investment-grade institution.

Excluded from the definition of gross reserves are commercial bank foreign currency deposits held at the Bank of Mongolia, commercial bank foreign currency current accounts held at the Bank of Mongolia, any foreign currency claims on residents, capital subscriptions in international institutions, assets in nonconvertible currencies, and gross reserves that are in any way encumbered or pledged, including, but not limited to, reserve assets used as collateral or guarantee for third-party external liabilities.

13. **International reserve liabilities** of the BOM are defined as the sum of

- all outstanding liabilities of Mongolia to the IMF; and
- any foreign convertible currency liabilities of the BOM to nonresidents with an original maturity of up to and including one year.

## C. Net Domestic Assets of the BOM

14. A ceiling applies to the level of net domestic assets (NDA) of the BOM. The ceiling on NDA will be adjusted downward (upward) by the amount of support from bilateral and multilateral donors (excluding IMF) in excess (short) of the programmed level. The ceiling on NDA will be adjusted downward by the amount of nonconcessional debt disbursed during the program period.

15. NDA will be calculated as the difference between reserve money and the sum of NIR and other net foreign assets (ONFA) of the BOM.

16. ONFA is defined as the sum of (i) BOM's monetary gold pledged as collateral for external loans to domestic private companies and (ii) other net foreign assets of the BOM, including the difference between accrued interest receivables on gross international reserves of the BOM and accrued interest payables on international reserve liabilities of the BOM and deposits of international financial institutions.

### D. Net Bank Credit to the General Government

17. A ceiling applies to the net bank credit flows to the general government (NBCGG) measured cumulatively from the beginning of the year. The ceiling on NBCGG will be adjusted downward (upward) by the amount of support from bilateral and multilateral donors (excluding IMF) in excess (short) of the programmed level. The ceiling will also be adjusted downward by the amount of nonconcessional debt disbursed during the program period.

18. **NBCGG** is defined as the sum of (i) net borrowing from the BOM (ways and means advances, loans, holdings of restructuring bonds, holdings of treasury bills and other government bonds, and the government liabilities to the IMF minus deposits) and (ii) net borrowing from commercial banks (loans, advances, holdings of restructuring bonds, and holdings of treasury bills and other government bonds minus deposits).

## IV. Fiscal Aggregates

### A. Fiscal Deficit

19. An indicative ceiling target applies to the general government fiscal deficit measured cumulatively from the beginning of the year.

20. Fiscal deficit is defined as total general government revenue and grants minus total general government expenditure and net-lending.

## V. Domestic Payment Arrears

21. A continuous performance criterion applies to the nonaccumulation of domestic payment arrears by the central government. Domestic payments are in arrears when the payment is not made on the due date, as specified in the regulation.

## VI. External Debt

### A. Medium- and Long-Term External Debt

22. A ceiling applies to the contracting and guaranteeing by the central government, the BOM, or other agencies on behalf of the central government of new debt with nonresidents with original maturities of over one year. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been received.

23. The definition of debt, for the purposes of the program, is set out in Executive Board Decision No. 12274, Point 9, as revised on August 24, 2000 (see Annex I).

24. Excluded from the ceiling are (i) the use of Fund resources; (ii) lending from the World Bank, the Asian Development Bank, and the International Fund for Agricultural Development; (iii) debts incurred to restructure, refinance, or prepay existing debts, to the extent that such debt is incurred on more favorable terms than the existing debt; (iv) concessional debts; (vi) any togrog-denominated treasury bill and government bond holdings by nonresidents.

25. For program purposes, the guarantee of a debt arises from any explicit legal obligation of the central government, the BOM, or other agencies on behalf of the central government to service a loan in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the central government, the BOM, or other agencies on behalf of the central government to finance a shortfall incurred by the loan recipient.

26. For program purposes, a debt is concessional if it includes a grant element of at least 35 percent, calculated as follows: the grant element of a debt is the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The NPV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the Organization for Economic Cooperation Development (OECD). For debt with a maturity of at least 15 years, the ten-year-average CIRR will be used to calculate the NPV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD would continue to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more). Loans provided by a private entity will not be considered concessional unless accompanied by a grant or grant element provided by a foreign official entity, such as both components constitute an integrated financing package with a combined grant element equal to at least 35 percent.

## B. Short-Term External Debt

27. A ceiling applies to the contracting and guaranteeing by the central government, the BOM, or other agencies on behalf of the central government of new debt with nonresidents with original maturities of one year or less. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been received.

28. For program purposes, the definition of debt is set out in Executive Board Decision No. 12274, Point 9, as revised on August 24, 2000 (see Annex I).

29. Excluded from the ceiling are (i) debts classified as international reserve liabilities of the BOM; (ii) debts to restructure, refinance, or prepay existing debts; (iii) togrog-denominated treasury bills, government bonds, and BOM bills held by nonresidents; and (iv) normal import financing. A financing arrangement for imports is considered to be "normal" when the credit is self-liquidating.

## VII. External Payment Arrears

30. A continuous performance criterion applies to the nonaccumulation of external payments arrears on external debt contracted or guaranteed by the general government or the BOM. External payments arrears consist of external debt-service obligations (principal and interest) that have not been paid at the time they are due, as specified in the contractual agreements. However, overdue debt and debt service obligations that are in dispute will not be considered as external payments arrears for the purposes of program monitoring.

## VIII. Performance Criterion of The Modification of Multiple Currency Practices

31. The performance criterion on the introduction or modification of multiple currency practices (MCP) will exclude any modifications as part of the introduction of the foreign exchange auction system, in line with staff advice, that may give rise to a MCP.

## IX. Data Provision

32. The authorities have committed to using the best available data, so that any subsequent data revisions will not lead to a breach of a performance criterion. All revisions to data will be promptly reported to the Fund's Resident Representative. The likelihood of significant data changes, including definitional changes, will be communicated to Fund staff as soon as the risk becomes apparent to the authorities.

33. Data required to monitor performance under the program, including those related to performance criteria and indicative targets, will be provided electronically or in hard copy to the Fund's Resident Representative by the 20$^{th}$ day of each month, unless otherwise indicated. The data to be reported are listed below, and the reporting responsibilities are indicated in parentheses.

### A. Monetary Data (BOM)

- The monetary survey, the balance sheet of the BOM, and the consolidated balance sheet of the commercial banks. Data will be provided on a monthly basis, with the exception of the balance sheet of the BOM, which will be provided on a weekly basis within five working days of the end of the respective week.

- Net international reserves and interventions of the BOM in the foreign exchange market on daily basis.

- Interest rates and volume on standing facilities and market operations on a weekly basis within five working days of the end of the respective week.

- A detailed breakdown of net credit to government from the BOM and the commercial banks.

- Stock of monetary gold in both thousands of fine troy ounces and U.S. dollars. If the BOM engages in monetary gold transactions or employs any other accounting rate, directly or implicitly, for valuing gold assets, this information will be reported to the Fund. Any increase in monetary gold through purchases from domestic sources and refining of nonmonetary gold held or purchased by the BOM will also be reported (both prices and volumes). Any liabilities that are guaranteed or otherwise backed by gold will be reported to the Fund.

- A detailed breakdown of "other items net" for both the BOM and the commercial banks, including, inter alia, all valuation changes in net international reserves and net other foreign assets arising from exchange rate changes and/or revaluation of gold.

- Outstanding balances of all deposit accounts of the general government in commercial banks, including those of the extrabudgetary funds.

- Outstanding balances of any new deposit accounts of the general government opened in addition to the existing ones for grants and loans received from multilateral or bilateral donors, including associated counterpart funds.

- A bank-by-bank list of required reserves and actual reserves.

- Results of each central bank bills auction within five working days of each auction, including amount of bills offered, amount demanded, amount sold to each bank, announced rates, and cut-off rates.

## B. Fiscal Data (Ministry of Finance (MOF))

- Consolidated accounts of the central, local, and general government, including detailed data on tax, nontax, and capital revenues, current and capital expenditures, net lending, and financing. Financing components should be separated into foreign sources (cash, project, and program loans) and domestic sources (bank and nonbank).

- Classified transactions of all social insurance funds.

- Domestic payment arrears of the general government.

- Noninterest outstanding payables by each subsector of the general government, including the social security funds, with a detailed breakdown by major categories and remaining maturity.

- Results of each treasury bills auction within five working days of each auction, including amount of bills offered, amount demanded, amount sold to each bank and nonbanks, and the average yield in percent per month.

### C. External Sector Data (BOM and MOF)

- Complete list of new contracts for the execution of public investment projects, which have been signed or are under negotiation with foreign or domestic entities, including details on the amounts, terms, and conditions of current or future debt or nondebt obligations arising from these contracts.

- Outstanding stock, disbursements, amortization, and interest payments of short-term external debt contracted or guaranteed by the government or the BOM by creditor in original currency and U.S. dollars.

- Outstanding, disbursements, amortization, and interest payments of medium- and long-term external debt contracted or guaranteed by the government or the BOM by creditor in original currency and U.S. dollars.

- Daily midpoint exchange rates of the togrog against the U.S. dollar, including the official, interbank, and parallel market exchange rates (BOM).

- Arrears on the external debt contracted or guaranteed by the government or the BOM by creditor in original currency and U.S. dollars.

### D. Other Data (National Statistical Office)

- The monthly consumer price index and a detailed breakdown by major categories of goods and services included in the consumer basket.

- The NSO's monthly statistical bulletin, including monthly export and import data.

## ANNEX I. GUIDELINES ON PERFORMANCE CRITERIA WITH RESPECT TO FOREIGN DEBT

Excerpt from Executive Board Decision No. 12274, as revised on August 24, 2000

9. (a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in point 9 (a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

INTERNATIONAL MONETARY FUND
INTERNATIONAL DEVELOPMENT ASSOCIATION

MONGOLIA

# Joint IMF/World Bank Debt Sustainability Analysis Under the Debt Sustainability Framework for Low-Income Countries[1]

Approved by Nigel Chalk and Anthony Boote (IMF)
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March 18, 2009

*The staff's debt sustainability analysis shows that Mongolia is at low risk of external debt distress. Although the debt ratios will rise significantly over the next two years as the government receives front-loaded foreign financing to recover from a major terms of trade shock, the debt outlook is expected to recover and improve over the medium term. Key medium-term risks involve large debt service in 2012−15 associated with the repayments to the International Monetary Fund (under the proposed SBA). Mongolia hardly has any domestic debt. If Mongolia manages its existing debt well and contracts new debt prudently, it should be able to ride out the effects of the adverse commodity shock and move to a new medium-term development path underpinned by the commodity sector.*

## I. Background

1. **This update reflects the macroeconomic framework underlying the new Stand-By Arrangement and staff projections through 2029**. It assumes that the implementation of prudent macroeconomic and structural policies, including the establishment of a fiscal framework to avoid procyclical policies over the commodity price cycle will help Mongolia recover from the current downturn and resume sustainable growth.[2]

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[1] The DSA has been produced jointly by the staffs of the International Monetary Fund and the World Bank, in consultation with the Asian Development Bank and the Mongolian authorities (Ministry of Finance, Debt Management Division). The fiscal year for Mongolia is January-December 2009.

[2] The DSAs presented in this document are based on the common standard LIC DSA framework. Under the Country Policy and Institutional Assessment (CPIA) Mongolia is rated as a medium performer, and the debt sustainability analysis uses the indicative threshold indicators for countries in this category. See "Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications" (http://www.imf.org/external/np/pdr/sustain/2004/020304.htm and IDA/SECM2004/0035, 2/3/04) and "Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework, Policy Implications" (http://www.imf.org/external/np/pdr/sustain/2004/091004.htm and IDA/SECM2004/0629,

(continued)

In particular, by 2012−13 the development of the country's mineral resources is expected to spur economic growth and boost exports well into the medium term.

2. **Mongolia's stock of external debt as of end-2008 is estimated at US$1.7 billion (35.8 percent of GDP)**. This includes public or publicly-guaranteed debt (PPG) of US$1.6 billion as reported by the Ministry of Finance and estimated private external debt of US$0.1 billion. Most of Mongolia's public debt is external with about 61 percent of external debt contracted with multilateral creditors on concessional terms and the remainder with official bilateral creditors.

Mongolia: Structure of External Public Debt, 2008

| | In US$ | In percent of GDP | Net Present Value in US$ |
|---|---|---|---|
| Public debt | 1,601 | 33.1 | 1,218 |
| Multilaterals | 984 | 20.3 | 682 |
| IMF | 20 | 0.4 | 18 |
| World Bank | 338 | 7.0 | 206 |
| AsDB | 575 | 11.9 | 415 |
| Official bilateral | 600 | 12.4 | 521 |
| Paris Club | 492 | 10.2 | 424 |
| Non-Paris Club | 108 | 2.2 | 97 |
| Commercial | 17 | 0.3 | 16 |

Source: Mongolian Ministry of Finance, AsDB, Bank and Fund staff estimates.

3. **Several years of strong growth and prudent debt management policies have helped reduce Mongolia's external PPG debt burden**. During the last five years, the PPG external debt has fallen to 33 percent of GDP in 2008 from 87 percent of GDP in 2003. The ratio of debt service to exports has fallen to 4 percent in 2008 from 23 percent in 2000. During the last three years, the composition of debt has shifted away slightly from multilateral to bilateral creditors resulting in a lower degree of concessionality.[3] The latest Debt Management Performance Assessment (DeMPA) concluded that Mongolia scores relatively high on indicators such as strategy development, coordination with macroeconomic policies, recording and reporting, which is important considering the baseline with large upfront borrowing.[4]

## II. Developments in 2009

4. **The near-term debt outlook will be adversely affected by the severe exogenous shock Mongolia is now facing**. Mongolia has been hit hard by the global financial crisis

9/10/04) and "Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief," (http://www.imf.org/external/np/pp/eng/2006/110606.pdf and IDA/SecM2006-0564, 8/11/06).

[3] The average interest rate has increased and the average grace and maturity have become shorter.

[4] Conducted by the World Bank in June 2008, available at http://siteresources.worldbank.org/INTDEBTDEPT/Resources/468980-1226602826665/DeMPAMongoliaFinal_EN.pdf

through a sudden drop in the price of copper; export proceeds are expected to fall by more than US$800 million this year. The severe terms of trade shock has exacerbated the balance of payments and fiscal imbalances as evidenced by the 16 percent of GDP swing in the current account. As a result, the recent gains in lowering debt ratios now look set to be reversed as the government resorts to extraordinary external financing to address the balance of payments pressure. Part of the balance of payments gap is expected to be financed with the proposed US$224 million (SDR 153.3 million) Exceptional Access Stand-By Arrangement from the Fund, and additional support from other international financial institutions (IFIs), mainly IDA and the Asian Development Bank (AsDB). The authorities have approached donors to request additional support to cover unidentified financing during the course of the Fund arrangement.

## III. Medium-Term Macro and DSA Assumptions

5. **Compared to the 2008 DSA conducted at the time of the 2008 Article IV the global environment has significantly worsened Mongolia's macroeconomic situation**.[5] Even under stress testing the previous DSA could not have foreseen the sharp downturn. Specifically, copper prices, Mongolia's main source of foreign exchange earnings have been halved since mid-2008. A fall in global demand—particularly China which absorbs the bulk of Mongolia's exports—has increased the country's vulnerabilities. As a result, the average real growth rate for 2009−10 has fallen by more than 4 percentage points as compared to the previous DSA and the current account has swung from a surplus of 7 percent of GDP in 2007 to a deficit of 10 percent of GDP in 2008. Government revenues and grants are on average 8 percent of GDP lower due to lower copper prices.

6. **The baseline macroeconomic framework takes into consideration the impact of the substantial fiscal adjustment for 2009−10, but assumes that the economy will return to sustained growth over the medium term, underpinned by the Oyu Tolgoi (OT) mining project**.[6]

- Growth is expected to remain low at close to 3 percent in 2009 due to the fall in copper exports and a decline in domestic demand driven by slowing credit growth and moderation in public sector wage increases as opposed to developments in recent years. Growth will rebound to 11 percent in 2012 supported by the development of

[5] IMF Country Report No. 08/200.

[6] Oyu Tolgoi is a copper and gold mine. In addition, the Tavan Tolgoi (TT) deposit, close to the border with China, if developed, would transform Mongolia into a major world coal producer. The TT project has not been incorporated in the underlying baseline macroeconomic framework due to the uncertainties about its size and time frame for development. Once TT materializes, it is projected to have an important short-term impact via increased equipment imports, FDI and loan inflows, and a medium to long-term beneficial impact on the current account, similar to OT.

the Oyu Tolgoi (OT) mine, which will start production in 2013. As Mongolia progresses toward a higher income level, the long run real GDP growth is expected to be 4½ percent.

- After a rebound in 2010−13, export growth is expected to average more than 18 percent over 2013−18, reflecting copper exports from the OT mine.[7] Similarly, the current account deficit is expected to amount to 6½ percent of GDP in 2009, and will remain in deficit until 2012 due to large imports of mining-related investment goods. After that point, the current account should gradually narrow before jumping to a substantial surplus in 2013 as the OT project comes on stream. Presuming the authorities choose to save a reasonable fraction of the mineral revenues from this project the current account is expected to converge to a steady state surplus of 5 percent of GDP by 2029.

- Given the up-front fiscal adjustment under the Fund-supported program, and a tightening of monetary policy, inflation is projected to slow to about 5 percent over the medium term.

- Fiscal revenues will be boosted by the OT project and are expected to reach 47 percent of GDP by 2019, gradually converging to 39 percent over the medium term. Expenditures are expected to decline steadily reaching 33 percent of GDP by 2029 by the end of the projection period consistent with the medium term fiscal framework to be put into place under the program.

- A stronger institutional framework will ensure that a greater proportion of windfall future mineral revenues are saved. By end-2009 the Government will submit to Parliament fiscal responsibility legislation that will include a structural fiscal rule with a reference to a conservative assumption on the medium-term level of copper prices and at a level that guarantees medium-term fiscal sustainability. As a result, the overall balance would be in substantial surplus in 2015−20 and would then gradually decline to reach a 1 percent surplus by 2029.

7. **Borrowing assumptions reflect Mongolia's move to middle-income status by 2013**.

- As the mining projects come on stream, Mongolia would become eligible for nonconcessional borrowing from both the IBRD and the AsDB in 2013. After that point concessional borrowing is projected to decline from 52 percent in 2014 to 27 percent by 2029.[8] Interest rates reflect IDA-blend terms and AsDB terms for

[7] WEO projections are used for copper prices through 2014 and then assumed at US$4,500/tonne through 2029.

[8] Mongolia has already reached middle-income status according to IDA definition.

concessional borrowing and market conditions for commercial loans with borrowing rates at about 14 percent.

- Capital inflows, private external debt and portfolio investment, (which have all been negligible so far), in addition to foreign direct investment, are expected to increase, in line with developments of mining projects, and substantially help to sustain growth and build international reserves.

## IV. Debt Sustainability

8. **Mongolia's external public debt ratios will remain low despite the need to resort to increased foreign financing in 2009 and 2010 to fill the large balance of payments and fiscal needs**.[9] The baseline public debt indicators move with the external debt indicators, since public debt consists largely of external debt.

- Substantial one-off borrowing is required to smooth adjustment to the large terms of trade shock. This will, however, lead to a temporary but significant increase in the level of external public debt. The development of the country's mineral resources should provide a comfortable level of financial resources to meet Mongolia's flow financing needs, which are most pressing in 2012−14 (see below). As a result, external public debt is forecast to fall from 48 percent in 2010 to 9 percent at the end of the simulation period, with the net present value falling from 37 percent in 2010 to 8 percent of GDP at the end of the simulation period.

- Total public debt consists largely of external debt and this is expected to remain in the medium term, given the relatively small domestic market and the large investments needed for mining infrastructure. The baseline public DSA results are very similar to the external DSA findings and present no concerns under the baseline case.

9. **Mongolia's risk of debt distress remains low**.[10] Stress testing shows that a one-time 30 percent exchange rate depreciation relative to the baseline in 2010 would breach the threshold over the 2010−12 period. However, when the OT project comes online in 2013, the

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[9].The debt burden thresholds for medium policy performer are 150, 40, and 250 for the PV of debt in percent of exports, GDP, and revenue, respectively. Under the same medium policy classification, thresholds for debt service are 20 percent and 30 percent of exports and revenue, respectively.

[10] The *Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries* defines a "low risk of debt distress" when: "All debt indicators are well below relevant country-specific debt-burden thresholds. Stress testing and country-specific alternative scenarios do not result in indicators significantly breaching thresholds. In case where only one indicator is above its benchmark, judgment is needed to determine whether there is a debt sustainability problem or some other issues, for example, a data problem.

adverse effects of the depreciation would be gradually unwound. In line with the OT project, government deposits are expected to rapidly increase providing a comfortable fiscal reserve cushion.[11] Therefore, the development of the resource sector reflects a fundamental, permanent structural shift in the country's economy. This renders the historical scenario irrelevant as it systematically underestimates future growth prospects arising from the positive impact of significant investment in the mining project and exports growth. Although the debt service-to-exports and debt service-to-revenues ratios will peak in 2011−12, they will stay far below the thresholds. The exceptional access under the SBA and the broad program framework (including fiscal adjustment and monetary restraint), are intended to bolster reserves and restore confidence in the currency and should therefore make the probability of a real depreciation of this magnitude relatively low.

10. **The risk of public debt distress remains low**. As explained in the previous paragraph, the historical scenario is not applicable to Mongolia as the country is undergoing a structural shift. For similar reasons, fixing the primary balance permanently at the projected exceptional 2009 fiscal deficit of 6 percent of GDP cannot be considered a realistic worst-case scenario for Mongolia. We think the permanent growth shock scenario is unrealistic given Mongolia's mining prospects, although we did check that a prolonged growth shock would not endanger the PV of debt-to-GDP ratio. Although new exogenous shocks can never be ruled out, the Government's intention to instate a fiscal responsibility law will make Mongolia more robust.

11. **The maturity structure of debt contracted in 2009 could present some repayment clustering in 2012−2014**. The external public debt service should remain manageable, with the debt service-to-revenue ratios falling throughout the DSA horizon. However purchases under the SBA are expected to fall due in 2012−15 putting some pressure on the balance of payments. Reflecting these repayments, the external public debt service-to-exports ratio is expected to peak at 4 percent in 2012 before falling back to 2 percent over the long term.

## V. Alternative Scenarios

### Scenario 1: Sovereign Borrowing

12. **Under the Fund-supported program the Government is allowed to raise US$200 million of nonconcessional debt**. This scenario assumes that Mongolia will issue a US$200 million bond in 2009 with a five-year maturity. Given current market conditions, particularly for first-time issuers, the spread could be very high (1,500 bps over U.S. Treasury bonds)[12] (Box 1). However, a partial guarantee by an institution with a high

[11] The DSA is conservatively undertaken on a gross rather than on a net basis.

[12] Assuming the benchmark interest rate, the U.S. Treasury bond, to be 3 percent.

credit rating could help reduce the spread by several percentage points. There is no impact on overall demand as proceeds can not be used for additional spending beyond the program fiscal targets and will be used to cover bank any recapitalization costs that would be reflected in the 2010 budget financing.

13. **Under this sovereign borrowing scenario, external debt burden indicators would be slightly over the indicative policy thresholds**. The PV of public debt would rise to 42 percent of GDP, above the 40 percent of GDP threshold, before returning below 40 percent in 2011.

**Scenario 2: Shock to Copper Price Scenario**

14. **Copper is the main source of Mongolia's export earnings**. It accounted for 33 percent of 2008 merchandise exports. This scenario, assumes that the global recession will last longer than expected and copper prices will be on average 20 percent lower than in the baseline scenario (US$4,500/tonne) during 2010−15.

15. **Under this low copper price scenario external debt burden indicators breach the indicative policy thresholds**. The PV of debt-to-GDP ratio would increase significantly higher and breach the 40 percent threshold between 2011 and 2014. Overall, the external DSA in the low copper price scenario shows an economy that remains vulnerable to changes in commodity prices, despite the substantial increase in export volumes that are expected with the development of the OT mineral project.

## VI. Conclusions

16. The external DSA indicates that Mongolia's external debt dynamics are subject to low risk of debt distress even though the country's risk has increased compared to the 2008 DSA due to a sharp deterioration in the macroeconomic outlook. This is a result of both a sharp deterioration in the terms of trade combined with loose domestic policies in the recent past. However, borrowing under the Stand-By Arrangement and other donor financing will increase debt ratios only during the next three years, and will be offset by Mongolia's substantial mineral wealth potential. Even in a scenario of a significant depreciation of the currency, external debt rises initially, but is brought steadily downward over time. Indeed, it is the staff's expectation, presuming prudent policies are brought to bear and a significant portion of the mineral-related flows are saved, that Mongolia could end up as a net external creditor by 2029.

**Box 1. Prospects for a Sovereign Bond Issue by Mongolia**

A simple ratings model amongst a sample of 44 rated emerging markets based on macroeconomic indicators such as CPI inflation, FX debt relative to FX reserves and trade openness suggests that Mongolia deserves a B rating with downward risks (speculative grade), which is similar to Fitch's recent assessment (Fitch, 2009). This puts it in the same league as Pakistan, Argentina, Lebanon, Ecuador and Ukraine.

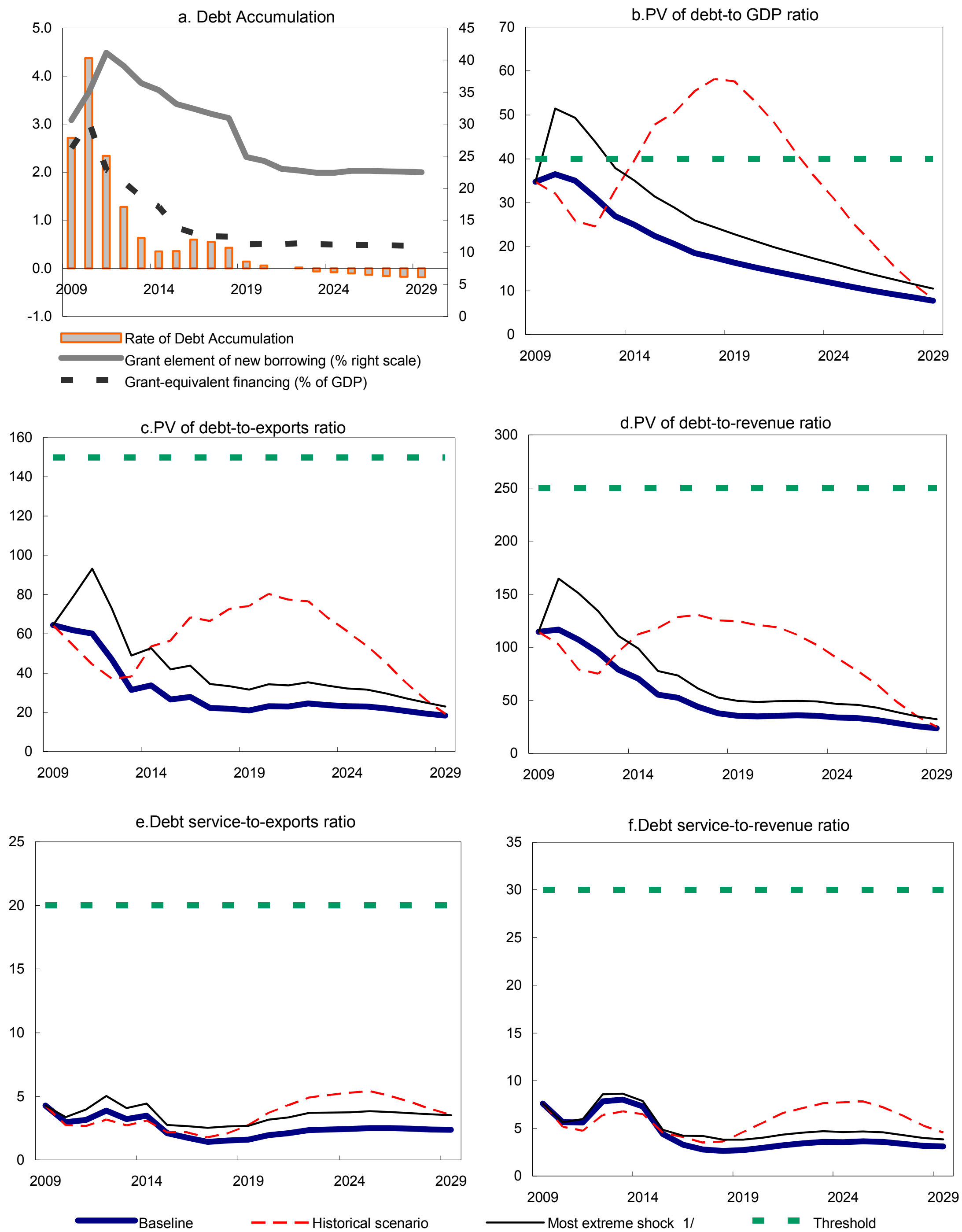
In a recent Credit Suisse (2009) report, strategists found that emerging market sovereign spreads can be explained quite well with the sovereign rating and the loans-to-deposits ratio, which reflects current investor concerns that the largest contingent liability for governments is a potential recapitalization of the banking sector. Applying this relationship to Mongolia's data, we estimate that Mongolia's sovereign spread would be about 1500bps under mid-February 2009 market conditions. This shows that the market conditions are very difficult for low-rated sovereigns (see also the table below). Moreover, a first-time issuer in financial difficulties may find it even more difficult to enter the market at this stage.

Recent Spreads on Sovereign Bond Issues

| Country | Rating (S&P/Moody's) | Date | Amount (US$ million) | Amount (Percent of GDP) | Coupon (Percent) | Spread over benchmark (Basis points) |
|---|---|---|---|---|---|---|
| Jamaica | B/B1 | Jun. 2008 | 350 | 2.6 | 8.00 | 417 |
| Lebanon | CCC+/B3 | Aug. 2008 | 500 | 1.8 | 8.50 | 504 |
| Philippines | N.A./B1 | Jan. 2009 | 1,500 | 0.9 | 8.38 | 600 |
| Indonesia | Ba3/BB– | Feb. 2009 | 1,000 | 0.2 | 10.38 | 847 |

Sources: Bank Indonesia, Credit Suisse, Bloomberg, update from World Bank (February 2009), Mongolia Quarterly Economic Update. Available at http://www.worldbank.org/mn.

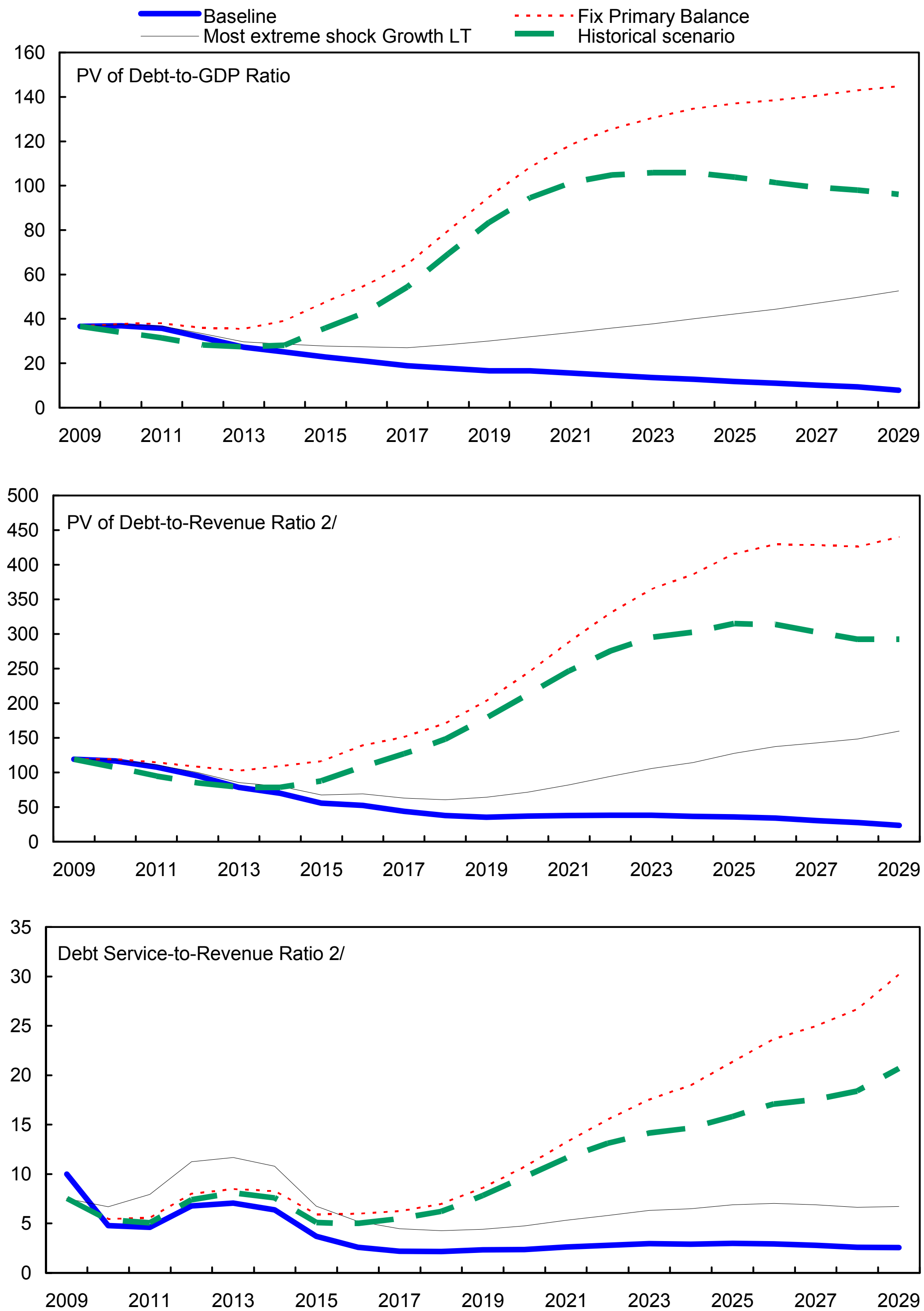
Figure 1. Mongolia: Indicators of Public and Publicly Guaranteed External Debt Under Alternatives Scenarios, 2009–2029 1/




Source: Staff projections and simulations.

1/ The most extreme stress test is the test that yields the highest ratio in 2019. In figure b., it corresponds to a one-time depreciation shock; in c. to a exports shock; in d. to a one-time depreciation shock; in e. to a exports shock and in picture f. to a exports shock.

Figure 2. Mongolia: Indicators of Public Debt Under Alternative Scenarios, 2009–2029 1/

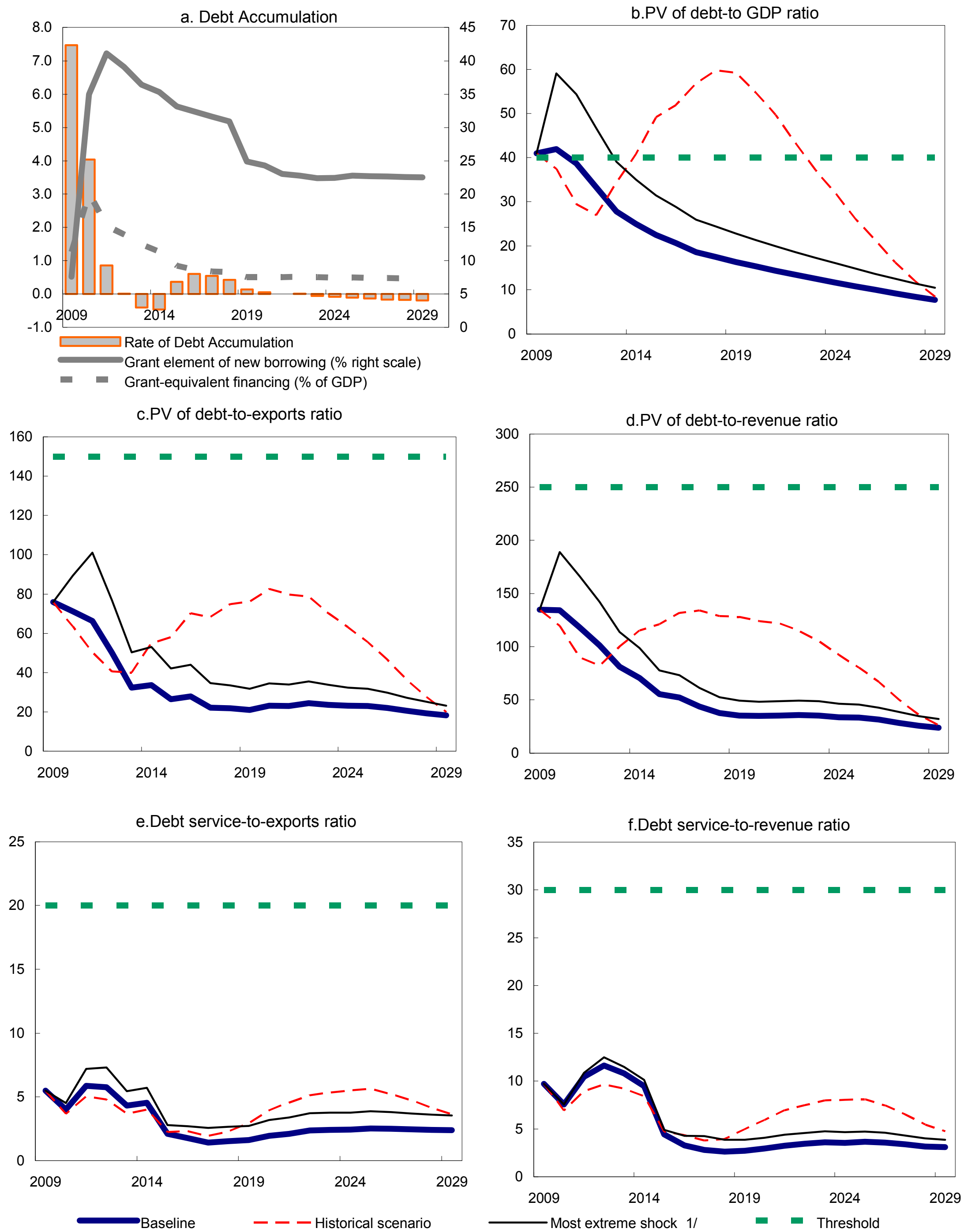



Sources: Country authorities; and Fund staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2019.

2/ Revenues are defined inclusive of grants.

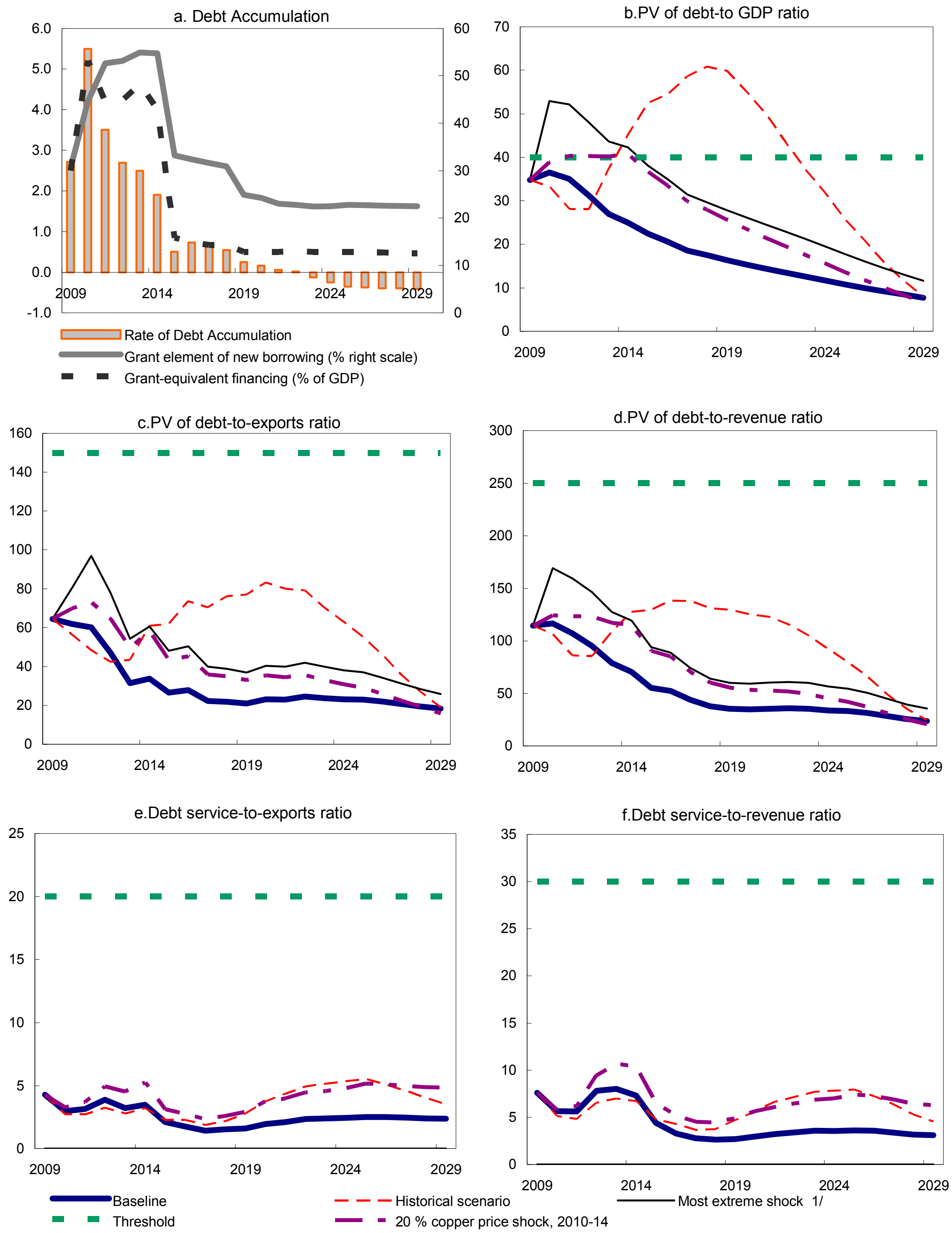
Figure 3. Mongolia: Indicators of Public and Publicly Guaranteed External Debt with Sovereign Bond, 2009–2029 1/




Source: Staff projections and simulations.

1/ The most extreme stress test is the test that yields the highest ratio in 2019. In figure b., it corresponds to a one-time depreciation shock; in c. to a exports shock; in d. to a one-time depreciation shock; in e. to a exports shock and in picture f. to a exports shock.

Figure 4. Mongolia: Indicators of Public and Publicly Guaranteed External Debt Under Lower Copper Price Scenario, 2009–2029 1/




Source: Staff projections and simulations.

1/ The most extreme stress test is the test that yields the highest ratio in 2019. In figure b., it corresponds to a one-time depreciation shock; in c. to a exports shock; in d. to a one-time depreciation shock; in e. to a exports shock and in picture f. to a exports shock.

Table 1. Mongolia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2005–2029

(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | Estimate | Projections | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | Average | Standard Deviation 5/ | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2009-14 Average | 2019 | 2029 | 2015-29 Average |
| Public sector debt 1/ | 45.4 | 39.4 | 33.1 | | | 46.8 | 47.8 | 46.3 | 41.3 | 35.8 | 33.3 | | 20.8 | 8.9 | |
| *Of which:* foreign-currency denominated | 44.3 | 38.9 | 33.1 | | | 46.8 | 47.8 | 45.9 | 41.1 | 35.8 | 33.3 | | 20.8 | 8.9 | |
| Change in public sector debt | -14.4 | -6.0 | -6.3 | | | 13.7 | 1.0 | -1.5 | -5.0 | -5.5 | -2.5 | | -1.8 | -0.9 | |
| Identified debt-creating flows | -25.6 | -11.8 | -2.6 | | | 13.6 | -0.6 | -1.2 | -3.9 | -6.1 | -4.6 | | -16.8 | -2.0 | |
| Primary deficit | -8.6 | -3.2 | 4.7 | 1.4 | 5.1 | 4.7 | 3.8 | 3.0 | 2.1 | -0.4 | -2.0 | 1.9 | -15.5 | -1.6 | -6.9 |
| Revenue and grants | 36.6 | 40.9 | 35.2 | | | 30.8 | 31.6 | 33.1 | 33.1 | 34.6 | 35.8 | | 46.6 | 32.9 | |
| *Of which:* grants | 0.1 | 0.5 | 0.3 | | | 0.3 | 0.3 | 0.4 | 0.3 | 0.3 | 0.3 | | 0.3 | 0.3 | |
| Primary (noninterest) expenditure | 28.0 | 37.6 | 39.8 | | | 35.5 | 35.4 | 36.1 | 35.2 | 34.2 | 33.8 | | 31.1 | 31.3 | |
| Automatic debt dynamics | -16.6 | -8.2 | -7.1 | | | 9.2 | -4.4 | -4.2 | -6.0 | -5.8 | -2.6 | | -1.3 | -0.4 | |
| Contribution from interest rate/growth differential | -15.6 | -8.6 | -9.7 | | | 10.7 | -2.7 | -4.1 | -6.0 | -5.8 | -2.6 | | -1.3 | -0.4 | |
| *Of which:* contribution from average real interest rate | -10.9 | -4.3 | -6.5 | | | 11.5 | -0.7 | -1.4 | -1.3 | -1.0 | -0.6 | | -0.1 | 0.0 | |
| *Of which:* contribution from real GDP growth | -4.7 | -4.2 | -3.2 | | | -0.9 | -1.9 | -2.7 | -4.7 | -4.8 | -2.0 | | -1.2 | -0.4 | |
| Contribution from real exchange rate depreciation | -1.0 | 0.4 | 2.6 | | | -1.4 | -1.7 | -0.1 | 0.0 | 0.0 | 0.0 | | ... | ... | |
| Other identified debt-creating flows | -0.4 | -0.4 | -0.1 | | | -0.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.0 | |
| Privatization receipts (negative) | -0.4 | -0.4 | -0.1 | | | -0.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.0 | |
| Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.0 | |
| Debt relief (HIPC and other) | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.0 | |
| Other (specify, e.g. bank recapitalization) | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.0 | |
| Residual, including asset changes | 11.2 | 5.8 | -3.7 | | | 0.1 | 1.6 | -0.3 | -1.1 | 0.7 | 2.1 | | 15.0 | 1.1 | |
| Other Sustainability Indicators | | | | | | | | | | | | | | | |
| PV of public sector debt | 1.0 | 0.5 | 26.1 | | | 36.6 | 36.9 | 35.7 | 31.6 | 27.2 | 25.1 | | 16.6 | 7.9 | |
| *Of which:* foreign-currency denominated | 0.0 | 0.0 | 26.1 | | | 36.6 | 36.9 | 35.3 | 31.4 | 27.2 | 25.1 | | 16.6 | 7.9 | |
| *Of which:* external | ... | ... | 26.1 | | | 36.6 | 36.9 | 35.3 | 31.4 | 27.2 | 25.1 | | 16.6 | 7.9 | |
| PV of contingent liabilities (not included in public sector debt) | ... | ... | ... | | | ... | ... | ... | ... | ... | ... | | ... | ... | |
| Gross financing need 2/ | -5.2 | -0.5 | 6.8 | | | 7.8 | 5.3 | 4.5 | 4.4 | 2.1 | 0.3 | | -14.4 | -0.7 | |
| PV of public sector debt-to-revenue and grants ratio (in percent) | 2.9 | 1.2 | 74.2 | | | 119.0 | 116.7 | 108.0 | 95.4 | 78.5 | 70.3 | | 35.6 | 23.9 | |
| PV of public sector debt-to-revenue ratio (in percent) | 2.9 | 1.2 | 74.8 | | | 120.4 | 118.0 | 109.1 | 96.4 | 79.3 | 70.9 | | 35.9 | 24.1 | |
| *Of which:* external 3/ | … | … | 74.7 | | | 120.3 | 118.0 | 108.0 | 95.8 | 79.3 | 70.9 | | 35.9 | 24.1 | |
| Debt service-to-revenue and grants ratio (in percent) 4/ | 9.3 | 6.8 | 6.0 | | | 10.0 | 4.8 | 4.6 | 6.8 | 7.1 | 6.4 | | 2.3 | 2.6 | |
| Debt service-to-revenue ratio (in percent) 4/ | 9.4 | 6.9 | 6.1 | | | 10.1 | 4.8 | 4.7 | 6.9 | 7.1 | 6.5 | | 2.4 | 2.6 | |
| Primary deficit that stabilizes the debt-to-GDP ratio | 5.9 | 2.8 | 10.9 | | | -9.0 | 2.8 | 4.5 | 7.1 | 5.1 | 0.5 | | -13.7 | -0.7 | |
| Key macroeconomic and fiscal assumptions | | | | | | | | | | | | | | | |
| Real GDP growth (in percent) | 8.6 | 10.2 | 8.9 | 6.5 | 3.3 | 2.7 | 4.3 | 6.0 | 11.3 | 13.0 | 6.0 | 7.2 | 5.5 | 4.5 | 5.8 |
| Average nominal interest rate on forex debt (in percent) | 1.2 | 1.1 | 0.9 | 1.8 | 0.7 | 1.5 | 1.2 | 1.4 | 1.4 | 1.5 | 1.6 | 1.4 | 1.6 | 2.1 | 1.8 |
| Real exchange rate depreciation (in percent, + indicates depreciation) | -2.3 | 1.0 | 8.7 | 0.9 | 3.4 | -3.3 | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Inflation rate (GDP deflator, in percent) | 23.1 | 12.3 | 22.4 | 13.5 | 6.7 | 0.0 | 9.4 | 6.4 | 6.2 | 5.9 | 4.8 | 5.4 | 5.3 | 5.4 | 5.4 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 0.1 | 0.5 | 0.2 | 0.1 | 0.2 | -0.1 | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 |
| Grant element of new external borrowing (in percent) | ... | ... | ... | … | … | 30.6 | 35.0 | 41.1 | 39.1 | 36.4 | 35.3 | 36.2 | 24.9 | 22.5 | ... |

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

1/ General government or nonfinancial public sector, gross debt.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2. External Debt Sustainability Framework, Baseline Scenario, 2006–2029 1/

(In percent of GDP, unless otherwise indicated)

| | Actual | | | Historical | Standard 6/ | Projections | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | Average | Deviation | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2009-2014 Average | 2019 | 2029 | 2015-2029 Average |
| External debt (nominal) 1/ | 45.1 | 40.1 | 35.2 | | | 58.1 | 66.5 | 74.1 | 63.9 | 49.3 | 38.5 | | 34.7 | 18.9 | |
| *Of which:* public and publicly guaranteed (PPG) | 44.3 | 38.9 | 33.1 | | | 46.8 | 47.8 | 45.9 | 41.1 | 35.8 | 33.3 | | 20.8 | 8.9 | |
| Change in external debt | -16.2 | -5.0 | -4.9 | | | 23.0 | 8.3 | 7.6 | -10.2 | -14.6 | -10.8 | | -1.4 | -1.3 | |
| Identified net debt-creating flows | -32.7 | -24.8 | -13.5 | | | -2.5 | -3.7 | -0.8 | -13.7 | -28.0 | -24.7 | | -15.3 | -4.8 | |
| Non-interest current account deficit | -7.5 | -7.1 | 9.3 | 1.8 | 6.8 | 5.4 | 4.8 | 8.8 | 0.1 | -16.7 | -17.5 | | -11.8 | -1.9 | -7.5 |
| Deficit in balance of goods and services | -4.8 | -2.7 | 11.7 | | | 11.6 | 11.0 | 13.9 | 4.8 | -24.6 | -18.6 | | -29.6 | -6.0 | |
| Exports | 64.4 | 64.2 | 59.6 | | | 54.0 | 59.0 | 58.2 | 66.2 | 85.7 | 74.2 | | 77.8 | 42.2 | |
| Imports | 59.6 | 61.5 | 71.4 | | | 65.6 | 69.9 | 72.1 | 71.0 | 61.1 | 55.6 | | 48.2 | 36.2 | |
| Net current transfers (negative = inflow) | -6.0 | -5.5 | -3.3 | -8.6 | 3.0 | -7.2 | -7.0 | -5.7 | -5.1 | -3.5 | -2.9 | | -1.9 | -1.8 | -1.9 |
| *Of which:* official | -3.5 | -3.4 | -1.4 | | | -5.9 | -5.3 | -3.9 | -3.3 | -1.7 | -1.1 | | -0.1 | 0.0 | |
| Other current account flows (negative = net inflow) | 3.2 | 1.1 | 0.9 | | | 1.0 | 0.7 | 0.6 | 0.5 | 11.4 | 3.9 | | 19.7 | 5.9 | |
| Net FDI (negative = inflow) | -9.2 | -9.2 | -13.0 | -7.5 | 3.3 | -7.8 | -7.6 | -8.3 | -8.4 | -5.5 | -5.0 | | -3.0 | -3.0 | -3.0 |
| Endogenous debt dynamics 2/ | -16.0 | -8.5 | -9.8 | | | 0.0 | -0.8 | -1.4 | -5.4 | -5.8 | -2.2 | | -0.5 | 0.1 | |
| Contribution from nominal interest rate | 0.5 | 0.4 | 0.3 | | | 1.2 | 1.5 | 2.2 | 1.8 | 1.3 | 0.5 | | 1.3 | 1.0 | |
| Contribution from real GDP growth | -3.8 | -3.7 | -2.7 | | | -1.2 | -2.3 | -3.6 | -7.2 | -7.1 | -2.7 | | -1.8 | -0.8 | |
| Contribution from price and exchange rate changes | -12.6 | -5.2 | -7.5 | | | … | … | … | … | … | … | | … | … | |
| Residual (3-4) 3/ | 16.5 | 19.8 | 8.6 | | | 25.4 | 12.0 | 8.5 | 3.5 | 13.4 | 13.9 | | 13.9 | 3.5 | |
| *Of which:* exceptional financing | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.0 | |
| PV of external debt 4/ | ... | ... | 26.1 | | | 46.2 | 55.2 | 63.3 | 54.0 | 40.5 | 30.2 | | 30.3 | 17.8 | |
| In percent of exports | ... | ... | 43.7 | | | 85.5 | 93.6 | 108.7 | 81.5 | 47.2 | 40.7 | | 38.9 | 42.2 | |
| PV of PPG external debt | ... | ... | 24.0 | | | 34.8 | 36.5 | 35.1 | 31.2 | 27.0 | 25.0 | | 16.4 | 7.7 | |
| In percent of exports | ... | ... | 40.2 | | | 64.5 | 61.9 | 60.2 | 47.1 | 31.5 | 33.7 | | 21.0 | 18.3 | |
| In percent of government revenues | ... | ... | 68.7 | | | 114.4 | 116.8 | 107.2 | 95.1 | 78.7 | 70.4 | | 35.4 | 23.8 | |
| Debt service-to-exports ratio (in percent) | 5.9 | 6.5 | 4.2 | | | 6.3 | 4.5 | 8.3 | 29.7 | 19.7 | 18.8 | | 7.4 | 11.2 | |
| PPG debt service-to-exports ratio (in percent) | 5.4 | 4.3 | 3.5 | | | 4.3 | 3.0 | 3.2 | 3.9 | 3.2 | 3.5 | | 1.6 | 2.4 | |
| PPG debt service-to-revenue ratio (in percent) | 9.5 | 6.8 | 5.9 | | | 7.6 | 5.6 | 5.6 | 7.8 | 8.0 | 7.3 | | 2.7 | 3.1 | |
| Total gross financing need (billions of U.S. dollars) | -0.4 | -0.5 | -0.1 | | | 0.1 | 0.0 | 0.3 | 0.7 | -0.3 | -0.5 | | -1.0 | 0.1 | |
| Non-interest current account deficit that stabilizes debt ratio | 8.6 | -2.1 | 14.2 | | | -17.6 | -3.6 | 1.2 | 10.3 | -2.1 | -6.7 | | -10.4 | -0.6 | |
| Key macroeconomic assumptions | | | | | | | | | | | | | | | |
| Real GDP growth (in percent) | 8.6 | 10.2 | 8.9 | 6.5 | 3.3 | 2.7 | 4.3 | 6.0 | 11.3 | 13.0 | 6.0 | 7.2 | 5.5 | 4.5 | 5.8 |
| GDP deflator in U.S. dollar terms (change in percent) | 26.0 | 13.0 | 22.9 | 10.2 | 10.7 | -25.2 | 2.9 | 4.5 | 4.6 | 4.3 | 3.3 | -0.9 | 2.2 | 2.2 | 2.3 |
| Effective interest rate (percent) 5/ | 1.2 | 1.1 | 0.9 | 1.8 | 0.7 | 2.6 | 2.8 | 3.7 | 2.9 | 2.3 | 1.1 | 2.6 | 4.0 | 5.1 | 4.2 |
| Growth of exports of G&S (U.S. dollar terms, in percent) | 36.9 | 24.2 | 24.3 | 20.3 | 16.1 | -30.6 | 17.3 | 9.3 | 32.5 | 52.7 | -5.3 | 12.7 | 5.0 | 3.5 | 4.7 |
| Growth of imports of G&S (U.S. dollar terms, in percent) | 19.5 | 28.5 | 55.3 | 19.6 | 15.6 | -29.5 | 14.6 | 14.2 | 14.6 | 1.5 | -0.4 | 2.5 | 4.4 | 3.9 | 5.2 |
| Grant element of new public sector borrowing (in percent) | ... | ... | ... | ... | ... | 30.6 | 35.0 | 41.1 | 39.1 | 36.4 | 35.3 | 36.2 | 24.9 | 22.5 | 25.4 |
| Government revenues (excluding grants, in percent of GDP) | 36.5 | 40.4 | 34.9 | | | 30.4 | 31.3 | 32.7 | 32.8 | 34.3 | 35.4 | | 46.3 | 32.6 | 38.0 |
| Aid flows (in billions of U.S. dollars) 7/ | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.1 | |
| *Of which:* Grants | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.1 | |
| *Of which:* Concessional loans | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | 0.0 | 0.0 | |
| Grant-equivalent financing (in percent of GDP) 8/ | ... | ... | ... | | | 2.5 | 3.0 | 2.0 | 1.8 | 1.5 | 1.3 | | 0.5 | 0.5 | 0.6 |
| Grant-equivalent financing (in percent of external financing) 8/ | ... | ... | ... | | | 33.9 | 37.8 | 45.8 | 44.2 | 42.3 | 42.5 | | 46.9 | 51.8 | 47.2 |
| Memorandum items: | | | | | | | | | | | | | | | |
| Nominal GDP (billions of U.S. dollars) | 3.2 | 3.9 | 5.3 | | | 4.0 | 4.3 | 4.8 | 5.6 | 6.6 | 7.2 | | 12.1 | 23.5 | |
| Nominal dollar GDP growth | 36.8 | 24.5 | 33.8 | | | -23.3 | 7.4 | 10.8 | 16.5 | 17.9 | 9.5 | **6.5** | 7.8 | 6.8 | 8.2 |
| PV of PPG external debt (in billions of U.S. dollars) | | | 1.3 | | | 1.4 | 1.6 | 1.7 | 1.7 | 1.8 | 1.8 | | 2.0 | 1.8 | |
| (PVt-PVt-1)/GDPt-1 (in percent) | | | | | | 2.7 | 4.4 | 2.3 | 1.3 | 0.6 | 0.4 | 1.9 | 0.1 | -0.2 | 0.1 |

Source: Staff simulations.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 3.Mongolia: Sensitivity Analysis for Key Indicators of Public Debt 2009-2029

| | Projections | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2019 | 2029 |
| **PV of Debt-to-GDP Ratio** | | | | | | | | |
| **Baseline** | 37 | 37 | 36 | 32 | 27 | 25 | 17 | 8 |
| **A. Alternative scenarios** | | | | | | | | |
| A1. Real GDP growth and primary balance are at historical averages | 37 | 34 | 31 | 28 | 27 | 28 | 84 | 96 |
| A2. Primary balance is unchanged from 2009 | 37 | 38 | 38 | 36 | 36 | 39 | 95 | 145 |
| A3. Permanently lower GDP growth 1/ | 37 | 37 | 37 | 33 | 30 | 29 | 30 | 53 |
| A4. Alternative Scenario :[Costumize, enter title] | 39 | 42 | 39 | 36 | 34 | 32 | 63 | 64 |
| **B. Bound tests** | | | | | | | | |
| B1. Real GDP growth is at historical average minus one standard deviations in 2010-2011 | 37 | 38 | 38 | 35 | 31 | 30 | 27 | 28 |
| B2. Primary balance is at historical average minus one standard deviations in 2010-2011 | 37 | 39 | 41 | 36 | 31 | 29 | 20 | 11 |
| B3. Combination of B1-B2 using one half standard deviation shocks | 37 | 37 | 37 | 33 | 28 | 26 | 19 | 12 |
| B4. One-time 30 percent real depreciation in 2010 | 37 | 51 | 48 | 42 | 36 | 34 | 24 | 17 |
| B5. 10 percent of GDP increase in other debt-creating flows in 2010 | 37 | 46 | 44 | 39 | 34 | 31 | 22 | 12 |
| **PV of Debt-to-Revenue Ratio 2/** | | | | | | | | |
| **Baseline** | 119 | 117 | 108 | 95 | 79 | 70 | 36 | 24 |
| **A. Alternative scenarios** | | | | | | | | |
| A1. Real GDP growth and primary balance are at historical averages | 119 | 108 | 95 | 85 | 79 | 79 | 179 | 292 |
| A2. Primary balance is unchanged from 2009 | 119 | 119 | 115 | 108 | 103 | 109 | 204 | 440 |
| A3. Permanently lower GDP growth 1/ | 119 | 118 | 111 | 100 | 86 | 80 | 64 | 160 |
| A4. Alternative Scenario :[Costumize, enter title] | 126 | 160 | 150 | 136 | 126 | 123 | 242 | 247 |
| **B. Bound tests** | | | | | | | | |
| B1. Real GDP growth is at historical average minus one standard deviations in 2010-2011 | 119 | 119 | 116 | 106 | 91 | 85 | 59 | 85 |
| B2. Primary balance is at historical average minus one standard deviations in 2010-2011 | 119 | 124 | 124 | 110 | 91 | 81 | 43 | 34 |
| B3. Combination of B1-B2 using one half standard deviation shocks | 119 | 117 | 111 | 99 | 82 | 74 | 40 | 36 |
| B4. One-time 30 percent real depreciation in 2010 | 119 | 161 | 146 | 127 | 105 | 94 | 52 | 50 |
| B5. 10 percent of GDP increase in other debt-creating flows in 2010 | 119 | 145 | 133 | 118 | 98 | 88 | 46 | 38 |
| **Debt Service-to-Revenue Ratio 2/** | | | | | | | | |
| **Baseline** | 10 | 5 | 5 | 7 | 7 | 6 | 2 | 3 |
| **A. Alternative scenarios** | | | | | | | | |
| A1. Real GDP growth and primary balance are at historical averages | 8 | 5 | 5 | 7 | 8 | 8 | 8 | 21 |
| A2. Primary balance is unchanged from 2009 | 8 | 5 | 6 | 8 | 8 | 8 | 9 | 30 |
| A3. Permanently lower GDP growth 1/ | 8 | 6 | 6 | 8 | 8 | 8 | 4 | 11 |
| A4. Alternative Scenario :[Costumize, enter title] | 8 | 6 | 6 | 9 | 11 | 10 | 10 | 14 |
| **B. Bound tests** | | | | | | | | |
| B1. Real GDP growth is at historical average minus one standard deviations in 2010-2011 | 8 | 6 | 6 | 8 | 9 | 8 | 4 | 7 |
| B2. Primary balance is at historical average minus one standard deviations in 2010-2011 | 8 | 5 | 6 | 8 | 9 | 8 | 3 | 4 |
| B3. Combination of B1-B2 using one half standard deviation shocks | 8 | 5 | 6 | 8 | 8 | 7 | 3 | 4 |
| B4. One-time 30 percent real depreciation in 2010 | 8 | 7 | 8 | 11 | 12 | 11 | 4 | 7 |
| B5. 10 percent of GDP increase in other debt-creating flows in 2010 | 8 | 5 | 7 | 9 | 9 | 8 | 3 | 5 |

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

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the length of the projection period.

2/ Revenues are defined inclusive of grants.

Table 4.Mongolia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2009-2029
(In percent)

| | Projections | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | **2019** | 2029 |
| **PV of debt-to GDP ratio** | | | | | | | | |
| **Baseline** | 35 | 36 | 35 | 31 | 27 | 25 | **16** | 8 |
| **A. Alternative Scenarios** | | | | | | | | |
| A1. Key variables at their historical averages in 2009-2029 1/ | 35 | 32 | 26 | 25 | 33 | 40 | **58** | 8 |
| A2. New public sector loans on less favorable terms in 2009-2029 2 | 35 | 36 | 35 | 32 | 28 | 26 | **17** | 9 |
| **B. Bound Tests** | | | | | | | | |
| B1. Real GDP growth at historical average minus one standard deviation in 2010-2011 | 35 | 37 | 36 | 32 | 28 | 26 | **17** | 8 |
| B2. Export value growth at historical average minus one standard deviation in 2010-2011 3/ | 35 | 41 | 46 | 41 | 36 | 33 | **21** | 8 |
| B3. US dollar GDP deflator at historical average minus one standard deviation in 2010-2011 | 35 | 38 | 38 | 34 | 29 | 27 | **18** | 8 |
| B4. Net non-debt creating flows at historical average minus one standard deviation in 2010-2011 4/ | 35 | 40 | 41 | 37 | 32 | 30 | **19** | 8 |
| B5. Combination of B1-B4 using one-half standard deviation shocks | 35 | 38 | 38 | 34 | 30 | 27 | **18** | 8 |
| B6. One-time 30 percent nominal depreciation relative to the baseline in 2010 5/ | 35 | 51 | 49 | 44 | 38 | 35 | **23** | 10 |
| **PV of debt-to-exports ratio** | | | | | | | | |
| **Baseline** | 64 | 62 | 60 | 47 | 31 | 34 | **21** | 18 |
| **A. Alternative Scenarios** | | | | | | | | |
| A1. Key variables at their historical averages in 2009-2029 1/ | 64 | 54 | 44 | 37 | 38 | 54 | **74** | 19 |
| A2. New public sector loans on less favorable terms in 2009-2029 2 | 64 | 62 | 60 | 48 | 32 | 35 | **22** | 22 |
| **B. Bound Tests** | | | | | | | | |
| B1. Real GDP growth at historical average minus one standard deviation in 2010-2011 | 64 | 62 | 60 | 47 | 31 | 33 | **21** | 18 |
| B2. Export value growth at historical average minus one standard deviation in 2010-2011 3/ | 64 | 79 | 93 | 73 | 49 | 53 | **32** | 23 |
| B3. US dollar GDP deflator at historical average minus one standard deviation in 2010-2011 | 64 | 62 | 60 | 47 | 31 | 33 | **21** | 18 |
| B4. Net non-debt creating flows at historical average minus one standard deviation in 2010-2011 4/ | 64 | 68 | 71 | 55 | 37 | 40 | **24** | 19 |
| B5. Combination of B1-B4 using one-half standard deviation shocks | 64 | 70 | 68 | 53 | 36 | 38 | **23** | 19 |
| B6. One-time 30 percent nominal depreciation relative to the baseline in 2010 5/ | 64 | 62 | 60 | 47 | 31 | 33 | **21** | 18 |
| **PV of debt-to-revenue ratio** | | | | | | | | |
| **Baseline** | 114 | 117 | 107 | 95 | 79 | 70 | **35** | 24 |
| **A. Alternative Scenarios** | | | | | | | | |
| A1. Key variables at their historical averages in 2009-2029 1/ | 114 | 103 | 79 | 75 | 96 | 112 | **125** | 25 |
| A2. New public sector loans on less favorable terms in 2009-2029 2 | 114 | 116 | 107 | 96 | 81 | 73 | **37** | 28 |
| **B. Bound Tests** | | | | | | | | |
| B1. Real GDP growth at historical average minus one standard deviation in 2010-2011 | 114 | 118 | 111 | 98 | 81 | 73 | **36** | 24 |
| B2. Export value growth at historical average minus one standard deviation in 2010-2011 3/ | 114 | 132 | 140 | 125 | 104 | 93 | **45** | 25 |
| B3. US dollar GDP deflator at historical average minus one standard deviation in 2010-2011 | 114 | 121 | 116 | 103 | 85 | 76 | **38** | 25 |
| B4. Net non-debt creating flows at historical average minus one standard deviation in 2010-2011 4/ | 114 | 128 | 126 | 112 | 93 | 83 | **41** | 24 |
| B5. Combination of B1-B4 using one-half standard deviation shocks | 114 | 123 | 117 | 104 | 86 | 77 | **38** | 23 |
| B6. One-time 30 percent nominal depreciation relative to the baseline in 2010 5/ | 114 | 164 | 151 | 134 | 111 | 99 | **49** | 32 |

Table 4b.Mongolia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2009-2029 (continued)
(In percent)

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | **2019** | 2029 |
|---|---|---|---|---|---|---|---|---|
| **Debt service-to-exports ratio** | | | | | | | | |
| **Baseline** | 4 | 3 | 3 | 4 | 3 | 3 | **2** | 2 |
| **A. Alternative Scenarios** | | | | | | | | |
| A1. Key variables at their historical averages in 2009-2029 1/ | 4 | 3 | 3 | 3 | 3 | 3 | **3** | 4 |
| A2. New public sector loans on less favorable terms in 2009-2029 2 | 4 | 3 | 3 | 3 | 2 | 2 | **2** | 1 |
| **B. Bound Tests** | | | | | | | | |
| B1. Real GDP growth at historical average minus one standard deviation in 2010-2011 | 4 | 3 | 3 | 4 | 3 | 3 | **2** | 2 |
| B2. Export value growth at historical average minus one standard deviation in 2010-2011 3/ | 4 | 3 | 4 | 5 | 4 | 4 | **3** | 4 |
| B3. US dollar GDP deflator at historical average minus one standard deviation in 2010-2011 | 4 | 3 | 3 | 4 | 3 | 3 | **2** | 2 |
| B4. Net non-debt creating flows at historical average minus one standard deviation in 2010-2011 4/ | 4 | 3 | 3 | 4 | 3 | 4 | **2** | 3 |
| B5. Combination of B1-B4 using one-half standard deviation shocks | 4 | 3 | 3 | 4 | 3 | 4 | **2** | 3 |
| B6. One-time 30 percent nominal depreciation relative to the baseline in 2010 5/ | 4 | 3 | 3 | 4 | 3 | 3 | **2** | 2 |
| **Debt service-to-revenue ratio** | | | | | | | | |
| **Baseline** | 8 | 6 | 6 | 8 | 8 | 7 | **3** | 3 |
| **A. Alternative Scenarios** | | | | | | | | |
| A1. Key variables at their historical averages in 2009-2029 1/ | 8 | 5 | 5 | 6 | 7 | 6 | **5** | 5 |
| A2. New public sector loans on less favorable terms in 2009-2029 2 | 8 | 6 | 6 | 6 | 5 | 5 | **3** | 2 |
| **B. Bound Tests** | | | | | | | | |
| B1. Real GDP growth at historical average minus one standard deviation in 2010-2011 | 8 | 6 | 6 | 8 | 8 | 8 | **3** | 3 |
| B2. Export value growth at historical average minus one standard deviation in 2010-2011 3/ | 8 | 6 | 6 | 9 | 9 | 8 | **4** | 4 |
| B3. US dollar GDP deflator at historical average minus one standard deviation in 2010-2011 | 8 | 6 | 6 | 9 | 9 | 8 | **3** | 3 |
| B4. Net non-debt creating flows at historical average minus one standard deviation in 2010-2011 4/ | 8 | 6 | 6 | 8 | 8 | 8 | **3** | 4 |
| B5. Combination of B1-B4 using one-half standard deviation shocks | 8 | 6 | 6 | 8 | 8 | 7 | **3** | 3 |
| B6. One-time 30 percent nominal depreciation relative to the baseline in 2010 5/ | 8 | 8 | 8 | 11 | 11 | 10 | **4** | 4 |
| *Memorandum item:* | | | | | | | | |
| Grant element assumed on residual financing (i.e., financing required above baseline) 6/ | 28 | 28 | 28 | 28 | 28 | 28 | **28** | 28 |

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

INTERNATIONAL MONETARY FUND

# Mongolia—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Strategy, Policy, and Review Departments

(In consultation with other Departments)

Approved by Andrew Tweedie and Anthony Boote

March 19, 2009

1. **This note assesses the risks to the Fund arising from the proposed Stand-By Arrangement (SBA) for Mongolia and its effects on the Fund's liquidity, in accordance with the policy on exceptional access.**[1] The authorities are requesting an 18-month SBA with access of SDR 153.3 million (300 percent of quota). The arrangement would be front-loaded with a first purchase of SDR 51.1 million (100 percent of quota) upon approval and a purchase of SDR 25.6 million (50 percent of quota) in June 2009. The remaining resources would be phased in five quarterly purchases of SDR 15.3 million (30 percent of quota), with the last purchase scheduled to take place in September 2010 (Table 1).

**Table 1. Mongolia: Proposed SBA—Access and Phasing**

| Availability | Date 1/ | SDR mn. | Percent of quota | |
|---|---|---|---|---|
| | | | Purchase | Cumulative |
| 2009 | April (approval) | 51.1 | 100.0 | 100.0 |
| | June | 25.6 | 50.0 | 150.0 |
| | September | 15.3 | 30.0 | 180.0 |
| | December | 15.3 | 30.0 | 210.0 |
| 2010 | March | 15.3 | 30.0 | 240.0 |
| | June | 15.3 | 30.0 | 270.0 |
| | September | 15.3 | 30.0 | 300.0 |
| | Total | 153.3 | 300.0 | 300.0 |

Source: Finance Department.

1/ Reviews are assumed to take place at the end of each month shown on the table. Purchases are assumed to take place on the first day of the month following the review.

[1] See *IMF Concludes Discussion on Access Policy in the Context of Capital Account Crises; and Review of Access Policies in the Credit Tranches and the Extended Fund Facility,* Public Information Notice (PIN) No. 03/37; available via the internet: http://www.imf.org/external/np/sec/pn/2003/pn0337.htm).

## I. BACKGROUND

2. **Mongolia has had four financial arrangements with the Fund since becoming a member in February 1991 (Table 2 and Figure 1)**. An initial SBA in 1991, at a time when Mongolia was not yet eligible to use concessional resources, laid the foundation for later ESAF arrangements. Mongolia made purchases under the SBA amounting to just over half of the approved amount of SDR 22.5 million. From 1993 to 2005, Mongolia had two ESAF arrangements and one PRGF arrangement, and in all cases it was unable draw upon all of the available resources. Under Mongolia's most recent PRGF arrangement, which started more than a year after the previous arrangement had lapsed, only the first and second reviews were completed, with a year's delay in 2003. At that time the arrangement was extended, but no further reviews were completed despite broad achievement of the macroeconomic objectives, reflecting governance concerns at the Bank of Mongolia. Mongolia's ex-post assessment in 2005 noted that the failure to complete the Fund-supported programs, even when many of the key objectives were met, suggested lack of sustained ownership. Mongolia has made repurchases and repayments in a timely fashion, and its outstanding obligations to the Fund have been on a declining path since 2001. As of end-February 2009, Mongolia's outstanding obligations, all to the PRGF Trust, were SDR 12.4 million.

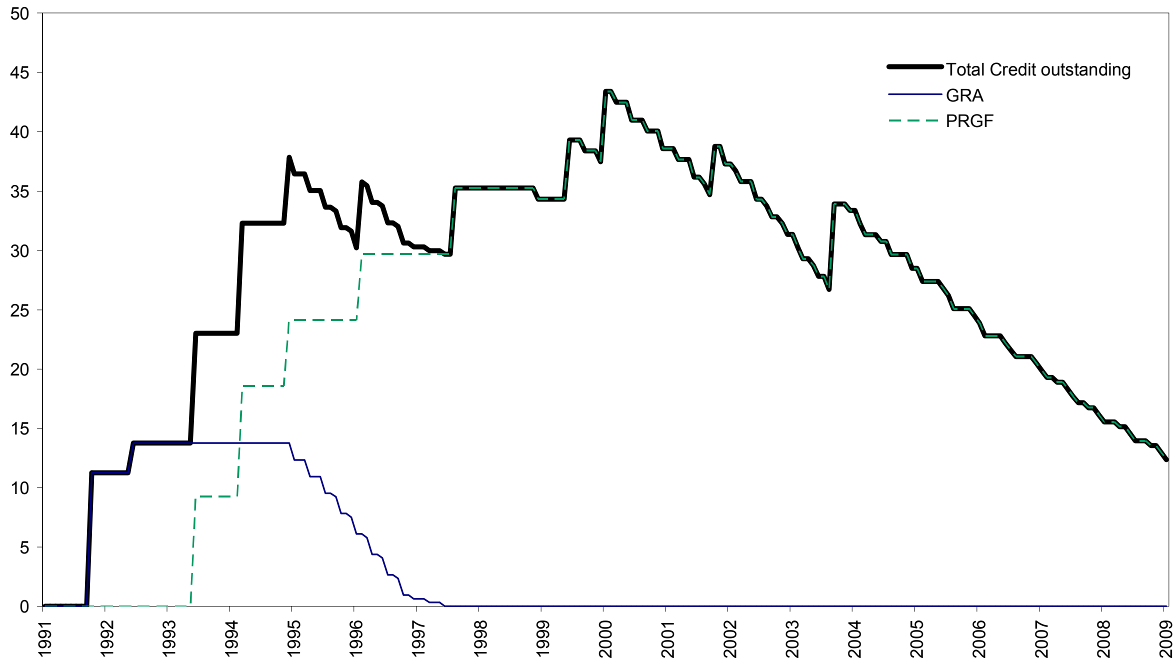
**Table 2. Mongolia: IMF Financial Arrangements, 1991–2015**
(In millions of SDRs)

| Year | Type of Arrangement | Date of Arrangement | Date of Expiration or Cancellation | Amount of New Arrangement | Amount Drawn | Purchases/ Disbursements | Repurchases/ Repayments | Fund Exposure 1/ | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | GRA | PRGF | Total |
| 1991 | SBA | 4-Oct-91 | 31-Dec-92 | 22.5 | 13.8 | 11.3 | -- | 11.3 | -- | 11.3 |
| 1992 | | | | | | 2.5 | -- | 13.8 | -- | 13.8 |
| 1993 | ESAF | 25-Jun-93 | 24-Jun-96 | 40.8 | 29.7 | 9.3 | -- | 13.8 | 9.3 | 23.0 |
| 1994 | | | | | | 14.8 | -- | 13.8 | 24.1 | 37.9 |
| 1995 | | | | | | -- | 6.3 | 7.5 | 24.1 | 31.6 |
| 1996 | | | | | | 5.6 | 6.9 | 0.6 | 29.7 | 30.3 |
| 1997 | ESAF | 30-Jul-97 | 29-Jul-00 | 33.4 | 17.4 | 5.6 | 0.6 | -- | 35.2 | 35.2 |
| 1998 | | | | | | -- | 0.9 | -- | 34.3 | 34.3 |
| 1999 | | | | | | 5.9 | 2.8 | -- | 37.5 | 37.5 |
| 2000 | | | | | | 5.9 | 4.8 | -- | 38.6 | 38.6 |
| 2001 | PRGF | 28-Sep-01 | 31-Jul-05 | 28.5 | 12.2 | 4.1 | 5.4 | -- | 37.3 | 37.3 |
| 2002 | | | | | | -- | 5.9 | -- | 31.3 | 31.3 |
| 2003 | | | | | | 8.1 | 6.1 | -- | 33.4 | 33.4 |
| 2004 | | | | | | -- | 4.9 | -- | 28.5 | 28.5 |
| 2005 | | | | | | -- | 4.0 | -- | 24.5 | 24.5 |
| 2006 | | | | | | -- | 4.0 | -- | 20.4 | 20.4 |
| 2007 | | | | | | -- | 4.3 | -- | 16.1 | 16.1 |
| 2008 | | | | | | -- | 3.2 | -- | 13.0 | 13.0 |
| 2009 2/ | | | | | | -- | 0.6 | -- | 12.4 | 12.4 |
| *2009 3/* | *SBA* | *30-Mar-09* | | *153.3* | | *92.0* | *4.2* | *92.0* | *8.7* | *100.7* |
| *2010 3/* | | | | | | *61.3* | *3.0* | *153.3* | *5.7* | *159.0* |
| *2011 3/* | | | | | | -- | *2.4* | *153.3* | *3.3* | *156.6* |
| *2012 3/* | | | | | | -- | *17.6* | *137.3* | *1.6* | *139.0* |
| *2013 3/* | | | | | | -- | *59.1* | *79.8* | -- | *79.8* |
| *2014 3/* | | | | | | -- | *60.7* | *19.2* | -- | *19.2* |
| *2015 3/* | | | | | | -- | *19.2* | -- | -- | -- |

Source: Finance Department.

1/ As of end-December, unless otherwise stated.
2/ As of end-February 2009.
3/ Figures under the proposed program in italics. Assumes repurchases on an obligations basis.

**Figure 1. Mongolia: IMF Credit Outstanding, 1991–2009**
**(In millions of SDRs)**




Source: Finance Department.

3. **Mongolia's external debt is moderate and consists predominantly of public sector debt to multilateral and bilateral creditors**. At end-2008, Mongolia's total external debt was estimated at about 35 percent of GDP, i.e., below the corresponding ratios for most of the exceptional access cases since the exceptional access framework was put in place in 2003.[2] Likewise, Mongolia's external debt service ratio to exports of goods and services is lower than nearly all of the previous exceptional access cases, reflecting its large mineral exports and its high share of concessional debt. Mongolia's external public debt ratio of 33 percent of GDP is higher than the corresponding ratios for all except four of the previous exceptional access cases (Table 3, Figure 3, Panel B), reflecting its reliance on public and publicly guaranteed external borrowing.[3] At end-2008, three-fifths of Mongolia's public external debt was due to multilateral creditors (Figure 2).

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[2] No comprehensive data on Mongolia's private external debt are available, and while the amount is estimated to be small, it is expected grow in line with the anticipated development of mining projects.

[3] The previous exceptional access cases used as comparators in this paper are four of the five arrangements approved since the exceptional access framework was put in place (Argentina, Brazil, Turkey, and Uruguay), and the recent cases approved in 2008–09. The 2008 extended arrangement for Liberia also involved exceptional access. However, this arrangement was different from other exceptional access cases since, in this case, exceptional access was granted in the context of Liberia's clearance of arrears to the Fund.

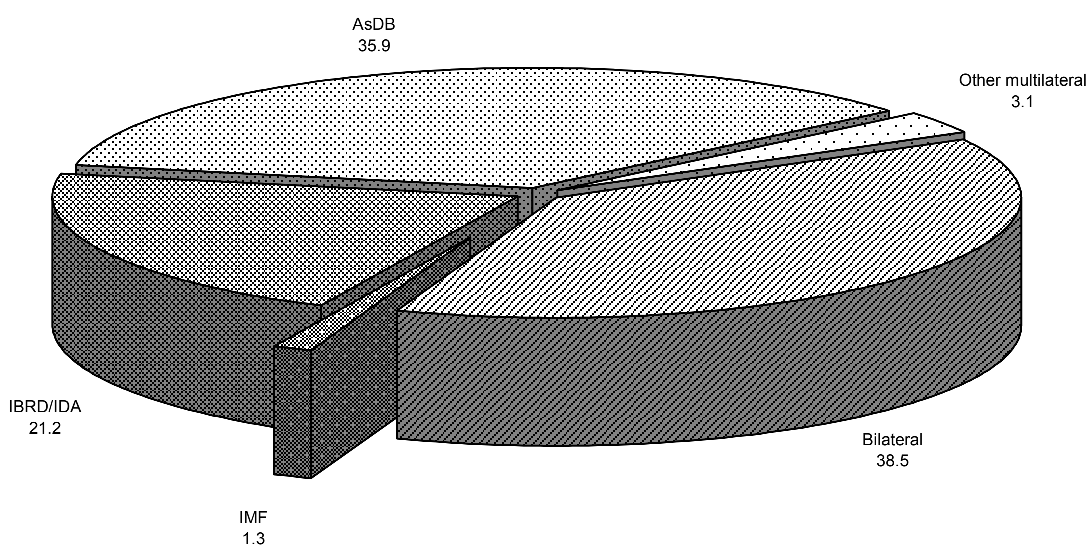
4. **This external public debt accounts for virtually all of Mongolia's total public debt** (Figure 3, Panel C). At end-2008, total government and government-guaranteed debt was estimated at about 33.1 percent of GDP, which is below the corresponding ratios for most of the previous exceptional access cases.

**Table 3. Mongolia: Total External Public Debt, 2004–2008 1/**

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|
| | (In Millions of US Dollars) | | | | |
| Total Public External Debt | 1,312 | 1,360 | 1,414 | 1,529 | 1,601 |
| Multilateral | 856 | 830 | 909 | 1,002 | 984 |
| IMF | 44 | 35 | 31 | 25 | 20 |
| IBRD/IDA | 287 | 276 | 301 | 331 | 338 |
| AsDB | 499 | 486 | 538 | 565 | 575 |
| Other mulilateral | 26 | 33 | 39 | 81 | 50 |
| Bilateral | 456 | 530 | 505 | 527 | 617 |
| | (In Percent of GDP) | | | | |
| Total Public External Debt | 72.3 | 59.0 | 44.3 | 38.9 | 33.1 |
| Multilateral | 47.2 | 36.0 | 28.5 | 25.5 | 20.4 |
| Bilateral | 25.1 | 23.0 | 15.8 | 13.4 | 12.8 |

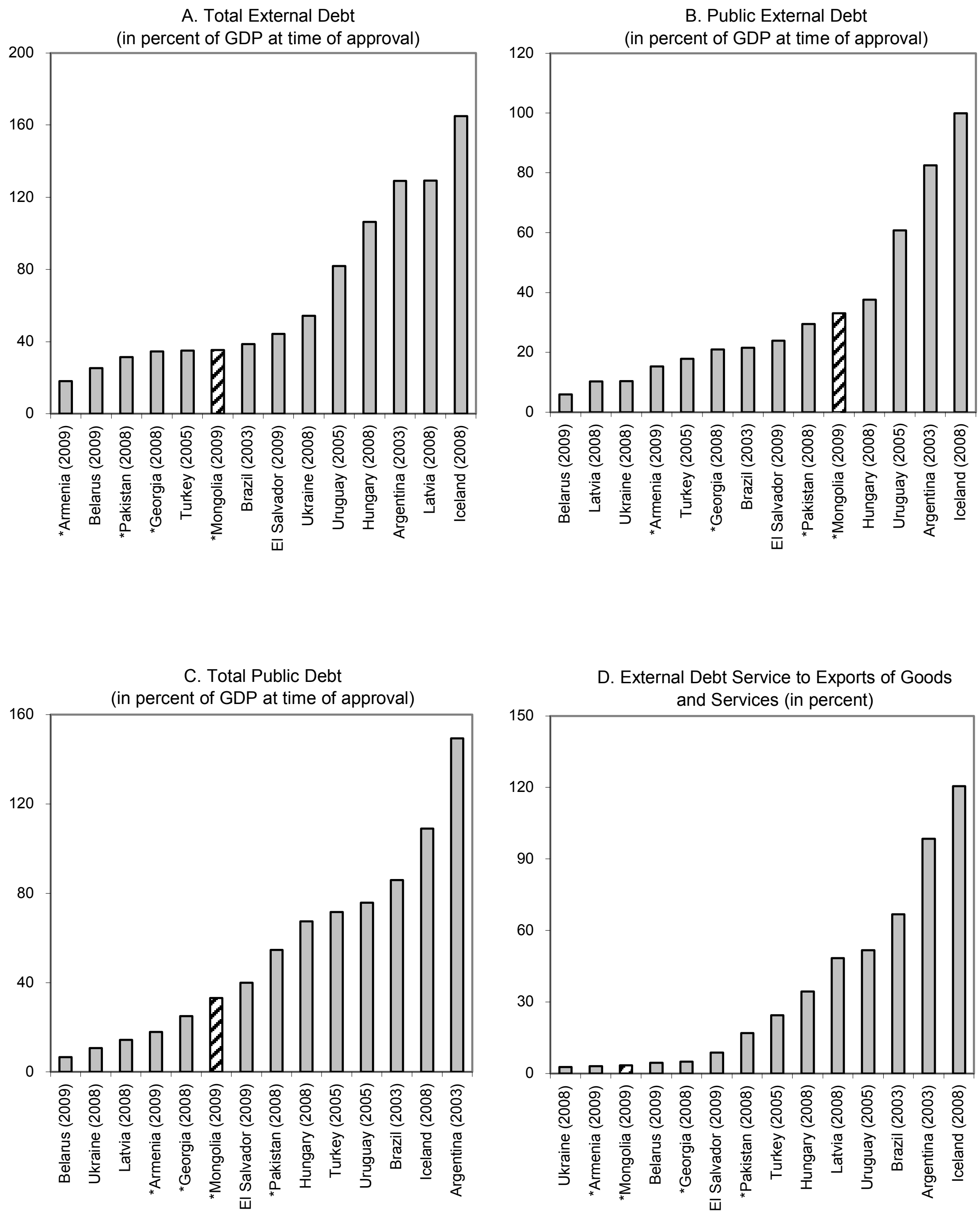
Source: Mongolian authorities and IMF staff estimates.

**Figure 2. Mongolia: Composition of Total External Public Debt, end-2008**
(in percent)




Source: Mongolian authorities and IMF staff estimates.

## Figure 3. Debt Ratios for Recent Exceptional Access Arrangements 1/ 2/




Source: Mongolian authorities and IMF staff estimates, and World Economic Outlook.

1/ Year in parenthesis corresponds to the year of approval. Ratios are for the year indicated in parenthesis, with the exception of Belarus, El Salvador, Armenia and Mongolia, for which 2008 ratios are shown. Asterisks indicate PRGF eligible countries.

2/ For arrangements approved since September 2008, estimates as reported in each staff report on the request of the Stand-By Arrangement.

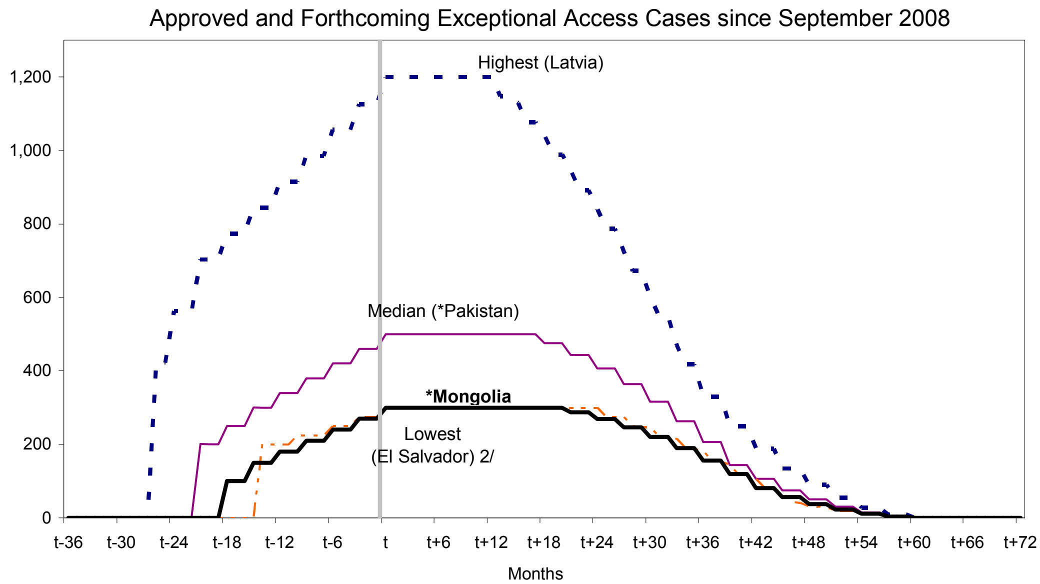
## II. The New Stand-By Arrangement—Risks and Impact on Fund's Finances

### A. Risks to the Fund

5. **Access under the proposed arrangement would greatly exceed that in previous arrangements for Mongolia:**

- If all purchases are made as scheduled, Mongolia's outstanding use of GRA resources would rise to over 200 percent of quota with the first four drawings, and then to 300 percent of quota in October 2010, remaining at 300 percent of quota through July 2012.[4] In terms of quota, this projected peak exposure would be the same as that of El Salvador—the lowest peak exposure for recent exceptional access cases (Figure 4). Including outstanding PRGF loans, the peak exposure, at 311 percent of quota (SDR 159 million) occurs from October 2010 to February 2011. In SDR terms, this peak level of credit outstanding would be more than three times larger than the historic peak in Mongolia's outstanding credit.

**Figure 4. Fund Credit Outstanding in the GRA around Peak Borrowing 1/**
**(in percent of quota)**




Source: IFS, Finance Department, and IMF staff estimates.
1/ Peak borrowing 't' is defined as the highest level of credit outstanding for a member. Repurchases are assumed to be on an obligations basis. Asterisks indicate PRGF eligible countries.
2/ The authorities have expressed their intention to treat the arrangements as precautionary, as balance of payments pressures have not materialized.

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[4] Debt service to the Fund is calculated on an obligations basis, in line with the guidelines stipulated in *Review of Fund Facilities—Proposed Decisions and Implementation Guidelines* (available via the internet: http://www.imf.org/external/np/pdr/fac/2000/02/). Under the obligations schedule, the first repurchase is scheduled to take place in July 2012, 3¼ years after the first purchase under the arrangement.

- Under the proposed SBA, Mongolia's total outstanding use of GRA resources will be 1.9 percent of GDP following the first purchase, and 5.4 percent of GDP after the final disbursement (Table 4). This peak relative to GDP would be close to the median of the exceptional access cases approved since September 2008.

- In SDR terms the peak GRA exposure of SDR 153.3 million would be the lowest of the recent exceptional access cases (Figure 5, Panel A). In particular, Mongolia's peak credit outstanding would be the lowest of the PRGF eligible countries among recent exceptional cases, with Pakistan being the highest, and Armenia and Georgia being the other countries in this group.

6. **Mongolia's external public debt ratios will rise significantly over the next two years as a result of front-loaded foreign financing, including from the Fund, and also owing to depreciation of the exchange rate** (Table 4):

- By end-2010, public external debt would increase to just under 50 percent of GDP, with Fund credit being 5.4 percent of GDP. Mongolia's outstanding use of GRA resources would account for about 11 percent of its projected public external debt and 22 percent of international reserves.

- Mongolia's projected debt service to the GRA would peak in 2014 at about SDR 61 million (and debt service to the PRGF Trust would fall to zero), at which time it would account for about half of public external debt service.[5] (At current SDR interest rates, Mongolia would pay an effective interest rate of about 1.8 percent over the duration of the loan, not including service charges or commitment fees, but the actual interest rate paid will depend on future developments in the SDR interest rate.)

- In terms of exports of goods and services, external debt service to the Fund on GRA credit would peak at 1.8 percent in 2014, lower than the peak in all of the recent exceptional access cases. Total public external debt service would peak at a relatively low 3.9 percent of exports of goods and services in 2012, partly reflecting high projected growth in exports as mineral resources are developed.

[5] Currency holdings resulting from scheduled purchases under the proposed SBA would be subject to level-based surcharges of 100 basis points over the basic rate of charge (adjusted for burden sharing) on credit outstanding exceeding 200 percent of quota from May 2009 through October 2013.

## Table 4. Mongolia: Capacity to Repay Indicators

(In millions of SDRs, at end of period unless otherwise noted)

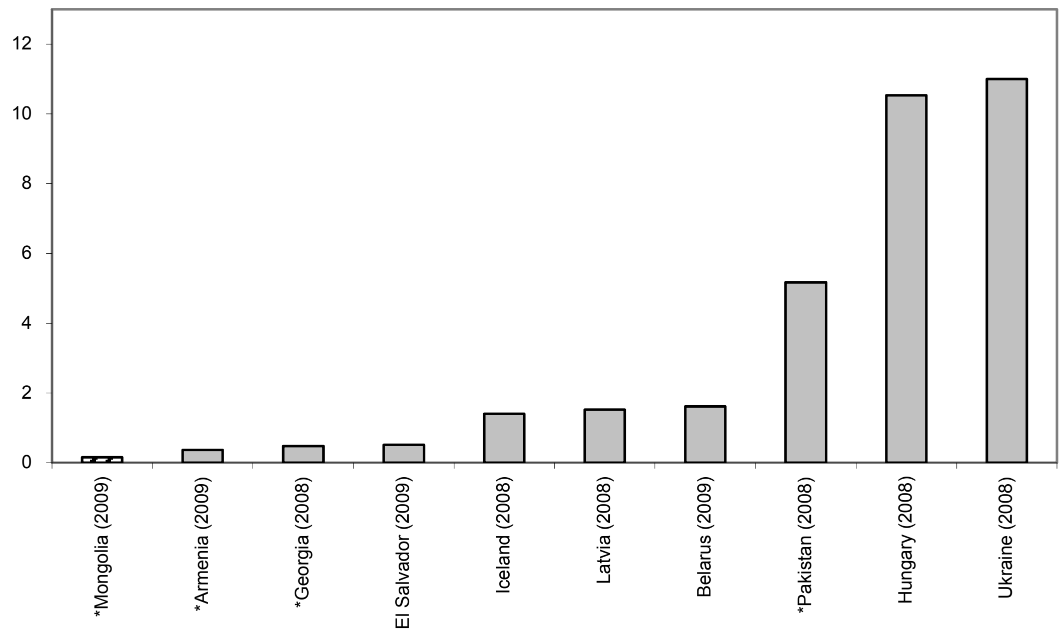
| | Apr-09 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| **Exposure and Repayments (In SDR millions)** | | | | | | | | |
| GRA credit to Mongolia 1/ | 51.1 | 92.0 | 153.3 | 153.3 | 137.3 | 79.8 | 19.2 | 0.0 |
| (In percent of quota) | (100.0) | (180.0) | (300.0) | (300.0) | (268.7) | (156.2) | (37.5) | (0.0) |
| Charges due on GRA credit 2/ | | 1.1 | 2.4 | 3.0 | 2.9 | 1.9 | 0.8 | 0.1 |
| Debt service due on GRA credit 2/ | | 1.1 | 2.4 | 3.0 | 18.8 | 59.4 | 61.4 | 19.3 |
| **Debt and Debt Service Ratios 3/** | | | | | | | | |
| In percent of GDP | | | | | | | | |
| External debt, public | 33.1 | 46.8 | 47.8 | 45.9 | 41.1 | 35.8 | 33.3 | 30.0 |
| GRA credit to Mongolia | 1.9 | 3.4 | 5.4 | 4.9 | 3.8 | 1.9 | 0.4 | 0.0 |
| In percent of Gross International Reserves | | | | | | | | |
| External debt, public | 243.7 | 218.5 | 190.6 | 178.7 | 167.0 | 161.9 | 143.0 | 122.3 |
| GRA credit to Mongolia | 11.8 | 16.9 | 21.6 | 19.1 | 15.4 | 8.5 | 1.8 | 0.0 |
| In percent of Total Public External Debt | | | | | | | | |
| GRA credit to Mongolia | 4.9 | 7.7 | 11.3 | 10.7 | 9.2 | 5.2 | 1.2 | 0.0 |
| Total debt to the Fund 4/ | 5.9 | 8.5 | 11.8 | 10.9 | 9.3 | 5.2 | 1.2 | 0.0 |
| In percent of Exports of Goods and Services | | | | | | | | |
| External debt service, public | 3.5 | 4.3 | 3.0 | 3.2 | 3.9 | 3.2 | 3.5 | 2.1 |
| Debt service due on GRA credit | | 0.1 | 0.1 | 0.2 | 0.8 | 1.6 | 1.8 | 0.4 |
| Total debt service to the Fund 4/ | | 0.4 | 0.3 | 0.3 | 0.8 | 1.7 | 1.8 | 0.4 |

Sources: Mongolia authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

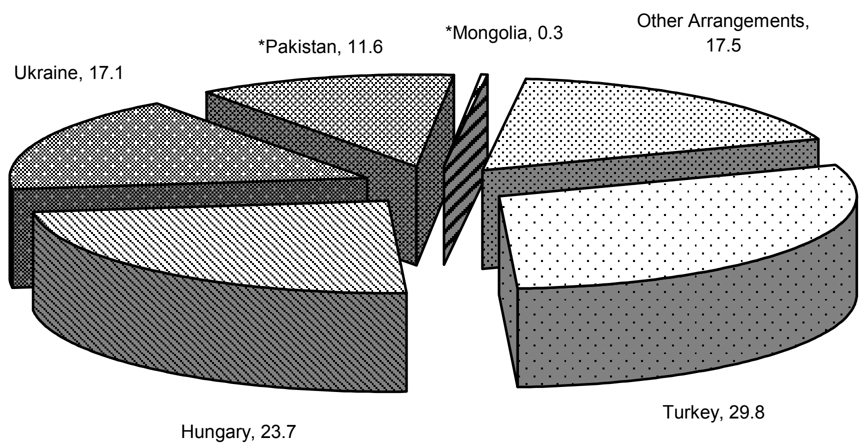
1/ Repurchases follow the obligations schedule.
2/ Includes surcharges and service fees.
3/ Staff projections for external debt, GDP, gross international reserves, and exports of goods and services, as used in the staff report that requests the proposed SBA.
For April 2009, projections for external debt, GDP, gross international reserves, and exports of goods and services are as of end-December 2008.
4/ Total debt to the Fund comprises balances outstanding on GRA credit and PRGF loans.

## Figure 5. Exceptional Access Levels and Credit Concentration 1/

A. Total Access of Recent Exceptional Access Arrangements
(In billions of SDRs)




B. Credit Concentration of Fund GRA Exposure 2/
(As a percentage of total credit outstanding)




Source: Finance Department.

1/ Asterisks indicate PRGF eligible countries.
2/ Credit outstanding as of March 9, 2009 plus the first purchase under the proposed arrangement with Mongolia.

## B. Impact on the Fund's Liquidity Position and Risk Exposure

7. **Given the comparatively low access in nominal terms under the arrangement, the impact on the Fund's liquidity and credit risk exposure is relatively small** (Table 5):

- **The proposed arrangement would reduce Fund liquidity by less than 0.2 percent**. Commitments under the proposed arrangement would reduce the one-year forward commitment capacity (FCC) of SDR 95.4 billion by SDR 153.3 million.[6] [7]

- **Fund credit to Mongolia as a share of total current Fund credit from the GRA would increase to 0.3 percent with the first purchase (Figure 5, Panel B)**. The share of the top five borrowers of total outstanding credit would decrease marginally to just over 85 percent.[8]

- **Were Mongolia to accrue arrears on charges under the proposed arrangement, the Fund's remaining burden sharing capacity would be somewhat reduced**.[9] Projected charges on the GRA obligations will peak at about SDR 3 million in 2011–12 or about 15 percent of the Fund's current estimated residual burden-sharing capacity.[10] However, the impact on the Fund's burden sharing capacity of potential arrears from this arrangement would decline if the Fund's loan portfolio were to expand further.

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[6] The FCC is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of GRA resources available for new financing over the next 12 months. Following the creation of the Short-Term Liquidity Facility (SLF), the calculation of the FCC will exclude repurchases falling due under the SLF—see *A New Facility for Market Access Countries—The Short-Term Liquidity Facility—Proposed Decision* (available via the internet: http://www.imf.org/external/np/pp/eng/2008/102708.pdf).

[7] Data as of March 9, 2009. This FCC is determined on the basis of available quota resources only; in addition, the Fund has access to SDR 34 billion under the NAB/GAB borrowing arrangements and US$100 billion under the borrowing agreement with Japan.

[8] Given the possibility of new financing operations, including some that will involve exceptional access, the concentration of the Fund's lending portfolio is likely to change in coming months.

[9] Under the burden-sharing mechanism, the financial consequences for the Fund that stem from the existence of overdue financial obligations are shared between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge, respectively. The mechanism is used to accumulate precautionary balances in the special contingent account (SCA-1) and to compensate the Fund for a loss in income when debtors do not pay charges. The Executive Board has set a floor for remuneration at 85 percent of the SDR interest rate. No corresponding ceiling applies to the rate of charge.

[10] Burden sharing capacity has declined recently, despite the increase in credit outstanding, reflecting the steep decline in the SDR interest rate.

- **Potential GRA exposure to Mongolia would be small in relation to the current level of the Fund's precautionary balances**. After the first purchase, Fund credit to Mongolia would be about 0.7 percent of the Fund's current precautionary balances, and the total access amounts to about 2 percent of current precautionary balances.

### Table 5. Mongolia: Impact on GRA Finances

| | As of 3/9/09 |
|---|---|
| **Liquidity measures** | |
| One-year Forward Commitment Capacity (FCC) 1/ | 95,361.7 |
| Mongolia's impact on FCC 2/ | (153.3) |
| **Prudential measures** | |
| Fund GRA credit outstanding to Mongolia (percent of current precautionary balances) 3/ | 0.7 |
| Mongolia's annual GRA charges (percent of Fund's residual burden sharing capacity) | 0.0 |
| Fund GRA credit outstanding to Mongolia (percent of total GRA credit outstanding) 4/ | 0.3 |
| **Memorandum items** | |
| Fund's precautionary balances 3/ | 6,938.6 |
| Fund's residual burden sharing capacity 5/ | 20.0 |
| Fund GRA credit outstanding to five largest debtors (percent of total GRA credit outstanding) 4/ | 85.5 |

Sources: Mongolia authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to usable resources plus repurchases one-year forward minus the prudential balance. FCC determined on basis of available quota resources only; in addition, the Fund has access to SDR 34 billion under the NAB/GAB borrowing arrangements and $US 100 billion under the borrowing arrangement with Japan.
2/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.
3/ As of end-April 2008.
4/ Reflects total Fund credit outstanding plus the first purchase of Mongolia.
5/ Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

## III. Assessment

8. **The proposed program, and its front-loaded financing, aim to forestall an impending crisis in response to a major shock to the price of Mongolia's main export commodity.** Economic imbalances were already present as a result of past procyclical policies, and reserve losses have been rapid. Accordingly, the main elements of the program include large upfront fiscal adjustment, flexibility in the exchange rate, a tightening of monetary policy, and efforts to restore confidence in the banking system.

9. **There are substantial risks to the proposed arrangement for Mongolia.** Achieving the upfront fiscal and monetary tightening will be challenging, implying downside

risks to international reserves and the exchange rate, with potential consequences for the health of the banking system and for depositor confidence. Uncertainties surrounding the timing and magnitude of donor support needed to meet overall financing needs add to these risks. Political developments in the run-up to the May presidential elections add to policy implementation concerns, elevating the risks stemming from the front-loaded nature of the Fund's financing, particularly given Mongolia's past mixed track record of program implementation. The global economic environment is highly uncertain, and copper prices could well fall further, putting additional pressure on the economy. There is also a risk that Mongolia's mineral wealth will be commercialized at a much slower pace than currently envisaged, undermining medium-term growth and balance of payments prospects.

10. **These risks may adversely affect Mongolia's capacity to repay the Fund, although the impact on the Fund's finances would be contained by the relatively low level of access in nominal terms**. While prospects for key debt and debt service ratios appear manageable, this outlook depends on rebuilding international reserves and on export growth reliant on international mineral prices and on investments to develop the country's mineral resources. In these conditions, the authorities' commitment to firm implementation of the program, particularly their willingness to take further policy measures if needed, will be crucial to the success of the program and Mongolia's ability to repay the Fund.

INTERNATIONAL MONETARY FUND

MONGOLIA

**Request for Stand-By Arrangement—Supplementary Information**

Prepared by the Asia and Pacific Department in Consultation with Other Departments

Approved by Nigel Chalk and Anthony R. Boote

March 30, 2009

1. This supplement is to update the Board on the events that have taken place since the issuance of the staff report. It does not change the staff's assessment contained in that report.

2. **Monetary policy**. In advance of the foreign exchange auction, the authorities tightened monetary conditions considerably to prevent an overshooting of the exchange rate. On March 10, the central bank raised its 7-day central bank bill rate (the Bank of Mongolia's policy rate) from 9.75 percent to 14.0 percent. Following that increase, on March 18, the central bank also raised rates on its repo, collateralized loan and overnight facilities by 300 basis points (to 20 percent, 23 percent, and 24 percent respectively). In addition, the central bank has begun consolidating its issuance of longer dated central bank bills at the 12-week maturity; on March 23, the central bank conducted its first auction of such bills with an average interest rate of 19.9 percent, bringing the real rate to positive levels as inflation dropped to 17 percent in February.

3. **Foreign currency auctions**. On March 24, the Bank of Mongolia began allocating its foreign exchange by way of a two-way, transparent auction to local commercial banks. The authorities have opted for a multiple price auction structure, in line with international practice and MCM advice. Following the interest rate increases, and in anticipation of the auction, the informal market rate had appreciated by 7 percent, bringing it in line with the central bank reference rate. The first auction left the exchange rate broadly unchanged and since then the currency gained another 3½ percent in the informal market.

4. **Fund jurisdiction under Article VIII, Sections 2(a), 3, and 4**. Following the introduction of the foreign currency auctions, Fund staff is currently reviewing whether the authorities continue to maintain exchange restrictions or multiple-currency practices (MCPs) subject to Fund jurisdiction. As noted in the staff report, before the introduction of the foreign exchange auctions, the authorities maintained one exchange restriction and one MCP for balance of payments purposes. The authorities have committed to removing any exchange measures by June 1. Fund staff will keep the Executive Board apprised of the situation and

will get back to the Board as soon as any findings with respect to exchange restrictions or MCPs have been made.

5. **Bilateral support**. On March 17, the Russian Federation and the Mongolian authorities signed an agreement on the provision of import credit—through Rosselkhozbank of Russia to a consortium of Mongolian commercial banks—for farming sector development. The details of the credit scheme are yet to be specified, but arrangement is intended to finance purchases of agricultural equipment and other inputs, such as seeds and fertilizers, from the Russian Federation and does not involve any government guarantees.

6. **Structural performance criteria**. In light of the Board decision on March 24 to eliminate structural performance criteria (SPC) from May 1, 2009, the staff consulted with the authorities and they preferred—and the staff agree—to convert the three SPCs to structural benchmarks at this stage. A fuller move to review-based structural conditionality will be considered at the next review.

7. The exceptional access criteria have also changed[1] and paragraph 27 of the staff report has been revised to reflect these changes.

[1] Mongolia still requires exceptional access as planned disbursements in the first year of the program are 240 percent of quota.

Press Release No. 09/110
FOR IMMEDIATE RELEASE
April 1, 2009

International Monetary Fund
Washington, D.C. 20431 USA

**IMF Executive Board Approves US$229.2 Million Stand-By Arrangement for Mongolia**

The Executive Board of the International Monetary Fund (IMF) today approved a 18-month Stand-By Arrangement for Mongolia in an amount equivalent to SDR 153.3 million (about US$229.2 million) to support the country's economic stabilization program.

Upon the Executive Board's approval, an amount equivalent to SDR 51.1 million (about US$76.4 million) becomes immediately available to Mongolia. The remaining amount will be phased in, subject to quarterly reviews. The total amount of the IMF resources made available under the arrangement equals 300 percent of the country's quota.

Key objectives of the IMF-supported program are: to restore macroeconomic stability through fiscal, monetary and financial sector policies; and to protect the poor from the burden of the needed adjustment. The program also aims at outlining a solid macroeconomic framework to provide the basis for the authorities to approach the broader international community for financial support.

Following the Executive Board discussion on Mongolia, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chairman, stated:

"Mongolia has been severely affected by the global financial crisis through a sharp reduction in the prices of its main mineral exports, notably copper. The authorities' program aims to smooth Mongolia's adjustment to the large terms-of-trade shock, put the fiscal finances on a sustainable footing, allow for a more flexible exchange rate, address weaknesses in the banking system, and mitigate the impact of adjustment on the most vulnerable. The authorities are committed to restoring macroeconomic stability and putting in place the conditions for strong and equitable growth.

"The centerpiece of the authorities' economic program is a significant adjustment in the fiscal stance to strengthen Mongolia's finances and restore fiscal sustainability. The program also seeks a legislated framework for fiscal responsibility, which will help limit the procyclicality of fiscal policy.

“The program is supported by a shift in Mongolia’s monetary stance designed to safeguard international reserves, prevent an overshooting of the nominal exchange rate, and put inflation on a steady downward path. The central bank’s recent decisions to raise interest rates and contain liquidity are consistent with those objectives.

“The authorities have moved quickly to address vulnerabilities in the banking system, taking one bank into conservatorship, clarifying the blanket deposit guarantee scheme, and requiring other banks to raise their level of capital over time.

“The program aims to address the social consequences of the economic downturn, in particular on the more than one third of the population living below the poverty line. In the coming months, the authorities intend to improve the system of social transfers through better targeting, ensuring that the very poorest households are more fully protected, while conserving fiscal resources,” Mr. Kato said.

**ANNEX**

**Recent Economic Developments**

Mongolia has been hit hard by the global economic and financial crisis through a sudden and catastrophic drop in the price of its main export commodities, most notably copper. This shock, combined with the procyclical policies implemented during the more favorable times, has quickly exacerbated the country's macroeconomic situation in the past several months. Mineral revenues, which accounted for more than one-third of budget revenues at the peak of the commodity boom in 2007, have fallen sharply and expected to account for only 12½ percent of total revenues in 2009, putting significant pressures on the fiscal position. The economic growth is set to fall to around 3 percent this year from 9 percent in 2008, and the current account deficit is expected to remain substantial, at around 6½ percent of GDP this year, mainly due to a sharp fall in the terms of trade. The shock to the economy has also led to a retrenchment of credit; broad money has fallen by 14 percent since mid-2008, and the banking system came under stress.

**Program Summary**

Against this background, the Mongolian authorities have embarked on a program to restore macroeconomic stability while protecting the poor during the process of adjustment. To support this program, they have requested IMF financial assistance.

The program includes the following key elements:

- **Fiscal policy:** The large drop in the mineral revenues necessitates bold fiscal measures to bring government finances back to a sustainable level. The program seeks to constrain the general government deficit to 6 percent of GDP in 2009. The fiscal adjustment is centered primarily around expenditure restraint. The biggest savings will come from postponement of domestically financed capital expenditure plans. Additional savings will be generated from a wage and hiring freeze, cuts in some untargeted social allowances, and reductions in other purchases and good and services. To prevent the future boom-bust fiscal cycle, a stronger institutional framework will be placed to ensure a greater proportion of windfall copper revenues is saved.

- **Monetary and foreign exchange policy:** The program envisages strengthening the country's international reserve position and calibrating monetary policy to prevent any undue overshooting of the exchange rate and to keep inflation on a downward path. A new system of foreign currency auction has been introduced to have a nondiscriminatory and transparent mechanism to sell foreign exchange that allows for market determination of the exchange rate.

- **Financial sector:** To build confidence in the local banking system, the program includes measures to further strengthen the banking system by improving the current framework for deposit guarantees and enhancing bank supervision.

- **Social protection:** With one-third of the population living below the poverty line, improving the social safety net is a key element of the program to ensure that the poorest segment of the society are protected adequately. In collaboration with the Asian Development Bank and the World Bank, the authorities will design a comprehensive overhaul of the existing untargeted system of social transfer programs. The goal will be to better target these programs towards the very poor and increase the support that poor households receive.

Mongolia, which joined the Fund on February 14, 1991, has a quota of SDR 51.1 million (about US$76.4 million).

**Statement by Hi-Su Lee, Executive Director for Mongolia and Suk-Kwon Na, Advisor to Executive Director April 1, 2009**

## Introduction

1. The economy had performed very well until end-June of 2008, primarily spurred by a sharp run-up in the international prices of copper and gold. Real GDP growth had averaged 9 percent for the period 2004-2008, with growth rate in 2007 peaking at 10.2 percent. In this environment, the main concern was placed on the possibility of overheating and the ensuing negative impact, as manifested by the increasing trend of inflation rate from 6 percent in June 2007 to 34 percent in August 2008.

2. This inflationary pressure had resulted from procyclical policies including a relaxation of monetary and fiscal policies. In fact, high mineral prices, combined with the mid-2006 introduction of a Windfall Profit Tax on minerals and improvements in tax administration, contributed to improving the budget revenues and further provided the platform for the more expansionary government spending. This spending spree took the form of broadening of social welfare programs, increase in the civil service wage bill and more than a doubling of capital expenditures. Such procyclical policies in the past have caused the fiscal position to be vulnerable to unexpected external shocks and ultimately functioned as the one deep-rooted cause of the current economic crisis of Mongolia.

3. On top of this, the recently-evolving global financial crisis has had severe impact on the fiscal account, the balance of payments and the exchange rate of Mongolia, mainly through a sudden and sharp drop in the price of Mongolia's key mineral exports. As a direct impact, mineral revenues have fallen by 10 percent of GDP so far, and their expected share out of the budget revenues also sharply dropped to only 12½ percent in 2009 from one-third in the boom period of 2007. Secondly, the degeneration and spill-over of the global financial turmoil have affected capital flows to Mongolia, leading to still large and sizable private capital outflows. As a result, with the central bank's intervention in slowing the depreciation trend, net international reserves have depleted dramatically and steadily from the peak of US$1 billion during the mid-2008 to around US$.5 billion in end-February 2009. The declining economic activity and degenerating BOP still put downward pressures on the currency, despite an almost 40 percent depreciation from November 2008.

## The Objectives of the Program

4. The aforementioned stark swings in the economic situation made the authorities resort to the Fund collaboration and assistance in addressing the imminent risks. The accelerated deterioration of macro economic variables called for more drastic adjustment measures in a timely and comprehensive manner. To alleviate the imminent risks, successive mission visits were made during the first quarter of 2009 and the authorities decided to request an 18-month Stand-By Arrangement based on the exceptional access provision.

5. The proposed program aims at efficiently averting an impending crisis emanating from a combination of external shocks and domestic policy slippages. It further provides the

significant momentum for the authorities' quick recovery and medium-term stability after the program period ends. This program is also expected to play a catalytic role in attaining international donor support. Thus, we see as the suitable setting that the main focus is being placed at large upfront fiscal adjustment; flexibility in the exchange rate; a tightening of monetary policy; and efforts to restore confidence in the banking system.

6. The authorities are fully cognizant of the seriousness of the risks and the subsequent necessity for robust adjustment efforts. At the same time, as alluded to in the DSA document, it is encouraging that Mongolia is at low risk of external debt distress, with the debt outlook expected to recover and improve over the medium term. They fully know that this somewhat bright result arises from the Oyu Tolgoi and Tavan Tolgoi mining projects, which are being negotiated with international mining companies for large copper, gold and coal deposits. While, in this sense, seeing the current problems as transitory in nature and preferring short-term arrangement combined with a smoother adjustment, the authorities are committed to steadfast implementation of the reform measures under the Fund program. They also bear in mind the warning messages from the DSA that more protracted global recession and ensuing steadily lower copper prices in the future would not only dampen the external debt dynamics but also sizably damage their fiscal situation and mid-term economic stability plan. Thus, they will maintain a conservative stance on the price development of copper and on the world growth outlook in pressing ahead with the current crisis.

7. To maximize the effectiveness of the program, the authorities have taken considerable prior actions in line with the purport of the program, such as passing the amended budget consistent with the fiscal targets under the program; the revision of the deposit guarantee legislation; and appointment of an international auditor for Anod Bank.

**Fiscal Policy**

8. The authorities acknowledged that the procyclical measures adopted in the recent years, such as civil service wage increase, newly-introduced universal transfers and sharply increased capital expenditures, cannot be sustained under the current situation of collapse in global mineral prices. The authorities thus resubmitted to parliament their 2009 budget which is commensurate to the 6 percent of GDP overall deficit target for 2009. With the recent parliament's approval of the amended budget on March 13, 2009 giving a signal of political ownership for the program, the momentum for fiscal adjustment has been much strengthened.

9. Looking ahead, the authorities principally agreed with staff that a more balanced fiscal adjustment, including additional revenue-enhancing measures and a revamp of household transfer programs, are warranted for restoring the fiscal situation into a sound path. We also find some scope for further belt-tightening in the fiscal area, as the revised budget is focusing on the expenditure reductions in capital outlays as well as the increase in excise taxes on some staple products and custom duties. However, given the political difficulty surrounding the presidential elections in May 2009 and specific risks like fiscal seasonality, it will now take some time to adopt additional fiscal adjustment measures. It is therefore intended that the staff's recommendation on additional fiscal consolidation will be fully considered and appropriately taken in the forthcoming fiscal measures, which are expected after the presidential elections. The authorities are committed to continuing such consolidation effort in

the period ahead to stabilize the fiscal situation into a more sustainable medium-term path, with a short-term deficit target for 2010 at 4 percent of GDP.

10. With regard to the social transfers that are overlapped and untargeted in part, the authorities agreed with staff that it is pivotal to strengthen the existing social transfer system and to remove the inefficiencies. Thus, the authorities are committed to carrying out the comprehensive reform for the entire social transfer system soon, with focus being placed on cutting back the untargeted transfers and increasing the transfers to the poor who are in urgent need. With full utilization of the help from the Asian Development Bank and the World Bank, the authorities plan to incorporate these reform measures starting with the 2010 budget.

11. Given the still prevailing risks from both revenue and expenditure sides and the possibility of failure in obtaining sufficient donor support, the authorities stand ready to monitor the development of the fiscal account and to react in a timely manner by accelerating the currently-established reform measures.

**Structural Fiscal Reforms**

12. More strengthened structural framework is strongly warranted, as world mineral prices tend to repeat the unexpected price fluctuation and cause an undesirable boom-bust fiscal cycle again. From the fiscal perspective, Mongolia is by nature a fragile economy, significantly relying on mineral revenues. In light of this, with the goal of stronger fiscal framework, the authorities are making the ambitious plan to enact the fiscal responsibility legislation, including the introduction of a structural fiscal rule, by the end of this year with cooperation from the Fund and the World Bank. They will take conservative stance on the medium-term level of copper prices as well as medium-term fiscal sustainability, while pursuing the cautious approach of saving more portions of windfall mineral revenues for safeguard purposes.

**Monetary and Exchange Rate Policy**

13. The Bank of Mongolia (BOM) is committed to maintaining a flexible exchange rate to facilitate the needed adjustment and safeguard its international reserves. While accepting the destructive impact of the monetary easing and provision of liquidity to banks in the past, the BOM agreed to staff's advice of tightening monetary policy to levels that are consistent with money demand. This swing in policy would contribute to alleviating the depreciation trend of the togrog. As first measure, the BOM has already adopted a step increase in policy rates from 9.75 percent to 14 percent on March 10. In addition, on March 18 the BOM raised rates on its repo, collateralized loan and overnight facilities by 300 bps to 20 percent, 23 percent, and 24 percent, respectively. Keeping watchful of market development, the BOM continues to react in a timely manner in case an extraordinary event emerges.

14. Since November 2008, the BOM allowed flexible movements in the exchange rate, so that the currency has depreciated by almost 40 percent in nominal terms. However, as a result of rapid reserve loss, the BOM started to allocate foreign exchange for essential needs, such as staples imports. This system led to a multiple currency practice as the market rate and the official mid-point rate have deviated substantially. While trying to narrow the difference between the official and the informal exchange market, the authorities clarified that this current

practice is only temporary due to the current extreme stress on the balance of payments. In light of this, the authorities have firmly committed to lifting such restrictions before June 1, so as to allow the exchange rate to flexibly adjust to a level consistent with economic fundamentals.

15. To that end, the BOM has moved swiftly to introduce a new system of foreign currency auctions, which is one of the structural benchmarks under the program. On March 24, the BOM began allocating its foreign exchange by way of a two-way, transparent auction to local commercial banks. This improvement, benefiting from the technical assistance from MCM, helps to strengthen price discovery and to enhance the transparency of foreign exchange sales. As a result, the market rate and the official rate have converged. In parallel, as a method of developing the foreign exchange market, the revision of relevant laws to require Erdenet – the state-owned main copper company – to pay taxes in togrog, as well as the establishment of screen-based system for inter-bank foreign exchange transactions, are both being pursued.

**Banking System**

16. The authorities are of the view that bolstering confidence in the banking system is a key priority in stabilizing the financial market. With regard to mitigating further deposit outflow, the authorities announced in November 2008 a deposit guarantee policy restricted only to time and savings deposits and recently expanded the coverage of such guarantee to current accounts and interbank deposits to restore confidence in the banking system.

17. From the central bank side, wide-ranging measures in coping with banks' weakness and strengthening banking supervision have been put in place, including (i) increasing banks' risk-weighted capital adequacy ratio to 12 percent by end-2009, including through foreign participation; (ii) completing an updated on-site examination of the five largest banks by June 2009, together with strengthening off-site monitoring; (iii) identifying problem banks and devising a supervisory enforcement plan by end-June 2009; and (iv) strengthening its fit and proper review of shareholders and management.

18. All the relevant authorities, including the BOM and the Financial Regulatory Commission, will submit a revised Banking Law and other related laws and legislations to the parliament by end-June 2009 in order to make strengthened supervision concrete in legal terms. Through these legal actions, the government seeks to strengthen the prompt corrective action clauses in the Banking Law, improve the bank resolution framework, initiate consolidated supervision, and reinforce prudential supervision requirements. In addition, the government intends to update the laws on foreclosure of collateral for the purpose of facilitating loan recovery and rebalancing the borrowers' protection.

**Program and International Support**

19. There exists need for further international support for filling the budgetary financing gaps of around US$205 million in 2009-10, although the exceptional access of 300 percent of quota (SDR 153.3 million) under the proposed program works to maintain gross reserves at the sufficient level. With the successful conclusion of a donor conference on March 14, most of the gap has been secured through the financing support from the Asian Development Bank, the World Bank and the Japanese government. While the remaining financing gaps still necessitate

the support of other donors, the authorities are committed to taking corrective measures to address any donor shortfall and mitigate risks to the program. In this light, staff's reassessment of the availability of financing will be done during the first review if necessary.

20. The option of a sovereign bond issuance is worth attracting the authorities' attention. However, as the authorities are well aware of its costliness and the ensuing concern over debt sustainability, they underscored that such issuance would be consistent with debt sustainability and that a ceiling on the new non-concesssional borrowing under the program would be strictly observed in any cases.

21. As for the remaining bilateral arrears, the government of Mongolia and the BOM are committed to resolve this issue as soon as feasible by seeking an agreement on arrear clearance with their creditors. Toward this end, they have already initiated contact with creditors to begin the process of resolving outstanding arrears.

**Conclusion**

22. Given the huge negative nature of imposing risks in various areas, the authorities are fully cognizant of the significance of their strong commitment to the Fund program as well as its steadfast implementation in swiftly averting the current crisis. Although the pertinent analyses alluded to the manageable burdens of external public debt, the authorities bear in mind that this outlook is based on the assumption of sufficient international reserves, steady mineral export growth - which is determined by unexpected international mineral prices - and sustained foreign investments in mineral resources. In this regard, the authorities stick to the conservative and medium-term perspective and intend to take further corrective measures in the period ahead if needed.

23. Given the run-up to the presidential elections in May 2009, the authorities strive to minimize possible political distractions and assuage disturbances in the process of deciding and implementing the Fund program. It is worth noting that the political leaders, including the key presidential candidates and prime minister, have shown strong interest in the Fund's involvement. In addition, the parliament issued a decree, in accordance with a recent budget amendment, that the Government should revise the current social welfare system and submit any amendment during the spring session.

24. Going forward, the authorities noted the merits of the Fund's concessional arrangement in restoring the economy into medium-term sustainable growth and stability. Thus, we would like to convey to the Board the authorities' intention to request a transition to a concessional arrangement at a reasonable time once the imminent crisis has been resolved. Related to this, we invoke our fellow Directors' full support and understanding at this time.

25. Finally, my Mongolian authorities wish to express their utmost appreciation to the Fund and its staff for their long-standing cooperation and, more importantly, very timely and appropriate policy advices during this economic crisis. They also extend their deepest gratitude to the Fund's mission chief, Ms. Meral Karasulu, and her team for their hard work and dedication in assisting to formulate Mongolia's economic reform program.