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12:05 p.m., June 4, 2008

3. Mongolia—2008 Article IV Consultation

Documents: SM/08/136 and Correction 1, and Supplement 1, and Supplement 2; SM/08/151 and Correction 1; SM/08/153 and Correction 1

Staff: Kronenberg, APD; Mazarei, PDR

Length: 1 hour, 4 minutes

Executive Board Attendance

T. Kato, Acting Chair

Executive Directors	Alternate Executive Directors
	S. Itam (AE)
	I. Mannathoko (AE), Temporary
	R. N'Sonde (AF), Temporary
	J. Maciel (AG), Temporary
R. Murray (AU)	
	J. Prader (BE)
	R. Perez (BR), Temporary
	J. He (CC)
	L. Jimenez (CE), Temporary
	P. Charleton (CO)
	A. Lahreche (FF), Temporary
	F. Haupt (GR), Temporary
	P. Ray (IN), Temporary
	F. Valeri (IT), Temporary
	H.Yamaoka (JA)
	A. Monajemi (MD), Temporary
	H. Caracalla (MI), Temporary
	M. Tomic (NE), Temporary
	M. Leemets (NO), Temporary
	A. Lushin (RU)
	S. Alnefaee (SA), Temporary
	A. Matoto (ST), Temporary
	A. Raczko (SZ)
	S. Lin (UA), Temporary
	H. Rab (UK), Temporary

L. Hubloue, Acting Secretary
S. Maxwell, Assistant

Also Present
IBRD: G. Boyreau, C. Finch, S. Gooptu. Asia and Pacific Department: D. Burton, S. Dunaway, T. Feridhanusetyawan, R. Kronenberg, S. Lee, J. Shik Kang. External Relations Department: Y. Kamata. Fiscal Affairs Department: D. Kim. Monetary and Capital Markets: E. Loukoianova, M. O'Brien. Policy Development and Review Department: A. Mazarei. Secretary's Department: O. Vongthieres, M. Yslas. Statistics Department: G. Jones. Senior Advisors to Executive Directors: S. Mathema (ST), J. Yoon (AU). Advisors to Executive Directors: P. Gasiorowski (SZ), K. Harada (JA), D. Mevis (BE), A. Shabunina (RU), F. Waqabaca (ST), J. Yang (CC).

3. MONGOLIA—2008 ARTICLE IV CONSULTATION

Mr. Murray and Mr. Yoon submitted the following statement:

The second phase of transition is underway in Mongolia, and it is no less dynamic than the first transition to a market-based economy in the early 1990s. Backed by higher mineral prices and with substantial potential for resource exploitation, the Mongolian economy has continued to show a strong growth momentum in recent years, together with steady improvement in its socio-economic environment. Given the crucial importance of maximizing benefits from the current opportunities, the Mongolian authorities have strived to put in place the right policies and to build sound institutions so as to achieve sustainable growth and improve the standard of living. In this process, constructive discussions with Fund mission teams and their recommendations have proven very useful, for which our authorities are very grateful. We are particularly appreciative of this year's Article IV consultation which has been fruitful and very timely, particularly given sharp changes in the global and domestic economic environment as well as the upcoming parliamentary elections.

Economic Outlook and Challenges

The Mongolian economy has continued its solid growth at nearly 10 percent in 2007, aided by high mineral prices and the vital private sector activities. Per capita GDP has tripled over the last few years, and there has been considerable improvement in living standards. Despite the weakening world economy and the financial turmoil in major financial markets, the medium-term outlook for the Mongolian economy should remain favorable. Strong growth is expected to continue, considering significant contributions from the mining sector such as the Oyu Tolgoi project, as well as other iron, coal, gold and copper mine projects. Given the prospects of resource developments, the authorities expect that growth rates over the medium term will be well above 10 percent, exceeding what the staff conservatively projected.

Despite the remarkable progress and the favorable medium-term outlook, there are daunting challenges and risks ahead which the Mongolian authorities are fully aware of. Given the imminent threat of impending inflationary pressures, the authorities implemented bold measures to stabilize inflation so as to avoid entrenching of inflationary expectation. These included the tightening of monetary and fiscal policies as well as steps to address supply-side bottlenecks. Over the longer term, Mongolia's economic progress should alleviate still-widespread poverty as well as tackle challenges and vulnerabilities stemming from terms of trade adjustments. The authorities will continue to make best efforts to sustain growth and alleviate poverty through preserving macroeconomic stability; continuing infrastructure investment and developing the non-mineral sector; enhancing mineral wealth management and allocating mineral resources, bearing in mind both efficiency and equity; and building sound institutions and improving better governance.

Fiscal Policy

The authorities have achieved a conservative fiscal policy outcomes in recent years, which is evidenced by sustained budget surpluses over the last three years. This year's budget envisaged an overall deficit at 2.5 percent of GDP, which is similar to that originally envisaged in last year's budget. However, given the urgent need to curb inflationary pressures, the authorities have moved quickly to tighten the fiscal stance. The authorities believe that another year of fiscal surplus will again be recorded this year. To this end, the authorities decided not to proceed with proposals to amend the budget this year, despite strong political pressures and difficulties from the upcoming parliamentary elections. The introduction of a new, large social transfer program, such as the creation of the Motherland Wealth Distribution Fund, has not been proceeded with. The authorities have also been trying to strengthen expenditure restraint, including by reducing government purchases in goods and services as well as the termination of fuel subsidies.

On civil service wages, the recent salary increases, implemented in the context of the Civil Service Reform Strategy, were inevitable, especially considering the low public sector pay levels and the need to provide professional civil services, in order to strengthen the institutional capacity of the government sector. Nevertheless, further increases will be carefully reviewed in the context of the broader comprehensive civil service reforms. Considering the supply-side bottlenecks and poor status of infrastructure such as transportation, public investment will continue to be given utmost priority, while capacity constraint will be taken into account in determining appropriate levels of public investment and individual project priorities. The authorities will also endeavor to rely principally on concessional external loans that are consistent with these investment priorities and appreciate the Fund's Debt Sustainability Analysis in this context. Related to expenditure reform, the authorities appreciate the Poverty and Social Impact Analysis mission and their findings.

On the medium-term fiscal framework, the authorities welcome discussions on the choice of fiscal target, and broadly agree that the non-mineral balance would be a reasonable target for the time being, especially when the risk on inflation is high. They will also consider alternative targets, including exploring the "structural budget balance" concept over the medium-term as suggested in the Fund's fiscal sector technical assistance. As each fiscal indicator has its own merits and weaknesses, determination of fiscal policy rules, including the choice of a fiscal target, will be considered carefully over time. For example, the non-mineral balance, as suggested by staff, will be a good indicator for measuring the fiscal stimulus, but may fail to deliver a desirable resource allocation in the intertemporal context. Building on past experiences as well as staff recommendations, the authorities will further explore this issue, while having in mind the need to ensure macroeconomic stability and fiscal sustainability.

The authorities appreciate the staff's analysis on the fiscal regime for the Mongolian mining sector. While there have been delays in the regime design, the authorities will ensure that a transparent, stable and internationally-competitive fiscal and investment regime is established while maximizing benefits from vast mineral deposits. The authorities also remain strongly committed to operationalizing Mongolia's participation in the Extractive Industries Transparency Initiative.

Monetary and Exchange Rate Policies

The authorities are fully aware of the urgent need to tackle rising inflationary pressures. In order to contain the inflation to a single-digit rate by year's end, the Bank of Mongolia (BOM) has significantly tightened its monetary policy stance. The policy rate has been raised drastically by 335 basis points since last July; the reserve requirement ratio has been heightened; and money growth has significantly slowed including through open market operations. Policy coordination between the monetary and fiscal authorities has also been strengthened with frequent discussions and exchanges of information. Inflation has not been contained yet, with the April inflation rising to 26 percent, partly due to higher oil and food prices and imported inflation. However, money growth has begun to slow down significantly, and the BOM is expecting a gradual lowering of inflation from hereon. The authorities are closely watching the inflation development, and stand ready to take further measures should the situation warrant it.

Given the vulnerabilities from commodity price movements and the lack of reliable monetary policy instruments, the authorities believe that a managed floating exchange rate regime is the most suitable for Mongolia. The central bank's transactions in the foreign exchange (FX) market have been only to resolve systematic excess demand in the market, and there has not been any intention to fix the exchange rate at a predetermined level. In this regard, the Mongolian authorities deeply regret the MCM's reclassification of their currency regime as a conventional peg, and reiterate their commitment to a managed floating regime. The authorities agree with the need to strengthen the FX markets, which will enable greater flexibility by the FX market itself. This includes widening the bid-ask spread; phasing out the role of the central bank in gold market operations; and developing the FX market infrastructure, such as introducing the screen-based trading system.

On the exchange rate level, the authorities believe that current exchange rates are broadly consistent with the fundamentals, especially given that the size of the divergence from the fundamentals, estimated by staff at roughly 5 percent, is well within margins of error. In this regard, the authorities urge staff to be careful in assessing the exchange rate level, while agreeing fully with the need for greater exchange rate flexibility.

Financial Sector Policies

The Mongolian financial system has been developing and performing well in line with the economy as a whole. The authorities welcome discussions with the FSAP team, and agree with the need to carefully prioritize and sequence financial sector development initiatives. As pointed out in the Financial Sector Stability Assessment, the banking system remains profitable and sound, with the non-performing loan ratios falling from 5.5 percent in 2005 to 3.2 percent in 2007. Given high credit growth and a possible deterioration of banks' balance sheets, the authorities will continue to stay vigilant in monitoring various risks, while strengthening frameworks for prudential supervision and risk management. As the non-bank financial sector is still underdeveloped with weak supervision, the newly-established Financial Regulatory Commission will make efforts to develop its supervisory capacity over savings and credit cooperatives and insurance companies. Close attention will also be paid to strengthening the legal framework, financial infrastructure, accounting and auditing standards, and corporate governance.

The authorities will carefully review the plan to create a development bank, given the need to support underserved sectors of the economy, such as infrastructure development, as well as taking into account failed experiences in other countries. In this process, the authorities will make sure they avoid creating unfair competition or other distortions in the financial sector.

Other Issues

There have been considerable achievements in statistics, as the recent Fund review found that Mongolia meets most of the recommendations of the General Data Dissemination Standards. Nevertheless, the authorities recognize the need to further improve the coverage and scope of macroeconomic data, which they will continue to support.

The authorities greatly appreciate the various technical assistance provided by the Fund covering fiscal, monetary as well as other institution-building areas. We believe that, given the need for further assistance, such activities should be further strengthened in the future.

Lastly, the authorities deeply regret Fund management's decision to close the resident representative (RR) office. As requested by the Prime Minister of Mongolia, given the crucial role played by the RR office in Mongolia, we urge management again to critically review their decision to close the RR offices in Mongolia and in other countries that have significant potential but continue to face major challenges and vulnerabilities where these offices have proven very productive and efficient.

Mr. Gakunu and Ms. Mannathoko submitted the following statement:

We thank staff for their concise report and helpful supporting documents, and Messrs. Murray and Yoon for their informative buff. We also commend the authorities for Mongolia's strong growth performance in recent years, but note the emergence of new risks to macroeconomic stability.

Rising food and fuel prices are a concern, and we support the view that prompt action is necessary to contain inflation. The data suggest that the quadrupling of the inflation rate from June 2007 to April this year is due primarily to rapid imported food inflation. Could staff provide more information on the inflation rate, excluding food? To the extent that inflation is driven primarily by imported food prices rather than by domestic pressures, stabilization measures should focus first on what can be done to address the impact of food import prices. The popular consensus in this regard has been to adopt a range of targeted fiscal measures in the short term, as well as to lift any taxes there may be on food imports or consumption, and to speed up longer term adjustment measures to facilitate food supply. Given the growth in fiscal revenues, could staff indicate what is being done with respect to short-term fiscal measures and the enhanced use of social safety nets for the poor to help them deal with the food and fuel price shocks.

Regarding exchange rate policy, in the medium term, the authorities may wish to consider allowing – through their foreign exchange market operations - for a bit more exchange rate appreciation against the Russian and (to a lesser extent) Chinese, currencies. These two markets are the main sources of food and fuel imports to Mongolia. The 2007 depreciation of the tögrög against the Chinese renminbi and Russian ruble by 7 and 8 percent respectively, will have fuelled imported inflation, and so the wisdom of sustained currency depreciation at this time may need to be reconsidered. The staff assessment suggests that the tögrög is undervalued, so there may be room to accommodate moderate currency appreciation so that the currency is less undervalued. We are cognizant that the real effective exchange rate appreciated over the past year and that the authorities wish to avoid exacerbating real appreciation of the tögrög against Mongolia's main export market, China. The challenge will be to permit a nominal exchange rate level that does not fuel inflation and that allows a competitive real exchange rate to be preserved.

Considering developments in monetary aggregates, we note from Messrs. Murray and Yoon's statement that despite a sharp tightening in monetary policy, inflation still reached 26 percent in April. To the extent that most inflationary pressure stems from import prices, the authorities may not have to resort to excessive monetary tightening. We therefore encourage caution when considering restrictive monetary policies that could unduly curb growth.

On fiscal policy, we commend the authorities for the fiscal surpluses recorded in the past. We note, however, that even though rapid mineral sector expansion is having a positive impact on overall productivity and revenues, prudent management of fiscal resources and wage restraint will nevertheless become increasingly important. We are conscious of the fact that fiscal pressures may already be contributing to inflation, though to a lesser extent than import prices. In view of the acceleration in recurrent spending by government, it is advisable for the authorities to exercise fiscal restraint in this area going forward. A distinction should however be made between current and capital expenditure. We therefore urge the authorities to focus more on guarding against rapid expansion in recurrent expenditure – including wages. With respect to capital expenditure, to the extent that it enhances the scope for business expansion and growth, it is likely to be beneficial in sustaining growth and increasing absorptive capacity; and so here we would urge the authorities to focus less on cuts and more on ensuring efficiency and high social returns from these public investments.

Mining is an increasingly important sector and so we agree with staff that the mining regime should be improved to help bring about higher mining sector growth. Improvements in the fiscal and investment systems design, and in the efficiency and transparency of the mining regime would be beneficial in the long run. We also add, however, that measures to boost productivity and growth in the more labor-intensive non-mining sector should not be neglected, as the expansion of this sector will be necessary to sustain employment and reduce poverty going forward.

With these few remarks, we wish the Mongolian authorities success.

Ms. Xafa and Ms. Valeri submitted the following statement:

We thank staff for the excellent set of papers and Mr. Murray and Mr. Yoon for their informative buff. Mongolia's economic performance has been exceptionally strong in recent years, supported by large terms-of-trade gains and rapid development of the country's huge mineral wealth. However, inflation has accelerated, driven by soaring food and fuel prices and by loose monetary conditions, and the current account surplus is shrinking. The main challenge is to tighten macro policies to ease overheating pressures, while putting in place a framework for longer-term management of mineral resources. We broadly share staff recommendations and focus our remarks on key issues.

Fiscal Policies

In view of overheating pressures, we agree with staff's recommendation to maintain a fiscal surplus of about 1½ percent of GDP in 2008. We note Mr. Murray's and Mr. Yoon's statement that the authorities expect such a surplus to materialize – as happened last year – despite the fact that the budget envisages an overall deficit of 2½ percent of GDP – which is similar to what was envisaged in last year's budget. While the expected surplus is welcome, the practice of targeting a constant overall balance can lead to strongly procyclical spending if the "shadow" target does not materialize. We would therefore encourage the authorities to increase the transparency of their budgetary policy by adopting realistic budget targets.

To maintain fiscal sustainability over the medium term, the authorities should implement a comprehensive fiscal strategy aimed at restraining spending, strengthening mineral wealth management, and increasing non-mineral revenues. Excessive reliance on mineral taxation would pose risks if copper and gold prices decline significantly. Inter-generational equity is also an important element in assessing the long term sustainability of the fiscal stance. A ruled-based fiscal policy would put the administration of mineral resources on a sounder footing by reducing spending pressures during mineral booms and introducing a sustainable long-tem strategy for managing the mineral wealth. As regards the choice of fiscal rule, the authorities need to decide whether the main goal is to stabilize fiscal revenues or save for future generations. In either case, they should seek to sever the link between minerals prices and fiscal spending, possibly through an overall limit on the growth of spending or a constant expenditure-to-GDP ratio, as proposed by staff. We invite staff comments as to why the authorities believe that the formal adoption of such a rule will be difficult in the near term.

Monetary and Exchange Rate Policies

While we fully agree with staff that monetary tightening is needed, we are confused about the degree of tightening that is already in place. The authorities believe that the BOM has already tightened its policy stance significantly, and that inflation has now peaked and will soon start to decline. Staff, on the other hand, sees room for further increases in the policy rate if inflation does not show signs of declining soon, and also urges the authorities to put on hold plans to transfer deposits of the social security system from the BOM to commercial banks. One source of confusion is the apparent contradiction between staff's statement that reserve requirements were cut in 2007 (para. 3) and the buff statement that they were raised (p.3). We also note that the increase in the policy rate to 9.75 percent in March still leaves it strongly negative in real terms, as inflation reached 26 percent y-o-y in April. Staff comments are invited.

As regards the exchange rate assessment, we fully agree with staff that exchange rate movements should not be expected to eliminate fluctuations in the current account (in fact, we are not aware of any theory that would predict such an outcome). We agree with the authorities that the slight undervaluation of the togrog estimated by the reduced-form equilibrium REER approach is within the margin of statistical error. On the exchange rate regime, while we understand that the authorities regret the classification of their currency regime as a conventional peg, we also note the large accumulation of reserves by the BOM in 2006-07. The authorities' argument that the accumulation was due to the payment of taxes by mining companies in dollars does not hold water because the BOM should be under no obligation to buy these dollars from the government. Rather, the problem seems to be the absence of an interbank market for foreign exchange. We thus welcome the authorities' efforts to improve the FX market infrastructure and liquidity. However, we also believe that the flows going through the FX market should be carefully managed to avoid Dutch disease.

Structural Reforms

We are pleased that the authorities are implementing the Civil Service Reform Strategy (CSRS) by approving its Action Plan and completing a Civil Service Census (SIP II). However, the public sector wage bill remains high, giving rise to concerns about fiscal sustainability over the medium term. Moreover, qualified civil servants are scarce, suggesting the need for efficiency improvements in the public sector. Further steps therefore are needed to reduce the size of the civil service while improving their skill level and pay scale.

We welcome Mongolia's participation in the Extractive Industry Transparency Initiative, and encourage the authorities to take steps to operationalize their participation. We also appreciate the recent steps taken to improve compliance with the AML/CFT framework. Like staff, we advise caution about proposals to establish a development bank, given the disastrous experience with such institutions elsewhere.

With these remarks, we wish the authorities success in their reform efforts.

Mr. Larsen and Mr. Rab submitted the following statement:

We are grateful to staff for an excellent report and thank Messrs. Murray and Yoon for an informative statement. We agree with much of the staff appraisal and would highlight a few points for emphasis.

Mongolia's economy has grown impressively over recent years. The mining sector's contribution to this has been significant. Prospects from untapped resources have the potential to further add to economic development. We note that other sectors' contribution is also increasing, which is essential to sustain growth.

We agree with staff that recent signs of overheating call for appropriate policy responses. Inflation has increased rapidly from 6 percent in June 2007 to 21 percent in March 2008, due to both demand and supply factors. It is important to address these through fiscal and monetary tightening. High inflation expectations may pose risks through further spiraling inflation, hurting competitiveness, and adversely affecting growth. We therefore encourage the authorities to take credible actions, which will send the right signals on commitment to tackling inflation.

On fiscal policy, we agree with staff on the need to contain public spending. Expenditure has risen dramatically due to higher civil service wages, doubling of capital expenditure, and provision of universal social welfare. Medium-term fiscal plans need to be consistent with macroeconomic absorptive capacity, and the authorities' implementation capacity. Wage increases should be linked to public sector reform and social welfare programs need to be properly targeted. We agree with staff that a fiscal stimulus in next year's budget, which is driven partly by upcoming elections, will further aggravate inflation and associated risks. We commend the authorities on some of the measures taken to tackle this, including cancellation of plans for further spending increases in an amended budget.

The rapid rise in domestic revenue offers real opportunities for development in Mongolia. However, dependence on mineral revenues also increases volatility linked to price movements. We encourage the authorities to adopt a clear revenue management policy and avoid pro-cyclical expenditure spikes. We support staff advice on the need to reduce the non-mineral deficit to help ensure intertemporal smoothing of expenditure. We welcome the authorities' commitment to participating in the Extractive Industries Transparency Initiative.

On monetary policy, we agree with the recommendation on slowing the growth of reserve money through further issuance of central bank bills and welcome to this end the decision to raise interest rates. Greater flexibility in the exchange rate should also reduce pressure on monetary growth – though we acknowledge the authorities' explanation that pressures in 2006/07 came partly from the fact that foreign companies' tax liabilities were paid in foreign currencies.

Rapid credit growth poses risks for loan quality and may add to the vulnerability of the financial sector. We welcome in this regard the authorities' commitment to maintaining strong banking supervision.

We note that Mongolia has a comfortable external position. External debt has dropped sharply and reserves are more than adequate. Although the current account is likely to shift rapidly from surplus (2.5 percent of GDP) to a deficit (9-13 percent of GDP), we note that this will be driven by large mining projects and therefore should not result in external instability. We support staff recommendations on the need to be cautious with non-concessional sources of external finances.

Finally, we encourage the authorities to improve the scope and coverage of national accounts and government statistics, and broaden dissemination to the public. With these comments we wish the authorities success in their future reform efforts.

Mr. Prader and Mr. Mevis submitted the following statement:

We thank the staff for their comprehensive set of papers and Messrs. Murray and Yoon for their insightful buff.

In 2007, the Mongolian economy experienced strong GDP growth of 10 percent, which was not exclusively driven by the mining sector. However, growth in combination with increased public spending and adverse global economic developments by end 2007 had pushed inflation to a worrisome level of 21 percent. With these developments, the economy faces the risk of overheating. In addition to the relaxed fiscal policy, monetary aggregates have also recently displayed utterly high growth, which should be monitored closely as their impact on inflation could endanger macroeconomic stability. However, the staff reports that the Mongolian authorities have made good progress in tackling several problems. We commend the authorities for this and encourage them to implement tight and prudent fiscal and monetary policies which seem necessary at this juncture.

Since we broadly share the staff's assessment, we will make only a few comments for emphasis.

It is noteworthy that appropriate fiscal measures led to a surplus in recent years. We commend the authorities for reducing significantly the NPV of external debt from 51 percent in 2004 to 24.5 percent of GDP at end 2007. The authorities should maintain their commitment to reducing debt even further.

Favorable mineral prices and an improvement in tax revenue have resulted in a record (projected) level of government income of 44.4 percent of GDP in 2008. However, it is regrettable that this favorable outturn in government revenue is paralleled by an even stronger increase in government spending. We share the staff's concerns that this increased spending feeds into inflation. Furthermore, the rapid increase in spending on several fronts – apart from causing inflationary concerns – may veil the impact of expenditures. The past increases in civil servants wages by 49 percent in 2007 may have disrupted the wage hierarchy. The private sector could find it difficult to compete with the high public sector wages and consequently make it difficult for the private sector to hire qualified staff. This would hinder diversified growth. In addition, the 90 percent increase in government transfer payments bears the risk of being uncontrolled and badly targeted.

With the increased fiscal spending, it is projected that Mongolia will run a fiscal deficit of 2.5 percent of GDP in 2008. In this regard, the staff has rightly emphasized that the authorities should rather aim at maintaining a fiscal surplus of 1.5 percent of GDP in 2008. It is also in view of the high inflation rate that we support the measures of fiscal tightening suggested by the staff.

Revenue from the mining sector is volatile given the fluctuating nature of the world prices of minerals. Therefore, we agree with the staff that it could be beneficial for the Mongolian authorities to reduce the nonmineral fiscal deficit from 12.5 percent in 2007 to 8 percent by 2010. While according to the debt sustainability analysis, at present Mongolia's debt situation is comfortable, the authorities should not be complacent and should certainly refrain from undertaking commercial loans. It would be especially regrettable if the authorities would make use of the authorization given by parliament to take up US$1.2 billion in commercial loans. We commend the authorities for cancelling plans on further spending in 2008 and lifting the temporary VAT exemptions. In addition, the cancellation of fuel subsidies is welcomed.

Obviously, inflation at 21 percent is a matter of serious concern. Furthermore, spiraling broad money growth (57 percent) and growth of credit to the private sector (75 percent) could indicate an overheating of the economy and should be monitored closely. While the authorities have little control over the exogenous supply-side factors that are driving the inflation rate, the above-mentioned demand-side threats to price stability can be influenced. We agree with the recommendations made by the staff that reserve money growth should be slowed and we welcome the decision to increase the yield on CBBs.

According to staff's assessment, the exchange rate seems to be slightly undervalued. The authorities should strengthen the foreign exchange market and allow correct market rates to prevail. In addition, the technicalities leading to an undervaluation and a slight rigidity of the exchange rate (i.e., tax payments of mining companies in U.S. dollars) should be resolved as soon as possible.

We commend the Bank of Mongolia for its sound supervision of the banking sector and welcome the progress made in the supervision of nonbank financial institutions. Further strengthening of supervision is the next logical step.

Lastly, we encourage the authorities to conclude, as soon as possible, the mining deals in the Oyu Tolgoi mineral project and the Tavan Tolgoi coal deposit. In addition to the installation of a transparent and competitive tax environment for the mining sector, a quick and smooth settlement of negotiations might increase incentives for international investors to engage in Mongolia. This should certainly serve the authorities' effort to maximize the benefits from Mongolia's vast natural resources.

Mr. Lushin and Ms. Shabunina submitted the following statement:

We thank staff for a set of insightful papers and Messrs. Murray and Yoon for their informative buff. Mongolian authorities should be commended for transforming favorable trade conditions to strong economic growth and low debt levels. With copper and gold accounting for more than 50 percent of its export, Mongolia, like many other resource-rich countries, faces a number of difficult problems in choosing the optimal strategy for the use of its finite resources. We share the thrust of staff's appraisal and would limit our comments to several issues.

We welcome the authorities' proper fiscal response to rising inflationary pressures. The decision to aim at maintaining a moderate fiscal surplus in 2008, as indicated by Messrs. Murray and Yoon in their buff statement, is commendable given the political pressure for larger spending in the view of upcoming elections. While the surplus could be achieved through budget revenues exceeding the envisaged level, we would still encourage the authorities to exercise moderation with regard to expenditure growth, which over the last several years has been very high.

With the rapidly rising budget revenues the pressure to bring civil service wages to the level comparable with the private sector is high. While an increase in public wages may be needed to attract highly skilled employees to civil service, we believe that the pay rise of that size (49 percent growth in the civil service wage bill) should be accompanied by a visible rise in efficiency and transparency. Introduction of performance indicators and higher accountability of civil servants is highly desirable. We share the staff's opinion that higher differentiation of public wages could help boost motivation of government employees. We welcome the authorities' intention to have a cautious approach to any further wage bill increase.

We share staff's concern over the fact that a large part of social expenditure is financed from the Development Fund. The authorities rationale to make social payments conditional on the windfall budget gains in order to avoid risks of a future increase in budget deficit and debt accumulation is clear. However, the strategy of making social spending correlated with volatile resource revenue seems vulnerable to us. If gold and copper prices were to fall, high political pressures to keep the social payments intact are likely to appear. Overall, we would like to join staff and encourage the authorities to devise a sustainable medium term fiscal framework.

We note the divergence in views on the exchange rate classification between staff and the authorities. From additional explanation provided by staff we understand that this divergence is mainly for technical reasons: the BOM did not intervene to keep the dollar peg, instead large accumulation of foreign exchange reserves came from the dollar payments of windfall taxes in the mining sector. However, the narrow band used by the BOM for selling U.S. dollars resulted in the stickiness of the exchange rate and consequent depreciation of the togrog against the currencies of the main trade partners, Russia and China. This resulted in higher imported inflation, and staff's recommendation to permit greater exchange rate flexibility is aimed at minimizing this effect. On the other hand, higher flexibility of the exchange rate contains potential dangers for a small economy like Mongolia, that is heavily dependent on mineral resource extraction and does not have any other nominal anchors except the exchange rate. Mongolia's current and capital account balances are subject to large fluctuations caused by copper and gold price changes, as well as by FDI inflows related to mining investment projects. We would welcome staff comments on the available policy options that help resolve this trade-off, possibly based on the experience of other countries.

We welcome the improvement in statistics and the authorities' commitment to Extracting Industries Transparency Initiative.

With the above remarks, we wish the Mongolian authorities every success.

Mr. Charleton submitted the following statement:

We thank the staff for a comprehensive set of papers and Messrs. Murray and Yoon for their helpful buff. We broadly share the staff's analysis and prescriptions and offer the following comments for emphasis.

With the Mongolian economy driven essentially by a narrow range of mineral products and by agriculture, it is inherently vulnerable to exogenous shocks such as commodity price developments and extremely severe weather. To some extent the government can moderate these forces through sound policies, but there will always be periods of good and weak performance. Recent years have been a period of strong growth and significant progress has been made on raising living standards and diversifying the economy. The basic institutional infrastructure to facilitate future growth is also being put in place.

The fact that inflation has spiked to more than 25 percent is itself evidence that both monetary and fiscal policy have been too loose in a period of rapid growth. On the fiscal side, we welcome the authorities' recognition of the need to maintain a fiscal surplus this year and to adopt a coherent medium-term fiscal target that reorganizes the inherently volatile nature of mineral revenue. That said, all elements of expenditure - wages, social transfers and capital expenditure - are growing very rapidly and there needs to be a greater sense of prioritization. Even if one accepts that there was a genuine need to boost public sector wages significantly, they seem to be now driving up private sector wages and there can be no case for further increases.

It is perplexing that the government has been authorized to issue a very large volume of commercial foreign debt at a time when the budget should be in continuous surplus, there is a strong FDI, high external reserves; and the economy is clearly not able to absorb the flow of money impacting it. Is there any indication of the timeframe or for what specific purposes the government might proceed with this issue? We would be less concerned about the debt sustainability aspect of the borrowing than about the inflationary aspect of such financing.

The staff calls for a further tightening of monetary policy and this is appropriate. Interest rates have already been raised significantly but, inflation is gaining momentum even more rapidly. The basic nature of the financial system and the thinness of the markets suggest that the monetary transmission mechanism may be quite weak. While the exchange rate is purported to be flexible, the fact that it has depreciated sharply against the major trading partners (China and Russia) while remaining stable against the U.S. dollar indicates a high degree of management and the staff is correct to classify it as a de facto peg. For a resource-based economy, subject to exogenous shocks and undergoing significant structural change, a more flexible rate is both appropriate and necessary to regain control of inflation. While the degree of undervaluation appears quite modest, this reflects the high rate of inflation, an inherently undesirable situation.

We note the interesting FSAP paper and support the thrust of its recommendations. The financial system is, however, at the early stages of development and the focus needs to be on getting the basics right. Our concern would be that very rapid credit growth in a system with little culture of credit or risk assessment could very easily lead to a rapid rise in default when the economic cycle turns; the history in Mongolia is not reassuring. We also share the staff ‘s reservations on establishing a development bank or other special financial operation; the experience elsewhere is almost universally negative.

Given the intrinsic resources of the economy, the medium-term prospects are good and we wish the authorities every success in their endeavors.

Mr. Warjiyo and Ms. Matoto submitted the following statement:

We thank staff for the well-written set of papers, and Mr. Murray and Mr. Yoon for their insightful buff. We commend the Mongolian authorities for the impressive macroeconomic performance in recent years, with average growth of 9 percent over the past four years, underpinned by high mineral prices and private sector activities. The level of reserves is comfortable at 4½ months of non-mining imports with improvements in the fiscal position, debt sustainability and financial sector soundness. Notwithstanding the positive medium-term outlook, there are clear signs of economic overheating which, if not addressed appropriately, could jeopardize macroeconomic stability and derail the growth momentum. In particular, domestic demand has been strong, fueled by expansionary fiscal and monetary policies, which lead to inflationary pressures. The immediate priority for the authorities is thus to regain macroeconomic stability for sustaining economic growth, and we welcome the authorities' commitment to implement prudent monetary and fiscal policies in this regard.

On fiscal policy, we welcome that the authorities have taken bold steps to contain expenditures in view of current macroeconomic conditions. As Mr. Murray's and Mr. Yoon's statement makes it clear, these expenditures restraints should be able to turn the planned fiscal deficit of 2.5 percent of GDP in 2008 into a small surplus to put it in line with the need to restore macroeconomic stability. Expenditure re-prioritization and efficiency without negating Mongolia's pressing infrastructure and development needs are thus steps in the right direction. On the revenue side, we note the important contribution made by the windfall profits tax on minerals and welcome the discussions on the choice of fiscal target for the medium-term fiscal framework. We encourage the authorities to further explore this issue to ensure macroeconomic stability and fiscal sustainability, giving consideration to Mongolia's circumstance. Finally, we would appreciate some assessment of the sensitivity of fiscal revenue on commodity prices. Do staff consider the revenue projections reasonable, and, in the event commodity prices shift, could the new more restrictive expenditure envelope be sustained?

We agree that while Mongolia's external debt position remains healthy, recourse to non-concessional borrowing should be a last resort. Therefore, we shared staff's concern that the authorities may issue a large amount of commercial debt (amounting to 25 percent of

GDP) and urge the authorities to move carefully on this front. Staff updates on the proposed debt issuance would be appreciated.

On monetary policy, we agree that growth in monetary aggregates should be slowed to help bring inflation down to single digit. In this regard, we welcome the steps taken by the authorities to tighten the monetary policy stance through raising the policy rate, increasing reserve requirement ratio and using open market operations to reduce money growth. Like Mr. Gakunu and Ms. Mannathoko, we agree there is merit in allowing greater appreciation of the currency, especially against the ruble and renminbi, since Russia and China are the main sources of food and fuel imports to Mongolia. We note the authorities' views on the operations of mining companies and their impact on the exchange rate, as well as their explanation of their activities in the foreign exchange market. We are sympathetic to their concerns, and welcome the changes introduced that should reduce dollarization and allow for more orderly development of the foreign exchange market.

We welcome the improvement in the financial soundness indicators and the efforts to curb nonperforming loans. Nevertheless, continued vigilance is needed, given the growth in credit and a possible deterioration of banks' balance sheets, and the authorities are encouraged to enhance the prudential supervision and risk management frameworks. We note the establishment of the Financial Regulatory Commission with the objective to develop its supervisory capacity over savings and credit cooperatives and insurance companies. On the larger program of structural reforms, we note that the authorities conveyed to staff the strong public support for greater state ownership in the mining sector. On one hand, we see the attractiveness of this option as it potentially promises a more equitable distribution of gains from the sector. However, we could also see the public sector having to ramp-up capital spending to properly exploit Mongolia's mineral resources, at some risk to the fiscal position. We are also concerned that support for market-based reforms might be waning, and this could have political implications on future private investment proposals, especially foreign direct investment. We therefore urge the authorities to work to build greater public consensus in this area, while ensuring gains from the mining sector are distributed equitably.

With these remarks, we wish the authorities continued success in their future endeavors.

Mr. Guzmán and Mr. Jiménez submitted the following statement:

We thank the staff for a very informative and clear set of papers and Mr. Murray and Mr. Yoon for an insightful buff. We are glad to observe the excellent performance of the Mongolian economy in recent years, including the outstanding rates of growth in the last four years, the improvement of the external position and the reduction in the NPV of the external public debt. Nevertheless, while the medium-term economic outlook is favorable, the signs of overheating are worrisome, with rapid increase in the rate of inflation resulting mainly from the acceleration in government spending and domestic credit as well as supply-side factors (the persistence of structural constraints and the rise in global energy and commodity prices). We suggest authorities to address these issues promptly, both in terms of macroeconomic policies and also in terms of structural reforms needed.

As the staff has indicated, authorities should tighten both fiscal and monetary policies. Regarding fiscal policy, it will be desirable to maintain a fiscal surplus instead of implementing a fiscal stimulus. We are particularly concerned about the projected nominal rise in the wage bill, which not only increased by 49 percent in 2007, but it is expected to rise to 91.4 percent in 2008. Moreover, while we recognize the significant infrastructure investment needs, we concur with the staff in that the projected issuance of commercial foreign debt at this time would indeed aggravate inflationary pressures. Foreign financing should be fully consolidated with the general budget. In the medium term, sharp disruptive swings in government spending should be avoided, which calls for a prompt establishment of a medium-term fiscal framework, including a nonmineral fiscal target.

Regarding monetary policy, the rise in the policy interest rate and the containment of liquidity expansion are desirable elements. Policy coordination with fiscal authorities is extremely important at this time, as it is the maintenance of a flexible exchange rate policy and the strengthening of the interbank foreign exchange market. We would appreciate additional comments from the staff on the divergence of the REER from the fundamentals (additional appreciation of the REER may be desirable?) and clarify further the discrepancy of view with authorities in this regard.

Finally, we appreciate the staff's views on financial sector supervision, debt sustainability, the mining sector, government employment and wages, and other fiscal issues, and also the comments on the importance of improving data quality. We expect that further reform progress in these areas is achieved in order to reduce bottlenecks and capacity constraints.

With these remarks, we wish authorities every success in their endeavors.

Mr. Kishore and Mr. Ray submitted the following statement:

We thank staff for the set of papers and Mr. Murray and Mr. Yoon for their informative buff. We broadly agree with the staff evaluation and offer a few comments.

Real Economy

Mongolian economy seemed to have done exceedingly well with real GDP growth averaging 9 percent over the past four years. It is heartening to note that in 2007 the economy continued to grow at nearly 10 per cent. The major driver for this growth had been Mongolia's mining sector, dominated by copper, gold and coal and the economy had indeed been aided by high prices of copper and gold. We are in particular intrigued by the rather low projection of growth of mineral GDP in 2007 and 2008 (as given in the selected issues paper). Are there any downside risks to economic growth in the eventuality of a mineral price reversal? We appreciate clarification from the staff.

Inflationary Situation and Monetary Policy

We agree with the staff that, with inflation increasing sharply from 6 percent in June 2007 to 21 percent in March 2008, current inflationary situation poses a risk to macroeconomic stability. With the broad money growth surpassing 50 percent mark, clearly there are liquidity hangover and signs of overheating in the economy. However, the buff statement informs us that notwithstanding the tightening of monetary policy stance, inflation rose to 26 percent in April 2008. Being triggered by high energy and food prices, are the demand management policies ineffective because of cost-push nature of inflation? Does the authorities have a strategy for inflation control? We invite staff comments on this issue.

Fiscal Policy

In view of the increasingly expansionary fiscal scenario and overheating problems, we find merit in staffs' recommendation to maintain a fiscal surplus of about 1½ percent of GDP in 2008. We also agree with the staff that Mongolia's vast mineral deposits could provide large budgetary resources. Are there any move for establishing any stabilization fund for the mineral revenue?

With these comments we wish the authorities continued success in their future endeavors.

Mr. Rutayisire submitted the following statement:

We thank staff for the interesting paper and Messrs. Murray and Yoon for their informative buff.

We commend Mongolia for its impressive economic performance over the past few years, which translated into a sharp increase in the country's income per capita. This performance continued in 2007, as real output is estimated to have grown by 10 percent, driven mainly by the mining sector along with higher contributions by other sectors. The fiscal and external balances continued to register surpluses, though they declined significantly, and international reserves remained at a comfortable level. We fully agree with the importance for the country to increase capital spending to meet infrastructure needs and to take actions to mitigate the impact of the rising fuel and food prices on the poor which may, if necessary, warrant limited and temporary fiscal deficit. At the same time, we caution against the proliferation of overlapping and untargeted social welfare programs. The authorities should prioritize spending according to the most urgent needs, especially in light of the mounting inflation rate which has tripled between June 2007 and March 2008.

The authorities' immediate challenge in the near-term is to reduce these inflationary pressures by better prioritizing spending; tightening monetary policy to allow a carefully expansionary fiscal stance needed to meet the infrastructure and social needs; and addressing the daunting supply-side bottlenecks facing the Mongolian economy. Over the medium- and long-term, the challenge will be to take full advantage of the formidable economic prospects provided by the enormous geological potential to develop and implement a development strategy that will raise the standards of living of the population while maintaining macroeconomic stability.

In the fiscal sector, we commend the authorities for the strengthening in the tax administration, which along with positive developments in the mineral sector and continued strong overall activity, resulted in a remarkable revenue performance in 2007. On the expenditure side, efforts should be geared at prioritizing spending to reduce poverty and meet the Millennium Development Goals. We agree that attention should be given to monitoring inflationary pressures. The authorities' concurrence with this assessment is welcome and their decision to cancel some plans for further untargeted and non-priority spending increases in 2008 is positive towards maintaining fiscal sustainability and macro-stability. Mr. Murray's and Mr. Yoon's indication that the authorities contemplate a comprehensive public service reform that will deliver sustainable wages and benefits policies and ensure fiscal sustainability, is encouraging.

Regarding debt sustainability, we are pleased to note that, following years of strong economic performance, Mongolia is now at a low risk of debt distress and that going forward, its indicators of debt burden will continue to decline, even in the event of a decline in the terms of trade or further delays in developing a new copper and gold mine. However, as a sovereign bond issuance in the order of 25 percent of GDP envisaged would breach the threshold for the NPV of debt-to-GDP ratio, we encourage the authorities to give careful consideration to the debt sustainability and absorption risks associated with such borrowing. The recognition by the authorities of the need to rely primary on concessional borrowing in the near term is encouraging. It is not clear from the staff report why the authorities intend to raise such volume of nonconcessional funds. Staff comments are welcome.

We agree that monetary policy should be tightened to support the fiscal efforts in reducing inflation. In this regard, we welcome the measures already taken in this regard, notably the steady increase in the policy interest rate on seven-day central bank bills since July 2007, and the readiness of the authorities to take further measures should inflation developments warrant it. On the exchange rate policy, we note staff's assessment that the togrog may be somewhat undervalued by 5 percent in relation to its medium-term fundamentals. However, as stated by Mr. Murray and Mr. Yoon in their buff, the Mongolian authorities believe that the exchange rate is broadly in line with fundamentals. This is not the first time that staff' studies on the alignment of exchange rates with fundamentals in member countries come up with inconclusive results from quantitative estimations. There is a clear need to review the whole framework used for assessing the degree of undervaluation of exchange rates.

In the financial sector, we welcome the continued improvement in financial indicators and the findings by the FSAP that the BoM's framework for banking supervision is well developed. We agree that, in the present context of rapid credit growth and the mutation of the banking sector, close supervision of financial sector practices is warranted. We note the progress made in the strengthening of the central bank operations, notably regarding the supervision of nonbank institutions, the AML/CFT framework, risk management and governance structures. We also welcome the central bank's withdrawal from banking activities for commercial purposes.

On other structural issues, we welcome Mongolia's participation in the EITI and encourage the authorities to continue to increase transparency and strengthen the regulatory framework for the growing mining sector. We would appreciate the staff elaboration on how diversified the Mongolian non-mineral sector is and on its medium-term growth prospects. Furthermore, as recognized by Mr. Murray and Mr. Yoon in their buff, it is important for Mongolia to tackle the supply-side bottlenecks facing the economy, not only on development grounds but also to contribute to curbing inflationary pressures which seem permanent in nature.

With these remarks, we wish the Mongolian authorities every success in their endeavors.

Mr. Fayolle submitted the following statement:

We commend the staff for a comprehensive and very informative set of papers, and thank Messrs. Murray and Yoon for their useful buff.

Thanks to the rapid development of the mining sector, Mongolia has exhibited excellent records in terms of growth, leading to a doubling of its per capita GDP over the last four years. The country has therefore fully benefited from the recent increase in commodity prices, and future prospects are promising, with more resources scheduled for exploitation in the coming years. The main challenge for the authorities going forward will be to ensure that the policy-mix is supportive of both growth and macro-economic stability, and to avoid the infiltration of Dutch disease, which already shows signs of taking hold.

In the short run, inflation will obviously be the main item on the authorities' agenda. As shown in Box 1, the spike in inflation not only highlights the vulnerability of Mongolia's small open economy to imported inflation. It also underlines the risks associated with the large increase in revenues and the high liquidity of the economy. It will therefore call for consistent policy-mix. In this regard, we concur with the staff's appraisal and would like to underline the following comments.

Public expenditures clearly outpace the absorptive capacity of the economy. In addition to the increase in revenue and the parallel growth in expenditures, the authorities have provided a significant fiscal impulse by switching from an 8 percent of GDP surplus in 2006 to a planned 2½ percent of GDP deficit in 2008. This creates excess demand resulting in a rapid hike in price levels, and calls for rebalancing action. We concur with the staff that a budget surplus would be more appropriate at the current juncture and urge the authorities to target such an objective, along the lines suggested by the staff.

Fiscal policy needs to be supported by a tightening in monetary policy. The increase in the policy rate of the BOM seems to have had some effectiveness so far, but we agree with the staff that some further tightening might be necessary in the future, as real interest rates remain very negative. Going forward, the depreciation of the currency against Mongolia's main trading partners is another source of inflationary pressures that will have to be addressed. On the one hand, depreciation fuels imported inflation; on the other hand, the large increase in reserves – of more than 25 percent of GDP – feeds the liquidity of the economy, which also spurs price increases. Allowing the currency to appreciate in effective terms would also contribute to containing demand pressures; the staff analysis suggests there is some room for maneuver in this respect.

In the overall macroeconomic context of high inflation, abundant liquidity, and potential volatility in terms of trade, a strong financial sector is essential. We welcome the staff's assessment that banking sector supervision is in line with the current needs of the sector. As the financial sector develops overall, however, supervision will need to be stepped up, notably in the non-banking sector. The FSSA provides the authorities with a consistent and comprehensive list of recommendations that we hope the authorities will be able to implement.

Mr. Raczko and Mr. Gasiorowski submitted the following statement:

We would like to thank staff for the set of well written papers and Mr. Murray and Mr. Yoon for their insightful buff.

Mongolia enjoyed strong growth despite fluctuations in its minerals sector contribution to GDP. Despite the broadening of the basis, the prospects for future dynamic growth require further structural reforms, mainly in the extraction industry. We agree with staff's opinion that the major policy challenge, which is an effective exploitation of mineral resources, should be supported by the restoration of macroeconomic stability. The sharp rise in inflation, which exceeded twenty percent, needs tighter fiscal and monetary policies.

Although an adequate macroeconomic policy is necessary to contain second round effects, the vulnerability to external food prices should be carefully examined. For instance, the rise by 38 percent of bread price indicated a low flexibility of a supply side for some foodstuff products. We will welcome staff's comment about a possible food market distortion, e.g., inelastic distribution system, tariff system or rigid administrative regulation of trade.

Although Mongolia maintained a substantial fiscal surplus in the last years, we share the staff's view that the current hike in inflation needs a tightening of fiscal policy. Taking into account that the share of budgetary expenditures in GDP is very high compared with other countries with a similar GDP per capita ratio, we commend the efforts to contain budgetary expenditures. Especially, the social spending should be better targeted and wages of civil services employees contained.

On monetary policy, we share staff's view that the further increase of interest rate would be appropriate to better contain liquidity of the banking sector. Assuming tightening of the fiscal policy, we agree with the staff's recommendation to implement more flexible exchange rate policy. Floating exchange rate helps to contain inflation and may be implemented without risk- taking into account a comfortable level of foreign currency reserves.

We note with satisfaction that the authorities are in agreement with staff regarding the need for a proper fiscal and investment regimes for the mining sector. Our understanding is that these regimes should clarify the rules of engagement of the public sector in large projects and provide for a transparent regulations on the cooperation with the private sector.

We note from the staff paper that the issue of the public sector equity participation is still an open issue. Does it mean that the public sector is investing – together with the private sector – in some of the mining projects? Does such participation improve the credit rating of the projects?

We welcome the conclusion of the FSAP, which we find very timely. Even though the financial system is still developing, the authorities should treat the FSAP as a priority setting paper. We share Mr. Charleton's opinion that the focus should be on preparing good basis for the development of the financial sector. We would particularly stress the need for a design and implementation of the proper supervisory body that would cover all deposit taking institutions. In this light, one issue of our concern is that under a fast credit growth the banks have an opportunity to hide the amount of non-performing loans by rolling them over.

With this remarks, we wish the authorities every success in their endeavors.

Mr. Yamaoka and Mr. Harada submitted the following statement:

We thank the staff for their well-written papers, and Mr. Murray and Mr. Yoon for their informative statement.

Inflationary Pressures and Macroeconomic Policies

Since the latter half of last year, inflation has accelerated in many countries including Mongolia. The current global inflationary pressures suggest that macroeconomic policies in some overheating economies have not yet been sufficiently tightened. At this juncture, it is critically important for the Fund to give appropriate policy recommendations to member countries, without engaging in "wishful thinking' regarding the future course of commodity prices, so as not to create persistent inflationary pressures.

Mongolia's economy has recently registered a growth of around 9 percent, while inflation has accelerated rapidly and now exceeds 25 percent. In view of such economic developments, and the increases in fiscal spending and domestic credit, we generally agree with the staff's recommendation to tighten the fiscal and monetary policies in order to contain inflation.

Fiscal Policy

Concurring with the staff's views on Mongolia's fiscal policy, we encourage the authorities to tighten fiscal spending, and avoid unduly increases in civil service wages. Although we understand the country's demand for infrastructure, the current inflationary pressures and supply-side bottlenecks require that the authorities prudently prioritize their capital spending, and build infrastructure in a gradual manner so as not to further destabilize supply and demand conditions.

In this regard, it would be beneficial for the authorities not to rely on borrowing on a non-concessional basis. Needless to say, non-concessional borrowing would lead to a worsening of the country's debt sustainability. Moreover, the avoidance of non-concessional loans would give the authorities incentives to prioritize projects and deter from an unduly expansion of capital spending.

We also reiterate that subsidies and tax-exemptions cannot be measures to stabilize inflation over the long run. Rather, subsidies and tax-exemptions for specific products could impair producer incentives to increase supply. Although these policy measures seem effective in a very short run, over the medium term they would prolong supply shortages and inflationary pressures. (The situation may become worse, especially if many countries simultaneously take the this type of measures to alleviate the rise in commodity prices.) The Fund should play an important role in avoiding such a "fallacy of composition.") In addition, the government may not be able to continue such subsidies and tax exemptions beyond the budgetary limit.

We also share the staff's view that the authorities should strengthen the macro-fiscal framework to cope with volatility and uncertainty in the mining sector. In addition, we underscore the importance of enhancing transparency in the mining sector.

Monetary and Exchange Rate Policies

We also agree with the staff's recommendation to tighten monetary policy in order to contain inflation. Having said that, the recent experience of many countries (including that of Mongolia during the first three months of the year) suggests that controlling reserve money, in itself, cannot substantially dampen inflationary pressures. (For example, reserve money can be reduced by a reduction in reserve requirements, but such a decline in reserve money would loosen monetary conditions).

In this regard, we believe that the staff's recommendation on reserve targeting seems to follow a "beating-around the bush" approach. Rather, we would like to encourage the Bank of Mongolia (BOM) to execute the necessary increases in its policy interest rate, which is currently far below inflation, so as to effectively influence the funding costs of private entities. (Otherwise, it would be difficult to curb credit growth). In this context, we share the staff's recommendation to move toward a more flexible exchange rate policy.

Besides, we feel the necessity of further elaboration in the staff's remarks on the relationship between the level of international reserves and inflationary pressures. The accumulation of international reserves may lead to inflationary pressures only if the central bank were not to undertake necessary sterilizing operations. Thus, the level of international reserves is not directly connected to domestic assets nor inflationary pressures. (In other words, the true issue lies in the monetary policy stance of the central bank that does not fully sterilize excess liquidity). In addition, we are not fully convinced by the Staff Report's implied criterion that assumes an "optimal" level of international reserves. We would welcome the staff's further elaboration on these issues, if any.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Henriksson and Ms. Leemets submitted the following statement:

We would like to thank staff for the comprehensive set of papers and Messrs. Murray and Yoon for their interesting buff.

We are pleased to observe that Mongolia's economy continues to enjoy robust economic growth. The strong growth in prices of Mongolian exports and stable macroeconomic framework during last years have both been helpful in doubling the Mongolian per capita income. The authorities should be praised for these developments and to effectively seize the opportunity the current growth is offering, we share staff's analysis on main policy challenges that the authorities are facing.

In the context of emerging capacity constraints and a surge in inflation there are clear signs of overheating pressures. In those circumstances, the authorities should refrain from adding to demand, either through higher public spending, additional increases in public sector wages, or through lowering the level of taxes even further. The good macroeconomic situation would rather call for a wise decision on the structural front, in which we are happy to observe the ongoing discussions for optimal fiscal rule, and also changes in the mineral sectors on creating clearer framework for investments and revenue-sharing. Regarding the demand-related pressures in the economy we consider the decrease in non-mineral deficit as a good starting point for necessary fiscal rule to emerge. Also, the ideas to cap the growth of public sector's role in the economy, e.g., through a targeted constant expenditure-to-GDP ratio, seem appealing.

Both fiscal and monetary policy measures should be used in slowing inflation and from keeping the inflation expectations from becoming entrenched. Mongolia is in a critical juncture. We wish the authorities the will and wisdom to use the current good times and prepare the country for a long-sustained growth.

Mr. He and Ms. Yang Jiehan submitted the following statement:

We thank staff for the well-written reports and Mr. Murray and Mr. Yoon for their informative buff.

We commend the Mongolian authorities on their impressive economic performance over the past few years. Due to higher mineral prices and buoyant private sector activities, GDP growth has been robust and living standards have improved substantially. The fiscal and current accounts have been in surplus while public debt has dropped sharply and international reserves have reached record highs. Although the authorities face rising inflationary pressures and swings in the pillar mining industry, the economic outlook is likely to remain favorable given the country's rich resources and the authorities' strong commitment to preserve macroeconomic stability and sustain the growth momentum.

Fiscal consolidation is indispensable for Mongolia's disinflation efforts in the short term. However, as a transitional and dynamic economy, the demand for investment in human capital and infrastructure has been on the rise. The vast mining revenues have created ample room for satisfying the rising investment demand, but, to check the high inflation, a balance needs to be struck in reducing expenditure. We welcome the authorities' prompt action in cutting low priority expenditure, while planning to maintain crucial public investment. Given that the authorities have different views from staff on the need to slow wage increases and public investment—pointed out by staff as important contributing factors to inflation—we would appreciate staff's analysis on how to strike a balance between maintaining microeconomic stability and strengthening the government's personnel capacity. Moderate wage increases may need to be accompanied by streamlining. Moreover, in view of the still-widespread poverty, we welcome staff's comments on how the vulnerable can best be protected from the impact of higher food prices.

In the medium term and to benefit Mongolia's long-term sustainable development, it will be vital to establish a sustainable fiscal framework to tackle the inherent volatility and uncertainty in the mining sector. We encourage the authorities to work with staff in designing a transparent and sustainable fiscal framework and an investment regime for the mining sector to improve the efficiency of mining investments and make best use of revenues.

To contain inflation, monetary tightening is crucial. We are pleased that money growth has slowed significantly since the central bank took a combination of tightening policies—raising policy rates and the reserve requirement ratio, and strengthening open market operations. We welcome the authorities' commitment to maintain the managed floating exchange rate regime and intervene in the foreign exchange market only to smooth excess fluctuation. Further development of the foreign exchange market is a precondition for greater exchange rate flexibility.

In evaluating the Togrog exchange rate, staff recognizes the difficulty in making current account balance projections and uncertainties in using the CGER models. As before, we caution against mechanical use of less-trusted models in the Fund's surveillance, particularly in view of the dynamics in emerging market and transitional economies.

Despite the profitability of the banking sector, as reported in the FSAP, the rapid credit growth and rollover of loans may become potential risks. We are pleased the authorities realize the problem and have strengthened prudential supervision. With establishment of the Financial Regulatory Commission, supervision of the non-bank financial sector will be further enhanced. Regarding the establishment of a development bank, we agree with the authorities that it will be prudent to proceed carefully, taking the needs of the economy into account and drawing on other countries' experience to avoid distortions and unfair competition.

We encourage the Fund to extend needed technical assistances to Mongolia, helping the authorities build up their macroeconomic management and statistics capacities.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Heath and Mr. Lin submitted the following statement:

Thanks to its vast mineral wealth and its improving terms of trade, Mongolia's economy has grown at impressive rates in recent years. However, inflation has created major challenges for economic policy. Policies should also focus on safeguarding financial stability and fiscal sustainability.

Monetary Policy/Exchange Rate

The combination of rapid reserve accumulation, substantially improved terms of trade (notwithstanding the expected deterioration in 2008), a persistently high inflation differential, and a stable nominal exchange rate, vis-à-vis the dollar, are all suggestive of a real exchange rate below its equilibrium value.

The staff rightly cautions that further reserve accumulation would exacerbate inflationary pressures. The authorities' recognition of the monetary origins of persistent inflationary pressure is encouraging, and we welcome the recent moderation in the growth of money and net foreign assets. We encourage the authorities to maintain a moderate growth rate of reserve money, as recommended by the staff.

Greater exchange rate flexibility could enable more effective management of domestic monetary conditions and could help dissipate inflationary pressure. It could also enable smoother adjustment to structural changes or to swings in commodity prices. Therefore, we welcome the authorities' intention to allow greater flexibility, as explained in the informative statement of Messrs. Murray and Yoon. The planned measures to develop foreign exchange markets will enable a longer-term transition to a market-determined exchange rate. In the interim, however, greater flexibility will also require adjustments to the central bank's price setting mechanism.

Fiscal Policy

Rapid growth of government expenditures has amplified inflationary pressure, and the staff's call for greater spending restraint merits immediate attention. The authorities have taken steps in the right direction by canceling plans for further increasing spending, and by planning cuts in purchases of goods and services. We strongly encourage the authorities to also restrain nondiscretionary spending and aim for substantial fiscal surpluses over the medium term. Rationalizing social spending and civil service expenditures, as recommended by the staff, would be an important step in this direction.

Relatedly, potential plans to issue new commercial foreign debt of up to 25 percent of GDP create risks to debt sustainability. The staff makes a strong case for caution in tapping nonconcessional sources of external financing.

More generally, we encourage the authorities to develop a fiscal framework that ensures longer-term fiscal sustainability, and we welcome Messrs. Murray and Yoon's statement's thoughtful discussion of alternative frameworks. The benefits of a medium-term framework are enhanced by the possibility of significant contingent liabilities in the event of a major economic shock, as described in the Financial System Stability Assessment.

Financial Sector

The combination of very rapid credit growth, exposure to volatile commodity prices, and an underdeveloped financial sector is cause for concern. The recent history of several banking crises and failures of dozens of savings and credit cooperatives underscores the risks to financial stability. Accordingly, we commend the authorities for recently completing an FSAP, and we urge them to develop contingency plans promptly and to strengthen supervision of financial institutions' liquidity, credit, and operational risks, as recommended by the FSSA.

We welcome recent improvements in bank compliance with prudential norms related to the AML/CFT framework. We encourage the authorities to accelerate progress, especially among non-bank financial institutions.

Exchange Rate Assessment

We welcome the staff's assessment of the exchange rate. Appropriately, the staff discusses the relative merits of the ERER, ES, and MB approaches.

However, we are not convinced by the staff's reasoning for dismissing the ES and MB approaches. The staff argues that mining investment will induce volatility in the current account, and that this volatility compromises the validity of the ES and MB approaches.

This argument misapprehends the MB methodology and its underlying reasoning. The current account norm is to be compared with the underlying current account balance—corrected for cyclical and other temporary factors—not the actual current account balance at a particular moment in time. Volatility of the current account implies a need to disentangle carefully temporary and persistent components of savings and investment, not an inherent problem with the MB approach. In our view, a more fundamental issue with the MB approach in Mongolia's case is the potential difficulty of computing a current account norm for an economy in the midst of a major structural break.

An underlying current account balance could also be used in the ES approach. The more fundamental question regarding the ES approach is whether Mongolia should target its current level of NFA.

For both models, we would prefer to have a transparent discussion of the more fundamental difficulties, rather than a dismissal of the methodology for the reasons given. We also think it could be useful to discuss these issues further in a future selected issues, or in the Fund's more general work on exchange rate valuation. We would appreciate further commentary by the staff.

Mr. Bakker and Mr. Tomic submitted the following statement:

We thank staff for well-written papers and Mr. Murray and Mr. Yoon for their informative buff. At the outset let us state that we commend the authorities for the progress in improving financial sector soundness, securing debt sustainability and improving central bank governance in line with recommendations expressed during the last Article IV consultations.

Mongolia benefited from the increasing mineral prices and macroeconomic variables registered impressive results. In addition, the growth of the mining sector spilled over to other sectors of the economy, reducing unemployment, and pushing production to the frontier. Income per capita more than doubled in a couple of years but inflationary pressures materialized in the second half of 2007 and are now becoming a major threat for macroeconomic stability as well as for the authorities' intentions to further improve the standard of living of its citizens.

The policy measures should therefore strive to reduce inflationary pressures, while at the same time allowing the removal of capacity bottlenecks that could jeopardize and slow down long- term goals. We note that despite these challenges, both the external and internal balances are predicted to remain at a comfortable level.

With a still high poverty incidence the authorities are facing the serious problem of neutralizing the effect of high food prices for the most vulnerable group. We understand from the staff report that current welfare programs are overlapping and virtually universal. Although we support the staff on the need to conduct restrictive fiscal policy, we wonder whether there is enough space, potentially by better targeting, to accommodate the need to achieve fiscal restriction, without jeopardizing the protection of the poorest and capital infrastructure development. Despite the urgent need to reduce inflationary pressures, which are caused by factors only partly under the authorities' control, we believe that infrastructure investment adequately prioritized and connected to private-sector development should continue, particularly if this would contribute either to export diversification or to further exploration in the mining sector). Staff is welcome to comment.

We encourage the authorities to implement the FSSA recommendations, particularly by passing already drafted legislation that will strengthen the legal framework for financial sector development. While we understand the authorities' motivation to set up a development bank, we support the staff's recommendation to avoid providing loans at concessional interest rates to clients already served by the private sector banking. Similarly, the intended reform of the Small and Medium Enterprises Development Fund, should not lead to weaker financial discipline and distorted credit risk assessments. Given the potential for investment in the Mongolian economy, economic development is likely to continue, granted that incentive distortion is avoided.

With these comments, we wish the authorities all the best in their future endeavors.

Extending his remarks, Mr. Murray made the following statement:

I want to give some sort of context to this discussion about Mongolia, but I also want to make some remarks about the exchange rate, and I thought that I should make them before we have the debate, because they are rather important.

Let me start by putting Mongolia into context, and there are two defining features in particular about Mongolia worth noting. One, the country is going through quite a significant resources boom, and this is really just the beginning of that boom and there is much more to come. Some of the developments are certainly permanent both in terms of higher prices for some of the commodities produced and likely to be produced by Mongolia, but also in terms of significant new investment in some pretty major projects.

The second defining feature about Mongolia is that it is very much a transition economy from the old Soviet satellite system. In many ways, that transition is going well and the country is transitioning to a rather robust democracy. It does have an evolving private sector economy. Importantly, I want to stress that, coming out of the old Soviet system, Mongolia has a strong skills base and a strong social policy underpinning society. It is quite a complex society and evolving into quite a dynamic small economy.

From an economic point of view, these two defining features are complementary. The benefits are already showing with quite a significant increase in per capita income, which is there for everyone to see. The benefits are flowing to the wider community. Having an evolving private sector and a strong skills base have been fundamental to that whole process. That cannot be said for a lot of other developing countries that are going through resources booms, because they do not have such an emerging private sector and they do not have a strong skills base, and trying to get the benefits of resource development across society is quite a difficult process.

However, there is a downside as well to all of this. The evolving democracy is robust and open, but it involves at times battles between the government and parliament, because the balance of powers between the various institutions are still being worked out. This means that as far as parliament is concerned--and this is maybe in relation to questions asked about the medium-term fiscal strategy by Ms. Xafa--they do have a medium-term fiscal strategy in mind which involves running a 2-3 percent deficit every year and spending the proceeds of the resources windfalls as quickly as possible on development projects and on spreading the benefits to the whole community. That is why they have such a fiscal dilemma, as far as I am concerned. This is why the authorities are determined that they want to establish a proper medium-term fiscal framework. It is important to have proper prioritization of spending and to get spending on infrastructure, and to target welfare payments appropriately and to deliver a well-paid public service. There is also a need to reform the public sector so that it operates both effectively and efficiently.

The bottom line on all of this is that it is extremely important that there is strong engagement by the Fund both in terms of the Article IV surveillance and its policy recommendations, but also in terms of technical assistance. I would note that the Asia and Pacific Department's engagement with Mongolia has been absolutely outstanding. From 2000 onwards, there have been almost 50 technical assistance missions by the Fund to Mongolia. At times I have wondered how the country can possibly absorb all of this, but they seemed to be doing it. The technical assistance has covered areas like the Bank of Mongolia operations and the development of a foreign exchange market, medium-term fiscal strategy, development of taxation policy, including how to deal with the minerals tax regime, banking supervision, AML/CFT, and statistics. This has been a very strong engagement by the Fund in a little country, and for that certainly we are very grateful, and it shows just what the Fund can do.

Turning to the foreign exchange situation, I want to reiterate that the Mongolian authorities have a firm commitment to a managed floating exchange rate regime with no predetermined path for the exchange rate. That is why they were so dismayed about the reclassification in the staff report. It is not difficult, just based on data, to see why that reclassification might have happened, but it left my authorities quite dismayed and disappointed, particularly given the nature of the major shocks to the economy as well as the availability or lack thereof of policy instruments. The Mongolian authorities believe strongly that a managed floating exchange rate regime is the most sensible. Against this understanding, the Mongolian authorities have been implementing, as far as they are concerned, a managed floating exchange rate regime since 1993.

> Over the past two years, the exchange rate vis-à-vis the U.S. dollar has remained fairly stable, as the staff have indicated. However, such an exchange rate development is more likely due to the absence of a foreign exchange interbank market, as well as continued excess demand in recent times for the U.S. dollar caused by mining companies' direct tax payments to the central bank in U.S. dollars. The Bank of Mongolia has expressed no intention or policy to keep the exchange rate at a certain level, and I want to make that quite clear. What I would like to report following on from our buff statement, is that they are making further progress in trying to deal with all of this. Particularly given the urgent need to develop the foreign exchange infrastructure, the authorities are implementing various measures to enhance exchange rate flexibility. We reported on some of that in the buff.
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> I want to reiterate that the role of the central bank in gold market operations is being phased out. The central bank Governor has taken further recent actions on that front. Also, the authorities are hopeful that the screens-based system for the foreign exchange market can be introduced by July at the latest.

Adding to his gray, Mr. Prader noted Mr. Murray's comments that the Mongolian authorities were committed to fiscal stability and sustainability, while at the same time they were spending revenues from the mineral resources wealth for development. As pointed out in the staff report and by others, there appeared to be a disconnect in that the authorities were spending the revenues on social expenditures rather than development priorities. The risk with such spending, as in Europe, was that it could become permanent, raising issues in the event of a shortfall in revenues. The authorities ought to consider a medium-term framework that ensured that windfall profits did not go into social and other non-development expenditures.

Mr. Murray clarified that it was clear that some spending was being directed toward development where much work remained to be done, including the upgrading and building of power stations and an airport network across the country. He reiterated that in the disagreements between the Parliament and the government, the Parliament's clear intentions were to run a 2-3 percent deficit every year irrespective of the availability of funds. During the current period of substantial windfall taxation revenue, the authorities were determined to spend it not only on development, but also on the social underpinnings in spreading the benefits across society. The revenues were also being spent on increasing the wages of public servants, many of which had outstanding education qualifications but were being paid extremely poor wages. In the broad picture, the key objective was to get development spending done as feasible, together with properly targeted transfer and welfare payments, and delivering large wage increases to the public sector while ensuring that public sector reform was also in train.

The staff representative from the Asia and Pacific Department (Mr. Kronenberg), in response to questions from Directors, made the following statement:

> On the discussion that just took place, I support most of Mr. Murray's comments and note that, for better or worse, there is this real, understandable political tension between parliament and the government, even though they both represent the same parties. It is my strong feeling that the government has been in agreement with the staff on government spending issues.
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> It is true that spending has been rising at an unsustainable pace, and the authorities are concerned about this. As we noted in the staff report, there were plans already being discussed for additional spending, including significant additional social spending, which would not have been well-targeted. The authorities came to a quick decision after our discussions that such plans were not wise at this point. The authorities are fully aware of the situation and risks, and have valued the relationship with the Fund, in particular, to help them make their case.
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> There were a few questions about monetary policy. Ms. Xafa asked whether the tightening of monetary policy is already ongoing or whether it is insufficient. Mr. Gakunu advised the authorities against over tightening of policies, because inflation has been driven partly by import prices. There was also a point that accumulation of international reserves need not lead to inflationary pressures if they are properly sterilized. These points are all well taken.
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> On the characterization of monetary policy at this point, it is a difficult situation to explain. First, the monetary aggregates are volatile on a month-to-month basis. Reserve money had been declining surprisingly strongly in the first few months of the year, and in May, it has risen. But, we are observing signs of some tightening already under way. As Directors noted, there has been a 355 basis point increase in the policy interest rate. As other Directors noted, there has been a much larger increase in inflation.

Let me point out that in recent months and weeks, we are seeing for the first time a slight, gradual, but continuous movement on the exchange rate. It is a small move, on the order of a little under one percent over the past month, but compared with the ranges observed over most of last year, it is an encouraging sign and it is taking place alongside a much more stable level of international reserves. My impression is that monetary policy shows signs of being tightened, and these trends would need to continue for it to be sufficient to have an adequate impact on inflation. The central bank bill interest rate has not been large enough to actually increase the outstanding amount of central bank bills, so that channel also remains.

Finally, the amount of monetary tightening needed will depend on the government's own spending patterns. That is why fiscal and monetary policies need to be carefully coordinated, particularly in this case with rising inflation. Last year, a great deal of spending was pushed out at the end of the year on capital projects. If that is not repeated this year, then the authorities may be in a better position to keep the growth of reserve money under control. To conclude, there is scope to tighten monetary policy across the three instruments, namely central bank bills, foreign exchange market and foreign exchange reserves, and the government's fiscal stance.

Turning to fiscal policy and the question of how expansionary the fiscal stance is, let me clarify that the official budget for 2008 calls for a deficit of 2 1/2 percent. As Mr. Murray was explaining, this has been the range of the budget every year for the past few years. To some extent, as Mr. Murray pointed out, it is the parliament's instructions in their medium-term fiscal framework. As you will note, the outturn over the past three years has been much stronger than that, particularly in 2006 when there was a surplus on the order of 8 percent of GDP. Last year, the surplus was smaller. The authorities see things similarly to the way we do on this issue. They recognize and agree that there are projects in the budget that should be slowed or possibly taken out. I think they also believe that as a point estimate, current policies will already deliver a small surplus. We would encourage them to identify in an orderly way the projects that should be slowed down or cut. They should continue to make efforts to better target these universal social welfare programs, particularly so they can provide more support to the most vulnerable groups.

On exchange rate policy, the authorities believe firmly that they have a floating exchange rate regime. I believe that this is their intention and that there was not at any point a conscious change in policy. However, the structure of the foreign exchange flows has, as Mr. Murray pointed out, changed in a very major way since mid-2006, when the copper and gold prices were rising very fast and at the same time a new windfall mining tax was applied. The result was that there was a very large increase in mining sector taxes. The large mining companies felt that they could not exchange that money at a reasonable price in the thin local market. They chose, without any prompting from the government, to pay a large portion of their taxes in dollars. So, structurally the situation involves a large inflow of dollars coming from taxes, not from exchange market intervention. In fact, vis-à-vis the rest of the economy, the central bank is a significant net supplier; it sells back a great deal of those dollars. But through last year, the central bank was still accumulating reserves still fairly quickly. The level of international reserves seems to be leveling off.

There are real technical issues at stake in introducing greater exchange rate flexibility because of the structural changes that have taken place, and it is very welcome news that the authorities are moving quickly with trials to put in place a screen-based foreign exchange system. I think that can make a difference. The authorities are discussing with the mining companies to pay more of their taxes in local currency, meaning that they would need to put more of the foreign exchange into the market. I do not know if there has been any firm decision on that yet. Certainly, the mining companies selling more foreign exchange to the market or even to the central bank at a wider spread could be beneficial in facilitating exchange rate flexibility.

On the exchange rate assessment itself, I agree with Mr. Murray's buff and comments of other Directors about the need to approach quantitative estimates in this case with great caution. Ultimately, my views were very similar to what Mr. Charleton said in his gray that, while the degree of undervaluation of the real exchange rate appears quite modest, this reflects the high rate of inflation, which is an inherently undesirable situation. We have an economy here that has had a large and favorable terms of trade shock, and a good deal of mineral discovery promising to keep those revenues strong in the future. So, it is not surprising that there would be upward pressure on the real exchange rate. I agree that this would be most usefully accommodated through a flexible exchange rate policy, and that is what the authorities are trying to do. Hopefully, the technical steps that they are taking will help them move in that direction.

There were a few questions on external and nonconcessional borrowing. This is another good example of the different perspectives of the parliament and government; it is very much in line with the budget deficit target issue. Parliament is anxious to start as many projects as possible. The government and Fund staff feel that there certainly is a need for infrastructure spending, but even to do the infrastructure spending requires some spare capacity, and there is not much of that in the system right now. So, investment in infrastructure, just like everything else, needs to take account of the absorptive capacity of the economy.

Regarding the substantial authorization for spending that was passed by parliament, I would note that there are not any current plans to use it. On the contrary, the government feels that this should be held off, because they have not identified projects that it would be useful to borrow for. We have advised the authorities that it does not make much sense, given their comfortable level of reserves, to borrow just to have to turn around and put that money back in the bank. The government is approaching that cautiously, and I hope they will continue to do so. Their objective is more the fact that eventually their eligibility for concessional loans will decline over time as they continue to experience the kind of growth they have and they want to be ready for that in the future.

Mr. Prader noted that Mr. Murray and the staff had emphasized the difference in views between parliament and the government and wondered which party was likely to prevail, in particular on external borrowing. What was staff's assessment of the situation?

Mr. Yamaoka made the following statement:

I would like to make a brief statement on monetary policy conditions in Mongolia. The growth rate in recent years in Mongolia is about 10 percent, so the natural rate of interest would be around 10 percent. Currently, the inflation rate of Mongolia is over 20 percent.

The chart on page 28 of the staff report provides some clues with regard to the monetary conditions of Mongolia. First, if we presume the transmission mechanism based on the quantitative theory of money, the purpose of central bank operations is to control broad money, not reserve money. But if we look at this chart that describes the relationship between broad money and reserve money, of course the money multiplier is extremely volatile. So, the control of reserve money does not have much influence on monetary conditions. If we look at the growth rate of broad money, it is around 50 percent, so the relationship between broad money and GDP is apparently increasing. This shows the easing conditions of monetary policy.

If we look at the transmission mechanism based on the interest rate pass-through, the central bank's purpose is to control or influence the financing cost of private entities. If we look at the chart on interest rates, the central bank bill rate just fixed the lower end of the monetary policy operation band, so it may not have much influence on the financing cost of private entities.

If we look at the bank lending rate, it is still on a decreasing trend. Of course, the central bank bill rate is much lower than maybe the natural interest rate plus the current inflation rate. So, the bank lending bill rate is still substantially negative.

These two examples provide evidence that monetary policy conditions are still accommodative. As the staff rightly indicated, the Central Bank of Mongolia started the operation of tightening, but my impression is it is far below the necessary level to terminate inflationary pressures.

The staff representative from the Asia and Pacific Department (Mr. Kronenberg) made the following statement:

On who will prevail between the parliament and government, it was difficult to say. I will point to past experience where over the past three years large fiscal surpluses have been achieved despite very strong pressures for additional spending. The cancellation of additional appropriations earlier this year, especially in an election season, was very encouraging. The fact that parliament probably would not see it in the business of allocating the use for borrowed money, there is a good chance that the government will continue to prevail. It is not unreasonable for the authorities to start looking for the future, but on a smaller scale, though $1.25 billion is significant, it would be inappropriate in the current inflationary environment, and for uses that are productive but could not be financed by concessional sources.

So, I cannot tell you the answer of whether it is going to happen or not, but the fact was that there was a lot of pressure back in February/March for them to move very quickly on this. They have been approached by many foreign financial institutions who are anxious to invest in Mongolia and anxious to see a sovereign bond issue. These financial institutions have been literally at the door of the central bank and ministry. So far, it appears that the government is holding off on that.

Regarding the comments on monetary policy, I agree with the points just made. We state in the staff report that the authorities need to tighten monetary policy further. I did not mean to suggest that where they are now is fully sufficient. I did say that they should move on all fronts, including the external policies, international reserves and exchange rate, interest rate, and the impact of government finances.

Mr. Lushin sought clarification on exchange rate issues, in particular the staff's advice for greater exchange rate flexibility. It was not clear whether the recommendation was for a short- or medium-term goal and, if the flexibility should be market- or administrative-based. He wondered if there was a reasonable basis to float the exchange rate, and if flexibility was desired immediately, whether the necessary framework was in place.

Mr. Raczko noted that one of the main issues facing Mongolia was inflation. But taking into account the characteristic of inflation, two-thirds being driven by food prices, it was difficult to view it as only a monetary phenomenon. It would be important to analyze the pass-through mechanism of international food prices into the retail prices and asked to what extent the staff had assessed the pass-through mechanism. Specific areas to review should include the flexibility of the supply shock of the food products, the level of price competition of the traders of food products in Mongolia, and the stabilization instruments which were used by the authorities, such as the proper management of food inventories by the country.

Mr. Lin, on the issue of exchange rate assessment, concurred with the importance of avoiding a mechanical approach using the CGER methodologies, and acknowledged the role of the staff's expertise on country-specific factors. However, as stated in his gray, the complications with the exchange rate models in the Mongolia case raised more general issues associated with exchange rate assessment, which could usefully be discussed further. In that context, he asked the staff to respond to some of the specific questions raised in his gray.

The staff representative from the Asia and Pacific Department (Mr. Kronenberg) made the following statement:

> Let me start with the ability of the market to support a more flexible exchange rate. As I mentioned earlier, there are real technical obstacles that make it difficult. It is a fact that the exchange rate used to float much more freely in the past, and the reason that has changed is not so much a policy decision as it is the structural characteristics of the economy. In the relatively short term, widening the spreads, including the spread at which the government or the central bank pays to the mining companies or credits the mining companies for their taxes, would be a significant step. The ability of the central bank to operate through a screen-based system would also be helpful. Given the structural characteristics of the economy, it is unlikely that the authorities could move in the very short term to a completely floating regime. I think the intention, especially the news on the screen-based system, is encouraging.
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> On inflation and food prices, there is no doubt that food price increases, including imported food price increases, have been among the most rapidly growing components in the CPI. First, that strengthens significantly the case for the tightening of monetary policy, including a more flexible exchange rate regime. There would be a fairly significant impact on imported food prices if the exchange rate appreciates.
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> I also should point out that I believe that both demand and supply factors are at work on inflation, even with respect to food inflation. I understand that when government wages increased very rapidly in a few steps late last year and earlier this year, the impact on domestic meat prices was immediate. So, I think that there are both supply and demand factors, and that tightening demand policies is very much part of what needs to be done.
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> On the exchange rate assessment, I am reluctant to put too much emphasis on any quantitative implications. The pressures in the economy that we are observing are for some degree of appreciation. Going forward, it is difficult to come up with any kind of current account norm. It is not that the impact of these new mines are going to

be temporary; the impact of the new mines will be permanent and have a long-term impact on the exchange rate. What we are saying, though, is that the time path of that impact is going to be strong and varied, because of the large up-front investments that go into the development of mines, and the large receipts received down the road. As I said, there are also other projects that are on the drawing board that we have not yet incorporated, but they are sooner or later likely to go forward.

One could theoretically strip out these mining projects from the CGER estimates and see what those calculations would provide. I do not think that that is the best approach, because I think the mining sector is a key feature of this economy and it represents the major structural change that is taking place. I would not feel comfortable drawing conclusions on anything that requires us to take out the mining sector from the calculations.

Mr. Murray made the following concluding statement:

On behalf of my Mongolian authorities, I want to thank Executive Directors and the staff, as well as thank the Acting Chair, particularly for the strong support and advice being given to Mongolia. My authorities certainly value the opportunity for the Article IV consultations with the Fund, and very much value the constructive policy advice. It is clear from today's debate and messages from the staff, but also messages from Executive Directors that this is a critical time for Mongolia. The country needs our support, but it needs our strong advice as well. I will certainly deliver all your views and all that strong advice to them.

As set out in our buff, the Mongolian authorities broadly agree with the staff appraisal. They fully recognize the importance of preserving macroeconomic stability, as well as building sound institutions in order to sustain not only growth but to alleviate wider poverty throughout the Mongolian society. The opportunities provided by the current commodity price boom need to be wisely exploited so as to enhance both this growth potential and improve living standards.

Given the inflation pressures, however, and the overall pressures on the whole economy, the ultimate policy priority for my authorities and particularly for the central bank Governor is to curb inflation. Certainly, in order to restore inflation to single digits and do that by the end of this year is quite a tall order. To some extent, things have moved rapidly on the inflation front. Part of it, as the staff has pointed out, is demand-driven, but part of it is supply-driven. Part of it is structural within the economy itself and in terms of the economy's transition to a full market economy. In this sense, I know that the central bank Governor is determined in his endeavors to meet this inflation challenge. He realizes how important it is. He has already taken certain steps to tighten policy, and he has a strong commitment to continue to tighten policy as necessary.

The government clearly knows the implications of the capacity constraints and where the economy is placed vis-à-vis the resources boom. In that sense, it has got some very clear messages from the staff. Obviously, they then made significant decisions not to submit the supplementary budget in which they are under significant pressure to do, and bearing in mind that that significant pressure was not only building from parliament, but building from the whole scenario of the upcoming general election. The government is facing difficulties in restraining expenditure due to that upcoming election, but it will continue with its endeavors for fiscal consolidation. It is committed to making sure that there is delivery of a surplus as has been delivered in recent years.

On inflation developments, the central bank stands ready to implement further measures should they be needed. I have listened closely to what Mr. Yamaoka said today, and he made some good points. Mr. Raczko has made some very good points as well. There is a whole series of issues here and the central bank has to clearly respond, but they also need to take into account that there are both supply and demand factors.

In all of this, of course, additional measures, it seems to all of us, do mean greater exchange rate flexibility and that is an issue in itself. The staff made quite clear the point today about the technical difficulties, including the spread and how the central bank needs to address that in terms of its dealings particularly with the mining companies, but also more widely.

Regarding the staff's exchange rate assessment, I would like to urge staff to pay particular attention to the authorities' concerns about market-sensitive information. For the benefit of Executive Directors, we are having discussions on some of that information that is in the Board report in terms of publication. I am anxious for this report to be published. The Mongolian government needs to be able to make sure that parliament and the wider community and all of the stakeholders in Mongolia see this report. This is a really important report at a particular point in time. Therefore, we are trying to bridge the gap between the authorities and the staff under the publications policy, and I will continue to make the strongest endeavors to make sure that this document gets published.

Over the longer term, my authorities will continue to intensify structural reform efforts and build sound institutions and their endeavors and their appetite for technical assistance not only from the Fund, but from the Bank, from the EBRD, the Asian Development Bank, and other stakeholders. It is a clear indication that they are concerned about structural reforms, and importantly they are concerned about institution-building and cultural change-building in that sense.

Importantly, from our point of view, they will accelerate their efforts to improve the medium-term fiscal framework and to improve revenue administration to further develop monetary policy instruments and to make the transition mechanism work much better, to strengthen financial supervisory capacity and to embark importantly on legal and judicial reforms.

Given these tasks, it seems to me and to my Senior Advisor, Dr. Yoon, that the Mongolian authorities need to continue technical assistance from the Fund and need good policy advice, and certainly my authorities are very anxious to continue to see that. In that sense, we continue to be very disappointed about the closing of the Resident Representative office. The Resident Representative, Mr. Jang, was very instrumental and will be until he leaves in making sure that there is a very good bridge between Headquarters and between my office and the authorities. I just want to leave the Board with the feeling that this is a sad development, personally, from my point of view.

Lastly, I would like to convey my authorities' special appreciation to Mr. Kronenberg and his mission team. Over the past ten years, on and off, Mr. Kronenberg has led many missions to Mongolia and he has shown unbelievable dedication to the development of the Mongolian economy. My authorities are grateful, in particular, for the latest Article IV consultation. This comes at a crossroads for Mongolia. They wish you, Roger, all the best in your future endeavors.

The Acting Chair (Mr. Kato) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for Mongolia's impressive economic performance in recent years, notably rapid GDP growth, budget and external current account surpluses, and record levels of international reserves. Directors considered that the medium-term outlook remains favorable, given Mongolia's vast mineral wealth. Nevertheless, they noted that near-term prospects are clouded by rising inflation, reflecting rapid growth in government spending and private sector credit, large increases in imported food and fuel prices, and the tightening of supply constraints. If allowed to persist, these inflationary pressures could threaten macroeconomic stability and impair growth.

Against this background, Directors underlined that the authorities' immediate priority is to address the risk of overheating by tightening both fiscal and monetary policies. On the structural front, steps should be taken to address transportation bottlenecks and other capacity constraints. Directors encouraged the authorities to establish a transparent, stable, and internationally competitive mining regime to reap the full benefits of the country's mineral resources.

Directors expressed concern about the inflationary consequences of a relaxation of fiscal policy over the past year. They welcomed the authorities' decision to cancel plans for additional spending in an amended budget. With revenues remaining much stronger than expected in the budget, Directors saw scope for maintaining a small surplus this year by curtailing low-priority capital spending and containing the wage bill. They welcomed the authorities' intention to consider future wage increases carefully in the context of a broader civil service reform aimed at enhancing efficiency. Directors encouraged the authorities to reduce the overlapping coverage and improve the targeting of social spending programs to help contain spending while assisting the most vulnerable groups.

Directors underscored the importance of establishing a clear medium-term fiscal framework to help anchor macroeconomic stability and avoid sharp swings in spending. In this context, they advised the authorities to consider, as part of the fiscal framework, the introduction of a separate limit on expenditure growth and the adoption of realistic nonmineral fiscal targets. The authorities should continue to rely on concessional sources of external finance whenever possible. Nonconcessional borrowing should be considered only for projects with clear economic viability that cannot be financed by concessional loans, and only when the risks of inflation have diminished. Directors also encouraged the authorities to consolidate any foreign financing with the general budget to ensure fiscal transparency.

Directors welcomed the recent tightening of monetary policy, and encouraged the authorities to stand ready to increase the policy interest rate further as needed. They observed that international reserves are now at a broadly comfortable level, and that a further large increase could complicate the efforts to reduce inflation. They also noted the staff's assessment that the real effective exchange rate is currently somewhat undervalued, although a few pointed out that the divergence was within the margin of error. Directors were of the view that, going forward, greater exchange rate flexibility would facilitate the conduct of monetary policy and adjustment to external shocks. Strengthening the interbank foreign exchange market to handle a larger share of foreign exchange transactions will be important, and in this regard, they welcomed the steps being taken by the authorities, including for the introduction of a screen-based trading system.

Directors commended the Bank of Mongolia (BOM) for the progress made in strengthening its governance and risk management practices. They encouraged the BOM to expedite the preparation of a strategy to exit from its role as a major purchaser of domestically produced gold.

Directors considered that the overall condition of Mongolia's financial system is generally healthy and the framework for banking supervision is well-developed. Given the rapid credit growth, they encouraged the authorities to monitor large exposures closely and improve the supervision of liquidity and operational risks of banks. Directors welcomed the progress made by the Financial Regulatory Commission since its inception in 2006 to create a framework for the supervision of nonbank financial institutions. Further efforts are still needed to strengthen the statutory framework, especially for savings and credit cooperatives, and to develop the tools for consolidated supervision. Directors welcomed the authorities' intention to review plans for the establishment of a development bank, taking account of the experience elsewhere so as to avoid creating unfair competition and distortions in the financial sector.

It is expected that the next Article IV consultation with Mongolia will be held on the standard 12-month cycle.

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SHAILENDRA J. ANJARIA
Secretary