

**FOR
AGENDA**

EBS/09/36

March 19, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Mongolia—Request For Stand-By Arrangement**

Attached for consideration by the Executive Directors is a paper on the request for a Stand-By Arrangement for Mongolia, which is tentatively scheduled for discussion on **Wednesday, April 1, 2009**. A draft decision appears on page 19. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Mongolia indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Ms. Karasulu (ext. 37113) and Mr. Feridhanusetyawan (ext. 35690) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Friday, March 27, 2009; and to the Asian Development Bank, the European Investment Bank, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

MONGOLIA

Request for Stand-By Arrangement

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

Approved by Nigel Chalk and Anthony R. Boote

March 18, 2009

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

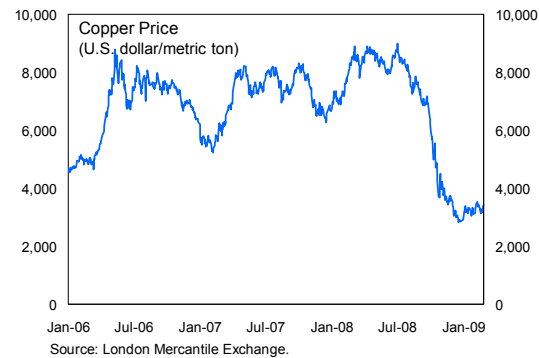
Program content: The proposed Stand-By Arrangement (of 300 percent of quota or SDR153.3 million) would aim to smooth adjustment to the catastrophic terms of trade shock, restore health to the country's fiscal finances, allow for greater exchange rate flexibility, address weaknesses in the banking system,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

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

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I. CONTEXT

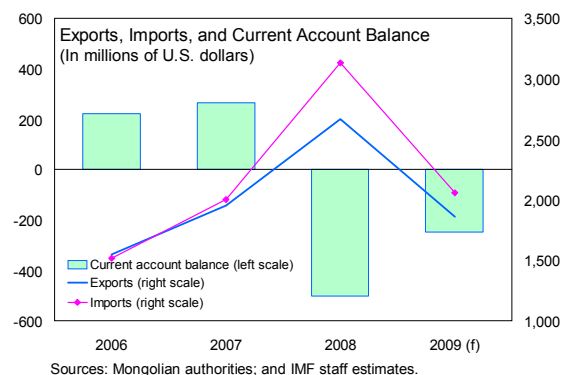
1. **Nature of the shock.** Mongolia has been hit hard by the global financial crisis through a sudden and catastrophic drop in the price of its main export commodities, most notably copper. From its peak in mid 2008, the copper price has fallen by 60 percent creating severe imbalances in both the fiscal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



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

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

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



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

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

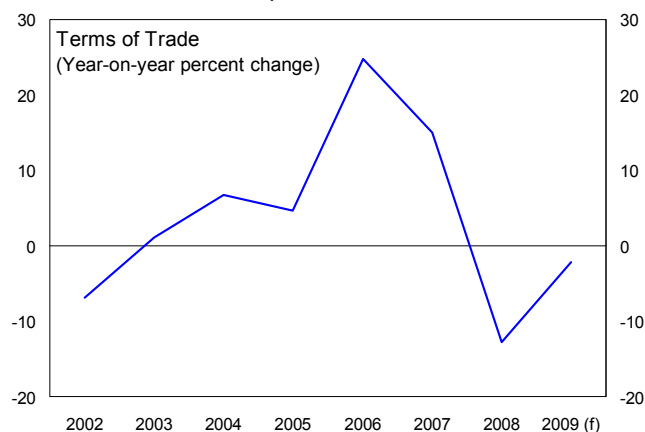
6. **Financial system.** Credit growth over the past two years has been rapid with almost one-half of lending to corporates being denominated in foreign currency. The shock to the economy since mid-2008 has led to a retrenchment of credit; broad money has fallen by 14 percent since mid-2008. The banking system is clearly under pressure. Loan-to-deposit ratios have risen to 140 percent and, in December, there was an isolated bank run on the fourth largest bank (Anod Bank). System-wide capital adequacy ratios—excluding Anod Bank—still average around 14 percent. However, this capital could be quickly eroded by a worsening of credit quality. This may arise from both the economic slowdown as well as credit risks from foreign currency lending in the context of a depreciating exchange rate. Banks with a weaker capital base and high levels of foreign currency lending are at particular risk.

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

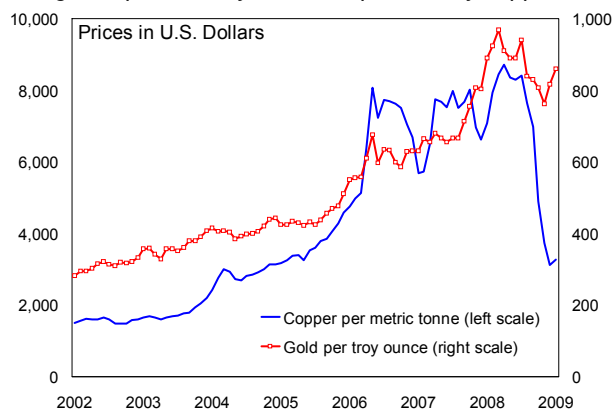
Figure 1. Macroeconomic Trends

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

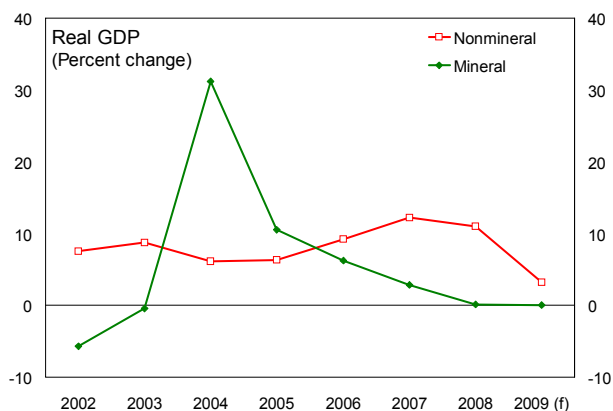
Following boom years in 2006 and 2007, the terms of trade has witnessed a catastrophic deterioration.



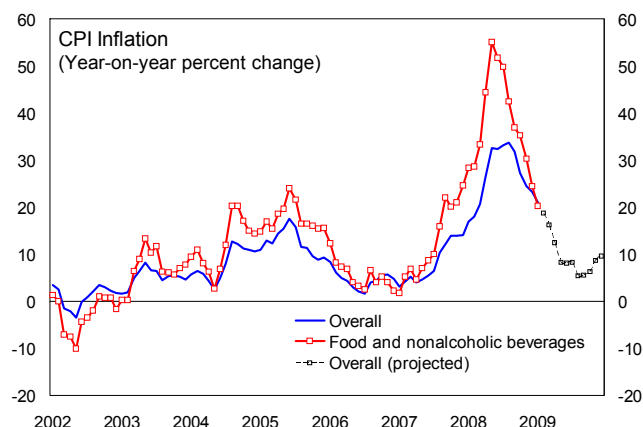
This has been primarily a result of the precipitous reduction in the global price of key minerals, particularly copper.



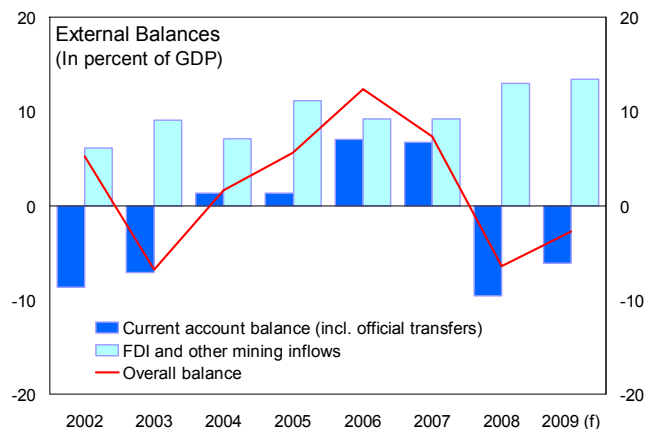
Activity in the mineral sector has fallen steadily since major projects came on line in 2004.



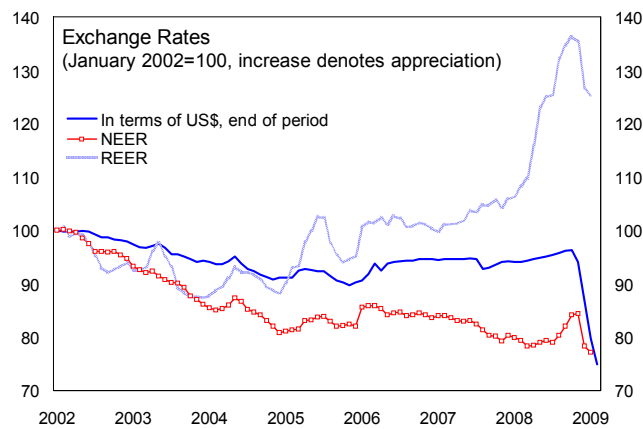
At the same time, the mineral boom has led to overheating and a rapid escalation of inflationary pressures. However, the economic downturn should allow inflation to fall rapidly.



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



Following a period of significant real appreciation, there is now strong downward pressure on the currency.

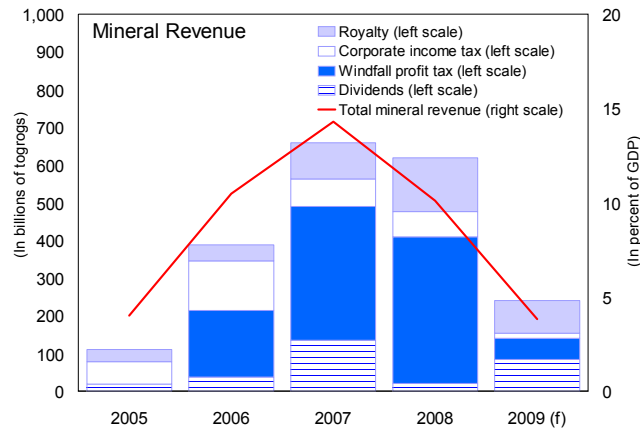


Sources: Mongolian authorities; and IMF staff estimates.

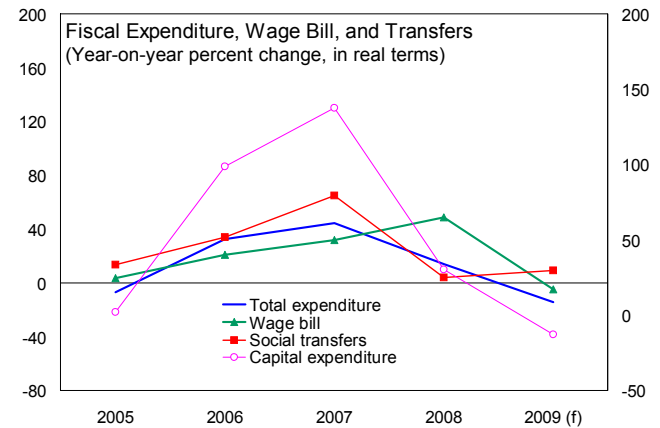
Figure 2. Policy Developments

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

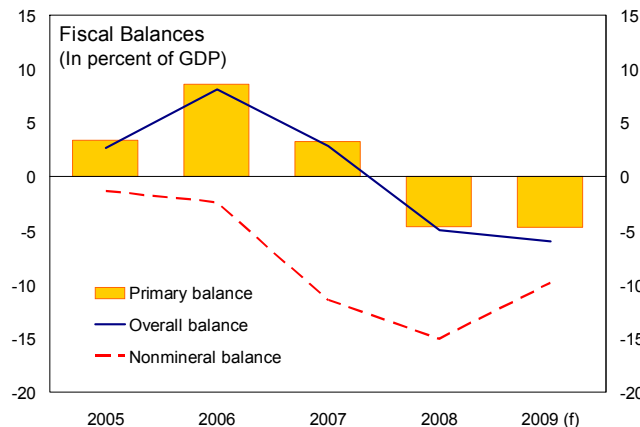
The loss of mineral revenue has had a significant impact on the fiscal accounts...



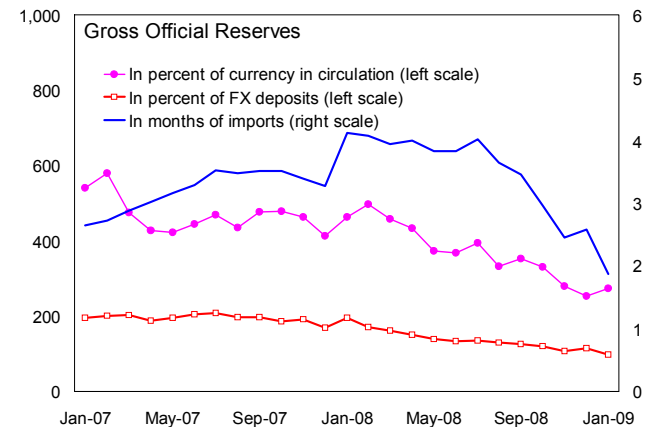
...and expenditures have been rising rapidly.



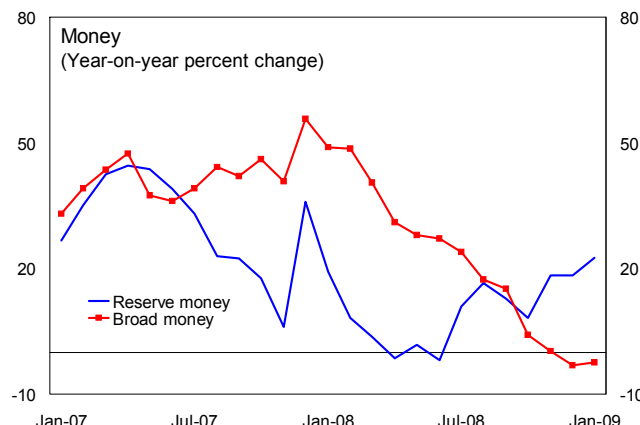
This has widened imbalances in the fiscal accounts which are now becoming acute.



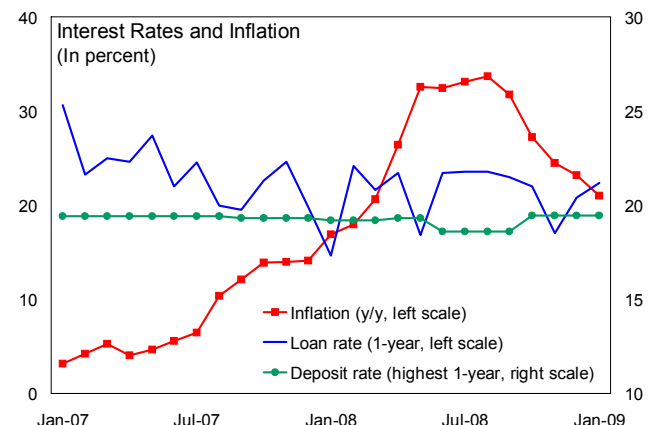
The central bank has been intervening, initially to prevent depreciation and, since November, to slow its pace.



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



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

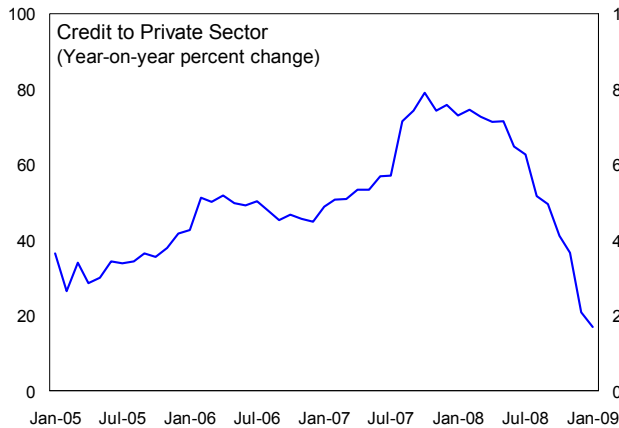


Sources: Mongolian authorities; and IMF staff estimates.

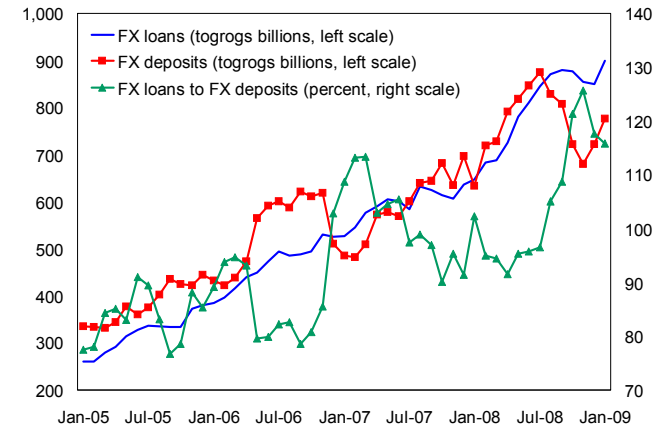
Figure 3. Financial Developments

Main Message: There has been a sudden stop in bank lending and sizeable outflows from the system. The banking system is facing liquidity pressures and is vulnerable to higher interest rates and a weaker currency.

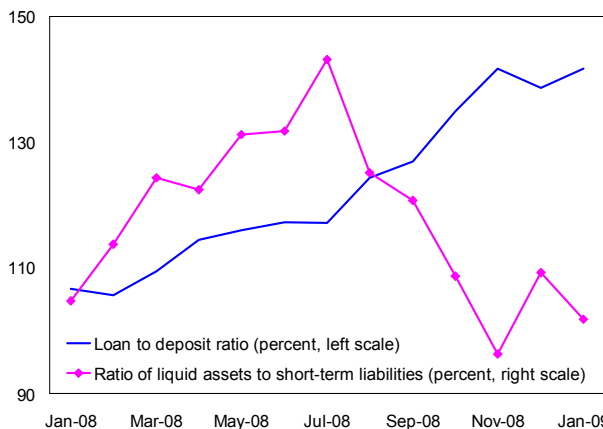
The rapid loan growth of the past couple of years has dried up. Demand for the local currency has slumped.



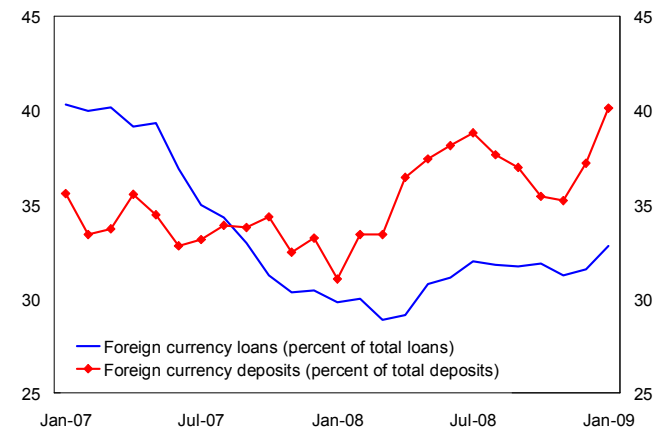
Deposits have declined, including those in foreign currency, loan-to-deposit ratios are rising rapidly...



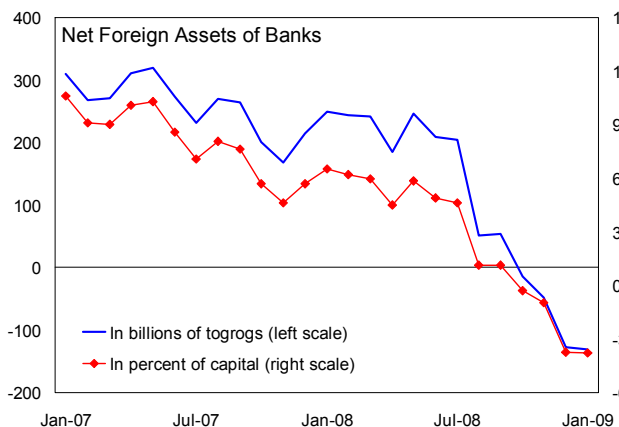
...and liquidity pressures are increasing.



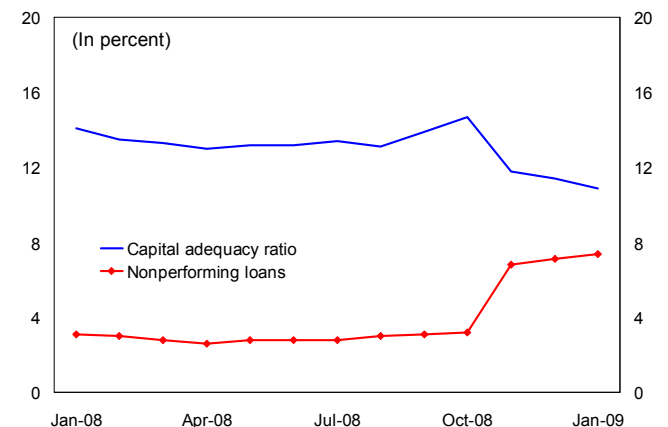
The financial system remains highly dollarized and FX borrowers do not necessarily have a natural hedge.



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



While capital ratios appear healthy, they may prove an inadequate cushion in the face of a marked worsening of credit quality.

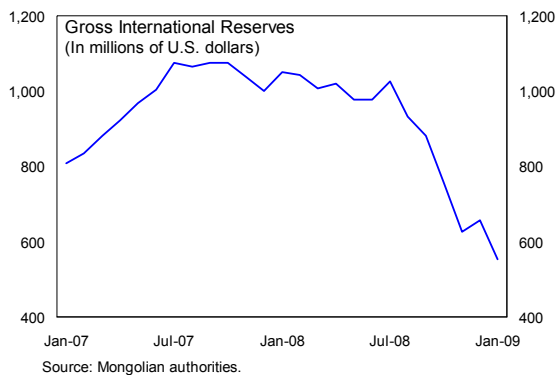


Sources: Mongolian authorities; and IMF staff estimates.

II. POLICIES

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

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



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

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

III. PROGRAM DISCUSSIONS

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

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

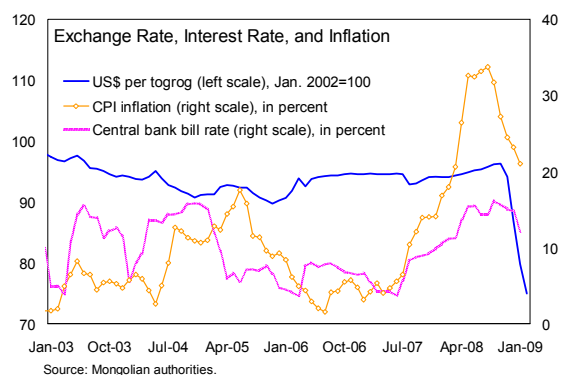
14. **Structural fiscal reform.** Recent events have starkly exposed the risks that pro-cyclical fiscal policies pose to the economy. To prevent the boom-bust fiscal cycle related to world copper prices, the government is committed to putting in place a stronger institutional framework to ensure a greater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

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

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

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

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



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

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

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

20. **Deposit guarantee.** The government has revised its deposit guarantee system in order to widen its scope and prevent potential abuse. The guarantee will not apply to deposits of related parties or subordinated debt holders. At the same time, the scope of the guarantee will be expanded to current accounts and interbank deposits in order to boost confidence in the banking system. Nevertheless, the credibility of the guarantee is still compromised by the government's weak fiscal finances.

IV. PROGRAM MODALITIES

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

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

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

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

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

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

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

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

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

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

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

Criteria IV. *The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver the adjustment.* There are significant

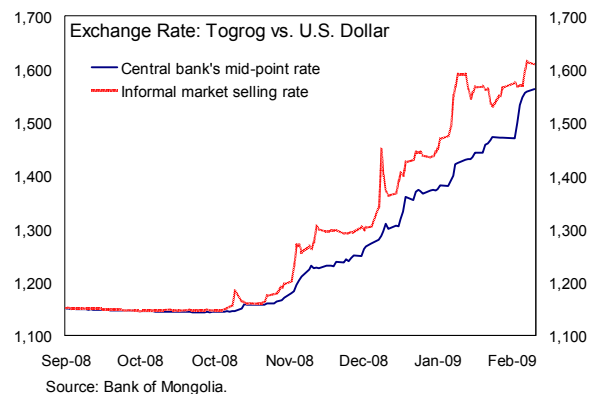
risks to the program. However, steadfast implementation of the broad policy framework outlined above provides the basis for averting the pending economic and social crisis. Parliamentary approval of a revised budget has provided a clear signal of broader political ownership of the proposed fiscal adjustment.

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

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

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

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



- First, the central bank rations its sales of foreign exchange to only a subset of imports. All other current account transactions are excluded. Residents remain free to purchase foreign exchange from the banks or foreign exchange bureaus and to implement transactions based on their own foreign exchange resources. However, anecdotal evidence suggests that certain current account transactions have failed because of the shortage of foreign currency in the market. This gives rise to an exchange restriction subject to Fund jurisdiction, since by rationing and restricting access to foreign exchange to a limited subset of imports, the government limits the availability of foreign exchange.
- Following from the above, the government's official action to ration and limit access to foreign exchange results in market segmentation and a multiplicity of rates. Foreign exchange purchased from the central bank is available at a better rate than in the foreign exchange market. This is because the mid-point rate and the market rate (as measured by the rate transacted at by banks and bureaus) have deviated substantially. The coexistence of two separate exchange markets results in a spread of more than 2 percent between the rates giving rise to a multiple currency practice.

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

V. RISKS

32. There are substantial risks to the program:

- ***Fiscal policy.*** The risks to the fiscal position have several components:
 - ◆ *Seasonality.* There is a clear seasonal pattern to payments and receipts in Mongolia. As the winter ends and economic activity picks up, government expenditures rise but the revenues associated with those activities arrive only later in the year. Thus the fiscal imbalance is considerably larger in the first half which, this year, will coincide with very tight financing conditions. This makes the fiscal targets in the program very challenging for the first half of the year.
 - ◆ *Revenues.* There are certainly risks to the revenue outlook. Most pertinently, the ability of Erdenet—the main copper company which is 51 percent government owned—to pay corporate taxes and dividends is unclear. Loss of that revenue, which is forecast to be 1½ percent of GDP this year, would have damaging consequences for the fiscal position.

- ◆ *Spending.* As has been alluded to earlier, the composition of expenditure reductions is less-than-ideal. If international experience is a guide, this puts at risk the sustainability of the intended adjustment. It will be vital, therefore, that the reduction in spending is maintained in 2010 and that ways are sought in the coming months to improve the quality of the fiscal adjustment.
- ◆ *Gold operations.* Finally, the government has, in past years, engaged in lending operations to finance working capital for gold mines in the country. These loans are usually paid out in the second quarter and received back later in the year once the gold is excavated and monetized by the central bank to become part of its foreign reserves. This year, that operation—the size or precise details of which are, as yet, unknown—could put pressure on the fiscal position early on in the year.

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

- ***Monetary policy.*** Upfront action to constrain liquidity and prevent the continued pace of international reserve loss is required. Such measures are certain to be unpopular. It will require steadfast implementation by the central bank if the program is to succeed. The recently announced interest rate increase is a very positive step in this regard.
- ***Deposit loss.*** Given the loss of deposits from the system over the past several months, the program assumes that a process of remonetization will get underway, prompted by higher local currency interest rates, by the credibility of the program, and the availability of substantial Fund and donor resources. However, as in any country, the pace at which banks will be able to attract deposits back into the system is uncertain, which could further constrain the availability of bank-intermediated financing.
- ***Banks.*** Stress test results—drawing on a framework put in place at the time of the last FSAP—suggest that banks are exposed to both interest rate and exchange rate risk. The former through maturity mismatches and the latter via the effect a weaker currency will have on the prospects for repayment of foreign currency loans by unhedged borrowers. These effects will be amplified by the impact of a rapidly slowing economy. It would not be surprising if some banks were to move into conservatorship over the next few months and such events will be need to be handled quickly and carefully.
- ***Global risks.*** As is clearly evident, the global economic context is highly uncertain. This translates directly to Mongolia's trade and fiscal revenues through the effect on

world mineral prices. Copper prices—which are forecasted based upon the WEO—could well fall further, putting additional pressures on the economy.

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

VI. STAFF APPRAISAL

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

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

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

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

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

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

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

PROPOSED DECISION

The following draft decision is proposed for adoption by the Executive Board, which may be adopted by a majority of votes cast:

1. Mongolia has requested a Stand-By Arrangement in an amount equivalent to SDR 153.3 million for an eighteen-month period from April 1, 2009.
2. The Fund approves the Stand-By Arrangement for Mongolia set forth in EBS/09/36, (3/19/09) and decides that purchases may be made under the arrangement on the condition that the information provided by Mongolia, on the implementation of the measures specified as prior actions in Table 2 attached to Memorandum of Economic Policies and the letter from the Minister of Finance and the Governor of the Bank of Mongolia, dated March 17, 2009, is accurate.

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

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

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

Sources: Mongolian authorities; and Fund staff projections.

1/ Based on period average exchange rate.

2/ Estimate, based on period average exchange rate.

3/ Share of households below national poverty line, based on The Millennium Development Goals Implementation 2007.

4/ For 2009-10, valued at the programmed exchange rate and gold price.

5/ Yield of 14-day bills until 2006 and of 7-day bills from 2007 onward.

6/ Includes prospective Fund credit under the SBA.

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

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

Sources: Ministry of Finance; and Fund staff projections.

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

Table 3. Mongolia: Monetary Aggregates, 2006–10

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

Sources: Mongolian authorities; and Fund staff projections.

1/ Valued at the programmed exchange rate and gold price.

2/ Includes nonperforming loans.

3/ Does not include commercial bank foreign currency deposits and foreign currency current accounts held at the Bank of Mongolia.

4/ Includes commercial bank foreign currency deposits and foreign currency current accounts held at the Bank of Mongolia.

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

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

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

Sources: Mongolian authorities; and Fund staff projections.

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

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

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

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

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

Sources: Mongolian authorities; and Fund staff projections.

1/ Based on period average exchange rate.

2/ Includes prospective Fund credit under the SBA.

Table 6. Mongolia: External Financing Requirements and Sources, 2009–2011
(In millions of U.S. dollars)

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

Sources: Mongolia authorities; and Fund staff projections.

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

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

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

Sources: Fund staff estimates and projections.

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

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

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

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

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

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

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

Sources: Mongolian authorities; and Fund staff estimates.

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

2/ Including official transfers.

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

Mongolia: Stand-By Arrangement

Attached hereto is a letter (the “Letter”), with an annexed memorandum of economic policies (the “MEP”) and a technical memorandum of understanding (the “TMU”), dated March 17, 2009 from the Minister of Finance and the Governor of the Bank of Mongolia requesting a Stand-By Arrangement and setting forth:

- (a) the objectives and policies that the authorities of Mongolia intend to pursue for the period of this Stand-By Arrangement;
- (b) the policies and measures that the authorities of Mongolia intend to pursue during the first year of this Stand-By Arrangement; and
- (c) understandings of Mongolia with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Mongolia will pursue for the remaining period of this Stand-By Arrangement.

To support these objectives and policies the International Monetary Fund (the “Fund”) grants this Stand-By Arrangement in accordance with the following provisions:

- 1 For the period from April 1, 2009 to October 1, 2010, Mongolia will have the right to make purchases from the Fund in an amount equivalent to SDR 153.3 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 51.10 million until June 15, 2009, the equivalent of SDR 76.65 million until September 15, 2009, the equivalent of SDR 91.98 million until December 15, 2009, the equivalent of SDR 107.31 million until March 15, 2010, the equivalent of SDR 122.64 million until June 15, 2010, and the equivalent of SDR 137.97 million until September 15, 2010.

- (b) None of the limits in (a) above shall apply to a purchase under this Stand-By Arrangement that would not increase the Fund’s holdings of Mongolia’s currency subject to repurchase beyond 25 percent of quota.

3. Mongolia will not make purchases under this Stand-By Arrangement that would increase the Fund’s holdings of Mongolia’s currency subject to repurchase beyond 25 percent of quota:
 - (a) during any period in which the data at the end of the preceding period indicate that:
 - (i) the floor on the net international reserves, or
 - (ii) the ceiling on the net domestic assets (NDA), or
 - (iii) the ceiling on the net bank credit to general government (NBCGG),

(iv) the ceiling on the contracting or guaranteeing of new nonconcessional external debt by the general government, the BOM, or other agencies acting on behalf of the general government with maturities of one year or more, or

(v) the ceiling on the contracting or guaranteeing of new nonconcessional external debt by the general government, the BOM, or other agencies acting on behalf of the general government with maturities of less than one year,

as set out in Table 1 of the MEP and further specified in the TMU is not observed; or

(b) (i) after June 30, 2009, if Mongolia has not carried out its intention with respect to revising relevant laws to require Erdenet to pay taxes in togrog, as described in Table 2 and paragraph 5 of the MEP, or

(ii) after June 30, 2009, if Mongolia has not carried out its intentions with respect to announcing a plan for Anod Bank based on the diagnostics assessment of the external auditor, as described in Table 2 of the MEP, or

(iii) after December 31, 2009, if Mongolia has not carried out its intentions with respect to submitting to parliament a Fiscal Responsibility Law consistent with a stronger budgetary framework that will facilitate sound fiscal management, as described in Table 2 and paragraph 8 of the MEP; or

(c) if at any time during the period of the Stand-By Arrangement:

(i) the ceiling on the accumulation of external payment arrears by the general government or the BOM, as described in Table 1 of the MEP and as further specified in paragraph 30 of the TMU, is not observed, or

(ii) the ceiling on the accumulation of domestic payment arrears by the general government, as described in Table 1 and paragraph 21 of the TMU, is not observed, or

(d) after June 14, 2009, September 14, 2009, December 14, 2009, March 14, 2010, June 14, 2010, and September 14, 2010 until the reviews contemplated in the paragraph 2 of the TMU are completed; or

(e) unless, for so long as Mongolia has outstanding sovereign external arrears to private creditors, or by virtue of its imposition of exchange controls there are outstanding non-sovereign external payment arrears, a financing assurances review is completed, or

(f) if, at any time during the period of the Stand-By Arrangement, Mongolia

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements that are inconsistent with

Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Mongolia is prevented from purchasing under this Stand-By Arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Mongolia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Mongolia will not make purchases under this Stand-By Arrangement during any period in which Mongolia: (i) has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, or (b) in respect of a purchase in support of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), or (c) pursuant to subparagraph 17 and 31 of Decision No. 8955-(88/126) on the Compensatory Financing Facility, or (d) in respect of a purchase under Decision No. 11627-(97/123) SRF on the Supplemental Reserve Facility, or (e) pursuant to paragraph 1(b) of Decision No. 5703-(78/39) or paragraph 10(a) of decision No. 4377-(74/114); or (ii) is failing to meet a repayment obligation to the PRGF-ESF Trust established by Decision No. 8759-(87/176), or a repayment expectation to that Trust pursuant to the provisions of Attachment I to the PRGF-ESF Trust Instrument.

5. Mongolia's right to engage in transactions covered by this Stand-By Arrangement can be suspended only with respect to requests received by the Fund after: (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Mongolia. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Mongolia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this Stand-By Arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Mongolia, the Fund agrees to provide SDRs at the time of the purchase.

7. Mongolia shall pay a charge for this Stand-By Arrangement in accordance with the decisions of the Fund.

8. (a) Mongolia shall repurchase the amount of its currency that results from a purchase under this Stand-By Arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchases as Mongolia's balance of payments and reserve position improves.

(b) Any reductions in Mongolia's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of reduction.

9. During the period of the Stand-By Arrangement Mongolia shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Mongolia or of representatives of Mongolia to the Fund. Mongolia

shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Mongolia in achieving the objectives and policies set forth in the Letter and the MEP.

10. In accordance with the paragraph 1 of the TMU, Mongolia will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 above have not been observed or because the Managing Director considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Mongolia has outstanding purchases in the upper credit tranches, the government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning Mongolia's balance of payment policies.

ATTACHMENT I

March 17, 2009

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

Dear Mr. Strauss-Kahn:

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

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

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

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

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

Sincerely yours,

/s/
S. Bayartsogt
Minister of Finance

/s/
L. Purevdorj
Governor of Bank of Mongolia

Attachments
Memorandum of Economic Policies
Technical Memorandum of Understanding

MEMORANDUM OF ECONOMIC POLICIES

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

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

I. MACROECONOMIC OUTLOOK

1. **The economic outlook for this year will be challenging.** Growth is projected to slow to 2¾ percent in 2009 reflecting weak exports and falling domestic demand. Inflation should, however, decline rapidly (from 23 percent at end-2008 to 9 percent by end-2009). Prudent policies and a flexible exchange rate should allow the current account deficit to stabilize at around 6 percent of GDP, albeit with a continued decline in exports.
2. **Although we anticipate an economic recovery will begin in early 2010.** Assuming a recovery in global economic conditions and an improvement in mineral prices we expect growth to turn around in 2010, reaching 4¼ percent, with a continued decline in inflation. Given the unusual uncertainty surrounding global economic prospects, there are, however, significant risks to this outlook.

II. FISCAL POLICY

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

Key Fiscal Targets
(In percent of GDP)

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

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

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

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

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

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

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

III. EXCHANGE RATE AND MONETARY POLICY

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

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

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

IV. STRENGTHENING THE BANKING SYSTEM

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

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

- The central bank has asked all banks to increase their risk-weighted capital adequacy ratio (CAR) to 12 percent by end-2009. By end-April 2009 banks will submit capital reinforcement plans under different assumptions about the future deterioration of asset quality.
- The central bank will increase the number of on-site supervisors, complete an updated on-site examination of the five largest banks by June 2009, and intensify off-site monitoring.
- The central bank will identify any problem banks and formulate a supervisory enforcement plan by end-June 2009 to ensure that weaker banks do not threaten financial stability.
- The central bank will strengthen its fit and proper review of shareholders and management and clearly identify beneficial owners in the case of complex bank ownership structures. The government and the central bank will ensure that banks' external auditors are appropriately qualified and experienced.

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

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

V. OTHER POLICIES

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

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

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

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

1/ Evaluated at the programmed exchange rate.

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

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

Table 2. Mongolia: Prior Actions (PA), Structural Performance Criteria (PC), and Structural Benchmarks (SB)

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

MONGOLIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. During the period of the arrangement, the authorities of Mongolia will maintain the usual close policy dialogue with the Fund. In this regard, the authorities are committed to take any additional measures that may be needed to ensure that the program remains on track. They will consult with the IMF on the adoption of measures, and in advance of revisions to the policies contained in the MEP, in accordance with the IMF's policies on such consultation. Further, the Government of Mongolia and the Bank of Mongolia will provide the Fund with such information as it requests on policy implementation and achievement of the program objectives.
2. The program will be monitored through quantitative performance criteria and indicative targets, structural performance criteria and structural benchmarks, and quarterly reviews (Table 1). This memorandum sets out the definitions for quantitative performance criteria and indicative targets under which Mongolia's performance under the program supported under a Stand-by Arrangement (SBA) will be assessed. Monitoring procedures and reporting requirements are also specified. The first review will take place on or after June 15, 2009, and the second review on or after September 15, 2009.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

3. Performance criteria for end-April 2009, end-June 2009, end-September 2009, end-December 2009, end March 2010, and end June-2010 have been established with respect to:
 - floors on the level of net international reserves of the Bank of Mongolia (BOM);
 - ceilings on the level of net domestic assets of the BOM;
 - ceilings on the level of net bank credit to general government;
 - ceilings on the contracting and guaranteeing by the central government or the BOM of new medium- and long-term external debt; and
 - ceilings on the contracting or guaranteeing by the central government or the BOM of new short-term external debt.
4. Performance criteria that are applicable on a continuous basis have been established with respect to
 - ceilings on accumulation of new external payment arrears of the central government and the BOM; and

- ceiling on accumulation of domestic payment arrears of the central government.
5. Indicative targets for end-April 2009, end-June 2009, end-September 2009, end-December 2009, end-March 2010, end-June 2010 have been established with respect to:
- ceilings on the general government fiscal deficit;

II. INSTITUTIONAL DEFINITIONS

6. The general government includes all units of budgetary central government, social security funds, extrabudgetary funds, and local governments.
7. The domestic banking system is defined as the BOM, the existing and newly licensed commercial banks incorporated in Mongolia and their branches.

III. MONETARY AGGREGATES

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

A. Reserve Money

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

B. Net International Reserves of the BOM

10. A floor applies to the level of net international reserves (NIR) of the BOM. The floor on NIR will be adjusted upward (downward) by the amount of support from bilateral and multilateral donors (excluding IMF) in excess (short) of the programmed level. The floor on NIR will also be adjusted upward by the amount of nonconcessional borrowing disbursed during the program period.
11. NIR will be calculated as gross international reserves less international reserve liabilities. For program monitoring purposes, the stock of foreign assets and foreign liabilities of the BOM shall be valued at program exchange rates and gold price as described on paragraph 8 above.

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

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

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

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

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

C. Net Domestic Assets of the BOM

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

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

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

D. Net Bank Credit to the General Government

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

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

IV. FISCAL AGGREGATES

A. Fiscal Deficit

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

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

V. DOMESTIC PAYMENT ARREARS

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

VI. EXTERNAL DEBT

A. Medium- and Long-Term External Debt

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

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

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

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

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

B. Short-Term External Debt

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

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

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

VII. EXTERNAL PAYMENT ARREARS

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

VIII. PERFORMANCE CRITERION OF THE MODIFICATION OF MULTIPLE CURRENCY PRACTICES

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

IX. DATA PROVISION

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

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

A. Monetary Data (BOM)

- The monetary survey, the balance sheet of the BOM, and the consolidated balance sheet of the commercial banks. Data will be provided on a monthly basis, with the

exception of the balance sheet of the BOM, which will be provided on a weekly basis within five working days of the end of the respective week.

- Net international reserves and interventions of the BOM in the foreign exchange market on daily basis.
- Interest rates and volume on standing facilities and market operations on a weekly basis within five working days of the end of the respective week.
- A detailed breakdown of net credit to government from the BOM and the commercial banks.
- Stock of monetary gold in both thousands of fine troy ounces and U.S. dollars. If the BOM engages in monetary gold transactions or employs any other accounting rate, directly or implicitly, for valuing gold assets, this information will be reported to the Fund. Any increase in monetary gold through purchases from domestic sources and refining of nonmonetary gold held or purchased by the BOM will also be reported (both prices and volumes). Any liabilities that are guaranteed or otherwise backed by gold will be reported to the Fund.
- A detailed breakdown of “other items net” for both the BOM and the commercial banks, including, inter alia, all valuation changes in net international reserves and net other foreign assets arising from exchange rate changes and/or revaluation of gold.
- Outstanding balances of all deposit accounts of the general government in commercial banks, including those of the extrabudgetary funds.
- Outstanding balances of any new deposit accounts of the general government opened in addition to the existing ones for grants and loans received from multilateral or bilateral donors, including associated counterpart funds.
- A bank-by-bank list of required reserves and actual reserves.
- Results of each central bank bills auction within five working days of each auction, including amount of bills offered, amount demanded, amount sold to each bank, announced rates, and cut-off rates.

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

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

- Classified transactions of all social insurance funds.
- Domestic payment arrears of the general government.
- Noninterest outstanding payables by each subsector of the general government, including the social security funds, with a detailed breakdown by major categories and remaining maturity.
- Results of each treasury bills auction within five working days of each auction, including amount of bills offered, amount demanded, amount sold to each bank and nonbanks, and the average yield in percent per month.

C. External Sector Data (BOM and MOF)

- Complete list of new contracts for the execution of public investment projects, which have been signed or are under negotiation with foreign or domestic entities, including details on the amounts, terms, and conditions of current or future debt or nondebt obligations arising from these contracts.
- Outstanding stock, disbursements, amortization, and interest payments of short-term external debt contracted or guaranteed by the government or the BOM by creditor in original currency and U.S. dollars.
- Outstanding, disbursements, amortization, and interest payments of medium- and long-term external debt contracted or guaranteed by the government or the BOM by creditor in original currency and U.S. dollars.
- Daily midpoint exchange rates of the togrog against the U.S. dollar, including the official, interbank, and parallel market exchange rates (BOM).
- Arrears on the external debt contracted or guaranteed by the government or the BOM by creditor in original currency and U.S. dollars.

D. Other Data (National Statistical Office)

- The monthly consumer price index and a detailed breakdown by major categories of goods and services included in the consumer basket.
- The NSO's monthly statistical bulletin, including monthly export and import data.

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

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

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

- (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);
- (ii) suppliers’ credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and
- (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

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