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| <p>EXECUTIVE BOARD MEETING</p> |
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EBS/18/91
Supplement 1

October 29, 2018

To: Members of the Executive Board

From: The Secretary

Subject: **Mongolia—Fifth Review Under the Extended Fund Facility Arrangement and Request for Modification and Waiver of Applicability of Performance Criteria—Supplementary Information, Revised Proposed Decision, and Supplementary Letter of Intent**

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| Board Action: | Executive Directors' consideration (Formal) |
| Tentative Board Date: | Wednesday, October 31, 2018 |
| Proposed Decision: | Pages 3–4 |
| Publication: | Yes* |
| Additional Information: | The proposed decision has been revised to refer to the supplementary letter of intent and to remove references related to “unavailability of information to assess the observance of the end-September 2018 performance criterion”, since the Mongolian authorities have now provided information on all the end-September 2018 performance criteria. |
| Questions: | Mr. Gottlieb, APD (ext. 38087) Mr. Agarwal, APD (ext. 37423) |
| Document Transmittal in the Absence of an Objection and in accordance with Board policy: | Forthwith—WTO After Board Consideration—Asian Development Bank, Asian Infrastructure Investment Bank, European Investment Bank, Organisation for Economic Cooperation and Development |

***The authorities have indicated that they consent to the Fund's publication of this paper.**



MONGOLIA

October 26, 2018

FIFTH REVIEW UNDER THE EXTENDED FUND FACILITY ARRANGEMENT AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA—SUPPLEMENTARY INFORMATION, REVISED PROPOSED DECISION AND SUPPLEMENTARY LETTER OF INTENT

Approved By
Markus Rodlauer
(APD) and **Daria**
Zakharova (SPR)

Prepared by the Asia and Pacific Department

This supplement contains information that has become available since the issuance of the staff report (EBS/18/91). The supplement does not alter the thrust of the staff appraisal.

- 1. Recent data have confirmed that the authorities met the end-September primary balance target.** In the staff report issued to the Board, staff proposed a waiver of applicability for the end-September quantitative performance criteria (QPC) target on the primary balance as the needed data was unavailable. Since then, the authorities confirmed that the target (-20 billion togrog, cumulative January-September) was met by a comfortable margin (actual number was 1644 billion togrog) (See Table 1 attached).
- 2. This strong performance suggests there will likely be further over-performance on fiscal targets in 2018.** Revenues remained strong in the third quarter and have risen 31 percent year-to-date. The key drivers remain mineral exports and strong imports. In light of this, staff project that the primary surplus will now reach 4.5 percent of GDP in 2018.
- 3. In mid-October, the Development Bank of Mongolia (DBM) issued an external bond raising US\$500 million.** The 5-year bond carries a coupon of 7.25 percent and was 8 times over-subscribed. Even though it did not come with a government guarantee, it received the same credit rating as that of government bonds: B- (Standard & Poor) and B (Fitch). The proceeds are expected to be solely for liability management (paying off short-term external debt with floating interest rates) and thus should not affect the stock of external public debt.

4. Since end-September, net international reserves have declined by about \$100 million amid ongoing balance of payment pressures. The fall in reserves would be larger but the authorities have been able to monetize \$38 million in gold in the month through October 18. Against the dollar, the togrog has depreciated 5.4 percent year-to-date and 0.7 percent since end-September.

5. Recently, BOM has taken several steps to ensure that the follow-up to the Asset Quality Review remains on track. BOM met the final prior action pending in the Staff Report by requesting that banks provide an update on progress in meeting the capital shortfall from the Asset Quality Review (AQR). However, these updates suggested further actions were necessary to ensure sufficient progress going forward. As this is a key program goal, staff returned to Ulaanbaatar for further discussions in mid-October and reached understandings on an addendum to the LOI (see attached) outlining an additional prior action (See Table 2 attached). Specifically, BOM would send a formal communication to the banks which a) requires them to incorporate the results of the AQR and recent on-site inspections in their October balance sheets and b) underscores that banks must raise the previously requested amount and type of capital by end-December 2018 or face intervention by BOM. On October 23, the authorities sent this communication to the banks and have now met the final prior action for this review.

Revised Proposed Decision

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

1. Mongolia has consulted with the Fund in accordance with paragraph 3(b) of the extended arrangement for Mongolia (EBS/17/30, 05/18/17, Supplement 2) (the “Arrangement”) in order to review program implementation.

2. The letter dated October 10, 2018 from the Minister of Finance of Mongolia and the Governor of the Bank of Mongolia (the “October 2018 Letter”) and the supplementary letter dated October 23 from the Governor of the Central Bank of Mongolia (the “Supplementary October 2018 Letter”) shall be attached to the Arrangement, and the letter dated May 17, 2017 (the “May Letter”) which supplements the letter dated April 13, 2017 (the “Letter”) together with its attachments, both from the Minister of Finance of Mongolia and the Governor of the Bank of Mongolia, as supplemented and modified, shall be read as further supplemented and modified by the October 2018 Letter and the Supplementary October 2018 Letter.

3. Accordingly, the Arrangement for Mongolia shall be amended as follows:
 - a. Paragraph 3(a)(iii) of the Arrangement shall be modified to read as follows:

“(iii) The floor on the primary balance of the general government (excluding DBM), or”

- b. A new paragraph 3(a)(vi) of the Arrangement shall be introduced and shall read as follows:
“(vi) the ceiling on DBM net lending”
 - c. The performance criteria set forth in paragraphs 3(a)(i) through 3(a)(vi) of the Arrangement for December 31, 2018 and March 31, 2019 shall be as specified in Table 1 of the Supplementary October 2018 Letter.
 - d. The continuous performance criteria set forth in paragraph 3(c)(i) - (ii) of the Arrangement shall be as specified in Table 1 of the Supplementary October 2018 Letter.
4. The Fund decides that the fifth review contemplated in paragraph 3(b) of the Arrangement for Mongolia is completed, and that Mongolia may make purchases 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 of the Supplementary October 2018 Letter is accurate.

Supplementary Letter of Intent

October 23, 2018
Ulaanbaatar

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Lagarde,

This letter is a supplement to the Letter of Intent signed on October 10. I am writing to inform you that I have taken the steps necessary to meet the final prior action under the 5th Review and ensure that the follow-up to the Asset Quality Review remains on track.

Specifically, in early September, I asked the 7 banks with capital shortfalls to submit plans by end-September which detailed how they would raise the capital requested by the Bank of Mongolia in May. All seven banks have now submitted capital plans to the Bank of Mongolia.

In addition, on October 23, the Bank of Mongolia (BOM) conveyed the results of the recent on-site inspections to all 7 banks. BOM indicated in this letter that Banks must update their balance sheets as of end-September accordingly. This means adequately classifying assets, making provisioning and adjusting capital adequacy ratios in line with the results of the on-site inspections. We asked the banks to share the updated balance sheets no later than end-October.

In this message to the banks, we also clarified that the amount and type of capital to be raised remains that communicated in May, that any Tier 1 shortfall must be met by issuing new common shares, and a failure to raise the amount and type of capital required by end-December would result either in public injections of capital or resolution consistent with the Banking Law.

We look forward to continuing to work together on ensuring a well-capitalized financial system in the months ahead.

/s/

N. Bayartsaikhan
Governor, Bank of Mongolia

Table 1. Mongolia: Quantitative Performance Criteria and Indicative Targets
(Replaces Staff Report Table)

| | Mar-18 | | Jun-18 | | Sep-18 | | Dec-18 | | Mar-19 | | Jun-19 |
|--|--------|--------|--------|--------|--------|--------|--------|----------------|--------|----------------|-------------------|
| | Target | Actual | Target | Actual | Target | Actual | Target | Revised Target | Target | Revised Target | Indicative Target |
| Performance Criteria 1/ 2/ 3/ 4/ | | | | | | | | | | | |
| Change in net international reserves (NIR) of the Bank of Mongolia (BOM) (floor, cumulative, change in eop stock, in million US\$ at program exchange rate) | 1,700 | 2,087 | 1,900 | 2,147 | 2,000 | 2,137 | 2,200 | 2,200 | 2,500 | 2,700 | 2,900 |
| Net domestic assets (NDA) of the BOM (ceiling, eop stock, in billion togrog at program exchange rate) | 2,400 | 1,351 | 2,700 | 1,443 | 2,300 | 1,663 | 1,950 | 1,950 | 1,800 | 1,800 | 1,700 |
| Primary balance of the general government (floor, cumulative since the beginning of the fiscal year, in billion togrog) | -377 | 637 | 240 | 948 | -20 | 1,644 | | | | | |
| Primary balance of the general government (floor, excluding DBM, cumulative since the beginning of the fiscal year, in billion togrog) | | | | | | | | 1,011 | | 62 | 200 |
| Net nonconcessional external debt maturing in one year or more, contracted and/or guaranteed by the government or the BOM (ceiling, cumulative flow from November 15, 2017, in million US\$). /5 | NA | NA | 20 | 20 | NA | NA | 20 | 20 | NA | NA | 20 |
| Stock of guarantees on external debt extended by the government or BOM (ceiling, eop stock, in million US\$) | 750 | 648 | 750 | 634 | 750 | 573 | 750 | 750 | 750 | 750 | 750 |
| DBM net lending (ceiling, in billion togrog) | | | | | | | | 254 | | 20 | 80 |
| Indicative Targets (IT) | | | | | | | | | | | |
| Reserve money (ceiling, in billion togrog) | 4,000 | 2,941 | 4,400 | 3,420 | 4,600 | 3,706 | 4,750 | 4,750 | 4,900 | 4,900 | 5,000 |
| Social spending (floor, cumulative since the beginning of the fiscal year, in billion togrog) | 1,387 | 1,201 | 2,841 | 2,594 | 4,287 | 3,843 | | | | | |
| Social protection spending (floor, cumulative since the beginning of the fiscal year, in billion togrog) | | | | | | | | 622 | | 174 | 336 |
| Continuous Performance Criteria | | | | | | | | | | | |
| New nonconcessional external debt maturing in less than one year, contracted and/or guaranteed by the government or the BOM (ceiling, eop stock, in million US\$). | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Accumulation of new external payment arrears (ceiling, eop, in million US\$). | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Memorandum items | | | | | | | | | | | |
| Budget support from bilateral and multilateral donors excluding Fund under the program baseline (eop stock, cumulative, in million US\$) | 603 | 603 | 703 | 703 | 753 | 706 | 753 | 753 | 1,096 | 1,096 | 1,155 |
| Net nonconcessional borrowing received and repatriated by the general government (including the DBM) under the program baseline (eop stock, cumulative, in million US\$) | 306 | 306 | 160 | 160 | 160 | 160 | 160 | 160 | 160 | 160 | 160 |
| Program exchange rate (togrog/U.S. dollar) | 2,489 | 2,489 | 2,489 | 2,489 | 2,489 | 2,489 | 2,489 | 2,489 | 2,489 | 2,489 | 2,489 |
| U.S. dollar per SDR | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 |
| Monetary gold price (U.S. dollar/ounce) | 1,142 | 1,142 | 1,142 | 1,142 | 1,142 | 1,142 | 1,142 | 1,142 | 1,142 | 1,142 | 1,142 |

1/ Evaluated at program exchange rates.

2/ Cumulative targets are all defined relative to 12/31/2016 except for the primary balance figures.

3/ Targets and actual from December 2017 on reflect the revised treatment of government forex deposits in the TMU.

4/ Additional new nonconcessional external debt inflows with the purpose of debt management do not affect the level of NDA as defined in the TMU.

5/ The net ceiling applies starting from the date of the completion of the second review. Prior to this date, the ceiling remains as specified in Table 10 of the May 31, 2017 □ Staff report and TMU.

Table 2. Mongolia: Structural Conditionality
(Replaces Staff Report Table)

| Prior Actions Due before Board Meeting | | Status |
|--|--------------------|---|
| Impose a limit of 30 months on all non-mortgage consumer loans effective January 1, 2019; and introduce sanctions for violations of the limits which at the very minimum requires banks to provision any loan that violates the DSTI limit. | | Met |
| Adopt a tightening bias in the official communication in the September monetary policy committee meeting given the risks from rapid credit growth, with a view to tightening monetary policy stance in the coming months if credit growth remains strong or if imports continue to rise. | | Met |
| Banks book all provisioning needs identified by the AQR adjusted only by loans that have been repaid in line with the template agreed with BoM. | | Met |
| BoM requires banks to submit, by end-September 2018, a detailed plan regarding how they will issue new capital in the amounts detailed in the May 8 letter from BoM. | | Met |
| BOM sends letters to banks with capital shortfalls which a) request that they update their balance sheets to reflect recent on-site inspections and b) underscore that capital to be raised remains at the amount communicated in May and that any Tier 1 shortfall must be met with common shares. | | Met |
| Structural Benchmark | Target Date | Status |
| Fiscal | | |
| Complete an audit of all existing concessions contracts, develop a repayment plan based on audit recommendations, contractual obligations and fiscal path, and incorporate in the medium-term fiscal framework (MTFF) repayment plan to be paid by the budget i) for each year of the MTFF and ii) the nominal sum for future years not covered by the MTFF. | End-August 2018 | Not met, implemented with delay in October 2018 |
| Implementation of 2019 Operational Plan that sets out the tax compliance improvement strategies for SMEs. | End-October 2018 | Expected to be Met |
| The MoF to approve a Guideline on appraisal and selection of public investment projects, including specific methodology and evaluation criteria. | End-December 2018 | |
| Enact a legislation to reform structure of retail fuel prices and increased excise tax rates. | End-December 2018 | Proposed to be reset to end-June 2019 |

Table 2. Mongolia: Structural Conditionality (Concluded)

(Replaces Staff Report Table)

| Structural Benchmark | Target Date | Status |
|---|--------------------|---|
| Banking | | |
| Financial Stability Council (FSC) finalization and publication of an NPL resolution strategy. | end-April 2018 | Not met, implemented with delay |
| Banks will book the provisioning gap identified by the AQR and reclassify their assets to non-performing category in line with the AQR. | End-June 2018 | Not Met |
| Based on the AQR findings and advice provided by external experts, regulation on asset classification and provisioning to be further improved in consultation with IMF staff. | End-September 2018 | Not Met |
| BoM to carry out a review of related party exposures based on improved legislation. | End-December 2018 | |
| BoM will intervene promptly on those banks that by-end December 2018 do not raise capital by the amounts stated in the May 8th letter sent to banks. | End-January 2019 | |
| Adoption of legislative amendments to strengthen the enforcement of creditor rights (simplifying appeals and notifications, improving auctions, and allowing effective out-of-court enforcement of collateral). | End-November 2018 | Proposed to be reset to end-February 2019 |
| Adoption of new prudential regulation with select elements from Basel II/III. | End-December 2018 | Proposed to be reset to end-June 2019 |
| Adoption of a reformed bankruptcy law (including improved access to procedures, protection of secured creditors, and an efficient reorganization process). | End-March 2019 | |
| Adoption of the law on private bailiffs and introduction of commercial courts. | End-April 2019 | |
| Adoption of a law for full public access to the real estate registry and establishing a price and transaction registry for real estate. | End-April 2019 | |
| Adoption of a new legal framework to address proliferation financing (newly proposed). | End-April 2019 | |