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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/88-1

10:00 a.m., October 31, 2018

1. Mongolia—Fifth Review Under the Extended Fund Facility Arrangement and Request for Modification and Waiver of Applicability of Performance Criteria

Documents: EBS/18/91 and Correction 1; and Supplement 1

Staff: Gottlieb, APD; Zakharova, SPR

Length: 35 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	D. Mahlinza (AE)
	L. Nankunda (AF), Temporary
	E. Rojas Ulo (AG), Temporary
	G. Johnston (AP)
	F. Fuentes (BR), Temporary
Z. Jin (CC)	
	A. McKiernan (CO)
	O. Bayar (EC)
	A. Castets (FF)
S. Meyer (GR)	
	P. Dhillon (IN), Temporary
	L. Cerami (IT), Temporary
M. Kaizuka (JA)	
	S. Alavi (MD), Temporary
	S. Geadah (MI)
	M. Tolici (NE), Temporary
	T. Gade (NO), Temporary
	L. Palei (RU)
	R. Alkhareif (SA)
	P. Pollard (US), Temporary

G. Bauche, Acting Secretary
S. Kalra, Summing Up Officer
D. Jiang, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: R. Agarwal, O. Brekk, N. Feyzioglu, G. Gottlieb, C. Rhee, R. Xu. Fiscal Affairs Department: W. Daal. Finance Department: Mizuho Kida. Legal Department: C. Joseph Marian, G. Otokwala. Monetary and Capital Markets Department: Laszlo Butt. Research Department: F. Narita. Strategy, Policy, and Review Department: S. Hassan, D. Zakharova. World Bank Group: N. Von Der Goltz.

Alternate Executive Director: P. Sun (CC). Senior Advisors to Executive Directors: Y. Danenov (SZ), S. Keshava (SA), Y.Liu (CC), T. Ozaki (JA), J. Shin (AP). Advisors to Executive Directors: F. Al-Kohlany (MI), S. David (AP), J. Essuvi (AE), A. Grohovsky (US), G. Kim (AP), N. Komura (JA), P. Snisorenko (RU), M. Sylvester (CO), A. Sode (FF).

1. MONGOLIA—FIFTH REVIEW UNDER THE EXTENDED FUND FACILITY ARRANGEMENT AND REQUEST FOR MODIFICATION AND WAIVER OF APPLICABILITY OF PERFORMANCE CRITERIA

Mr. Johnston and Mr. Khurelbaatar submitted the following statement:

Our Mongolian authorities are very thankful for the support they are receiving from the Fund and from their development partners. Performance under the EFF has been good, helped by solid demand for exports and buoyant mineral prices. However, challenges lie ahead for Mongolia and there is no room for complacency.

Program Performance

All quantitative targets for end-September 2018 have been met, despite an increase in imports that has put pressure on international reserves. Also, all prior actions for the fifth review—regarding monetary policy actions, macroprudential measures and the recapitalization of banks—have been completed. In particular, the submission of business plans by banks, regarding how they will raise new capital, was completed recently. While some structural benchmarks have taken a little more time than originally expected, the authorities remain committed to implementing all of these tasks, and are working hard to do so.

Fiscal Policy

Revenue continues to overperform, based on the strong performance of the mining sector and increased imports. In fact, revenue at end-September was over 30 percent higher than a year earlier. This has allowed the Government to propose an increase in spending for 2019 and still deliver a primary surplus of 1 percent of GDP.

At the outset of the EFF program, Mongolia undertook a strong fiscal adjustment including freezing capital expenditure. Next year’s budget—which is currently being discussed in Parliament—includes an increase in expenditure, mostly on capital projects, with priority given to resolving issues in the health and education sectors. With little or no recent investment, existing health and education facilities have been unable to cope with demand from the public, or provide adequate services. Some secondary schools, for example, have had to operate two or three shifts each day to accommodate their pupils. There are hospital patients in corridors due to a shortage of proper rooms, and resources are stretched. With an increase in investment, the authorities are aiming to provide adequate social services to the population while continuing the successful implementation of the program.

Upside surprises in revenue will be saved and used for reducing debt. Public debt is on a more aggressively declining path than envisaged at the outset of the program, thanks to positive global mineral prices and prudent fiscal management. Originally, debt was projected to peak at close to 100 percent of GDP in 2018 but is now expected to be down to 70 percent by the end of the year.

Financial Markets and Monetary Policy

Inflation at the end of September was 5.7 percent but in the medium term is expected to stabilize around the central bank's target rate of 8 percent. The tugrik has been depreciating as a result of a weakening balance of payments. The Bank of Mongolia has intervened in the foreign exchange market a number of times to address liquidity shortages and avoid excessive volatility. The accumulation of international reserves has therefore slowed, but the central bank is committed to continuing its reserve accumulation and to maintaining a floating exchange rate.

A key part of the EFF program is creating a strong, resilient banking sector. An asset quality review was conducted earlier this year and as a consequence a number of banks are required to raise additional capital by the end of the year. Banks have incorporated the findings of the AQR in their balance sheets and set out how they will raise this capital. The last two months of this year are a critical period in the bank recapitalization process as the deadline for raising this required capital is approaching. The Bank of Mongolia is committed to undertaking all necessary measures in coordination with the mission team.

Mongolia scored poorly on most AML/CFT requirements in last year's APG mutual evaluation and was given until June 2019 to make a substantial progress. The authorities are committed to undertake the required measures, including adopting the appropriate legal framework and strengthening supervision of financial entities. The authorities are also increasing funding for the organizations responsible for implementing the AML/CFT requirements.

Mr. Fachada and Mr. Fuentes submitted the following statement:

We thank staff for the informative report, and Messrs. Johnston and Khurelbaatar for their statement.

Since the start of the Extended Fund Facility (EFF) arrangement in May 2017, the Mongolian economy overperformed when compared to staff's growth and fiscal projections. The program remains fully financed, despite some delays in donor support, and all quantitative performance criteria (QPCs) for which data is available have been met. Considering the progress made thus far and the authorities' strong commitment to the program, we support the completion of the fifth review under the EFF.

The macroeconomic policy mix has been supportive of program performance. Fiscal revenue continues to overperform and is projected to generate a sizable primary surplus in 2018. Even under an expansionary fiscal stance in 2019, a 1 percent of GDP primary balance surplus is expected, consistent with the debt reduction strategy set out under the program. On the monetary front, we associate ourselves with staff's recommendation in favor of tightening to prevent overheating and facilitate an adjustment in the current account deficit.

Steadfast progress in the reforms agenda is warranted to strengthen macro-financial stability. Implementation of fiscal structural reforms has been limited this year, as legislation to strengthen tax administration failed to pass in Parliament. Progress in this area is warranted to support investment and the business environment, as well as to elevate the overall efficiency of fiscal policy. On the financial sector front, the Asset Quality Review (AQR) is near completion, with bank recapitalization expected by the end of the year. Yet, improving the AML/CFT framework remains a high-level priority for the financial sector as the risk of losing additional correspondent banking relationships persists.

Public debt has declined significantly but is still highly vulnerable to shocks. The combination of high growth and strong fiscal revenue performance under the EFF has expedited a steadfast reduction in the public debt-to-GDP ratio under the baseline. Nonetheless, the debt sustainability analysis reveals weaknesses in Mongolia's debt profile that need to be addressed, as it remains unfavorably exposed to growth and exchange rate risks. The sizable external financing needs driven by the country's large current account deficit is another source of concern.

Mr. Leipold and Ms. Cerami submitted the following statement:

We welcome Mongolia's strong economic and program performance and support the proposed completion of the fifth review as well as the request for modification and waiver of applicability of the performance criteria set forth in the Agreement. We acknowledge the good progress towards meeting most of the performance criteria and structural benchmarks and encourage the authorities to accelerate reforms to strengthen the financial sector, reduce inequality, and improve public financial management, while remaining committed to the program and mindful of the still large external debt.

As the economic rebound remains robust and becomes more balanced, driven by the external demand related to the mining sector but also supported by private consumption, while the balance of payment is weakening, priority should be given to increasing foreign reserves and reducing the still large external imbalance. To this end, the central bank should be ready to tighten monetary policy if inflation pressures intensify and credit and import growth remain strong and allow greater exchange rate flexibility to support competitiveness and build up foreign reserves. Bank of Mongolia (BOM) has already tightened its monetary stance and adopted some important macroprudential measures to curb consumer credit and unhedged foreign-denominated lending, but further tightening might be needed given the strong economy and the envisaged relaxation of fiscal restraint.

On fiscal policy, the authorities are targeting a primary surplus of 1 percent of GDP for 2019, smaller than the 3.2 percent projected for this year, but still larger than the initial program target and the estimated debt stabilizing level. The debt ratio is in fact expected to decrease further by the end of 2019. Given the still high public debt, its projected downward trajectory is welcome and should be sustained going forward. So long as the debt ratio remains on a downward path, we agree with the authorities and staff that a well-targeted increase in spending can be accommodated and might contribute to strengthening social cohesion and public support to the program and boosting potential growth. As explained in the report and emphasized in the buff statement, Mongolia badly needs more capital spending, particularly in health and education. We therefore support the authorities' plan to increase spending for reducing air pollution, improving health and education, reducing the public-private wage gap, and clearing unpaid concessions. In so doing, we take comfort in the authorities' commitment to save in full any revenue over-performance and cut expenditures in case of revenue shortfall. However, we also stress the importance of strengthening public financial management to enhance the effectiveness of investments and urge the authorities to update the public investment guidelines in line with the lessons drawn from the IMF and World Bank technical assistance.

We commend the authorities for introducing some major reforms to strengthen the financial sector, namely the bank recapitalization and the AML/CFT laws, reduce the central bank involvement in the government mortgage program, and prevent quasi-fiscal spending by the Development Bank of Mongolia. The reform of the financial sector should proceed with the recapitalization of banks to meet the identified capital requirements by the end-December deadline, the classification of non-performing loans in line with the findings of the AQR, and the review of the prudential and NPL resolution frameworks. Equally important for avoiding FATF's listing and preventing further withdrawals of the correspondent banking relationships will be the implementation of the AML/CFT laws and further legislative work to address proliferation financing.

Progress has regrettably been slower in other areas, including the mechanism for setting fuel prices and related excise taxes. We encourage the authorities to consider an automatic pricing formula, as suggested by staff, which by ensuring after tax full-cost recovery would discourage over-consumption, raise fiscal revenues, and limiting pollution. The three-stage approach to improving retail fuel pricing outlined in the authorities' Letter of Intent goes in the right direction and should be enacted by the end-June 2019 deadline.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

The Mongolian economy continues to strengthen, with growth projected above six percent in 2018 and 2019 and strong fiscal over-performance. Amid this backdrop, all quantitative performance criteria were met but one, for which there is no data, but which is expected to be met by a large margin. We therefore support completion of the fifth review under the Extended Fund Facility and the request for a waiver and modification of performance criteria. However, we are concerned by the re-emergence of balance of payments pressures, and ongoing domestic political pressures to loosen fiscal and monetary policies. Going forward, we urge the authorities to continue to build buffers, particularly in the external and financial sectors, while the opportunity presents itself.

Fiscal Policy

We welcome the continued fiscal over-performance and commitments by the authorities to save additional over-performance despite political pressures. Notwithstanding these commitments the 2019 budget also proposes a 3 percent of GDP increase in expenditures. We urge caution against further efforts to increase public spending, as buffers should be rebuilt now, and fiscal loosening would put additional pressure on the balance of payments. Staff notes that the increase in nominal wages for civil servants was significantly lower than the 50 percent demanded by labor unions. Do staff expect this to be a one-off increase, particularly given that the increase was very modest and 2020 is an election year? If so, what assurances did the authorities provide to staff?

More concerning is the failure to enact structural reforms to strengthen public financial management and put the fiscal position on a sustainable trajectory, and we urge the authorities to avoid further delays. Additionally, we encourage the authorities to adhere to high standards of development finance relating to transparency, good governance, and economic sustainability in its infrastructure investment.

Monetary and External Sector

While the fiscal position has continued to improve, the external position has worsened noticeably since the summer, with reserves declining for the first time since the start of the program. While some of this deterioration is due to exogenous factors, it also reflects looser monetary policy that will need to be tightened going forward, particularly given a rapid expansion in household borrowing. We encourage the authorities to allow greater exchange rate flexibility to help preserve foreign exchange reserves and to adopt sufficiently tight monetary and credit policies, including building on recently implemented macroprudential policies, to reverse the recent trend and help reach reserve targets.

Financial Sector

Finally, financial sector stability is an important component of this program, and we welcome the progress made through the Asset Quality Review (AQR). Going forward, it is imperative that banks accurately classify non-performing loans in line with the findings of the AQR, which was originally slated to occur in June but has unfortunately been delayed. We also urge the authorities to ensure that banks raise the necessary capital by end-December 2018 and welcome the focus on these issues for the sixth review. Could staff provide an assessment of the prospects of a successful recapitalization under the currently envisaged timeline, given the resistance we have already seen from banks to simply reclassifying their NPLs? As the 2019 budget should be passed soon, do staff assess that public capital support will be needed for systemic and viable banks that are under-capitalized?

Mr. Mahlinza and Mr. Essuvi submitted the following statement:

We thank staff for the well written report, and Mr. Johnston and Mr. Khurelbaatar for their helpful buff statement. We note that program performance has remained largely satisfactory, with all quantitative performance criteria (QPC) met, and some by large margins. Based on this and the authorities' continued commitment to reform, we support the request for modification and waiver of applicability of performance criteria and completion of the fourth review.

Mongolia's economy continues to grow strongly, driven largely by sturdy external demand, improved confidence and robust private sector credit growth. Owing to the strong economic performance, Mongolia is expected to achieve a fiscal surplus at end-2018, for the second year in a row, which is expected to contribute to a reduction of the still high public debt. This notwithstanding, increasing political pressure for loose fiscal and monetary policies and a fall in external demand could undermine the ongoing economic recovery.

Continued fiscal retrenchment is critical to reducing public debt. While the 2019 budget proposal envisages a 3 percent of GDP increase in expenditure, the fiscal stance remains stronger than the target at program approval and remains consistent with the debt reduction objective. Going forward, we urge the authorities to curb expenditure, and strengthen tax administration, while protecting social spending. In addition, efforts must be made to improve public financial management, with particular focus on concession contracts and public investment.

The authorities' commitment to a monetary and financial policy stance aimed at containing inflation and addressing external imbalances is welcome. In this respect, we agree that the authorities should stand ready to raise policy rates and tighten credit conditions if credit and import growth pressures persist. In addition, a greater exchange rate flexibility, supported by well communicated interventions in the FX market, is crucial to addressing external imbalances.

Rigorous implementation of structural reform measures is imperative for the success of the program. In this regard, we commend the authorities for the substantial progress made in the implementation of the conclusions of the Asset Quality Review (AQR). Going forward, efforts should be made to strengthen the banking system and ensuring that banks are fully capitalized. Sustaining this success requires stronger banking supervision, legislation and regulatory changes to address non-performing loans, and strengthening the AML/CFT framework. In particular, efforts should be made to develop and implement regulations for the recently passed AML laws. Finally, the authorities should prioritize measures to improve the business environment and take advantage of the current strong economic growth to diversify the economy.

Mr. Ostros and Mr. Gade submitted the following statement:

We thank staff for their reports and Mr. Johnston and Mr. Khurelbaatar for their informative BUFF statement. We commend the authorities for their program performance thus far. However, despite substantial progress, significant risks remain. We see some risk that the proposed policy mix – especially for 2019 – may become overly procyclical, while vulnerabilities are not yet appropriately mitigated. We encourage the authorities and staff to calibrate all economic and financial policies to avoid the risk of returning to the boom bust economy of the past. We find this particularly important in the current global economic and financial environment. We broadly agree with the staff appraisal and support the completion of the review.

The proposed sizeable fiscal loosening for 2019 is not advisable and risks an overly procyclical policy stance that, if implemented, needs mitigation in the overall policy mix. We acknowledge and commend the authorities on their fiscal performance thus far. This is in part a result of fiscal prudence, but also aided by a favourable external environment including demand and price developments for Mongolia's export commodities. We acknowledge the difficulty of assessing the economy's structural position and the fiscal stance, but we are strongly concerned about the proposed fiscal loosening of the primary balance of 2.2 percent of GDP in an economy likely already above potential, with credit growth, inflation, and currency weakening on the rise, as well as an overall high level of external debt – private and public. We acknowledge the reasonable spending priorities of the Mongolian authorities but are concerned about the impact of the very substantial discretionary fiscal overall loosening in the current economic and financial environment.

The tightening bias adopted by the central bank should be translated into a tighter monetary policy. We see merit in the central bank acting proactively with a tighter monetary policy to underpin confidence in inflation stability, while also having positive knock-on effects on the overall financial stability. This policy need is amplified if the fiscal loosening in 2019 looks increasingly likely to be implemented. Meanwhile, we are concerned of the central bank's engagement in foreign currency sales to stem the weakening of the currency. Priority should be given to building international reserves through an appropriately tight monetary policy, while currency intervention should be avoided.

It is crucial that the conclusions of the AQR are implemented and that banks raise new capital by end-year to meet the capital shortfalls identified in the AQR. The AQR process came off to a good start and added confidence to the financial sector and the program. Ensuring that banks are fully and soundly capitalized – preferably via common shares – remains critical to underpin this confidence and to add to the resilience of the banking sector. We encourage the authorities to press on with the stronger banking supervision, legislative and regulatory changes to address non-performing loans, as well as strengthening the AML framework. To mitigate any vulnerabilities that might arise from the accelerating rise in credit growth, we see merit in implement more binding macroprudential measures, such as a DSTI measure with a lower threshold. Consideration could also be given to broadening its scope.

We continue to encourage strengthening the overall business environment and a stronger component of economic diversification in the program. Given the sensitivity of the economy and public finances to external demand for commodities, the price of Mongolia's export commodities, and individual mining projects, greater attention to strengthening the business environment – which will also add stability to ongoing projects such as e.g. the OT mining project - and economic diversification should be considered in the program in collaboration with other contributors in the multi-donor financial package – especially IFIs.

Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written report and Mr. Johnston and Mr. Khurelbaatar for their helpful buff statement. We welcome the good performance under the extended arrangement, supported by strong external demand and expenditure restraint. In this context, large revenue overperformance and rapidly falling public debt ratio are noteworthy. At the same time, significant challenges remain, as underscored by staff, which call for tighter monetary and credit policies and implementation of further structural reforms. In view of the progress so far and the Mongolian authorities' continued commitment to the program, we support the completion of the fifth review and the associated decision. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

We welcome the agreement between staff and the authorities on the benefit of increasing public investment in 2019 to support long-term growth as well as maintaining the necessary social cohesion to implement other reforms under the program. Here, we are encouraged to note that even after substantial fiscal loosening, a primary surplus of 1 percent of GDP is expected in 2019, which will be consistent with continued reduction in the public debt ratio. In this connection, we look forward to the planned development of a guideline on appraisal and selection of public investment projects, which will be a step in the right direction to improve public investment efficiency. We also welcome the authorities' commitment to save any further revenue overperformance and cut expenditures at mid-year if there is a revenue shortfall. Protecting social spending remains an important priority and the authorities should also aim to build consensus on improving the targeting of assistance.

We take positive note of the authorities' commitment to tighter monetary and financial policy stance. Notably, we see the need for further efforts to build additional international reserves, which are still below 100 percent of the ARA metric, to help guard against external shocks. In the financial area, we welcome the progress made following the Asset Quality Review (AQR) and look forward to regulatory changes to address non-performing loans and successful completion of the bank recapitalization process by the end-December deadline.

Further improvement to the AML/CFT framework is a priority to address the concerns raised by the Asia/Pacific Group on Money Laundering. In this context, we are encouraged to note in the buff statement that "the authorities are committed to undertake the required measures, including adopting the appropriate legal framework and strengthening supervision of financial entities". We also welcome the increase in resources in the 2019 draft budget for the organizations responsible for implementing the AML/CFT requirements to improve the enforcement of preventive measures.

With these remarks, we wish the authorities further success.

Mr. Meyer and Ms. Fritsch submitted the following statement:

We thank Mr. Johnston and Mr. Khurelbaatar for their buff statement and staff for the concise report and broadly concur with staff's assessment and recommendations. The Mongolian economy records strong economic growth, leading to a welcome primary balance surplus that allows for a significant decrease in public debt, albeit remaining high. At the same time, however, the current account deficit remains high in the context of larger than expected import growth, lower donor flows and deteriorating terms of trade. This puts pressure on the exchange rate, especially against the backdrop of low foreign reserves. Further risks arise from high foreign currency denominated debt and from the large exposure to global commodity markets, in particular China's demand for minerals. These vulnerabilities thus continue to place a premium on reforms and prudent and judicious macroeconomic policies.

Given overall program performance, we consent to the completion of the fifth review and the request for modification and waiver of applicability of performance criteria, provided the still outstanding prior action has been implemented. We welcome the authorities' continuing commitment to the program and the progress on conditionality. However, we regret to take note of the slower pace of macroeconomic adjustments, important reform setbacks, and that the end-June indicative target on social protection assistance has not been met. Looking forward, we agree with staff that program risks are tilted to the downside and that the main challenge for the Mongolian authorities will be to implement a tight macro policy mix.

Regarding fiscal policy, we take note of the large surplus and the planned positive budget for 2019, although reckoning that it still implies strong fiscal loosening. We acknowledge that certain expenditure items are important to support long-term growth, such as efficient public investment in health, education, and infrastructure. Yet, we echo staff's call for continued fiscal discipline, particularly in the run-up to the 2020 elections, as it is key to facilitate a sustainable development path. Regarding the results of the Debt Sustainability Analysis, we take note that foreign currency-denominated debt to GDP is projected to remain high in the next two years. Given that foreign currency-denominated public debt is above the upper-risk assessment, how does staff assess this development?

Considering high inflation rates in the context of a loose monetary policy leading to an appreciation of the real effective exchange rate, we agree with staff that tightening of monetary policy is necessary. Since the REER has appreciated, Mongolia's competitiveness has decreased and import demand has been rising. Staff therefore rightly emphasizes that greater exchange rate flexibility is vital to tackle the large current account deficit as well as the negative net international investment position. To protect the economy from external shocks, it is critical to increase international reserves from their current low levels.

A successful completion of the bank recapitalization process and further improvements to the AML-CFT framework are important steps toward a stronger banking system. We commend the authorities for implementing the conclusions of the Asset Quality Review (AQR). Now it is essential that banks will reclassify their non-performing loans in line with the findings and correspondingly raise new capital. We therefore welcome staff's intention to focus on this issue in the next review. We acknowledge improvements to the AML-CFT framework, yet it is unfortunate that the authorities were not able to upgrade their assessment ratings. Thus, there is a risk that Mongolia could be publicly listed as a country with strategic deficiencies, which could result in vanishing confidence in the financial sector.

Finally, there are several important structural measures that the authorities need to address, relating to amongst others fuel prices and social spending. On fuel prices, we regret that excise taxes on fuel were abolished and echo staff's call for more frequent price adjustments to better mirror world oil prices. Regarding social spending, we take note with some concern that the authorities have concentrated their social spending on the Child Money Program. We agree with staff that a more even spending on means-tested targeted programs would be more favorable to reduce inequality.

Mr. Agung and Mr. Pham submitted the following statement:

We thank staff for the report and Messrs. Johnston and Khurelbaatar for their informative buff statement. The Mongolian current macroeconomic performance has continued to be strong with key targets under the Extended Fund Facility (EFF) program met, and growth is expected to recover. The authorities have made good progress especially regarding structural reforms and policies to rehabilitate and strengthen the financial sector. We support the completion of the fifth review of the EFF and the request for modification and waiver of applicability of performance criteria. While we welcome the authorities' continued strong commitment to key reforms in the banking and fiscal areas, we agree with staff that vulnerabilities in the economy remain high. These include lower external demand for commodities, rising domestic spending pressures, adverse changes to the investment climate and capital shortfalls in the banking sector. Therefore, a steadfast implementation of the reform program is key to build fiscal and foreign exchange buffers, strengthen the banking sector, and improve the investment climate.

On fiscal policy, continued fiscal discipline is critical and we welcome the authorities' proposed 2019 budget which envisages continued budgetary restraint and strengthening tax administration. However, given the still high public debt and pre-election spending pressure, we urge the authorities to take concrete steps to improve public financial management particularly with respect to concessions, public investment projects, and the operations of the Development Bank of Mongolia. We welcome the authorities' intention to continue to protect priority social spending to minimize the adverse impact of fiscal consolidation measures on the most vulnerable groups.

An appropriate policy mix to strengthen external sector is critical. The authorities' recent move to tighten monetary and credit policies is welcome step to reduce risk of overheating and support further strengthening in the balance of payments. This tight monetary policy should also be accompanied by a greater exchange rate flexibility, with the central bank's FX intervention limited to address excessive volatilities. In this regard, we see merit to establish a framework of exchange rate management.

The recently completed Asset Quality Review is a welcome step in addressing the increasing stock of corporate NPLs and strengthening the financial system. The ongoing reforms to strengthen the financial sector need to be further advanced with a focus on the follow-up to the AQR completed in January. It is critical that banks should be recapitalized by end December to support the performance of the economy. In this connection, we welcome the adoption of the June Recapitalization Law which allows for the use of public money to recapitalize systemic important banks, failing private sector participation. Could staff elaborate on the potential budgetary cost for recapitalizing these systemic banks. Are the authorities considering foreign partners' involvement in this process and if yes, is there any cap on foreign equity? After the recapitalization process, the authorities should continue monitoring banks' overall and quality of lending activities, including the performance of liquidity indicators. We support the authorities' adoption of macro-prudential measures and enhancing banking supervision, improving the legal and regulatory framework for NPLs, and strengthening AML/CFT regulations.

With these comments, we wish Mongolia and her people success in their future endeavors.

Mr. Geadah and Mr. Al-Kohlany submitted the following statement:

We thank staff for their report and Mr. Johnston and Mr. Khurelbaatar for their helpful buff statement. Mongolia's macroeconomic performance has been robust, underpinned by strong external demand and improved confidence. Progress under the EFF has been satisfactory, with all program performance criteria and most structural benchmarks and indicative targets for the review met, some with wide margins. Going forward, it will be important for the authorities to push forward on the remaining reform initiatives so as to increase the economy's resilience and put it in a long term sustainable position. We agree with the completion of the fifth review and the proposed decision, and highlight a few points:

We welcome the authorities' commitment to fully save fiscal revenue over-performance, particularly as public debt remains high. However, we are concerned with the setback in reforms that are listed in paragraph 6 of the staff report, and we would urge the authorities to implement measures aimed at strengthening non-commodity revenues and rationalizing spending. Strengthening tax administration and protecting social spending should also remain priorities, together with improving the efficiency of public spending.

Gross reserves declined in recent months, for the first time since the program started, in large part due to the authorities' intervention. We support the authorities' commitment to a monetary policy that aims at containing inflation and strengthens the balance of payments. To this end, maintaining an appropriately tight monetary policy and greater exchange rate flexibility will be key in the current juncture. Foreign exchange intervention should be limited to smoothing disorderly market conditions while rebuilding reserves.

On financial stability, the recent sharp rise in credit growth and the still high NPLs are causes for concern. We welcome the measures announced by the central bank to manage related vulnerabilities, including raising debt service-to-income ratios for new consumer loans, and increasing the risk weight on unhedged FX lending. It would be important to recapitalize banks in accordance with the asset quality review (AQR), and that capital shortfalls be addressed in a way that does not expose the public sector balance sheet.

We note the progress in addressing the AML issues flagged by the Asia Pacific Group (APG). The authorities' commitment to undertake the required measures is welcome, including adopting the appropriate legal framework and strengthening supervision of financial entities. Mongolia's correspondent banking relationships (CBRs) have been severely impacted as several foreign banks withdrew CBRs with Mongolia, including banks in the U.S. As a result, Mongolian banks must now access dollars via regional banks. We would welcome staff comments on the deterioration of CBRs, and its impact on trade, and remittances?

Mr. De Lannoy and Mr. Tolici submitted the following statement:

We thank staff for the focused report and Messrs. Johnston and Khurelbaatar for their informative buff statement. Due to a favorable external environment, the Mongolian economy has experienced a robust economic growth and a significant fiscal overperformance. While the near-term growth forecast is also favorable, risks and challenges persist, and it is critical that policies stay on course and ongoing political pressures to loosen fiscal and monetary policies do not slow down reforms.

We support the completion of the fifth review and request for modification and waiver of applicability of performance criteria. Since we agree with the thrust of the staff's assessments and recommendations, the following remarks are for emphasis.

Fiscal policy should remain prudent to ensure a further decrease of the public debt and a build-up of buffers.

We commend the Mongolian authorities for the fiscal overperformance and their continued commitment to expenditure restraint, despite the higher than expected rise in revenues. However, further progress with fiscal structural reform is warranted to preserve macroeconomic stability and to pursue a further build-up of buffers against external shocks. We take note that the implementation of fiscal structural reforms has been limited this year, and the much-needed strengthening of tax administration has been delayed, while for 2019 a loosening in fiscal stance is envisaged. Given the high public debt and the significant projected decrease in next year's primary fiscal surplus, we welcome the authorities' commitment to save all extra revenues and cut the expenditures if needed in order to safeguard the deficit targets under the program.

Further measures are needed to preserve the fiscal gains and ensure sustained adjustment. We welcome the authorities' intentions to develop and implement a flexible and transparent fuel price formula which will enable adequate taxation and consider environmental costs.

On social spending, while the social protection assistance has been preserved under the program, we concur with staff that spending most of it on the Child Money Program may not be optimal and encourage the authorities to finance means-tested targeted programs that are more effective in reducing inequality and protecting the most vulnerable groups.

Do the authorities consider further measures to support low income earners?

An appropriate monetary policy stance is critical to contain inflation and support further accumulation of reserves.

A shift in the monetary policy stance is required for maintaining an adequate macroeconomic policy mix. In the context of strong domestic demand, fueled by credit growth, and the anticipated loosening of fiscal policy, we concur with staff that tighter monetary conditions are warranted to prevent overheating of the economy and support the balance of payments.

We take note of the use of exchange rate interventions to limit the currency depreciation resulting in a significant loss of international reserves since end-May. Moreover, deteriorating terms of trade resulted in a competitivity loss in the non-mining exports sector and a widening of the current account deficit. Considering the very high external debt and a "weaker than fundamentals" external position, we urge the authorities to prioritize reserves build-up and allow a greater exchange rate flexibility. The authorities' commitment to limit the foreign exchange interventions only to address disruptive market conditions is welcome.

Improving the legal and regulatory framework and strengthening the supervisory regime must continue.

We take positive note of the completion of the major steps of the AQR and the progress made with safeguarding financial stability by adopting the Recapitalization Law. However, more efforts are needed to improve the legal and regulatory framework for NPLs resolution and for strengthening prudential regulation. The introduction of a ceiling on the debt service-to-income ratio is a welcome step in strengthening the macro-prudential framework.

We join staff in urging the authorities to continue addressing the money laundering concerns signaled by the Asia Pacific Group in the July 2017 AML/CFT assessment and avoid the risk of being listed as a country with "strategic deficiencies". Further substantial improvements in the AML/CFT legal and regulatory framework are needed to avoid negative developments in Mongolia's correspondent banking and cost of financing.

Structural reforms are critical to foster economic diversification and support sustainable and inclusive growth. The successful macroeconomic stabilization achieved under the Program creates conditions for an increased resilience against external shocks and domestic pressures. However, notwithstanding recent economic and financial reforms, key vulnerabilities and risks persist, as the Mongolian economy remains largely commodity-dependent. Mitigating these risks and fostering sustainable and inclusive growth requires structural reforms aimed at increasing resilience to commodity shocks by diversifying the economy and improving the business climate.

Are there programs envisaged by the authorities to improve the business climate and support economic diversification?

Mr. Gokarn and Mrs. Dhillon submitted the following statement:

We thank staff for the informative report and Mr. Johnston and Mr. Khurelbaatar for the candid buff statement.

The authorities' have demonstrated continued commitment to the three-year arrangement under the Extended Fund Facility. The impact is evident, with the economy showing strong growth at 6-7 percent. All quantitative performance criteria for which data is available have been met and prior actions for the fifth review—regarding monetary policy actions, macroprudential measures and the recapitalization of banks have been completed. Based on the progress so far and staff recommendations, we support the request for waiver and modification of performance criteria and recommend completion of the fifth review. That said, risks to the program remain from global commodity uncertainties, donor flows, terms of trade and, internally, from the spending pressures of the 2020 elections. Moving ahead, Mongolia needs to develop a more resilient and diversified economy that can deliver inclusive, and sustainable growth. We broadly agree with the thrust of the staff report and would like to limit ourselves to the following points for emphasis.

On the macro policy front, it is encouraging that the revenues have continued to overperform, and despite a related spending increase, a primary surplus of 1 percent of GDP has been targeted in 2019. The declining levels of public debt and attention of the authorities to health and education are commendable. In this context, we note the increase in Central Government spending on reducing air pollution, building schools and hospitals, amongst others, for maintaining the necessary social cohesion to implement other reforms under the program. We would like to hear staff views on whether the measures and allotments are constrained by the indicative floor applicable to the level of social protection spending and the extent to which the program can accommodate potential fiscal loosening. Beyond this, we support the staff stance on tighter monetary and credit policies and greater exchange rate flexibility.

Groundwork for a strong, resilient banking sector has been accomplished with the asset quality review conducted earlier this year. Success going forward will require robust banking supervision and more operative steps on non-performing loans. More immediately, we note that a number of banks are required to raise additional capital by the end of the year, through private means and some then through public capital under specific conditions. Given the fast approaching deadline of December 2018 for raising this required capital, we would like to have more details on the level of capitalization requirement, the progress envisaged and whether the gains under the program could be undermined if the capitalization does not materialize.

Finally, we note with concern the missed opportunity for Mongolia to improve the AML/CFT framework and, thereby, the consequent upgrades in their assessment ratings. Like staff, we would urge the authorities to address the deficiencies in a time-bound manner and demonstrate the effectiveness in enforcement of AML/CFT laws.

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

Mr. Lopetegui and Mr. Rojas Ulo submitted the following statement:

We would like to thank staff for a clear and concise report and Mr. Johnston, and Mr. Khurelbaatar for their helpful buff statement.

We support the Fifth Review under the Extended Fund Facility Arrangement (EFF) and Request for Modification and Waiver of Applicability of Performance Criteria, and the Proposed Decision. We base our support on the authorities' efforts and corrective and consistent measures of the economic policy in recent times under the EFF agreement, which implement structural reforms to improve the durability of the adjustment on the economy.

Mongolia's economy has shown a positive performance, although there is a need to persevere with the implementation of appropriate macroeconomic policies. The economy rebounded positively, supported by a resumption in OT-related investment, coal exports, and credit-financed private consumption. Economic growth is continuing to be robust and is projected to reach 6.2 percent in 2018 and stabilize at 5.0-5.7 percent in the medium and long term. We concur with the need to implement key structural reforms in the banking and financial areas that preserve improvements achieved, and to maintain a balanced and sustainable macroeconomic policy mix to enhance the resilience to the economy and boost the investment climate.

Efforts to maintain fiscal discipline and improve public financial management are necessary to support fiscal structural reforms. The positive performance of economic activity has led to increased public revenue and fiscal surpluses and reduced public debt. The primary balance is expected to reach a surplus of 3.2 percent of GDP in 2018 (excluding DBM), which is expected to remain close to 2.0 percent of GDP over the medium and long term. However, fiscal risks remain significant due to the planned increase in public spending which may reduce the projected primary fiscal surplus. We concur with the staff report that fiscal discipline should be continued to improve public financial management to maintain a strong commitment to the program.

Banks' increased lending appears stimulated by low interest rates and efforts to strengthen supervision are required. The total credit has accelerated, driven by loans to corporates as a response to the Bank of Mongolia (MOB)'s policy to lower policy rates and the reduction in uncertainty upon completion of the AQR. These factors support the economic recovery but have also generated increased macro and financial stability concerns as banks have still not reclassified their non-performing loans in line with the findings of the AQR. The successful completion of banks' recapitalization is a fundamental action to strengthen the banking sector. We support the implementation of comprehensive financial reforms focused on strengthening bank supervision, which will improve the efficiency of the financial system. We also support the authorities for their efforts to strengthen the AML/CFT framework.

International reserves have increased but exchange rate flexibility is essential to preserve this progress and maintain competitiveness. In the last year, BOM interventions along with the donor flows limited appreciation pressures on the exchange rate which led to an increase in international reserves. The current deterioration in balance of payments shows that the progress achieved may reverse. The authorities recognize the need for a shift in the composition of the domestic policy mix toward tightening domestic financial conditions and higher policy rates to prevent over-heating and support the balance of payments.

With these comments, we wish Mongolia and its people success in their future endeavors.

Mr. Sun and Ms. Ma submitted the following statement:

We thank staff for the comprehensive report and Mr. Johnston and Mr. Khurelbaatar for their helpful buff statement. It is good to note that economic growth in Mongolia remains strong and fiscal indicators continue to overperform. However, balance of payments pressures are mounting as foreign reserves declined for the first time since the program was approved, progress in the implementation of the fiscal structural reforms has been limited, public debt remains elevated, and the bank recapitalization process is at a critical stage. Given the significant challenges going forward, it is urgently needed to resist the temptation of loosening macroeconomic stance to avoid the previous boom bust cycle. As all quantitative performance criteria (QPCs) are met or expected to be met, we support the proposed decisions and would limit our comments to the following.

Tighter monetary and credit policies, together with a flexible exchange rate, are essential to ease the BOP pressure. Rebuilding foreign reserves is one of the program objectives of the EFF. However, increased commodity exports so far have failed to translate into foreign reserve accumulation due to increasing imports, high services deficit and income deficit under the current account, and more recently lower donor flows and deteriorating terms of trade. As such, we strongly support staff’s recommendation that tighter monetary and credit policies and greater exchange flexibility are needed to address the external imbalance and insulate Mongolia from external shocks. In this vein, the authorities’ shift to a tighter monetary stance and commitment to preserving exchange rate flexibility is a welcome development. Would staff consider introducing conditionality on foreign exchange intervention? What would be an appropriate band for non-intervention?

Fiscal stance needs to remain prudent. Thanks to the overperformance of the primary balance surplus, the authorities have substantially loosened the fiscal stance for 2019. While we support well-targeted and productive capital spending that would help bolster long-term growth and maintain social cohesion, we view it important to avoid procyclicality and to contain non-productive spending or spending purely for consumption in order to rebuild fiscal buffers in good times. It is regrettable that the fiscal structural reforms have made limited progress this year with important setbacks. Since domestic pressures for more spending could increase as the 2020 elections draw near, we encourage the authorities to remain fully committed to a fiscal consolidation path consistent with the objective of rapid debt reduction while avoiding increasing BOP pressures.

Continued efforts are needed to safeguard financial stability. We welcome the completion of most of the key milestones of the Asset Quality Review to address capital shortfalls in the banking system, albeit with a delay, and encourage the authorities to follow through on the remaining steps in the next few months. We are concerned about the decrease of correspondent banking relationships (CBRs) and encourage the authorities to promptly address deficiencies in the AML/CFT framework. We take positive note that the Bank of Mongolia has responded swiftly to sharp acceleration in bank lending by announcing several macroprudential measures. Going forward, rapid increase in credit to the household sector merits continued monitoring.

Finally, we wish the authorities all the best in their policy endeavors for a successful program.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written report and Messrs. Johnston and Khurelbaatar for a concise yet informative buff statement.

Mongolia’s economic growth has remained strong owing to robust external demand, improved confidence, and rapid credit expansion. The country is also experiencing the second year of large fiscal surpluses and rapidly declining public debt. However, there are pressures on the balance of payments and on the exchange rate stemming from loose monetary policy and worsening terms of trade. Downside risks to the outlook underscore the need for a well-coordinated and sound fiscal, monetary, and exchange rate policy mix and to steadfast implementation of structural reforms to keep the economy on a path of sustained high and inclusive growth. Given the progress to date and the authorities' commitment going forward, we support the proposed decision.

The continued fiscal overperformance, mainly achieved by robust revenue growth, improved buffers, and lower public debt are welcome signs that Mongolia is edging towards program's goal of fiscal sustainability. Despite increasing key expenditures to more sustainable levels after two years of sharp compression and low execution, the proposed 2019 budget remains consistent with rapid debt reduction. To build on achievements so far, the authorities need to maintain fiscal discipline, implement budgetary reforms, and resist domestic political pressures for policy relaxation. Continued expenditure restraint, while protecting social outlays, improved public financial management, and strengthened tax administration are essential to achieve the program's fiscal objectives and keep the development agenda on track.

The prospects for external sustainability, another primary goal of the program, remains clouded by the deteriorating terms of trade and risks from volatile global commodity prices. The central bank's move to support the currency by selling part of its international reserves in foreign exchange markets has further weakened the external position. If continued, this policy will widen the external imbalances and lead to further loss of competitiveness. We encourage the authorities to undertake determined measures to address the imbalances and cement the economy's resilience against external shocks, including by commitment to exchange rate flexibility and resuming reserve accumulation to reach 100 percent of the ARA metric by end-2019.

We commend the authorities' efforts to address the vulnerabilities in the banking sector, especially weaknesses highlighted by the AQR. Timely enforcement of corrective steps, including measures aimed at restoring banks' capital base and resolving NPLs are key to developing a sound and resilient banking sector. We welcome plans to enhance contingency planning, crisis preparedness, and readiness for bank resolutions. At the same time, strengthening and protecting the integrity of the banking sector is of paramount importance. In this context, we encourage the authorities to take resolute actions to address the remaining strategic deficiencies identified by the APG in Mongolia's AML/CFT regime.

We wish the authorities success in meeting the challenges ahead.

Ms. McKiernan and Mr. Sylvester submitted the following statement:

We thank staff for their useful report and Messrs. Johnston and Khurelbaatar for their helpful buff statement.

Progress under Mongolia's Extended Credit Facility (EFF) arrangement continues to be satisfactory and, as such, we support the completion of the fifth review and request for modification and waiver of applicability of performance criteria (PC). However, given considerable risks to the program's success going forward, we stress the importance of strong ownership and commitment to program objectives, and wish to offer some additional comments for emphasis.

We welcome the recognition by the authorities of the need for a different policy mix to support reserve accumulation. The recent change in the monetary and financial policy stance aimed at containing inflation and supporting further improvements in the balance of payments is a step in the right direction. We share staff's view that the authorities should stand ready to further tighten this policy stance if credit and import growth do not slow, and allow greater exchange rate flexibility to support competitiveness and reserves accumulation.

The authorities need to remain vigilant on the fiscal front to secure program objectives. Significant progress has been made in reducing fiscal imbalances, but risks associated with a still elevated public debt-to-GDP ratio, high susceptibility to terms of trade shocks, and rising spending pressures in the lead up to the 2020 elections need to be appropriately mitigated. In this context, we stress the importance of continued fiscal discipline while balancing the objectives of debt reduction and the need to continue to support long-term growth and maintain social cohesion.

We encourage the authorities to push forward with financial sector reforms to achieve the goal of a stronger banking system. Rising credit growth has supported Mongolia's economic recovery but has brought with it macro and financial stability concerns. We take positive note of the progress made in addressing these concerns and urge continued efforts in this regard, including by completing the remaining steps of the Asset Quality Review and making further improvements to the AML/CFT framework to help mitigate concerns, including those related to the loss of corresponding banking relationships.

Finally, we encourage the authorities to pick up the pace of key structural reforms. We note with concern that the reform momentum has waned during 2018 and there have been some significant reversals of key structural reforms, including the areas of strengthening tax administration and improving social protection. In this regard, we welcome the authorities' further commitment to the implementation of key structural policies under the program.

Mr. Hurtado submitted the following statement:

We thank staff for the report and Mr. Johnston and Mr. Khurelbaatar for their informative buff statement.

We agree with the main thrust of the report and support the proposed decision. Following are some aspects we would like to point out for emphasis.

Mongolia has made important progress under the Extended Fund Facility. Growth is strong, and the levels of savings and private investment have recovered significantly. Fiscal consolidation has taken place and the ratio of public debt to GDP seems to be in the process of being reined in. However, inflation has gone up, the current account deficit is widening, and the real exchange rate has appreciated in a likely unhealthy way. Given the fiscal adjustment, to what extent is the real appreciation a consequence of the dynamism of private spending and to what extent it is the result of intervention and nominal exchange rate repression?

The desire to increase public investment, given its low levels, and a need to elevate other public expenditures are natural. However, we strongly support the idea that fiscal easing should be accompanied by tighter monetary and credit policies, as well as by more flexibility of the real exchange rate. Do authorities share this premise and, if so, are those policies bound to encounter political opposition?

Finally, we would like to wish best success to the Mongolian authorities in their efforts to complete the program.

Mr. Bayar and Mr. Hagara submitted the following statement:

We thank staff for the informative report, and Messrs. Johnston and Khurelbaatar for their helpful buff statement. The Mongolian economy's growth performance has remained strong, supported by an ongoing large investment in the mining sector and private consumption fueled by strong credit growth. Against this backdrop, all quantitative performance criteria (QPCs) have been met or are expected to be met. We therefore support the completion of the fifth review under the Extended Fund Facility arrangement for Mongolia, and the request for a modification and waiver of applicability of performance criteria. We broadly share staff's assessment and policy recommendations, and would like to provide the following comments for emphasis.

Mongolia's continued fiscal overperformance is welcome, although primarily reflecting more favorable external conditions. With a strong revenue upswing related to mineral exports and investment imports, the fiscal QPCs continue to be met with high margins. As a result, public debt reduction has been more rapid than projected in the original program, even with assumed fiscal loosening in 2019. Nevertheless, a cautious approach to fiscal policy is warranted in view of still high domestic and external debt, the high volatility of economic developments in Mongolia, as well as higher contingent liability risks. At the same time, we strongly encourage the authorities to improve the sustainability of public finances with strengthened efforts in the fiscal structural area, including through well-targeted social spending. Adherence to the program's indicative floor on social spending and ensuring an adequate targeting are crucial in the face of mounting political pressures that could induce policy changes that would put the program at risk.

We agree with staff that tighter monetary policy is needed going forward. While recent macroprudential measures are steps in the right direction, credit growth has recently accelerated even further, driven by the corporate lending recovery. Furthermore, the monetary policy tightening bias also seems to be justified by strong growth that would already set to get an additional impulse from fiscal loosening in 2019, as well as the need to alleviate the pressure on international reserves. A tighter monetary policy should be accompanied by greater exchange rate flexibility to preserve competitiveness, strictly limiting interventions to disorderly market reactions.

Completing bank recapitalization should be the priority for the short term. The conclusion of the Asset Quality Review and the parliamentary approval of the Recapitalization Law are important steps to strengthen financial sector stability and seem to have already helped improve economic confidence. The authorities should now monitor and ensure that banks meet their recapitalization plans by the end of 2018, while having contingency plans ready. Going beyond the recapitalization, banks' supervision needs to be enhanced to make financial sector stability gains more sustainable. At the same time, the AML/CFT framework should be further improved, with additional focus on addressing the gaps identified by the Asia Pacific Group (APG) on Money Laundering. As the recent amendments to the AML framework missed the assessment deadline for the APG plenary, Mongolia now faces a risk of being publicly listed by the Financial Action Task Force as having "strategic deficiencies." We would appreciate staff's comments on the possible contingency measures that can be taken by the authorities and the shortest timeline for them to take effect.

Mr. Panek and Mr. Danenov submitted the following statement:

We thank staff for a comprehensive report and Messrs. Johnston and Khurelbaatar for their informative buff statement. A favorable external environment is supporting the robust recovery. Economic growth has been above 6 percent for the last three quarters and revenues continued to overperform, however reserves have declined for the first time since the start of the Extended Fund Facility (EFF) arrangement. Also, risks to the program remain significant, including from fluctuations on global commodities markets, rising domestic pressures to loosen fiscal and monetary policies, and the lack of investment.

We support the completion of the fifth review under the EFF, considering that all quantitative targets for which data is available have been met and three of four prior actions have been completed. We broadly share staff's assessment and would like to limit ourselves to the comments below.

We encourage the authorities to build up international reserves needed to counter future external shocks. In this regard, the central bank should be ready to raise policy rates and tighten credit conditions if inflation pressures intensify. Greater exchange rate flexibility would help mitigate possible external shocks.

We welcome the declining path of public debt and support the authorities' plan to increase capital spending in the health and education sectors. Such spending would contribute to strengthening social cohesion and boost potential growth. We agree with the authorities and staff that a well-targeted increase in spending can be accommodated. However, it is important to ensure the effectiveness of public investments and make sure the expenditures are reconsidered in case of any revenue shortfall.

We commend the authorities for implementing reforms aimed at strengthening the financial sector. It will be very important for the banks to meet by the end-December deadline the capital requirements identified during Asset Quality Review. Improving the AML/CFT framework remains a key priority also in order to prevent any more withdrawals of the corresponding banking relationships.

Mr. Kaizuka, Mr. Ozaki and Mr. Komura submitted the following statement:

We thank staff for the comprehensive report and Mr. Johnston and Mr. Khurelbaatar for the informative statement.

The authorities' efforts, together with strong external demand and donor supports, have significantly enhanced macroeconomic stability of the Mongolian economy. Still, as the buff statement appropriately mentions, there is no time for complacency as the economy remain facing necessary reform agenda to avoid falling into a boom-bust cycle again. The authorities should steadily proceed with the reforms by making the most of the current favorable economic environment. Japan will always support Mongolia to achieve this goal and thereby perform its high potential.

As to the fifth review under the EFF arrangement, Mongolia met all quantitative performance criteria (QPCs) for which data is available and prior actions (PAs), while we have to note that there are some delays in achieving structural benchmarks (SBs), including the reclassification of assets to the NPLs based on the Asset Quality Review (AQR) findings. Considering all these elements, we support the completion of the fifth review as well as other part of Proposed Decision, including the modification of QPCs.

However, we also agree with staff that the program faces several important downside risks, such as looser macroeconomic policies and weaker external demand. Furthermore, several reversals in the planned reforms, including the increase in upper income personal tax rates and the increase in the pension age, have led to delays in disbursement of some of the committed supports. Since the Mongolian economy still have vulnerabilities, especially in the external and financial sector, we urge the authorities to implement necessary reforms to enable such disbursements in a timely manner. In particular, the next disbursement from the World Bank and related reforms are key for the international support package. For its disbursement, we understand that the authorities need to show alternatives to the two reversals in the fiscal policy mentioned above and complete necessary actions required in its second tranche. Could staff comment on outlook of its disbursement?

Fiscal Policy

Maintaining fiscal discipline and building fiscal buffer, while meeting spending needs, remain critical. In particular, they are especially important at this current juncture where downside risks to global growth have risen. In this regard, we first commend that Mongolia’s fiscal position has improved substantially due to the authorities’ efforts, together with strong external demand. For example, the primary balance is now projected to reach 3.2 percent of GDP in 2018, while it was expected to be -2.5 percent in the original program. By contrast, the proposed 2019 budget includes a roughly 3 percent increase in expenditures, which would result in 1 percent primary balance surplus. While the fiscal stance in 2019 becomes substantially looser than in 2018, we can understand that the authorities have to address properly social and investment needs, which are critical to ensure political support for the reform. At the same time, however, we would like to reiterate that Mongolia is in a critical phase to build fiscal buffer to prepare a next potential economic downturn. Therefore, going forward, we urge the authorities to strike a right balance of these policy agenda.

In addition to fiscal stances, the authorities should carefully examine items in budges to limit their spending only on what Mongolia truly needs. In this regard, we would like to ask the following questions:

The staff report mentions that IMF and World Bank technical assistance has found that domestically financed investment tends to be inefficient in general. Could staff comment on quality of infrastructure governance, or equally, the strength of public management investment practices, in Mongolia? Nevertheless, the proposed 2019 budget includes a 2.7 percent increase in public investment. How does staff assess efficiency of public investment proposed in the 2019 budget?

We recognize that there was protest campaigns regarding wages in the public sector. Does the announced plan which raised nominal wage by 9 percent from September 2018 and will raise it by 8 percent in 2019 succeed in mitigate such protests? Also, could staff elaborate more on why “support service positions” have grown rapidly?

Despite significant progress last year, such as the passages of new laws for DBM and BOM, we note that implementation of fiscal structural reforms has been limited this year. In the beginning of this year, there were some slippages, including reversing the increase in pension age and the increase in upper income personal tax rates. Then, we also recognize that the indicative target regarding social spending has not been met. Enhancing fiscal policy framework and fiscal structure, as well as building fiscal buffer, are key agenda under the rapidly improving fiscal position. In this regard, we agree with staff on the priorities, including fuel prices, mortgage program, DBM, social spending, unpaid liabilities on concessions, and investment guidelines, and encourage the authorities to realize these reforms timely.

External Sector

Mongolia needs to accumulate international reserves steadily to strengthen external buffer. Although they increased substantially in 2017 by $1.8 billion to reach $3 billion, 74 percent of the ARA metric, international reserves declined in 2018 for the first time since the start of the program due to rising pressures on the balance of payments. In 2019, staff expects that reserves would reach $3.9 billion, 99 percent of the ARA metric, assuming BOM's FX purchases and donor disbursements. Given the looser fiscal stance in 2019, the authorities need to calibrate their credit and monetary policies carefully to achieve an appropriate policy mix to strengthen external buffer.

We also agree with staff that greater flexibility helps to mitigate negative external shocks in addition to accumulation of reserves. We welcome the authorities' commitment to consider regular and announced foreign exchange purchases to support reserve accumulation while preserving exchange rate flexibility. We encourage the authorities to closely consult with staff to design this policy.

Financial Sector

We highly commend that the authorities have completed most of the major interim steps of the Asset Quality Review. For example, based on the assessment of the AQR in January and its update in May, the BOM informed banks of their capital needs. Then, Parliament successfully passed a Recapitalization Law. In addition, all prior actins for this review which are related to the financial sector reform, including BOM asks banks to show how to meet capital shortfalls, were met. We consider that the authorities deserve credits on this financial sector reform.

The AQR process will enter the most critical phase over the next few months. Since the AQR process forms a critical part of the program, we have a strong interest in progress in financial sector reforms. We understand that banks now develop and implement their recapitalization plans. We see substantial merits that banks improve their balance sheets by reclassifying assets into NPLs based on the AQR and recapitalizing accordingly. To this end, we encourage the authorities to closely communicate with banks in this process. Also, as a precaution, it is welcoming that the authorities are advancing in their contingency planning. What are the challenges for full implementation of recapitalization plans? In addition, under the recapitalization law, systemic banks that are unable to address capital shortfalls will be eligible for public capital, subject to strict conditions. Could staff comment on possibilities and, if any, magnitude of public fund injections to certain banks based on banks' recapitalization plan?

Structural Reform

Efforts on economic diversification are warranted because the high dependency on commodity is the fundamental source of vulnerabilities in the Mongolian economy. To this end, the authorities need to develop a clear medium-term strategy. From this perspective, while the authorities would face political pressures on capital spending as the proposed 2019 budget indicates, we encourage the authorities to allocate their resources into priorities under such a strategy.

At the same time, improving business environment in the mining sector is also imperative. In this regard, the staff report mentions the risk related to the investment agreement underlying the OT mine. Could staff elaborate more on this risk and its outlook?

Mr. Palei and Mr. Snisorenko submitted the following statement:

We thank staff for their report and Mr. Johnston and Mr. Khurelbaatar for their informative buff statement. Macroeconomic outcomes in Mongolia remain solid on the back of the continuous fiscal consolidation and favorable external environment. All end-September quantitative performance criteria have been met, and the progress is evident in implementation of the structural reforms, especially in fiscal and financial sectors. We support the completion of the fifth review under the Extended Fund Facility.

Despite the sizeable additional fiscal expenditures proposed in the 2019 budget, the authorities intend to deliver 1 percent primary fiscal surplus. It is also consistent with the debt reduction objective, keeping on track the recent overperformance compared to the original program projections. In this context, we welcome the authorities' commitment to save 100 percent of any further revenue over-performance and to cut expenditures at mid-year, if there will be a revenue shortfall. At the same time, the implementation of fiscal structural reforms has been somewhat delayed, with several important setbacks. We note the discussion between the authorities and staff on the reforms of fuel pricing and look forward to proposals to address inefficiencies in fuel prices regulation developed by the government with the assistance of the IMF.

We agree with staff that tighter monetary policy stance is warranted in the context of the ongoing fiscal easing and weakening balance of payments, while macro-prudential measures should be complements rather than substitutes for a tightening of the monetary policy stance. We also agree that a more ambitious move towards more flexible exchange rate regime with appropriate allowance for the accumulation of international reserves is critical to address still large external imbalances and ensure the resilience of the Mongolian economy to a variety possible shocks.

We welcome the Mongolian authorities' commitment to additional reforms in the financial sector. The implementation of the Asset Quality Review has been successful so far. However, the recapitalization phase due to be completed in December would be a critical juncture. Could staff comment on the readiness of the contingency plan to ensure prompt regulatory response in case of some banks failing to meet the December deadline? We also look forward to the discussion of the results of NPL reclassification in the papers for sixth review. We noted that the estimates of the new capital to be called by December already incorporate the additional capital need from non-provisioned NPLs. Could staff share their estimates of the "true" amount of the NPLs used for this calculation?

Recently achieved macro-stabilization brings to the forefront wider structural reforms agenda, which is essential for the long-term success. We encourage authorities and staff to put special emphasis on promoting economy diversification and improving the business climate. Could staff provide more details on the recent progress with structural reforms?

With these comments, we wish Mongolia further success in program implementation.

Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Messrs. Johnston and Khurelbaatar for their insightful buff statement. We welcome the continuous improvement in the macro-financial environment which has once again been better than expected since the last review and commend the authorities for their continuous efforts to restore macroeconomic stability and rebuild adequate buffers. As all quantitative performance criteria (QPCs) for which data is available have been met, we support the proposed completion of the fifth review as well as the request for modification and waiver of applicability of the performance criteria set forth in the Agreement.

Notwithstanding these achievements, there is no room for complacency since external vulnerabilities remain at an elevated level. Avoiding past mistakes that have led to repeated boom and bust episodes is essential for the success of the program. This means remaining committed to public debt deleveraging, rebuilding international reserves, adopting the right institutional framework to ensure countercyclical fiscal and monetary policies and keeping up with key structural reforms which will help with the diversification of the economy and to foster inclusive growth. While we agree with the thrust of staff appraisal we would like to offer the following comments:

We support the proposed adjustment of the quantitative performance criteria and of the indicative targets, notably the adjustments made to reflect the stronger outturns. Given the high financing needs in foreign currency in the years to come, we wonder whether, in the context of stronger than expected reserves accumulation in 2017, the QPC for international reserves could also have been increased. Staff comments are welcome.

On the fiscal front, we welcome the better than expected reduction of the fiscal deficit but remain worried by the sustainability of the ongoing adjustment. Using part of the current revenues windfall to increase some key public spending that have been sharply compressed over the last years appears reasonable in view of the rapid decrease of public debt, as also recognized by staff. Nonetheless, we encourage staff to further work on a change of the current fiscal framework to adopt an operational target that clear the nominal deficit from its cyclical and resources-related components.

On the redistributive nature of the tax and benefit system, we encourage the authorities to enhance the progressivity of the tax structure and to increase the level and targeting of social spending. In this regard, we regret that the social spending target for end June has been missed and encourage the authorities to reach the end year target.

We also support staff recommendation to tighten monetary policy to tame inflation pressures. Greater exchange rate flexibility would also be valuable to improve competitiveness and act as a shock absorber.

Additionally, we encourage the authorities to remain committed towards the objective of rebuilding international reserves.

Concerning the recapitalization of the banking sector, we commend the authorities for their endeavors so far. Still, it is of paramount importance to complete this process by ensuring that all banks meet the capital needs identified through the AQR exercise by the December timeline. The resolution of the banks that would not be able to meet the capital requirements should be swiftly considered from this date onwards. Looking forward, stronger banking supervision and better management of non-performing loans will contribute to a sustained recovery and are of particular importance to ensure financial stability in the context of rapidly rising credit growth levels.

We commend the authorities for strengthening the AML/CFT framework but note that significant deficiencies remain to be addressed to prevent the inscription of Mongolia on the list of jurisdictions with strategic deficiencies by the FATF. We therefore welcome the introduction of structural benchmarks that will secure progress towards full compliance with international standards.

We thank staff for its work on fuel prices presented in box 2 which shows that the current framework is not optimal from a fiscal and environmental point of view. We support staff proposed reform plan but insist and the need to anticipate the implementation of the measures aiming at protecting the most vulnerable. Given the high reliance of Mongolia's economy on carbon-intensive raw materials, we reiterate our call to staff to assess the macroeconomic impact of Mongolia's carbon emission mitigation policies under its Paris agreement Climate Action Plan as well of the energetic transition of its main trade partners, such as China. We also encourage the authorities to maintain their efforts to enhance the transparency of the extractive sector, notably through systematic and regular disclosures of EITI data.

Mr. Kaizuka made the following statement:

We are happy to support the proposed decision, and at the Bali meeting I had the privilege of having a discussion with the Finance Minister of Mongolia, and we are quite impressed with his commitment to the reform and with the efforts made so far to deal with many challenges while he is also facing pressures against the reformists in the country.

I have three comments to make. First, on fiscal policy, we appreciate that the fiscal position has greatly improved. In order to make such an improved fiscal position sustainable on the longer horizon, there should be proper public financial management, which would enhance the confidence in the Mongolian economy among many stakeholders, including us. For this, we encourage the Mongolian authorities to enhance governance in public investment, including refraining from resorting to the off-budget or quasi-fiscal spending. I am happy that the Fund's technical assistance (TA) on the government's financial statistics have been provided using Japan's contribution to the Fund, and we are very willing to continue this support.

Second, on the financial sector reform, it is encouraging to see the tangible progress, including the completion of the asset quality review and the enactment of a recapitalization loan. The real challenge ahead is a proper implementation of the recapitalization plan, reflecting the result of the Asset Quality Review by banks. Recapitalization, funding to the NPL program, should be fully implemented in a decisive and speedy manner. If it is delayed, the balance sheet problem of the banks would weigh on the economic performance with a certain deflationary pressure, and such a drag on the economy may last over a longer period of time. This is exactly what we learned from our own financial crisis in the 1990s, so we encourage Fund staff to convey our message to the Mongolian authorities.

Lastly, on the disbursement of donor commitment, it is explained in the staff report that the disbursement will be delayed in the first quarter of 2019. Disbursement of the second tranche of the Japanese loan to Mongolia has to be delayed as it is systemically conditionally linked with the disbursement of the World Bank loan. While we have every intention to deliver our committed assistance to the country, we understand the World Bank is now negotiating possible conditions which could replace the previous conditions, including the progressive structure of income tax rates, and also raising the starting age of the pension payment. We encourage the staff to let the Mongolian authorities and the World Bank accelerate their negotiations.

Mr. Castets made the following statement:

I thank the staff for the quality of the report and also for the answers to our technical questions. As noted in our gray statement, we support the completion of the fifth review, and we would like to add the following comments for emphasis.

First, we welcome the better-than-expected economic and fiscal outlook, and we commend the authorities for their effort. Public debt is now on a firm downward trend, and we consider it a major achievement of the program so far. Nonetheless, it is crucial to ensure the sustainability of this recovery, notably by avoiding repeating past difficulties due to procyclical policies. Moreover, against a backdrop of increased external imbalances, we encourage the authorities to tighten monetary policy, let the exchange rate depreciate if necessary, and increase international reserves. This is also highlighted in several gray statements by several other Directors.

On the financial sector, as highlighted by Mr. Kaizuka], the coming months will be key to strengthen the banking sector, so an important first step has been taken with the Asset Quality Review, but we expect the authorities to swiftly implement the recapitalization process as planned.

Turning to the medium term, we encourage the authorities to strengthen the policies to adopt a greener and more inclusive economic model. This means, as also highlighted by the staff report, reinforcing the progressivity of the tax system, as well as increasing the level and the quality of social spending.

Reforms such as the removal of some fuel subsidies and the automatic fuel pricing mechanism will be a big step in this direction to recreate fiscal space once the social measures are in place to compensate the most vulnerable. We look forward to the authorities further engaging with the staff on the basis of the good analysis presented in the report.

Mr. Gade made the following statement:

I thank the staff for the hard work and good reports. We have issued a gray statement where we support the completion of the review and the associated revised decisions. The Mongolian authorities have made commendable efforts during this program. Fiscal prudence has been part of it, and the favorable external developments have been another part.

We note that there are significant vulnerabilities remaining, and it is imperative to get the policy mix right. We have some sympathy for the authorities' wish for additional spending on the relatively low public wages and also on education and health, but we are concerned about the likely procyclical fiscal easing, which looks like it could be more than 2 percent of GDP, and that is massive in the current environment. Without monetary tightening accompanied by a medium-term fiscal anchor, fiscal easing of this magnitude risks undermining the currently balanced developments. Granted, one issue may be that there may be a need to get a better grip on what the slack in the economy is, and especially differentiating mining from non-mining economic activities, as well as the fiscal revenue part of that. I would appreciate if the staff could comment more on that differentiation and what the slack in the non-mining economy actually is.

Second, we would also appreciate comments on the revenue overperformance, which was described in the supplement circulated to the Board. But whether the authorities intend to save it or whether it leads to an even larger fiscal stimulus are not entirely clear to me.

I have one comment on the medium term. Given how dependent the economy is on the extractive industry and fiscal revenue derived from that, I would like to know whether consideration has been given to developing a type of sovereign wealth fund that could absorb the windfall revenue. That could also be a way to prevent a return to the boom-bust cycles of the past, which is still a risk in the medium term.

Mr. Meyer made the following statement:

We thank Mr. Johnston and Mr. Khurelbaatar for their buff statement and the staff for the concise report. We commend the Mongolian authorities on robust economic growth and fiscal overperformance, which facilitated a much-needed and meaningful reduction in public debt. However, we are concerned with the slower pace of macroeconomic adjustment and important reform setbacks. Looking forward, we agree with the staff that program risks are tilted to the downside and that the main challenge for the Mongolian authorities will be to implement a tight macro policy mix. This should contribute to avoiding the boom-bust cycles of the past and toward guarding against shocks in external demand for commodities. To this end, we reiterate the staff’s call for prudent fiscal policy particularly in the run-up to the 2020 elections to address vulnerabilities related to the still high-level of public debt.

While we acknowledge that public investment in health, education, and infrastructure is needed to promote long-term growth, the authorities should consider tradeoffs arising from a procyclical fiscal stance. A key concern is the deterioration in the current account balance and the decline in foreign reserves as import growth has picked up, donor flows have decreased—I thank Mr. Kaizuka for his comments on that—and the terms-of-trade have deteriorated. Monetary policy will need to tighten, as suggested by the staff, to contain inflationary pressures and to reverse the process of currently declining international reserves.

Like Mr. Kaizuka and Mr. Castets, we commend the authorities for implementing the conclusions of the Asset Quality Review on the path toward a more resilient banking sector. Going forward, it is essential that banks will reclassify the nonperforming loans in line with the findings and correspondingly raise new capital.

We acknowledge the improvements to the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework, yet it is unfortunate that the authorities were not able to upgrade their assessment ratings. Thus, there is a risk that Mongolia could be publicly listed as a country with strategic deficiencies, which could result in vanishing confidence in the financial sector. Therefore, legal and regulatory improvements, as well as more effective enforcement, remain a key priority for safeguarding financial stability.

Finally, on prior actions, we encourage the authorities to complete the fourth prior action and submit detailed updates on banks' progress in raising new capital by the end of the year. As systemic financial institutions are eligible for public capital if they fail to meet the deadline, we encourage the authorities to refine contingency plans and to consider potentially adverse effects on the fiscal balance. I also ask the staff to elaborate on the prior actions. The document states that a prior action was expected to be met for this Board meeting. Can the staff elaborate on this?

With this, I wish the authorities all the best in their future endeavors.

Mr. Geadah made the following statement:

We support the completion of the review, and we have a few observations. First, we are pleased that Mongolia overperformed on the fiscal quantitative targets, which was partly due to efforts to contain spending, which we realize has not been easy. But we are concerned about the setbacks in fiscal structural reforms, especially given that this is an Extended Fund Facility (EFF) program. We hope that this program will help Mongolia make its public finances more resilient to the vulnerabilities associated with dependence on mining exports.

My second point is also related to the importance of mining exports. Mongolia intervened earlier this year to limit the depreciation of its currency.

It might be useful—not now but perhaps in the context of the Article IV consultation—to consider what exchange rate arrangement would serve Mongolia best in the long term so as to ensure the diversification of its economy.

Finally, I would like to support the points made by Mr. Kaizuka and Mr. Castets on the importance of recapitalizing banks based on the Asset Quality Review.

Mr. Hurtado made the following statement:

We note the success the program has achieved so far in Mongolia, and we support the decision that is proposed in the paper. That being said, I am not clear about the authorities' position on the following topic. It seems that there is a tradeoff that they are facing about easing fiscal policy.

The report makes a point, and we agree strongly with that point: if there is any fiscal easing, desirable for some reason, then the country will have to tighten monetary and financial policies and allow more flexibility for the exchange rate. We strongly agree with that. But in the written responses, it was not clear what the authorities' position is because it says that they are reluctant to do that because of the consequences of doing this tightening and the flexibilization of the exchange rate. But in the end, I was not clear what course of action is expected in terms of fiscal easing, the tightening of monetary policy, and the more flexible exchange rate.

Mr. Sun made the following statement:

We have issued a gray statement, and I will not repeat the points in our gray statement but just emphasize the following.

Performance under the EFF in Mongolia has been strong, thanks to both domestic reforms and a diverse and favorable external environment, including rising commodity prices. However, since commodity prices might drop, and domestic spending pressures might build up in the run-up to the elections, and there are already signs of stress under the balance of payments, we encourage the authorities to maintain the reform momentums, steadfastly implement fiscal consolidation, and build up sufficient buffers, reserve buffers in particular.

We also believe that diversification of the economy is essential to achieve sustainable growth for Mongolia, and we encourage continued efforts in this regard. We welcome the completion of the key aspects of the Asset Quality Review to address capital shortfalls in the banking system, albeit with a delay, and encourage the authorities to follow through on the remaining steps in the coming months. With that, we wish the Mongolian authorities all the best in their policy endeavors.

The staff representative from the Asia and Pacific Department (Mr. Gottlieb), in response to questions and comments from Executive Directors, made the following statement:[1]

I thank Directors for the questions. I registered five questions. The first question referred to the output gap. This is challenging to do in Mongolia because there is a very short time series of GDP, and there is also a significant amount of structural change within the economy. But we recognize that in a context of boom and bust, it is useful to separate the cycle from the underlying changes in the economy. Based on our methods, it suggests that the non-mining output gap is now closed, based on the recovery of the last two years. We do not put too much emphasis on these estimates. The key point is that the fiscal policy between this year and next year is undeniably procyclical. The economy is accelerating moderately, and the primary surplus is falling. We recognize that we can come back to the question in terms of what is going to happen next, but we felt that in light of the need to address certain spending needs in education and health, and the fact that even next year this is 6 percentage points tighter than the debt-stabilizing primary balance, we felt that it was appropriate, particularly in terms of maintaining social cohesion within the country.

The second question referred to what will be done with the further revenue overperformance found in recent months. The Finance Ministry has indicated that it fully intends to save the full amount, which is why we believe that based on the recent data, the primary surplus this year is likely to be higher than what was in the staff report.

The third question was about the sovereign wealth fund. There was a significant amount of discussion about the sovereign wealth fund in Mongolia. Our initial impression is that it would be better to pay down liabilities rather than accumulate assets at this time for two reasons. One reason is that they still have high-cost liabilities, including on the external side. The second reason is that some of the governance issues around maintaining a large pot of

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

money are quite challenging, so at this stage we still prefer prepayment to accumulating assets.

The fourth question was about the prior action. A supplement was issued late because of late-breaking developments in Mongolia. There are two developments on the prior action. One is the fourth prior action, which was listed as pending in the staff report, or expected to be met. This was met. The authorities requested that the banks submit plans giving the progress on what capital had been raised thus far and how they planned to meet the capital requested last May. But in meeting that prior action, the results of those plans suggested further work was needed in order to keep the program on track.

Specifically, there was some disagreement about the amount of capital that needed to be raised. For this reason, the staff returned to Mongolia two weeks ago for further discussions, where we agreed on a fifth prior action in which the authorities, the central bank, issued new letters to the banks requiring that banks update their balance sheets to reflect the Asset Quality Review results and subsequent onsite inspections, writing down capital accordingly, and also underscoring that the capital amounts from last May needed to be met with common shares. The Bank of Mongolia agreed with us that the plans received in October did need further action, and they promptly did this fifth prior action. That was done on Tuesday the 23rd. On that basis, we were able to continue with the Board meeting today.

The fifth question was what course of action the authorities intend to take on monetary policy and the exchange rate. For the near term, we take the fiscal position as given. There was an agreement about the budget. The budget has been submitted in line with that agreement, which is a surplus of 1 percent of GDP, and the authorities expect to pass a budget consistent with that agreement in November. Given that, which does imply some positive impulse to the balance of payments, we have started discussions with the authorities on what is the appropriate monetary and exchange rate policy reaction in that context.

In terms of monetary policy, there have been several steps. First, the authorities halted the easing cycle in June. Second, they adopted tighter macroprudential ratios because they believe that some macroprudential tightening can affect credit more effectively than the policy rate. Third, they adopted a tightening bias in September, and then the plan is to continue along these lines in the coming months. The next monetary policy committee meeting is in December, and the discussion of what to do in that meeting will be a key focus of the next mission.

In terms of the exchange rate, there is a broad agreement that countries are facing exchange rate pressure everywhere, and Mongolia should not be different in that respect, and they should recognize that these pressures are natural and reflect a changing external environment. The two challenges are that the portion of the consumer basket that is imported is very large in Mongolia, due to the small productive sector and the fact that external debt is very large. There is recognition of what depreciation means for both inflation and for balance sheets, and that underscores the reason for further tightening needed in monetary and credit policies.

Mr. Palei made the following statement:

I thank the staff for the additional comments. The situation with the sovereign wealth fund is interesting, because Mongolia as an economy has a strong balance sheet. It is a rich economy in per capita terms. Then we witnessed a very large program with total financing amounting to about 50 percent of GDP. From this point of view, maybe it makes sense to accumulate additional assets, even if on the net basis the authorities do not add anything. If they have additional, rather liquid assets in the sovereign wealth fund, even by doing some pre-borrowing in the good times, then they may have buffers accumulated in this sovereign wealth fund or whatever vehicle they choose to keep and maintain macroeconomic stability, smooth any negative shocks in financial markets or the terms-of-trade shocks they faced in the past.

I would encourage the staff to take an additional look at the balance sheet approach to debt sustainability and economic health and not to rule out accumulation of additional assets, as opposed to getting rid of liabilities at a faster pace. This should be an open question, and maybe at a later stage in additional reviews, the staff could address it in more detail. T

Mr. Johnston made the following concluding statement:

I thank Directors for their comments and I would like to express the authorities' appreciation for the work of the mission chief, Mr. Gottlieb, and his team, and also to Mr. Furusawa for his personal interest in Mongolia.

We are right at the midpoint of the program, so it is useful to look at what progress has been made. If we look back to when the EFF was being negotiated early last year, Mongolia had a very large fiscal deficit, low growth, falling reserves; the togrog had plummeted, and there was a large bond repayment coming due that could not be financed. Since then, major reforms have been undertaken to improve fiscal discipline, run prudent monetary policy, a flexible exchange rate, strengthen the independence and the governance of the central bank, and conduct an independent Asset Quality Review in the banking sector. Alongside a rebound in commodity prices and export volumes, these actions have stabilized the economy and produced much better outcomes than were initially expected. Just taking public debt for example, initially it was projected to peak at close to 100 percent of GDP this year, but now it is expected to be down to 70 percent.

Those current favorable conditions are certainly a useful tailwind. That gives the authorities space to continue addressing Mongolia's key vulnerabilities without creating social instability and a public backlash against the program. Priorities for the second half of the program are about reducing public and external debts, recapitalizing the banking sector, and accumulating reserves.

Directors make good points about the fiscal stance in the overall macro policy mix. It is useful to note that the planned increase in spending next year is on worthwhile social and infrastructure projects. It has been increasingly difficult to defend not doing these things when the fiscal position has been so good. Funnily enough, revenue overperformance is actually politically challenging.

Also, the Mongolian Parliament is a very active place. It debates legislation vigorously and does not always do what the government would like. There have been a few delays and hiccups, but the program is on track, and the authorities are very committed to it. What is important in the longer-term is to use this program to rebuild buffers, strengthen institutions, and develop policy responses that mean Mongolia can withstand future shocks—and that will inevitably occur, especially for a country dependent on vast mineral resources—and help them get out of the boom-bust cycles that have characterized Mongolia's development for too long.

The following summing up was issued:

Executive Directors welcomed Mongolia's performance under the Fund-supported program. The macroeconomic outlook and debt dynamics have improved on the back of strong external demand, renewed confidence, and sound policy implementation. However, Directors noted that significant vulnerabilities remain and emphasized the need to build additional external buffers. With rising pressure on emerging markets generally, they emphasized that continued strong commitment to the program will be critical to foster sustainable growth that is less volatile and more inclusive.

Directors welcomed the strong fiscal outturn so far in 2018 and commended the authorities' intention to save the revenue over-performance. However, with public debt still relatively high and balance of payments pressures rising, they expressed concerns about the loosening fiscal stance in the proposed 2019 budget. Nonetheless, Directors recognized Mongolia's expenditure needs especially on critical infrastructure and social protection programs and thus supported the program target of 1 percent of GDP primary balance surplus in 2019. They also highlighted the need to strengthen tax administration, improve public financial management and advance fiscal reforms. Directors also underlined the scope to make social spending more targeted and efficient.

Noting the need to accumulate further foreign exchange reserves, Directors welcomed the authorities' readiness to raise interest rates and urged swift policy action in coming months if the balance of payments does not strengthen sufficiently. Directors also advised caution on foreign exchange intervention and encouraged greater exchange rate flexibility going forward.

Directors welcomed the ongoing efforts to strengthen the financial sector. These include steps taken by the Bank of Mongolia to ensure that bank balance sheets better reflect asset quality and that the capital which banks are raising is sufficient in amount and quality. At the same time a prompt response would be required to preserve financial stability should banks be unable to raise adequate capital by the end-December deadline. Directors also called for further efforts to strengthen banking supervision, facilitate the resolution of non-performing loans, and improve the AML/CFT framework. Noting that the rapid increase in credit growth raises both macro and financial stability concerns, Directors supported the authorities' efforts to address potential risks with macro-prudential policies while noting that further tightening may be necessary.

Structural reforms remain key to sustained, inclusive growth and greater resilience. Directors emphasized the need for reforms to improve the business environment and diversify the economy.

The Executive Board took the following decision:

Mongolia—Fifth Review Under the Extended Fund Facility Arrangement and Request for Modification and Waiver of Applicability of Performance Criteria

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. (EBS/18/91, Sup. 1, 10/29/18).

Decision No. 16436-(18/88), adopted
October 31, 2018

APPROVAL: March 5, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. We would welcome staff comments on the deterioration of CBRs (correspondent banking relationships), and its impact on trade, and remittances?

- Mongolian commercial banks' dollar accounts held at U.S. institutions have been progressively closed over the past four years, forcing these banks to shift their dollar accounts to non-US banks.

- While the macroeconomic impact appears limited so far, this decline in CBRs could weigh on trade and capital flows over time by increasing the cost of doing business, particularly with respect to bank financing.

- There is increasing political awareness of the need to address FATF recommendations but strengthening the legal framework and demonstrating evidence of better enforcement takes time.

2. ***As the recent amendments to the AML framework missed the assessment deadline for the APG plenary, Mongolia now faces a risk of being publicly listed by the Financial Action Task Force as having "strategic deficiencies." We would appreciate staff's comments on the possible contingency measures that can be taken by the authorities and the shortest timeline for them to take effect.***

- The IMF, in conjunction with other donors, has stepped up its technical assistance in this area. Progress improving the legal framework and ensuring its effective implementation is underway. An AML/CFT mission from the IMF visited Mongolia in September to provide technical assistance to the Bank of Mongolia and the Financial Information Unit (FIU).

- The mission recommended to increase resources available to the FRC, FIU and law enforcement agencies and ensure fit and proper supervision for banks and NFBIs through an amended law on AML/CFT and updated regulations. The 2019 budget has increased resources for these efforts but developing the needed capacity will take time.

- With such steps in place, the mission recommended that the authorities seek a new rating on technical compliance from the APG in January 2019. It also noted that the authorities could organize multilateral meetings with international correspondent banks to help facilitate renewed CBRs. The authorities are following up on implementation of these recommendations.

3. ***In this regard, the staff report mentions the risk related to the investment agreement underlying the OT mine. Could staff elaborate more on this risk and its outlook?***

- There is an active discussion within Mongolia about whether the investor agreement underlying OT provides sufficient benefits to Mongolia. Outstanding issues include the interest rate on the shareholder loan, tax assessments, and the location of a new power station for the mine.

- A number of parliamentary committees and audits have been established by the authorities to assess these issues. Encouragingly, there are signs of consensus emerging to resolve the key issues.

- However, the risk is that unilateral changes are made to the investor agreement which OT considers sufficiently worrisome to halt further investment in the mine. Such a move would directly reduce near term output but also substantially weigh on medium term prospects by lowering mining exports and reducing other potential mining investments.

Fiscal Policy and Debt Sustainability

4. ***Staff notes that the increase in nominal wages for civil servants was significantly lower than the 50 percent demanded by labor unions. Do staff expect this to be a one-off increase, particularly given that the increase was very modest and 2020 is an election year? If so, what assurances did the authorities provide to staff?***

5. ***We recognize that there was protest campaigns regarding wages in the public sector. Does the announced plan which raised nominal wage by 9 percent from September 2018 and will raise it by 8 percent in 2019 succeed in mitigate such protests? Also, could staff elaborate more on why "support service positions" have grown rapidly?***

- The recent increases allow for a 3 percent real wage increase in 2018-19. This does not reverse the fall in purchasing power since 2013 but this was not the goal since some adjustment in the wage bill was necessary amid particularly high public debt.

- Going forward, the authorities' stated intention is to preserve the wage bill in real terms, granting increases only in line with inflation. Discussions to ensure the 2020 wage bill remains consistent with macroeconomic stability will happen in the fall of 2019 during the budget preparation process.

- Rapid growth in the number of support service positions has been driven by large increases in the number of school teachers and medical staff. Some of this increase reflects a desire to improve access to public services in remote areas of Mongolia.

6. Do the authorities consider further measures to support low income earners?

- At this time, the authorities have not shared any plans to increase resources specifically for low income workers. There has been resistance to increasing targeted social protection assistance beyond the relatively small food stamps program.

7. We would like to hear staff views on whether the measures and allotments are constrained by the indicative floor applicable to the level of social protection spending and the extent to which the program can accommodate potential fiscal loosening.

- The program can accommodate the proposed fiscal loosening for 2019 agreed with the authorities. In terms of debt sustainability, the 1 percent primary surplus targeted in the proposed budget is still significantly tighter than the debt stabilizing level (-5 percent). However, to ensure this fiscal stance is consistent with reserve accumulation, the monetary stance will likely need to tighten going forward.

- The indicative floor on social spending is designed to ensure that the multi-year fiscal adjustment under the program does not come at the expensive of social protection spending. Meanwhile, the budget envelope itself provides assurance that total spending will not increase excessively, even in an election year.

8. The staff report mentions that IMF and World Bank technical assistance has found that domestically financed investment tends to be inefficient in general. Could staff comment on quality of infrastructure governance, or equally, the strength of public management investment practices, in Mongolia? Nevertheless, the proposed 2019 budget includes a 2.7 percent increase in public investment. How does staff assess efficiency of public investment proposed in the 2019 budget?

- According to the Public Investment Management Assessment by the IMF in 2016, Mongolia lags its peers on public investment efficiency. One reason is that public investment guidelines are inadequate to properly select and execute capital projects. Building on TA from donor partners, the authorities have committed to issuing a regulation on the appraisal and selection of investment projects by end-December.

- The proposed increase in capital spending in 2019 is large but this partially reflects the low base. Particularly if one includes previous quasi-fiscal spending, the proposed domestic investment is still substantially below the outlays seen in pre-program years.

- It is difficult to assess the efficiency of future spending ex-ante. There is a clear need for investment in the targeted areas (e.g. health, education, environment). However, the size of the impact on long-run growth is a function of how well it is executed.

9. ***Regarding the results of the Debt Sustainability Analysis, we take note that foreign currency-denominated debt to GDP is projected to remain high in the next two years. Given that foreign currency-denominated public debt is above the upper-risk assessment, how does staff assess this development?***

- The share of foreign currency-denominated public debt is indeed above the upper-risk assessment and a material exchange rate depreciation would substantially increase the level public debt.

- However, this shift towards FX-denominated debt reflects a program goal of replacing costly domestic debt with concessional external donor financing. This shift has already helped lower the effective interest rate from 6.6 percent to about 3 percent by 2020 and extend the average maturity of debt significantly.

- Due to highly favorable dynamics, public debt is projected to come down fairly quickly over the forecast horizon, which will in turn mitigate (but not eliminate) concerns about exchange rate risk to public debt.

Monetary Policy

10. However, we strongly support the idea that fiscal easing should be accompanied by tighter monetary and credit policies, as well as by more flexibility of the real exchange rate. Do authorities share this premise and, if so, are those policies bound to encounter political opposition?

- The authorities recognize that credit growth is currently very high. This concern is part of what has triggered the announcement of tighter macro-prudential regulations. However, they have expressed some skepticism that tighter policy rates would also help as they feel that the transmission to credit growth is weak.

- With respect to the exchange rate, they support flexibility as a general principle. Their concern is that amid thin markets, allowing too much depreciation can lead to a disorderly move in the exchange rate which is particularly costly in terms of inflation and Mongolia's high public debt.

- Both higher interest rates and a weaker exchange rate would general substantial political opposition. Out of the two, exchange rate depreciation is particularly difficult because of the significant share of imported goods in the consumer basket and thus the impact of a weaker exchange rate on purchasing power.

External Sector

11. ***Would staff consider introducing conditionality on foreign exchange intervention? What would be an appropriate band for non-intervention?***

- During upcoming missions, Staff intend to discuss ways in which an FX intervention rule might help the authorities in building reserves while preserving exchange rate flexibility. The aim is to limit interventions to disorderly market conditions, while bearing in mind the specifics of Mongolia's thin foreign exchange markets. However, at this time, Staff do not see a need for conditionality in this area as the authorities have consistently met the reserve targets under the program.

12. ***Given the fiscal adjustment, to what extent is the real appreciation a consequence of the dynamism of private spending and to what extent it is the result of intervention and nominal exchange rate repression?***

- The recent real appreciation is a function of both FX intervention (which has limited nominal movements in the exchange rate) and inflation (which has risen quickly relative to trading partners). With respect to the latter, it is difficult to say precisely how much reflects strong private spending (demand pressures) and how much is supply side shocks/imported prices. However, inflation in Mongolia is particularly vulnerable to external shocks given limited domestic production capacity and large consumption imports.

Financial Sector

13. ***Could staff provide an assessment of the prospects of a successful recapitalization under the currently envisaged timeline, given the resistance we have already seen from banks to simply reclassifying their NPLs? As the 2019 budget should be passed soon, do staff assess that public capital support will be needed for systemic and viable banks that are under-capitalized?***

- We believe that the authorities are taking the necessary steps to keep the AQR follow-up on track, albeit with some delays. The onsite inspections and communication to banks in October are particularly helpful steps in this regard.

Nonetheless, ongoing resistance is possible, and we are working with the authorities regarding the appropriate remedial steps for January if they prove necessary.

- We will only know whether and how much public capital is needed in January, long after the November 15 deadline for passing a budget. However, this is not a major concern. If public resources are necessary, they can be arranged outside the normal budget calendar.

14. ***In this connection, we welcome the adoption of the June Recapitalization Law which allows for the use of public money to recapitalize systemic important banks, failing private sector participation. Could staff elaborate on the potential budgetary cost for recapitalizing these systemic banks. Are the authorities considering foreign partners' involvement in this process and if yes, is there any cap on foreign equity?***

- Budgetary costs could emerge either because a systemic bank requires public re-capitalization or because a non-systemic bank needs to be resolved and funds are needed to protect certain deposits. At present, we do not see maximum likely fiscal costs to be more than a couple percentage points of GDP.

- Some of the commercial banks have already tried to attract foreign private investments in their recapitalization. There is no cap on foreign investment, but the recapitalization law prohibits foreign public investment in Mongolian banks.

15. ***Given the fast approaching deadline of December 2018 for raising this required capital, we would like to have more details on the level of capitalization requirement, the progress envisaged and whether the gains under the program could be undermined if the capitalization does not materialize.***

- In May, BOM asked select banks to address capital shortfalls which total MNT 960 billion (3.2 percent of GDP). The expectation is that banks either raise this capital or BOM will intervene as necessary with the exact response a function of how large the shortfall is and whether the bank is systemic or not.

- If the capitalization does not materialize in the size requested, we do not expect imminent risks to financial stability and the progress under the program thus far. With strong economic growth, Mongolia should not miss the window to strengthen banks' capital base which will be needed to support the economy during the next downturn.

16. ***What are the challenges for full implementation of recapitalization plans? In addition, under the recapitalization law, systemic banks that are unable to address capital shortfalls will be eligible for public capital, subject to strict conditions.***

Could staff comment on possibilities and, if any, magnitude of public fund injections to certain banks based on banks' recapitalization plan?

- The primary challenge for full implementation of recapitalization plans is that banks challenge the need to raise the requested amount and type of capital and the BOM does not want to push for sufficient corrective action.

- With respect to the potential fiscal costs of the recapitalization effort, we see a couple percentage points of GDP as a likely upper limit.

17. ***However, the recapitalization phase due to be completed in December would be a critical juncture. Could staff comment on the readiness of the contingency plan to ensure prompt regulatory response in case of some banks failing to meet the December deadline?***

- The authorities have started to prepare contingency plans in the case that banks do not address the capital shortfall in full. However, such plans still need further details regarding modalities and this will be a focus of the next review.

18. ***We noted that the estimates of the new capital to be called by December already incorporate the additional capital need from non-provisioned NPLs. Could staff share their estimates of the "true" amount of the NPLs used for this calculation?***

- The recent onsite examinations of the BoM have identified 2.5 times more NPLs in six banks than their previously reported figures which reflected the pre-AQR numbers.

Program Modalities

19. In particular, the next disbursement from the World Bank and related reforms are key for the international support package. For its disbursement, we understand that the authorities need to show alternatives to the two reversals in the fiscal policy mentioned above and complete necessary actions required in its second tranche. Could staff comment on outlook of its disbursement?

- The World Bank is still in discussions with the authorities regarding what is needed for the next disbursement to proceed. The outlook, in terms of size and timing, is sufficiently strong to assume this financing in our baseline.

20. ***Given the high financing needs in foreign currency in the years to come, we wonder whether, in the context of stronger than expected reserves accumulation***

in 2017, the QPC for international reserves could also have been increased. Staff comments are welcome.

- The program has de facto achieved a part-way similar outcome by not revising down the existing NIR targets despite some strong terms-of-trade shocks that materialized earlier this summer. That is, instead of revising up NIR targets in early 2017 and then revising them down in mid-2017, the program has maintained originally-envisioned targets—motivated by the over-performance in NIR accumulation in 2017.

Diversification

21. ***Are there programs envisaged by the authorities to improve the business climate and support economic diversification?***

- Economic diversification is a key objective of the authorities and has been reflected in the government long-term policy planning. In September, a "Mongolia Export Program for 2018-2022" was approved to promote export of non-mining and high value-added products. The authorities have also received significant support from the World Bank and Asian Development Bank in export diversification.

- At the same time, one of the best things that Mongolia can do to support diversification is macroeconomic stability. Most important are a well-capitalized banking system able to support sustainable and affordable lending, an exchange rate in line with fundamentals, a low fiscal deficit which does not crowd out private lending, and a stable and competitive investment climate.

22. ***We encourage authorities and staff to put special emphasis on promoting economy diversification and improving the business climate. Could staff provide more details on the recent progress with structural reforms?***

- The government has submitted a revised CIT law to Parliament to improve the business climate, facilitate investment and support small and medium sized businesses as part of the structural reforms envisaged in the EFF program. We expect the law to be approved during this fall session of Parliament.

- To enhance revenue mobilization, the government is planning to carry out a customs reform with tighter controls over export commodities in 2019. This will include establishing accredited customs laboratories at border points, investing in security systems, etc.