PD-ABD-223

U N C L A S S I F I E D

AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D.C. 20523

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

MONGOLIA: Cash Transfer
PAAD Number: 438-K-601

August 29, 1991

U N C L A S S I F I E D

CLASSIFICATION UNCLASSIFIED

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 438-K-601
2. Country: Mongolia
3. Category: Cash Transfer
4. Date
5. To: AA/APRE: Henrietta Holsman Fore
6. OYB Change Number: N/A
7. From: A/APRE/DR: Thomas Nicastro
8. OYB Increase: N/A
   To be taken from:
9. Approval Requested for Commitment of: $ 10,000,000
10. Appropriation Budget Plan Code
11. Type Funding: ☐ Loan ☒ Grant
12. Local Currency Arrangement: ☐ Informal ☐ Formal ☒ None
13. Estimated Delivery Period: N/A
14. Transaction Eligibility Date: N/A
15. Commodities Financed

16. Permitted Source		17. Estimated Source	
U.S. only		U.S.	
Limited F.W.		Industrialized Countries	
Free World		Local	
Cash	$10,000,000	Other	

18. Summary Description

The purpose of the recommended ESF Cash Transfer Program is to provide emergency balance of payments support to the Government of the Mongolian People's Republic (GMPR) in order to assist in the transition to a market-based economy. The GMPR requires immediate and substantial infusions of foreign exchange in the short-term to prepare for the winter of 1991-1992.

The U.S. dollars provided will likely be used to finance essential goods required to sustain the Mongolian economy and to provide a minimal, although dramatically depressed standard of living. No local currency will be generated.

There is no formal conditionality applied to the Program since the Government is currently negotiating an economic reform program with the International Monetary Fund (IMF). However, the Government covenants to: (a) implement, with due haste, its economic reform program; (b) obtain written approval from A.I.D. prior to purchasing pesticides with Program dollars; and (c) to establish a special account for local currency should there be generations.

"I certify that the methods of payment and audit plan are in compliance with the payment verification policy." APRE Controller

19. Clearances	Date
APRE/DR/PD:GMorris	8/22/91
APRE/GC:MKitay	
APRE/EEM:PDavis	8/23/91
APRE/A:WNorth	8/23/91
PPC/PB:PdelBosque	
FM/A/ENP:RBonaffon	8-29-91
DAA/APRE:GLaudato	8-29-91
STATE/EAP/M:JZaizer	

20. Action

☒ APPROVED ☐ DISAPPROVED

Authorized Signature

Date: 8-29-91

Title: AA/APRE: Henrietta Holsman Fore

AID 1120-1 (5-82) CLASSIFICATION

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GLOSSARY OF TERMS

ADB	Asian Development Bank
BOP	Balance of Payments
CMEA	Council for Mutual Economic Assistance
CN	Congressional Notification
ESF	Economic Support Funds
GDP	Gross Domestic Product
GMPR	Government of the Mongolian People's Republic
IBRD	International Bank of Rural Development
IMF	International Monetary Fund
MTI	Ministry of Trade and Industry
OAR	Office of the A.I.D. Representative
PAAD	Program Assistance Approval Document
PRC	People's Republic of China
TAF	The Asia Foundation
USSR	United Soviet Socialist Republics
WB	World Bank

I. EXECUTIVE SUMMARY

Secretary of State James Baker announced a $10 million ESF cash transfer to the government of the Mongolian People's Republic (GMPR) in early August 1991. The purpose of the Mongolian ESF Cash Transfer Program (438-K-601) is to provide emergency balance of payments support to the GMPR at a time of economic crisis unparalleled in the country's history. As the government begins a historic transition to a market-based economy, there has been a near total collapse in trade and aid relations with the Soviet Union, formerly its principal benefactor. Without immediate and substantial infusions of foreign exchange in the near future, the Mongolian economy threatens to decline out of control posing serious risks to social and political stability.

The ESF cash transfer program will be implemented by the Ministry of Trade and Industry (MTI) in coordination with the State Bank of Mongolia (International). Dollars provided under the program will most likely be used to finance essential raw materials, intermediate goods and spare parts required to sustain economic production of basic light industrial goods as well as to maintain an already depressed standard of living for Mongolians as winter approaches.

This ESF cash transfer program is part of a comprehensive emergency assistance package for Mongolia. The principal donors involved, in addition to A.I.D., are the International Monetary Fund (IMF), World Bank, Asian Development Bank and the Government of Japan. Bank assistance will be provided through loans in an amount of approximately $50 million, provided the GMPR and IMF conclude negotiations of a standby agreement favorably. In addition, the Japanese government is preparing to make available between $11 and $20 million. This package (including the Soviet barter arrangement) provides slightly more than the minimum amount of foreign exchange required by the GMPR to survive through winter, yet is a fraction of the estimated $310 million required in the coming twelve months.

Although the U.S. is the preferred source of goods financed by this program, special arrangements have been made to permit the procurement of goods from the Soviet Union. This is in recognition of Mongolia's virtually total reliance on the Soviet Union for industrial infrastructure and spare parts. Congress has been notified of this through the formal notification process as well as supplementary correspondence with the Secretary of State directly.

A.I.D. oversight for the program will be shared between the APRE bureau and the soon-to-be-established OAR/Ulaanbaatar. The accounting station for this program is AID/W/FM/A/PNP.

A financial assessment team examined the procedures used by the GMPR to account for foreign currency, and tracked sample procurement transactions used by the government. This assessment found that adequate controls exist to assure proper accounting for the funds. However, it is recommended that A.I.D. provide for PD&S funding for periodic monitoring of transactions during at least the first two three-month reporting periods in addition to audits.

No local currency will be generated under this program and no additional local currency program is desired. This is consistent with Section 575(a) of the Appropriations Bill. In the event that local currency is generated, A.I.D. and the GMPR will jointly program the proceeds.

The Agreement for the ESF cash transfer program will be signed in late August, assuming Congressional approval. The Agreement will expire one year hence. Formal conditionality is restricted to those conditions required of all cash transfers i.e. the establishment of a special non-commingled account. A.I.D. is confident, based on discussions with the GMPR and international donor organizations (IMF, UNDP, World Bank), that the process of economic liberalization is progressing on schedule.

II. INTRODUCTION

Mongolia has a rich and proud history dating back to the 13th century when, under the leadership of Genghis Khan, it controlled much of Asia and Europe. However, during the period between the 17th century and today, Mongolia has been dominated by either China or Russia. Beginning in the 17th century until 1911, Mongolia was a feudal society administered by the Manchus. When the Manchu Dynasty fell in 1911, Mongolia attempted to establish its independence from China, receiving limited political and military aid from Russia. Conflict between China and Mongolia intensified when Mongolia tried to unite all areas ethnically Mongol (which include parts of China and Russia) and Russia's own political interests precluded her giving more than minimal aid. A transitional period ensued leading up to 1921, when the Revolutionary Party held Mongolia's first Congress on Soviet territory and formed a provisional revolutionary government. Up until 1990, the Soviets maintained a strong influence, dominating Mongolian politics and economic development.

In 1990, Mongolia held its first democratic elections. The Mongolian People's Revolutionary Party gained a strong majority on a platform of economic reform and the transition to a free-market economy applied by traditional Mongolian principles. This move is largely attributed to the collapse of trade and aid with the Soviet Union. Prior to 1990, Mongolia's economy focused almost exclusively on the Soviet Union and Council for Mutual Economic Assistance (CMEA) countries. As will be described below, the changes resulting from this reorientation have left Mongolians and their economy reeling.

The U.S. Secretary of State visited Mongolia in 1990 to encourage the progressive changes taking place within government. This resulted in the initiation of a small assistance program to provide technical assistance and training in the area of privatization. This was followed by an $8 million emergency food aid program under PL480 in response to a projected food shortage and emergency medical supplies. During the Mongolian President's recent visit to the U.S., President Bush indicated a willingness to provide additional resources to help with the economic transition. This assistance was announced by the Secretary of State in a second visit to Mongolia in early August 1991.

The U.S. government's interest in Mongolia lies in strengthening an emerging democracy in its transition to a market economy. Thus, ESF funds are appropriate for this activity. Mongolia's future is dependent upon its ability to create an economic environment which will attract foreign investment. It possesses a well-educated, sophisticated population which is in need of Western market skills. The assistance provided by this cash transfer program is expressly intended as emergency aid to allow the Mongolian government time to implement an important economic reform program in the face of what many believe will be a harsh winter.

III. ECONOMIC ENVIRONMENT, PERFORMANCE AND POLICY[1]

In 1991, the Mongolian economy suffered a decline in real income which rivals the decline experienced in Western countries during the great depression. This shock was precipitated by the abrupt end to longstanding financing from the USSR and the collapse of trade between Mongolia and the USSR. This led to disruptions in industrial and electricity production due to the shortage of essential imported raw materials and spare parts, and the usual decline in economic activity associated with the economic and political transformation from a centrally planned system to a market economy.

The difficulties caused by the economic deterioration in Mongolia are more striking than those of Eastern European countries also experiencing economic and political transformations. In fact, the social and political tensions arising from the economic decline pose a serious threat to the new democracy developing in Mongolia. To combat this, the Mongolian government has committed itself to implementing major economic reforms in the near future. These reforms will be carefully negotiated with the IMF, World Bank, and the ADB. However, bridging financing is critically necessary for the government to have the opportunity to implement the reforms. A financing gap of $310 million is projected for the upcoming 12 month period, of which $233 million is needed to finance the current account deficit. Mongolia has urgent and immediate needs for spare parts, petroleum products, a variety of consumer products, medicines and inputs for the electrical power plants.

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[1] - Material for this section was provided by the Ministry of Finance through a paper entitled "The Urgent Need for Financial Assistance in Mongolia"; 1991.

The GMPR has estimated that it requires $50 million by September 1 in order to prevent a downward spiral of the economy and to maintain social stability until multilateral donors complete their assistance arrangements. The $10 million contribution provided through this PAAD directly addresses these needs. Additional financing will be provided by the World Bank and the ADB in the form of loans, and from the Government of Japan in the form of a grant. Finally, the Mongolian government is arranging to meet certain of its immediate needs through the negotiation of creative and controversial barter agreements with the Soviet Union.

A. Present Economic Realities

During the 1980s, the annual inflows of net foreign receipts on average equaled 30% of GDP. In 1990, these declined to approximately 25% of GDP, and as of January 1, these inflows have completely stopped as a result of the difficulties being experienced in the Soviet Union. This financing, which was provided almost entirely from the USSR, took the form of trade loans (8% of 1990 GDP), financing of turnkey projects (10% of GDP), and financing of equipment purchases (7% of GDP). As a result of this collapse in aid, most investment projects have stopped and many essential parts and equipment for key industries are now unavailable. Further, the imports of consumer goods have sharply decreased.

The GMPR estimates that the decline in real income, measured in US dollars, as a result of this shock is in the range of $275 to $500 million. The actual measure depends upon the exchange rate used to convert from rubles to dollar values. The lower figure is based on the IMF estimate that 25% of Mongolian GDP in 1990 is approximately $275 million. The latter is calculated using estimated world pricing of broad aggregates of Soviet goods as determined by a World Bank study done jointly with some East European governments.

With the termination of the former CMEA trade regime, and the movement to dollar trade, relative export and import prices were substantially revised. In particular, the price of copper fell by 21% relative to the price of petroleum products. As a result of this and other price changes, based on the basket of trade for the first six months of 1991, the Mongolian terms of trade with the USSR declined by 23%. Using 1991 trade volumes during the first five months, this decline means the purchasing power of Mongolian exports in 1991 declined by $72 million (6.6% of GDP) on an annual basis.

The new CMEA trade regime has led to a collapse in the volume of trade conducted between Mongolia and the USSR. Previously, over 85% of Mongolia's external trade was with the USSR, and 41% of internal trade comprised goods of Soviet origin. The decline in this trade has resulted in a 61% drop in imports during the first half of this year, and a 53% drop in exports. The remaining trade is dominated by copper exports and petroleum product imports. Previously, 60% of imports from the USSR were spare parts and equipment; these have now declined to 10% of total imports. Many exporting enterprises, particularly in textiles, carpets, food products, and clothing continue to produce goods but are unable to sell their production. As a result, inventories are rising. Very soon these enterprises will have to reorient their production towards domestic production and Western consumers, or they will be forced to cease operations.

With the decline in trade with the USSR, there is now a severe shortage of parts, raw materials and technical assistance needed to operate state enterprises. For example, electricity production has fallen by 11% in the first half of 1991 compared to the same period in 1990. The drop in production in other key sectors are: coal (2%), fluorspar (68%), cement (20%), knitwear (27%), carpets (34%), leather coats (12%), fresh meat products (38%), tinned meat (68%), bread (5%), dairy products (11%), laundry detergent (62%).

Even without these factors, experience gained in Eastern Europe has shown that the political and economic changes which undergird the movements towards a democratic and free society result in a sharp decline in real incomes and economic activity. This decline began in 1990, but is likely to accelerate in 1991 as the old system is dismantled. Based on experience in Eastern Europe, it is likely that GDP will fall by 5% to 10% in 1991 as a result of this factor alone.

B. Impact of the Shock

The GMPR estimates that the decline in real incomes in Mongolia is equivalent to 40-50% of GDP, or in the range of $450-550 million. These estimates are based on conservative estimates of the value of USSR financing, and take into account the series of shocks which the economy has recently faced. As a proportion of total domestic expenditures (GDP plus net foreign financing), this decline is on the order of 30-35%.

C. Macroeconomic Response

Apart from extreme examples such as wartime destruction, there are no documented examples of countries which have experienced such a sharp decline in real incomes so quickly. This shock is rapidly leading to a collapse of the economic system, and without rapid and careful response, there is a danger that the economy will decline out of control.

The series of shocks has resulted in a loss of budget revenues during the first half of 1991. Trade-based taxes, which previously comprised one-third of budget revenues, have fallen by half. Corporate income taxes and turnover tax revenues have also declined. In addition, a portion of the financing from the USSR was applied to government investment expenditures, and this financing has completely disappeared. The result is a budget deficit which at an annual rate is predicted to equal 25% of GDP (roughly six to seven times the magnitude of the US budget deficit).

The budget deficit is being financed by money creation. During the first five months of 1991, base money increased at an annual rate of 127% and during April and May, base money expanded at a 211% annual rate. As a result, the value of the Tugrik has depreciated by approximately 100% in the last half year, and the economy is becoming rapidly "dollarized." The State has maintained fixed prices for most essential commodities, and due to lower imports and production of these goods, in combination with the expansion of the money supply, severe shortages have resulted.

To guarantee that families receive adequate amounts of essential products, the government has temporarily introduced ration coupons for the basic foodstuffs since January. The government has managed to maintain adequate levels of consumption and production through imports of key products during the first half of this year, but as a result, foreign exchange reserves have fallen from $50 million on January 1 to approximately $25 million, and creditors have begun demanding advance payments and deposits in order to maintain credit lines. It appears there are now approximately $37 million in net outstanding payments due on trade in the first half of this year. The stock of petroleum product reserves has declined to two weeks supply.

D. Balance of Payments Projections and Financing Needs

The GMPR has made preliminary balance of payments projections for the twelve-month period beginning September 1. The projection is based on the assumption that a comprehensive economic reform program is introduced, and that financial assistance will be provided to guarantee minimum basic essential consumer goods, spare parts and raw materials. Underlying this projection are the following assumptions:

1. The level of seasonally adjusted imports in the first half of 1990 is maintained on an annual basis for this projection, with additional imports of urgently needed spare parts, raw materials, and consumer goods as discussed with the ADB and World Bank ($156 million). These are considered to be the minimum needs to maintain essential supplies of consumer goods, and to prevent a collapse of industrial production due to shortages during the next twelve months. This gives rise to $536 million of projected imports.

2. The reform measures result in a substantial rise in exports over the course of the year, but the growth is gradual and may accelerate. By the end of the twelve month period, exports are 20% above current levels, and on average 10% above current levels.

3. The current arrears on trade payments are made before the end of 1991 (estimated at $37 million).

4. There is no servicing or principal payment on debt to the USSR and other former CMEA countries. If payments are made, then the financing gap could increase significantly.

5. A gradual accumulation of reserves is permitted. Currently, reserves amount to $25 million[2], which is equal to 0.5 months imports. By September 1, 1992 reserves reach $65 million or 1.6 months imports, which is still considerably less than the generally accepted level of 3 months imports needed to guarantee BOP stability.

Based on these assumptions, the financing gap from September 1, 1991 to September 1, 1992 is $310 million. This gap represents approximately 62% of the decline in real incomes which the economy has recently suffered as discussed above. The actual financing used to support essential imports is $233 million, and equals 46% of the measured income decline; the remaining $77 million is held in reserves.

IV. PROGRAM CONCEPT AND STRUCTURE

The purpose of the proposed ESF program is to provide balance of payments support as a demonstration of USG support for the GMPR's economic transition to a market-based economy. Due to the economic crisis in Mongolia, substantial foreign exchange infusions are required in order for the government to continue its privatization and other economic reform efforts.

A. Donor Coordination

The ESF cash transfer program represents a critical part of an emergency package from a variety of donor organizations. These are presented below.

1. The Soviet Union - The GMPR prefers to obtain spare parts for the thermopower plants and the bulk of petroleum products from the Soviet Union through barter agreements in exchange for livestock and copper. This includes approximately $15 million worth of essential goods. At this time, the GMPR refuses to consider paying the Soviets for these goods in foreign exchange despite strong encouragement to do so. This results from the longstanding relationship and the belief that any foreign exchange provided will only result in a reduction of Mongolia's debt rather than the delivery of commodities. The barter arrangement is very controversial and is the subject of intense GMPR negotiation. There are hopeful signs, such as the fact that the Soviet Union has

[2] - This figure has been disputed by the IMF, which says actual foreign exchange reserves range from $0 to $75 million. Nonetheless, foreign exchange reserves remain critically low when compared to the import requirements of the economy.

signed similar arrangements with Eastern European countries. Nonetheless, past experience does not bode well. In the event that the negotiations are unsuccessful, the GMPR will make an appeal to the Japanese.

2. Government of Japan - Independent of the Soviet barter goods, the Japanese government will finance the procurement of heavy duty trucks, bulldozers and explosives for the mining sector. This package is valued at approximately $11 million. However, as mentioned above, the GMPR will request additional support in the event that the planned Soviet barter trade falls through. There is no evidence to suggest that the Japanese will respond.

3. ADB and the World Bank - The Asian Development Bank and the World Bank are preparing to make available loans of approximately $25 million to the GMPR contingent upon the favorable conclusion of a standby agreement with the IMF. Although both organizations are in the early stages of negotiations with the GMPR, they require that these funds be used principally to support the production of export products through procurement of raw materials and spare parts. This is in order to increase the probability of timely repayment. ADB and World Bank assistance will not be available until November at the earliest due to the approval processing. Hence, these funds will be of marginal value in preparing for winter.

4. A.I.D. - The purpose of the cash transfer is to provide emergency balance of payments support to the GMPR. Based on discussions with Government officials, we understand that they propose to use the dollars provided through the cash transfer program to finance imports, such as raw materials, intermediate goods and spare parts essential for the maintenance of an already severely reduced standard of living but one which will be tolerable in terms of mitigating possible political and social unrest. The cash transfer program is perhaps the most responsive to the Mongolians' survival this winter. This is due to the fact that: (a) U.S. assistance is the only source of funds immediately available; (b) it is grant as opposed to loan aid; (c) it is the most flexible program in terms of goods and source and does not dictate GMPR priorities. Consequently, the proposed program has received wide and favorable publicity in Mongolia. The GMPR is aware that this program requires AID/W and congressional approval.

Owing to the difficult logistical situation Mongolia faces and the fact that its entire industrial infrastructure is of Soviet origin, the dollars provided under this cash transfer may finance selected industrial goods from the Soviet Union. This "safety net" was recommended by A.I.D. and the Embassy in the event that the barter and Japanese options fail to materialize, and appropriate Congressional consultations have taken place.

The cash transfer program addresses the two principle concerns of the government in implementing its reforms: (1) maintaining economic activity and employment in the short term; and (2) providing essential items which are required to maintain social and political stability in the short-term. The cash transfer will enhance the political stability in the short term to permit the Mongolian government to continue implementation of its economic transition program. Specific reforms are discussed in Section VII Conditions Precedent.

B. Implementation Arrangements

The Ministry of Trade and Industry (MTI) is the implementing organization for this program, as designated by the Ministry of External Affairs. Specific responsibility for this program will reside in the Department of Foreign Trade within MTI. MTI's role in implementation is presented below:

1. Coordinating Ministry for reporting to A.I.D. - Reports will be provided to A.I.D. by MTI. It is understood that the State Bank and trading companies will submit necessary documentation to MTI for compilation on a quarterly basis.

2. Approval of Individual Transactions - MTI will select trading companies to procure priority goods. Prior to establishment of a letter of credit for a trading company, the State Bank of Mongolia requires the written approval of MTI.

C. Local Currency Determination

No local currency is generated through this Agreement. U.S. dollars will most likely be used to finance goods for the use of the GMPR and state-owned industry and enterprises. While this is perhaps inconsistent with the long-range strategy being developed for USAID/Ulaanbaatar, it is recognized that meeting the emergency needs of the government, as well as supporting the government's economic transition program, require flexibility in this regard. For example, most state-owned industries will be privatized, but this will take place in a phased approach over several years. Therefore, support to individual private enterprises at this time would cripple the cash transfer program.

V. ESF DOLLAR PROCEDURES

The proposed ESF program will consist of $10 million of FY 1991 funds. The funds will be disbursed into a separate, non-commingled special account to the State Bank of Mongolia's (International) U.S. correspondent back in one tranche. The GMPR has advised us that the US dollar resources will be used to finance essential goods required to sustain the Mongolian economy through the winter of 1991-1992. These include raw materials for light industry/food industry, industrial oils, and medicines and medical supplies.

The following goods and services are ineligible for reimbursement:

* Commodities financed by A.I.D. under PL-480
* Technical services financed by A.I.D. or any other Agency of the U.S Government
* Pesticides
* Fertilizer
* Passenger cars
* Firearms, explosives and ammunition
* Rubber compounding chemicals and plasticizers
* Military equipment
* Police equipment
* Weather modification equipment
* Surveillance equipment
* Luxury goods (such as gold, silver, coins/stamps, alcoholic beverages, jewelry, and fine furs)
* Abortion equipment
* Gambling equipment
* Non-durable consumer goods

The U.S. is the preferred source for eligible imports, although it is acknowledged that difficult logistical barriers will likely prohibit emergency procurement from the U.S. at this time. Goods purchased under this agreement will most likely come from Singapore, Korea, the United Kingdom and the Soviet Union. The GMPR understands that under no circumstances will U.S. dollars be used to finance goods from China or Eastern Europe.

U.S. dollars will finance the C.I.F. value of the goods delivered to the Mongolian border. U.S. dollars may not be used for the purpose of paying commissions or fees to trading companies in Mongolia.

The Agreement date is estimated to be on or about August 30, 1991.

A. Procurement from the Soviet Union

It is fair to say that virtually the entire industrial infrastructure of Mongolia was provided by the Soviets or other CMEA countries. This is particularly true of the mining and power generation sectors, but also includes telecommunications, transportation and other manufacturing sectors. The maintenance and subsequent replacement of this infrastructure from Soviet to Western sources is a long-term process and will be contingent upon the ability of the GMPR to attract foreign investment in the form of joint ventures (i.e., the Japanese are negotiating on the installation of a new telecommunications system.) In order to assist the GMPR to keep the economy functioning, procurement of industrial spare parts is essential. Consequently, this PAAD proposes to include the Soviet Union as a possible source for specific equipment. A.I.D.

has taken appropriate steps to ensure that this is well understood by Congress in advance of the approval of the PAAD. This has been achieved through the formal notification process, which included a message from the Secretary of State, as well as specific discussions between the Secretary of State and appropriate members of Congress.

B. Method of Payment

A.I.D. proposes to use the Direct Payment and the Reimbursement Method of Payment for eligible goods. Both are among the preferred methods per A.I.D. guidance. Under the direct payment method, the GMPR will utilize funds in the separate account upon presentation of eligible import documentation to the Mongolian State Bank (International) under standard Letter of Credit instructions. The GMPR utilizes funds from the Separate Account by authorizing commercial banks, through instructions provided with the Letters of Credit, to pay for eligible imports procured by registered trading companies. A.I.D. and the GMPR agree that a re-deposit to the separate account will be made for funds incorrectly applied to a disallowed use, thus permitting funds to be reprogrammed for allowable uses. This determination will be made during periodic reviews conducted by OAR/Ulaanbaatar or his designee.

Under the reimbursement method of payment, the GMPR will use its own funds to pay for eligible transactions. Prior to withdrawing or transferring funds from the dollar account, the Mongolia State Bank will submit to the A.I.D. Representative in Ulaanbaatar a list of paid transactions for which it requests reimbursement. A.I.D. will review and approve the transactions for financing. The Mongolian State Bank will then proceed to reimburse itself from the special account.

Most transactions under the cash transfer are likely to be through the direct payment method due to a lack of foreign currency reserves.

Prior to the disbursement of any dollars, the Bank will submit to A.I.D. the operating procedures for the separate bank account (See Conditions Precedent). The procedures will include a statement that the bank has opened a separate non-commingled dollar account in its correspondent U.S. bank or in the U.S. Federal Reserve Bank. As noted above, dollar payments are to be made by direct payment or reimbursement. The Bank will submit quarterly reports through the Ministry of Trade and Industry which include monthly copies of correspondent bank statements showing the account's activities and a reconciliation with the Mongolian State Bank's accounting balance. The documentation supporting the disbursements from the special account will be subject to review by authorized A.I.D. personnel.

C. Program Monitoring

The soon-to-be-established OAR/Ulaanbaatar and APRE are jointly responsible for monitoring the cash transfer program. General implementation (PAAD approval, PILs, etc.) will be the responsibility of APRE/DR. Upon approval of the PAAD and obligation of the funds through a grant agreement, APRE will await information regarding the establishment of a special account with the State Bank of Mongolia (International) correspondent U.S. bank. At that time, the APRE Controller will verify the transfer of funds in coordination with FM/A/PNP to this account. The APRE Controller will also make provision for periodic review of transactions under the program to ensure that no ineligible transactions are being financed with the A.I.D. dollars. There are several options for this periodic review, a process which is necessary as there is no prior experience with the GMPR: (1) TDYs of AID/W Controller staff for a period of approximately two weeks each quarter; (2) TDYs of staff from the appointed accounting station, should this occur in the near future; and (3) follow-up accounting assistance through an IQC firm (US or Manila). Whichever alternative is selected, the Controller will prepare and issue a financial report on the results of these reviews.

D. Audits

The Inspector General of A.I.D. will be requested to schedule audits to determine compliance with the terms of the Agreement and proper use of the funds. The APRE Controller will make periodic financial reviews in order to ensure that the funds are properly managed and accounted for. In addition, external auditors may be contracted to perform nancial reviews or audits of the dollar transactions. Such audits must be performed annually and must be in accordance with GAO auditing standards. Funding for these audits may be obtained from Project Development and Support (PD&S) funds for Mongolia.

E. Local Currency

Section 575(a) of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1991 requires the Agency to take steps to assure that local currency generated by the use of dollars provided under ESF, CIP and cash transfer programs is deposited in a separate account and managed in accordance with specified requirements "if assistance is furnished to the government of a foreign country . . . under agreements which result in the generation of local currencies of that country, . . ." A.I.D. has examined the Mongolia ESF cash transfer program and finds that the assistance dollars provided will not directly and foreseeably result in the receipt of local currency by the Mongolian government. The items to be financed by the GMPR with the dollars are for the GMPR itself and will be used for the purpose of abating the emergency facing Mongolia.

Referencing a legal opinion prepared by John Mullen, Deputy General Counsel, in March 1991, the Mongolian cash transfer does not appear to generate local currency as the flow is principally an internal account transaction from the Mongolian State Bank (International) to the state trading companies to the various state enterprises rather than a "tangible flow" of currency to the host government.

There are also compelling macroeconomic reasons to avoid the generation of local currency under the cash transfer program. It has been demonstrated that the government is experiencing a severe and growing domestic budget deficit. Should local currency counterpart funds be required, this will simply result in the printing of money, thus exacerbating an already serious hyperinflationary problem.

VI. FINANCIAL ASSESSMENT

APRE contracted the services of Sycip, Gorres, Velayo & Co. (SGV Consulting) through USAID/Manila to perform a financial assessment of the GMPR's ability to account for the dollars provided under this program. SGV examined the accounting practices of the State Bank of Mongolia (International) which was recently split off from the State Bank of Mongolia. In addition, SGV examined the procurement procedures utilized by GMPR ministries and tracked sample transactions for their adherence to standard procurement practices. The findings are presented below, abstracted from the full report which is held in the official files.

Based on the proposed system for the implementation of the cash transfer program and the responsibilities of each of the four participating entities in the program, the assessment found that the internal controls existing in the identified organizations with respect to the safeguarding of bank deposits and the procurement of imported commodities are reasonably sound and may be relied upon.

A. State Bank of Mongolia (International)

As the intended custodian of the special U.S. dollar account, the State Bank of Mongolia (International) follows internal procedures similar to the internationally accepted practices of commercial banks. There is adequate segregation of functions within the Department of Trade and Finance, the organizational unit within the Bank which will administer the account. In addition, there are reasonably sound internal accounting controls because the Department follows the widely accepted practice of balancing transactions at the close of each business day. This balancing procedure is subsequently checked by a separate accounting department. Furthermore, disbursements out of foreign currency deposits maintained by the Bank with its correspondent banks abroad can only be made when authorized by two signatory officers of the Bank. Finally, cabled or telexed instructions to foreigr depository banks are handled by a separate cable section which is under the Bank's treasury department.

B. Trading Companies

The procurement procedures of two sample trading companies, the Mongolimpex and the Mongolemimpex, were reviewed and assessed. These companies provide services to government entities in the importation of commodities. Mongolimpex has specialized in the importation of a wide range of products from Western nations as well as Japan, South Korea and Singapore. Mongolemimpex handles the importation of pharmaceuticals which are distributed to hospitals and pharmacies.

Both trading companies follow similar procurement procedures and have been in operation since 1984 and 1936 respectively. Mongolemimpex, which continued the work of the former Pharmaceutical Administration, adopted its current company name in December 1990. Both companies generally procure commodities from the better known and established suppliers and, as a rule, request quotations from three to five foreign suppliers. In both cases, adequate segregation of function exists among purchasing, inspection, and storage/distribution of imported commodities.

C. Ministry of Trade and Industry

As the overall coordinator of the implementation of the cash transfer program, the Department of Foreign Trade within the Ministry of Trade and Industry (MTI) will be responsible for allocating the importation of necessary commodities under the grant to the various trading companies, reviewing and approving all applications of the trading companies for the opening of letters of credit with the State Bank of Mongolia (International) in connection with the importation of the eligible commodities, and preparing the consolidated quarterly report on the implementation of the cash transfer program for submission to the USAID Representative in Ulaanbaatar.

The Department of Foreign Trade has been screening all applications for the opening of letters of credit for commodity importations in order to confirm that the commodities ordered are among the GMPR-approved priority items and also that adequate foreign currency allocations have been provided. The review function provided by the Department under this program is merely an extension of its present work. Approval by the Department will also serve as an authorization to the State Bank to effect disbursements from the Special Account.

D. Recommendations - The assessment identified two potential weaknesses. These do not preclude approval of the program, but should be addressed in the future as the government increasingly conforms to Western business practices. The first is the absence of an independent review of operations and financial transactions either by an internal review group or by an external contractor. Consequently, it is recommended that implementation of the Cash Transfer Program be reviewed by an independent organization soon after the first quarterly report is submitted. The second weakness noted by the assessment is the lack of written functional charts, job descriptions, and activities related to the procurement process. Without this foundation, it is difficult if not impossible to trace accurately procurement transactions.

VII. CONDITIONS PRECEDENT AND COVENANTS

Formal conditionality for the proposed ESF cash transfer will consist of only those items required by U.S. law to effect the transfer. It is the view of A.I.D. that the GMPR is moving with due speed in the transition to a market economy. This is due to the irreversibility of Mongolia's relationship with the Soviet Union and the mandate of the government as demonstrated by the elections.

A. Reform Progress

Several important changes have already taken place which are indicative of the GMPR's commitment to reform. These changes were recommended by, among other, Harvard economist, Jeffrey Sachs and the IMF as critical to the transition process. Firstly, a central bank has been created with appropriate powers to control money supply. This comprises one part of the new banking law which was passed in May of 1991. Although the government has only recently begun to implement the law, it provides for a solid banking foundation. In addition, the government has raised the exchange rate from $1=7Tk to the present 1$=40Tk at the advice of the IMF. Finally, the government has passed a privatization law which gives citizens the right to buy properties under state control. The government has also established a stock exchange which will facilitate the privatization of Mongolia's state enterprises. Vouchers have been distributed to all Mongolians, and stock brokers are being trained. A number of small enterprises have already been privatized and the government has reintroduced the private ownership of livestock. Although some of the changes introduced are marginal to the real transitional reforms, they document the willingness of the government to make structural economic changes.

Negotiations with the IMF have been in progress since May, 1991, and are near completion. These negotiations are critical for the government's future financing from the World Bank and the IMF. A.I.D.'s understanding of the recommended reforms includes the following items:

1. Price Liberalization - The IMF will certainly recommend that the GMPR liberalize prices. Although the government is unwilling to liberalize all prices simultaneously, it is expected to liberalize prices on a small number of commodities in the near future, such as meat and flour.

2. Exchange Rate - The IMF approves of the recent increase in the rate of exchange, but will recommend that this exchange rate apply to all transactions, and not, as the government has implemented, only to commercial transactions with the West (the Soviet Union still enjoys a $1=3Tk rate).

3. Budget Adjustment - The IMF will recommend that the government reduce expenditures in certain sectors of the economy. Parliament will consider this recommendation when it reconvenes in September.

4. Decrease Credit/Increase Interest Rates to Private Sector - The IMF will recommend that the government banks increase the interest rate charged to the private sector to decrease lending (interest rates are currently approximately 4%). The government is considering this recommendation in light of what it believes to be necessary incentives for the private sector.

5. Salary and Wage Controls - The IMF will recommend that the government maintain salary and wage levels for public sector employees. The government is concerned that liberalization of prices will require wage increases to maintain what is an already depressed standard of living, and is, understandably, concerned about the political ramifications.

It is too soon to judge the success of the economic transition, or even whether the tools recommended by the IMF will be appropriate for Mongolia. The government stresses in its meetings on the subject that the economic transition should permit a Mongolia-model to evolve rather than an emulation of Poland or other Eastern European experiences. The government is committed to the transition, but insists on tailoring the recommendations to Mongolia. Nonetheless, GMPR performance over the next twelve month period will play an important role in conditioning future donor assistance.

B. Conditions Precedent

The Agreement will contain one CP, as required by law, to the effect that:

Prior to the disbursement of funds, the GMPR will establish a separate account in a correspondent U.S. bank, and advise A.I.D. in writing. Funds in this account and interest earned on these funds may not be commingled with other funds of the GMPR.

The State Bank of Mongolia (International) is investigating possible U.S. correspondent banks now, and will select the bank which gives the most favorable terms. Relationships exist with both Chase Manhattan and Riggs banks.

C. Covenants

As discussed above, A.I.D. wishes to reinforce the importance of moving quickly on the economic transition. The program agreement will require the GMPR to represent that it is carrying out, with due haste, its economic reform program based on free market principles, as negotiated with the International Monetary Fund (IMF)."

In addition, environmental regulations prohibit the purchase of pesticides without first performing an environmental assessment and obtaining the approval of the Bureau Environmental Officer. Therefore, the following additional covenant is proposed:

> Funds provided under this Agreement will not be used to purchase pesticides without an environmental assessment and the prior, written approval of A.I.D.

Finally, it is necessary to covenant the procedures for programming local currency should there be generations resulting from the cash transfer. Although it is unlikely to occur, it is important to reinforce the need to account accurately for the funds as well as the goods financed by the program. Hence, a covenant will be added to the effect that:

> Should local currency be generated through the sale of goods financed by the Agreement, the GMPR will open a special account into which the proceeds will be deposited. The local currency will be jointly programmed by the GMPR and A.I.D.

ANNEX ONE

ENVIRONMENTAL THRESHOLD DECISION

Country	:	Mongolia
Title	:	Mongolia Cash Transfer
Program Number	:	438-K-601
Funding	:	$10 million
Life of Program	:	FY 1991 (one year)
IEE Prepared	:	Denny Robertson, APRE/DR/PD
Recommended Threshold Decision	:	Categorical Exclusion
Bureau Threshold Decision	:	Concur with Recommendation
Comments	:	None

M. Kux

Molly Kux, APRE/DR/TR
Bureau Environmental Officer

8-23-91

Date

cc: APRE/DR/PD
OAR/Ulaanbaatar
file

INITIAL ENVIRONMENTAL EXAMINATION

Country	:	Mongolia
Name	:	Cash Transfer Program
Program Number	:	438-K-601
Funding	:	$10,000,000
Life of Program	:	FY 91
IEE Prepared by:	:	Denny Robertson, APRE/DR/PD

Recommended Threshold Decision:

a. Recommendation

This program consists of a cash transfer to provide balance of payments assistance to support the economic transition of Mongolia. Funds from this program provide balance of payments assistance in support of the Government of the Mongolian People's Republic (GMPR) economic reform program currently being negotiated with the IMF. The dollars will likely be used to assure supplies of essential imports of commodities need to maintain industrial production and a minimum standard of living during the winter 1991-1992. No local currency will be generated by this cash transfer. Availability of funds under this program is contingent upon compliance with the conditions mutually agreed upon between the GMPR and A.I.D.

Pursuant to A.I.D. environmental regulations [22 CFR 216.2(c)(1)(ii)], an IEE is generally not required when:

> "A.I.D. does not have knowledge of or control over, and the objective of A.I.D. in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities, knowledge of or control over, the details of the specific activities that have an effect on the physical and natural environmental for which financing is approved by A.I.D."

Moreover, Handbook 3, Chapter 2, Appendix 2D, Section 216.2(c)(2)(vi) states that "contributions to international regional or national organizations by the United States which are not for the purpose of carrying out a specifically identifiable project or projects" are not subject to A.I.D.'s environmental procedures. The above exemptions do not apply, however, to assistance for the procurement or use of pesticides.

The FY 1991 ESF Cash Transfer Program will not provide support for the import, purchase or use of pesticides. A condition will be placed in the program agreement between the GMPR and A.I.D. that no pesticides will be procured or used without first doing an Environmental Assessment and having it approved by the APRE Bureau Environmental Officer.

Based on A.I.D. regulations in Handbook 3, Chapter 2, it is recommended that no further environmental studies be undertaken for this PAAD and that a "Categorical Exclusion" be approved.

Concurrence: ______________________
Thomas Nicastro, Chief
APRE/DR/TR

ANNEX TWO

PAAD Design Contacts

Deputy Prime Minister Ganbold

Ministry of External Affairs
- C. Battomor, America and Europe Desk
- M. Baasan, Policy Planning
- Dr. Namjim, Economic Affairs

Ministry of Trade and Industry
- R. Baayanbaatar, Minister
- G. Doyod, First Deputy Minister
- M. Batsaikahn, First Deputy Minister for Foreign Trade
- M. Yondon

Mongolia State Bank (International)
- B. Saran, Deputy Director General
- A. Minzh, Director of Trade Finance

Mongolimpex
- A. Buyandelger, Export Division

International Monetary Fund
- Mr. Kunio Saito, Mission Chief

IRIS Team
- Dr. Peter Murrell, Chief of Party
- Mr. Chas. Cadwell

World Bank
- Mr. David Pierce, Mission Chief

Harvard University
- Mr. Peter Boone, Team Leader

UNDP
- Mr. Enrique Lerdau, Consultant
- Ms. Gail Stevenson, Consultant
- Mr. Ed Mattes, UNISTAR Consultant

U.S. Embassy

Ambassador Joseph Lake
Kim Kirkman, Intern
Jane Dietze, Intern; Johns Hopkins School of International Studies