Foreign Direct Investment in Mongolia

An Interactive Case Study

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Foreign Direct Investment in Mongolia: An Interactive Case Study

This Case Study focuses on foreign direct investment (FDI) in a developing country context. The Case Study is designed to fit into the framework of a multi-day (e.g., weeklong) Trade and Investment Training Course for USAID Economic Growth Officers. It assumes that the Training Course would include approximately three modules to address the role of FDI in the developing world, i.e., current characteristics, benefits and costs, possible future directions, and key issues in FDI promotion. It further assumes that the course would be made up of 20 or so participants, all with field experience in USAID program design and implementation, and that the Course would be led – for FDI segments – by a facilitator and/or presenter(s) familiar with FDI topics.

OBJECTIVES

Within the Training Course structure outlined above, Case Study - Mongolia FDI has three objectives. It intends to help participants become better able to:

- Understand FDI as a possible driver in economic development.
- Analyze the types of constraints that discourage FDI or dilute its benefits.
- Define the kinds of practical actions that donor programs might support to stimulate FDI and maximize its impacts.
- To make the experience more realistic, the Case Study pursues these objectives in the context of the real-world economy of Mongolia, a low-income country whose needs, attractions and disadvantages for FDI are striking, and thus likely to stimulate interest and useful discussion among participants.

APPROACH

In order to encourage participants to consider the technical issues of FDI from multiple perspectives, the Case Study adopts a role-play approach. Participants will first be asked to divide themselves up into three Working Groups. Each Working Group will then assume a different identity in addressing Mongolia's FDI situation, namely: Government of Mongolia policymakers, foreign business people, or USAID technical experts/program planners.

A Case Study Scenario and Terms of Reference, provided below, set the stage and outline the tasks to be accomplished by Working Groups. Note, however, that the key deliverable for each Working Group will be a concise oral presentation highlighting its perspective on FDI for Mongolia. Three pauses will be built into the schedule of the Trade and Investment Course, and at each, one Working Group will be called upon to offer its presentation to the other Course participants.

Several documents on Mongolia's economy, private sector and business environment are provided as references for the Working Groups. It is assumed that the USAID Resource Guide ***Foreign Direct Investment: Putting It to Work in Developing Countries*** (February 2007 edition) is also available.

CASE STUDY SCENARIO

Ever since the Trade and Investment Framework Agreement (TIFA) between Mongolia and the United States entered into force in July 2004, the Mongolian government – and foreign companies presently doing business in Mongolia – have been keenly interested in advancing toward signing a full US-Mongolia Free Trade Agreement (FTA). These parties believe that an FTA with the US will improve business conditions and economic performance in Mongolia, stimulate trade and investment with the US and encourage greater engagement in Mongolia on the part of other economic partners. Presentations and discussions at the ***Mongolia Investor Forum***, sponsored by the ***Institutional Investor*** in New York in late March 2007, served to further underline the value of a future FTA with the US as an ingredient in a steadily improving future investment picture for Mongolia.[1]

Accordingly, Mongolia's policy makers and business leaders want to be proactive, and demonstrate to the US (and to the international business community generally) that Mongolia sees an important strategic role for FDI in its development, offers foreign investors some very attractive opportunities, and is prepared to undertake real reforms to enhance its appeal as an FDI host economy. In doing so, these policymakers and business leaders believe they will both begin to make the case for an FTA with the US – at least as far as investment matters are concerned – and at the same time help stimulate FDI interest domestically and overseas. As a first step, the Government of Mongolia (GoM) and the North American-Mongolia Business Council (NAMBC) have jointly organized a seminar, to be billed as a ***"Public-Private Dialogue on FDI for Mongolia,"*** to discuss Mongolia's critical FDI issues in an open and objective manner. The seminar will run for two days, and will be held in Ulaan Baataar. Attending this ***"Dialogue"*** will be a range of key GoM officials concerned with economic management and development planning, senior resident managers of the companies (both domestic and foreign) that are members of the NAMBC, and select representatives of USAID (and other leading donors) known for their expertise and experience in planning and executing economic growth programs.

You have been invited to participate in the ***"Dialogue"*** seminar. You will do so in your capacity as a GoM policymaker, senior business person, or donor agency technical expert-program

[1] The March 2007 Mongolia Investor Forum was an actual event. The Public-Private Dialogue on FDI in Mongolia is a fictitious event created for this case study.

manager. Apart from listening to presentations and contributing to the overall discussions of the seminar, the ***"Dialogue"*** organizers expect you to join those colleagues whose professional profile is like yours and form a Working Group within the seminar – i.e., separate Working Groups for GoM policymakers, NAMBC business people, and USAID technical and program experts. The core work product of your Working Group will be a presentation that you and your colleagues make to the seminar as a whole, addressing critical FDI issues for Mongolia from your professional perspective. Of course, these presentations will need to be fact-based, so the ***"Dialogue"*** organizers have assembled a range of important documents for your reference. Good luck!

TERMS OF REFERENCE FOR WORKING GROUPS

"Dialogue" organizers have outlined a general Terms of Reference for each Working Group to help focus the application of your expertise as you consider Mongolia's FDI flows and prepare your presentation. Note that each Working Group has a different core theme around which to perform its analysis and develop its perspective on Mongolia's FDI needs and prospects. Also, in line with your theme, ***"Dialogue"*** organizers have also posed a few strategic questions for you to think about as you develop your presentation, but you will want to amend or broaden this list based on your own insights.

1. GOM Policymakers

Core theme: Outline what you see as the strategic development role FDI has played in Mongolia's economy, and how that role might evolve in the future.

Key questions:

1. What have been Mongolia's recent FDI trends and how have these related to the pattern of domestic investment generally? Is this pattern typical for developing countries?
2. Looking across sectors, what have been FDI's likely development impacts? Where are the greatest future opportunities to harness FDI for Mongolia's growth and development, and why?
3. Are current and future global drivers of FDI (e.g., rise of service sector FDI, private participation in infrastructure, demise of Multifibre Arrangement, etc.) likely to have any relevance to Mongolia?
4. Given projected future opportunities, what will be the development benefits of FDI, on a sector-by sector basis? Where does/should FDI fit as a tool in poverty reduction strategies for Mongolia? Have FDI inflows to Mongolia created important economic or social costs?
5. What has been Mongolia's strategy in promoting FDI?

Presentation: Prepare a presentation for the "Dialogue" seminar around your core theme. Your presentation should be concise – e.g., 6-7 PowerPoint slides – but comprehensive and carefully thought through. The GoM Policymakers' Working Group will deliver the first "Dialogue" presentation.

2. North America-Mongolia Business Council (NAMBC)

Core theme: Outline what you see as the business motivation for FDI in Mongolia's economy and highlight the constraints that business encounters in investing in Mongolia.

Key questions:

1. Which sectors have been the destinations for Mongolia's FDI inflows to date and what have likely been the principal business motivations for this FDI?
2. What are the likely relationships between FDI and trade for Mongolia? Thinking of the East European and Chinese experience with FDI, are there global "network trade"[2] opportunities that FDI might help open up for Mongolia?
3. What are the most salient features of Mongolia's overall investment climate, and what impact might these features have on investment? Several (but not all) of Mongolia's ***Doing Business 2007*** scores are relatively favorable. What impact might each have on FDI?
4. Do you see any particular strengths or weaknesses in critical elements of Mongolia's institutional framework for FDI [e.g., the Foreign Investment Law and Foreign Investment and Foreign Trade Authority (FIFTA)]?
5. Overall, has government policy been helpful in attracting FDI, and how? What kinds of new policy initiatives might be undertaken to further enhance Mongolia as an FDI destination? Where do you see future sources of FDI inflows for Mongolia?

Presentation: Prepare a presentation for the "Dialogue" seminar around your core theme. Your presentation should be concise – e.g., 6-7 PowerPoint slides – but comprehensive, and carefully thought through. NAMBC Working Group will deliver the second ***"Dialogue"*** presentation.

3. USAID Technical Experts-Program Managers

Core theme: Outline what you see as a realistic program of technical assistance, training and other actions that donor agencies should undertake to support Mongolia's FDI goals.

Key questions:

1. What are the priority technical issues for donor agencies to target in supporting GoM and private sector efforts to increase FDI in Mongolia? How do these rank by importance?
2. What is the comparative advantage for USAID as a donor agency "pace-setter" in addressing these FDI issues? And what should be the overall strategy for USAID/Mongolia to adopt to support GoM and private sector efforts to make FDI work for Mongolia's development?
3. What innovative assistance initiatives might USAID/Mongolia design, consistent with overall USAID economic growth goals and strategies, to help the GoM promote FDI in non-traditional sectors (i.e., health and education services)?

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[2] Network trade refers to trade of goods at one or more stages of an international product value chain – for example, production and export of component parts that are used to manufacture a final good (e.g., auto parts), or the production and export of finished goods using imported components (e.g., apparel destined for export that is manufactured with imported fabric).

4. What might a future USAID/Mongolia program look like in outline – objectives, expected results, individual activities, outputs, activity budgets – to support the GoM and the private sector to increase Mongolia's FDI and maximize its impacts for development? (Assume 3-year duration and $5 million in a Mongolia Private Sector Led Economic Growth project.)
5. If the GoM decides to use enhanced tax incentives and development of new industrial free zones as major instruments for Mongolia's FID promotion, might this complicate USAID support in light of US Government policies set forth in ADS 225 (Guidelines for USAID Investment Assistance)? How might USAID/Mongolia proceed in this case?

Presentation: Prepare a presentation for the "Dialogue" seminar around your core theme. Your presentation should be concise – e.g., 6-7 PowerPoint slides – but comprehensive and carefully thought through. USAID Expert Working Group will deliver the third ***"Dialogue"*** presentation.

INVENTORY OF RESOURCE DOCUMENTS

The following are useful reference documents on Mongolia's FDI issues. Document 1 accompanies this text as Appendix I, and documents 2 through 12 are in a companion file as Appendix II.

1. Note on Background to Mongolia FDI Activity (attached as Appendix I)
2. ADB, Mongolia, Key Indicators of Developing Asian and Pacific Countries, 2006
3. IMF, Mongolia, Staff Report for the Article IV Consultation, December 18, 2006
4. ADB, Asian Development Outlook 2006, Mongolia
5. Government of Mongolia, Economic Growth and Poverty Reduction Strategy, Executive Summary
6. World Bank, Mongolia: Promoting investment and job creation, Executive Summary, 2006
7. ADB, Mongolia Private Sector Assessment 2004, Chapter 2, Enabling Environment for PSD
8. ADB, Mongolia Private Sector Assessment 2004, Chapter 3, Sector Profiles
9. World Trade Organization, Mongolia Trade Policy Review, 15-17 March 2005, Chapters 2-4
10. US Embassy, Mongolia Country Commercial Guide, 2005 Chapter 6, Investment Climate Statement
11. World Bank, Doing Business 2007, Mongolia
12. Millennium Challenge Corporation, Mongolia Sample Call Order Statement of Work, 2007

Appendix I: Note on Background to Mongolia FDI Activity

OVERVIEW

Mongolia is a vast, land-locked and sparsely populated nation. Its territory is larger than that of Britain, France, Italy and Germany combined, but it is home to only 2.6 million people, of whom about one-third live in Ulaanbaatar, the capital. Distant from major markets, most of Mongolia's foreign trade must pass through Russia or China, the two powerful neighbors that surround it. Mongolia is also poor: present per capita gross national income is estimated at about $690 per capita, making it a low-income country on the World Bank scale. On the other hand, Mongolia has some real assets. It is resource-rich, particularly in minerals, but also in its unique culture and unspoiled natural environment. Emphasis on education and public health in socialist era has meant that Mongolians are highly literate (over 90%) and enjoy a health status measured by life expectancy, infant mortality and other indicators that surpasses conditions in most other low-income countries. Since abandoning central planning in 1991, Mongolia has made real progress toward transforming itself into a market-based economy and a parliamentary democracy. The result has been an increasing private sector share of GDP – now about 80% of total economic output compared with zero in 1991 – and a series of free and fair elections that have allowed several peaceful transfers of power. Mongolia's continuing development challenge is thus to rapidly raise living standards by finding ways to overcome the constraints of isolation, distance and limitations in home market and population size, while still advancing and deepening economic, social, and political reform.

CURRENT ECONOMIC PERFORMANCE

After a sharp deterioration caused by the initial shock of transition and collapse of Soviet trade and aid, Mongolia's real GDP started growing again in 1993, and had returned to pre-transition levels by 2001. Growth during this period was generated from a general turnaround in the agricultural sector, and rapid expansion of services. At present, Mongolia is experiencing unprecedented economic growth, with real GDP increase averaging 7% since 2002. Soaring copper and gold prices, which have greatly boosted exploration and FDI in the minerals sector, have ignited this growth, and this has been reinforced by recovery of livestock herds, previously decimated by three exceptionally hard winters. Rising activity in these sectors has also spilled over into construction, financial services and retail, so that growth is now fairly broad-based. While statistics for 2006 are not yet finalized, improved terms of trade, driven by robust economic expansion and the run-up in minerals prices, may have led to a current account surplus in 2006, and better-than-expected mining income and other revenues have probably created a budget surplus. In 2007, however, the IMF projects a current account deficit (2% of GDP) with a rise in imports financed by FDI, and a fiscal deficit (almost 5% of GDP) due a decline in copper prices and several fiscal policy measures, notably cuts in the value added tax (VAT), personal income tax and corporate income tax. Despite the heightened pace of economic activity, inflation has declined and is now in single digits. With improvement in the terms of trade and expanded capital inflows from FDI and official aid, the real effective exchange rate of Mongolia's Tugrik has appreciated by 18% since the end of 2004.

ECONOMIC PROSPECTS AND POLICY PRIORITIES

With its significant mineral resources, Mongolia has the potential for continued strong growth, forecast for the medium term at 6%-7% per year. Mongolia's policymakers hold that recent performance derives in part from external factors, but also from sustained implementation of structural reforms and macroeconomic stability attained through sound policy management. They recognize the presence of continuing external risks – notably declining mineral prices – and therefore the need for maintaining macroeconomic stability, improving economic governance of public sector institutions and promoting private sector development to achieve growth potential. But in this context the authorities also emphasize two key policy priorities.

First, large-scale infrastructure investments are essential to future growth. This is constrained by the fact that Mongolia's gross domestic capital formation – already high at about 38% of GDP (2003) – significantly exceeds gross national savings – 13.7% of GDP (2003) – and has been financed in large part by official grants and loans and more recently by FDI. Achieving and maintaining the levels of investment needed in both economic infrastructure and social services (e.g., hospitals and schools) will be a major strain. Increasing and broadening the inflows of FDI throughout Mongolia's economy will therefore be an important answer to this problem.

Second, despite its economic progress, much of Mongolia's population still lives in poverty (36%), both in urban (39%) and rural (33%) areas. In 2003 Mongolia adopted an Economic Growth and Poverty Reduction Strategy built upon a series of policy reforms to accelerate growth and make it more pro-poor. This strategy features private sector-led growth, and launches measures for improvement in the business environment, particularly for rural entities and small and medium enterprises (SMEs), including finance for these activities; development of energy, road, communication and information technology infrastructure; and promotion of FDI and external trade. The strategy also calls for restructuring to make Mongolia's economy more competitive: privatization and regulatory, land and social service reform. It foresees substantial efforts to create income-earning opportunities for the poor, and to rationalize social service delivery and give it a pro-poor focus. Over the medium term, strategy implementation will involve resources equivalent to 40% to 45% of Mongolia's GDP.

External Sector

Trade: Foreign trade is important to Mongolia's economy, and exports and imports of goods and non-factor services are equivalent to about 56% and 57% of GDP respectively (2005). Net exports have grown rapidly since 2002. Minerals and metals now account for over three-quarters of all exports. In 2005, textiles and apparel represented another 18% of exports (including cashmere garments), but this share has dropped drastically since. Animals and animal products (notably raw cashmere) and hides and skins are also significant exports. On the import side, petroleum – Mongolia imports 100% of its needs – followed by machinery and transport equipment are the major import items. China is Mongolia's biggest export market, followed by the US (especially for cashmere garments), the UK and Russia. Russia is the biggest source of imports, particularly in fuel and foodstuffs.

Mongolia has been a member of the WTO since 1997, and has accepted all multilateral agreements. Since accession it has substantially liberalized its trade regime, reducing tariffs (average applied MFN tariff of 5%) and relaxing import licensing requirements. Also, upon accession, it agreed to remove a 30% export tax on cashmere by January 2007, but missed this target and the tax is still in place. Mongolia has not signed any regional or bilateral free trade agreements. It is a beneficiary of preferential schemes of Canada, the EU, Japan and the US under the Generalized System of Preferences. Mongolia is a member of the World Intellectual Property Organization (WIPO), and has signed conventions and treaties on intellectual property.

WTO staff point out that Mongolia's "participation in trade negotiations and arrangements has been made difficult by its limited human, technical and financial resources." Trade capacity building through technical cooperation is therefore essential, especially to train Parliament members on WTO rules, regulations and Mongolia's commitments; academic institutions on the multilateral trading system; and lawyers on dispute settlement mechanisms.

Foreign direct investment: Consistent with its desire to attract FDI, Mongolia has established a foreign investor-favoring regime of policies, laws and attitudes. No restriction is imposed on the size and content of FDI (except production of weapons), and, while foreigners cannot own land, they can lease it for periods up to 60 years. Mongolia imposes few performance requirements, and then mainly in the minerals sector – e.g., foreign investors that obtain exploration rights are to undertake exploration or pay a fine. No measure employed is inconsistent with the WTO TRIMs Agreement. Foreign companies and investors are subject to the same legal framework as domestic firms for matters of incorporation and other corporate activities. Neither foreign nor domestic firms face restrictions on obtaining foreign exchange and making transfers of investment funds, profits, and payments – although Mongolia still lacks sophisticated financial mechanisms often needed for transfer operations (e.g., letters of credit are hard to come by.) While corruption is a serious matter for all business in Mongolia, according to the US Embassy, there seems to be no concerted, systematic institutional abuse specifically targeted to foreign investment, and problems in the judicial system arise more from ignorance of commercial principles than from antipathy to foreign investors.

The Foreign Investment Law of Mongolia (FILM) is the legal foundation for FDI. It was amended in 2002 to allow franchising, leasing and local representative offices. FILM sets up a Foreign Investment and Foreign Trade Agency (FIFTA; www.investmongolia.com) charged with promoting and registering investments, and facilitating government and foreign investor relations. FIFTA is to operate as a one-stop shop and is reputed to be a "reasonably fair and efficient agency" according to investor and other reports. FILM established tax holidays for foreign investors, on a sliding scale increasing with the size and duration of a foreign investment; new tax legislation may modify these provisions, and provide investment tax credits instead. For relatively larger projects (over $2 million), FILM offers Stability Agreements to lock in extensive packages of tax incentives, with Ministry of Finance approval. For the largest projects, a customized

Stability Agreement can be negotiated directly with Parliament to establish an ad hoc range of tax, labor, environmental and other provisions. Only one such arrangement has been established to date, with a US petroleum exploration firm. In addition to these tax holidays, foreign firms – and domestic ones – engaged in certain priority sectors are also granted exemption from customs duties and VAT: agriculture, exploration for coal, oil, gas and minerals; processing and other industries; and infrastructure and construction.

Annual FDI inflows to Mongolia are now estimated at about $182 million (2005) – nearly a three-fold increase since 2001 – and roughly 10% of GDP. By sector, FIFTA reports that in 2005 most new FDI was registered in mining, including exploration (62%); trade and foodstuffs (17%); and banking and finance (3%). China accounted for over 70% of registered FDI, with other investors coming from South Korea, Russia, UK, US, Japan, Italy and Ukraine. FDI is estimated to generate over 67,000 jobs (2003) and to generate all Mongolia's mineral exports, and a substantial share of cashmere wool exports. Given this track record, in 2005 UNCTAD ranked Mongolia 12 out of 141 countries on its Inward FDI Performance Index, well above its rating (77 out of 141) on the Inward FDI Potential Index. (The former is the ratio of share of global FDI to global GDP, and the latter is a measure of relative attractiveness for FDI.)

Mongolia has bilateral investment treaties with 19 countries, including a BIT with the US, signed in 1994 and entering into force in January 1997. The US and Mongolia also signed a Trade and Investment Framework Agreement in July 2004.

Business Environment

The natural barriers to development that Mongolia faces are formidable: vast internal distances, isolation from global markets and small population base. As a result, remedying the man-made obstacles to economic growth and private sector efficiency created by an unfavorable business environment become all the more urgent. Given the socialist command economy that was its point of departure, Mongolia has made enormous strides. Over the past 15 years, a basic policy, legal and regulatory framework for a market economy has been defined and implemented. Prices have been deregulated. Farms and most small and medium (and some large state-owned enterprises) have been privatized. The financial sector has been liberalized and rationalized, and after surviving turmoil in the late 1990s, is becoming stronger and gaining some measure of confidence among business and consumers. And throughout the period, Mongolia's authorities have generally pursued fiscal and monetary policies favoring macroeconomic stability.

Reform priorities: But much more needs to be done. According to the World Bank's ***Doing Business 2007*** surveys, Mongolia actually scores relatively well, 45 out of 176 countries on an "ease of doing business" scale. Its ranks on registering property (17) and protecting investors (19) are quite favorable, but those for getting credit (65), closing a business (115) and especially trading across borders[3] (165) – are considerably weaker. Recent analyses, including a detailed World Bank investment climate assessment, reinforce most of these indicators and point to priority areas for reform:

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[3] This sub-set of indicators measures time, costs and numbers of procedures required to import and export.

- ***Corruption.*** According to Transparency International (TI), in 2006 Mongolia ranked 99 out of 163 countries on TI's Corruption Perceptions Index. Mongolia's private sector operators cite corruption as the most serious and widespread obstacle to business, and many believe that the problem is worsening. Lack of transparency and accountability and the need for political connections has become pervasive in normal government-business interactions: customs, tax, public procurement, land registration and the like. Parliament's newly adopted Anti-Corruption Law may begin to remedy such problems.
- ***High cost and poor access to credit.*** In Mongolia, interest rates are 10% to 15% higher in real terms than in comparator countries. In part, this is a sign of capital scarcity – and hence the need for FDI – but such rates are also an indicator of riskiness in lending. On the one hand, at these rates and with the very high collateral requirements demanded by banks, few firms can use or even want bank financing for investment or working capital. Rather, they meet capital needs by drawing upon internal funds and informal sources. Some estimate that only 8% of investment is now bank-financed. On the other hand, banks impose these rates and collateral demands to offset business lending risks: borrowers' poor financial data and opaque corporate governance; and Mongolia's still-weak legal and regulatory framework for debt recovery, liquidation of assets and bankruptcy.
- ***Burden of taxation.*** Mongolia's tax to GDP ratio was over 32% in 2006, a high level for low-income countries. High corporate tax rates and absence of provisions for loss-carry-forwards tend to discourage investment. A new Tax Law, effective January 1, 2007, should have an impact: it both lowers rates for corporate and personal income taxes, and for business, introduces tax loss carry-forward provisions. (It may also terminate tax holidays for some investments, but introduce investment tax credits in their place.) However, tax administration continues to be a major problem. Tax inspections are frequent and rules are too often applied in an arbitrary manner. The result is rent-seeking by inspectors, and additional costs and tax evasion for business.

Lack of consultation with private sector parties to be affected by laws and regulations, along with poor coordination among government agencies interpreting, applying and enforcing directives and rules, has hindered reform implementation in the past. However, groups exist to communicate private sector views to policymakers, and there is evidence that they are increasingly effective – e.g., Mongolian National Mining Association on the Mining Law, Mongolian Tourism Association on tax concessions, and NAMBC on the new Tax Law. For the latter, NAMBC helped organize a series of events to bring together private operators and government officials to debate tax issues and highlight international best practices.

Technical barriers to trade and transport constraints. Although Mongolia's trade regime is quite liberal, private business people encounter practical difficulties traversing the system. First, customs administration is slow and unpredictable. Customs valuation, based in Mongolia on the "transactions value" method, seems to be particularly problematic, and easily open to abuse and corruption. Second, transport services for importers and exporters are costly and limited. Rail access the Chinese and Russian markets, and through them to the key international seaports of Tianjin or Vladivostok, is undependable. A shortage of rail cars on the Chinese side, the need to change gauge between Mongolian and Chinese rail networks, and a lack of containers – notably refer containers for meat exports – add to cost and complication in doing business in Mongolia. Inadequate air transport links, for both passenger and freight, intensify these difficulties. Third, beyond Mongolia's borders, poor harmonization of customs procedures with those of China and Russia, and complex sanitary and phytosanitary restrictions for direct exports and for transit shipments delay movement of goods and reduce competitiveness of Mongolian exports.

Privatization and public sector restructuring. Mongolia began privatization in 1991, with a voucher-based transfer of 4,500 SMEs and farms to private sector-based owners. Between 1996 and 2000, another 950 somewhat larger entities were privatized by sealed-bid auctions. Since 2000, government has been engaged in privatizing its largest and most valued companies: major banks, an insurance company, oil and gas distribution company, agro-processing firms and coal mining operations. (Certain minerals sector companies – e.g., in gold and copper mining – will remain State-owned, often in joint venture with Russian or Chinese firms.) After a false start, the important Gobi Cashmere Joint Stock Company is now moving toward privatization. Still to be privatized is MIAT, the State-owned airline, presently under a management contract with foreign airline experts whose charge is to ready the carrier for sale. In the strategic energy sector, government has undertaken a sweeping restructuring program. With implementation assistance from US consultants, the program is designed to rationalize and upgrade electricity production and distribution, and prepare sector enterprises for future privatization. Parliament has also adopted Guidelines for Social Sector Restructuring, Reform and Privatization, designed to encourage private sector participation in health and education.

Minerals Law. In 1997 Mongolia passed legislation to regulate exploration, mining and related activities within its territory. This Minerals Law is widely hailed throughout the global industry as world-class, investor-friendly legislation. Under a Mineral Resources Authority of Mongolia (MRAM) in a regulatory and licensing role, the law creates a competitive, market-driven enabling environment for minerals exploration and development. Together with Mongolia's Tax and Foreign Investment Laws, it has been very successful in encouraging private sector participation and foreign investment in Mongolia's minerals sector. There have been some (failed) initiatives in Parliament to weaken investor protections in the Minerals Law, and legislation has been passed to provide provincial (*aimags*) authorities a licensing power additional to that of MRAM. But at the same time, Mongolia has joined the Extractive Industries Transparency Initiative, a program designed to increase public sector accountability. Overall, the mining industry has been generally satisfied with the business environment it encounters in Mongolia, and this is important: with mining's strategic role and appeal for FDI, what happens in the sector broadly shapes perceptions of Mongolia's investment climate within the entire international business community. Therefore, the new Tax Law's imposition of a windfall profits tax on mineral earnings – passed against a trend of soaring copper prices – is a significant event, and one which will be closely watched for impacts on Mongolia's competitiveness and future FDI inflows.

Free Zones and regional development. As part of its Regional Development Strategy, and as a means of promoting FDI, Mongolia has launched a free trade zone (FTZ) program. Enterprises locating in these FTZs are to enjoy simplified administrative and customs procedures, and exemptions and concessions on customs duties, taxes and fees. Laws have been passed (2003) to establish FTZs at Altanbulag (on the northern border with Russia) and Zamiin-Uud (southern border with China). An additional FTZ is also planned for Tsagaa Nurr (western border with

Russia), and various Industry and Technology Parks are also to be developed in 10 other secondary cities and districts around the country. All the FTZs and Parks are to host export-oriented trade and industry. Zamiin-uud is the first to these FTZs scheduled for development, and an international tender calling for investor-sponsors was announced in 2004. This Zamiin-Uud FTZ is intended to include a casino to boost tourism as well as industrial activity. Questions have been raised in the international donor community as to whether the economic rationale, costs and benefits and institutional arrangements for these FTZs has been properly defined and appraised.

SECTORAL OPPORTUNITIES AND FDI POTENTIAL

Agriculture. About 40% of Mongolia's employment and 22% of its GDP is generated by the agricultural sector, mainly animal husbandry. Sectoral activity is volatile, with output heavily impacted by Mongolia's harsh weather. Key products with are cashmere and meat and hides and skins. In cashmere, Mongolia presently accounts for about 25% of world production, and its production and value-added could be enhanced through investments in technology and better supply chain management. The sector is fully open to foreign operators. Mongolia presently exports some meat and meat products to Russia and to the EU. Livestock and ranching operations are open to foreign operators, who have access to long-term land leases. Regional export markets for meat in Russia and China would be significantly expanded if sanitary and phytosanitary (SPS) standards could be improved. This requires modern technology to upgrade production, veterinary services, slaughter and packaging. With higher SPS standards and more reliable, cost-effective transport services – including a Tripartite Transport Transit Agreement with China and Russia, and reliable air freight capacity – meat exports for the global market might also be developed.

Tourism. Mongolia's natural beauty, rich history and unique culture combine to make it a distinctive tourism destination. Distance from major markets, poor international air transport services, difficult domestic transportation (both land and air), limited tourism infrastructure and a short season are constraints. By some estimates, as many as 80,000 tourists per year now travel to Mongolia, and hotel, tourist camp and restaurant facilities are steadily improving to accommodate more. Investment has been modest to date, but the sector is open for foreign operators, alone or in joint venture with local firms. Developing international and domestic air services – e.g., open skies treatment for air charter operations – plus continuing upgrade in facilities and products and intensified overseas promotion are all essential for tourism's future.

Mining and minerals. Mongolia's resources – 6000 deposits of 80 minerals (including copper, gold, fluorspar and 150 billion tons of coal) are rich, and mining and mineral processing are a large part of Mongolia's industrial activity. Copper and gold have made up about two-thirds of exports, and have proven to be a major attraction for foreign and domestic investors. Petroleum resources, exploited in production sharing contracts with the Petroleum Authority of Mongolia, have engaged US, Chinese and Vietnamese firms. Mongolia's policy is to privatize coal operations but to maintain some public sector ownership and activity in other mining and mineral processing (notably for copper and gold). Nevertheless, the Minerals Law provides ample scope for private participation and development of mining. A continuing positive business environment, infrastructure upgrades and favorable world minerals prices should boost mining output and earnings for foreign and domestic operators.

Manufacturing. From a 12% share of GDP in 1995, manufacturing now represents less than 5% of Mongolia's total economic output. Heavy industry, based on State-owned enterprises, has virtually shut down, so that present activity is largely labor-intensive light manufacturing in clothing, food products and textiles, plus some leather, carpets and footwear. Until the end of the Multifibre Arrangement (MFA) in January 2005, Mongolia had a relatively robust industry in manufacturing apparel for export. This industry, stimulated by MFA quotas, was financed by Chinese and Korean FDI, and depended upon imported inputs. In peak years it accounted for over 11% of total exports and employed over 20,000 persons, mostly women. With the end of MFA, this activity virtually disappeared. The manufacturing operations that remain in Mongolia are low in productivity, and need significant infusions of capital and technology to become internationally competitive. Tax and customs administration reform and improvement in transport services would also help operators access and compete in regional markets.

Financial services. Several years' efforts to restructure and to build regulatory capacity and systems have transformed Mongolia's financial services. The sector now has 17 commercial banks, nearly 90 non-bank financial institutions (NBFIs) and 550 savings and credit companies, as well as a range of securities firms, exchange bureaus and insurance companies. In the 1990s, restructuring was accompanied by several major bank insolvencies that led to a series of banking crises. After difficult and costly government-financed rescues, commercial banking operations have stabilized, and the banking sector has strengthened. Almost all State equity in the banking system has now been sold, including the recent privatization of Savings Bank, the largest retail bank and the last fully State-owned operator. Foreign investors have purchased two major banks (Trade and Development Bank and Agricultural Bank), and have successfully and profitably expanded their operations. Risks remain, however, as the number of non-performing loans is still high in the sector, and profitability may be declining among some smaller banks. Also, concerns persist about the effectiveness of prudential supervision for banking. The NBFI sub-sector has grown very rapidly and is involved in lending, factoring and financial leasing. It has attracted FDI: foreign investors may now own about 20% of NBFI capital. Regulation of NBFIs, despite a new law, is fragmented and not consistent with international standards. In the insurance industry, the largest insurer (Mongol Daatgal, with 90% of the market) has been privatized to a group of foreign and domestic owners. Policymakers aim to modernize and broaden the insurance industry, which is fully open to foreign suppliers, subject to licensing.

Infrastructure. Development of infrastructure systems and services to accelerate development is one of Mongolia's principal challenges. Private financing will be essential – especially in the form of FDI provided by consortia of experienced infrastructure operators and developers. The legal and regulatory framework for private sector participation in infrastructure must be refined and strengthened to allow this to happen. To date, private investors have been most successful in telecommunications, notably through the entry and rapid expansion of two cell phone operators (Mobicom and Skytel, Japanese- and Korean-Mongolian joint ventures, respectively). Private companies also compete with Mongolia Telecoms in the international call market. Pressure is mounting to end MT's domestic monopoly on local and national wired services, and to allow more cell phone providers. In energy, the unbundling of the sector into 18 different corporatized operators in generation, transmission and distribution is a precursor to future privatization. Foreign operators, perhaps in joint ventures with Mongolian investors, will be expected to provide technology, capital and management expertise to raise efficiency and quality of electricity services. Finally, in transport, both rail and air modes may attract foreign private sector participation. The former could entail private train operating companies to lease track from Mongolia National Railroad, to upgrade freight and passenger service. The latter could involve privatization of MIAT, including some form of deregulation of domestic and international air transport.

Social services. From 1995, with the introduction of a new Education Law, Mongolia has been promoting private sector participation in education services, particularly at the tertiary level. The outcome has been rapid growth of new private universities and diploma institutes – about 180 in all as of 2002, of which 160 in Ulaanbaatar – but an erosion of educational standards. The private sector has found the pool of graduates produced by these institutions to be poorly prepared and ill-adapted to the needs of the economy. Nevertheless, the traditional State-funded system of academic and vocational education is inadequate for the task of providing trained manpower, so efforts to define a useful private role in educational services are likely to continue. In health, Mongolia has already developed a system of private hospitals and clinics in parallel to the (still dominant) State facilities. There have been some initiatives to contract out hospital services to private operators at the local level and in provinces, but this has been poorly organized and the financial results and levels of care have been unsatisfactory. However, programs are being designed to allow the sale and lease-back of medical facilities with private operators, as well as to renew and improve management contracting, and to outsource non-clinical services and support activities. To succeed, the programs will need to enlist experienced and expert private operators and investors, and function within a sound institutional framework with proper certification and quality-assurance mechanisms.

USAID AND OTHER DONOR PROGRAMS

Because of Mongolia’s geopolitical significance, strategically wedged between Russia and China, and given its sustained and generally successful economic transition efforts, it has attracted widespread support in the donor community. This support includes both multilateral and bilateral organizations. Since the beginning of Mongolia’s transition up through 2003, these donors have supplied more than US$2.6 billion in aid (half in loans). This aid has been mainly directed to the economic sectors (transport, industry and construction, and electricity and heating). The Asian Development Bank (ADB) and the World Bank have been the main multilateral donors. ADB activity has been in agriculture, infrastructure, health, education, and the financial sector, with some support for government reform and capacity-building. The World Bank has concentrated on transportation, telecommunications, energy, financial sector, and private sector development, plus special initiatives in poverty alleviation, through pro-poor health, education and urban services. In recent years the European Bank for Reconstruction and Development has also funded restructuring programs and management contracting projects to upgrade state-owned enterprises in the transport and mining sectors.

Among bilaterals, Japan, the US and Germany have been major providers of assistance. USAID/Mongolia’s program has been a leader in private sector development, with emphasis on economic policy reform and competitiveness, including work in the tourism, cashmere and meat exporting sectors, as well as in privatization. USAID Mongolia’s 2007 budget request amounts to about $7.5 million, devoted to economic growth ($5.6 million, for trade, investment and private sector competitiveness), and democracy and governance ($1.9 million, for strengthening the judiciary and increasing the accountability of Parliament). Additionally, Mongolia is a Millennium Challenge Account-eligible country, and is in the final stages of refining its proposed MCA Compact. Mongolia’s Compact proposal is broad-based, with initiatives in transport (including private sector participation in rail enterprise), telecommunications, and social services (private sector participation in health, education and vocational training). If approved, the multiyear MCA Compact could involve funding approaching $300 million.

Appendix II. Additional Resource Documents

ADB, Mongolia, Key Indicators of Developing Asian and Pacific Countries, 2006

IMF, Mongolia, Staff Report for the Article IV Consultation, December 18, 2006

ADB, Asian Development Outlook 2006, Mongolia

Government of Mongolia, Economic Growth and Poverty Reduction Strategy, Executive Summary

World Bank, Mongolia: Promoting investment and job creation, Executive Summary, 2006

ADB, Mongolia Private Sector Assessment 2004, Chapter 2, Enabling Environment for PSD

ADB, Mongolia Private Sector Assessment 2004, Chapter 3, Sector Profiles

World Trade Organization, Mongolia Trade Policy Review, 15-17 March 2005, Chapters 2-4

US Embassy, Mongolia Country Commercial Guide, 2005 Chapter 6, Investment Climate Statement

World Bank, Doing Business 2007, Mongolia

Millennium Challenge Corporation, Mongolia Sample Call Order Statement of Work, 2007

Mongolia

Item	1988	1990	1995	2001	2002	2003	2004	2005
POPULATION								
Total population [a] *million; as of 1 July*	2.04	2.15	2.24	2.44	2.48	2.50	2.53	2.60
Population density *persons per square kilometer*	1	1	1	2	2	2	2	2
Population *annual change, %*	2.5	2.4	1.4	1.2	1.6	0.8	1.2	1.2
Urban population, *% of total population*	...	...	51.9	57.2	57.4	53.4	59.1	60.2
LABOR FORCE [b] *thousand; calendar year*	772.2	829.3	812.7	872.6	901.7	959.8	986.1	1001.2
Employed	743.3	783.6	767.6	832.3	870.8	926.5	950.5	968.3
Agriculture	243.8	258.8	354.2	402.4	391.4	387.5	381.8	386.2
Industry [c]	118.0	131.6	108.1	93.3	99.2	109.5	114.2	113.9
Others	381.5	393.2	305.3	336.6	380.2	429.5	454.5	468.2
Unemployed	...	...	45.1	40.3	30.9	33.3	35.6	32.9
Unemployment rate, %	...	...	5.5	4.6	3.4	3.5	3.6	3.3
Labor force *annual change, %*	...	4.4	-2.6	2.9	3.3	6.4	2.7	1.5
Labor force participation rate, %	...	...	68.5	62.2	62.6	64.5	64.4	63.5
Male	...	...	71.9	64.9	64.9	66.9	65.2	64.8
Female	...	...	65.1	59.7	60.5	62.2	63.7	62.2
NATIONAL ACCOUNTS [d] *Mn Tugriks; calendar year*								
At Current Market Prices								
GDP by industrial origin	10301	10465	550254	1115641	1240787	1461169	1910881	2266505
Agriculture	1499	1592	209146	277561	256624	293378	399042	491111
Mining			66023	100832	125896	185789	365565	461306
Manufacturing	3313	3724	66378	90144	77975	90464	98493	99856
Electricity, gas, and water			9665	32955	46812	49212	61187	70365
Construction	645	524	9237	21932	29014	44766	46498	52543
Trade	1886	2035	93566	297832	344010	387086	465057	561148
Transport and communications	1342	1257	35074	144941	182765	202754	240893	275531
Finance [e]			1233	-55	4020	7792	6341	7797
Public administration	1616	1334	16651	48180	55959	61659	70807	75055
Others			43281	101320	117711	138270	156998	171794
Net factor income from abroad	-1288	-1170	-11353	31722	66511	72001	160238	190000
GNP	9013	9295	538901	1147363	1307297	1533170	2071119	2456505
Structure of Output *% of GDP at current prices*								
Agriculture	14.6	15.2	38.0	24.9	20.7	20.1	20.9	21.7
Industry	38.4	40.6	27.5	22.0	22.5	25.3	29.9	30.2
Services	47.0	44.2	34.5	53.1	56.8	54.6	49.2	48.1
Expenditure on GDP	10301	10465	550254	1115641	1240787	1461169	1910881	2266505
Private consumption	5750	6511	348964	834662	957790	1024971	1187277	1338061
Government consumption	3137	3118	72331	217491	236659	253391	321976	342286
Gross fixed capital formation	4538	3380	149150	351594	360918	498480	616571	718799
Increase in stocks	-203	206	25343	50615	38690	57478	81433	85227
Net exports of goods and services	-2838	-2201	-5721	-211310	-264596	-285249	-230302	-168010
Statistical discrepancy	-83	-548	-39813	-127411	-88673	-87900	-66073	-49857
Structure of Demand *% of GDP at current prices*								
Private consumption	55.8	62.2	63.4	74.8	77.2	70.1	62.1	59.0
Government consumption	30.5	29.8	20.7	19.5	19.1	17.3	16.8	15.1
Gross domestic capital formation	42.1	34.3	31.7	36.1	32.2	38.0	36.5	35.5
Net exports of goods and services	-27.5	-21.0	-1.0	-18.9	-21.3	-19.5	-12.1	-7.4
At Constant 2000 Prices								
GDP by industrial origin	1005790	1021816	886366	1029542	1070681	1130285	1251426	1329455
Agriculture	287477	295986	294053	242086	211962	222252	261578	281682
Mining			91096	126625	116183	113507	152486	169730
Manufacturing	173622	179780	88772	84598	100683	105039	106432	80755
Electricity, gas, and water			22488	25285	26103	26389	28046	29211
Construction	61975	44275	22544	21701	24939	35963	35987	40263
Trade	207163	247622	170376	265556	299442	320761	340965	373084
Transport and communications	174594	158348	72755	126664	146781	163121	180443	199798
Finance [e]			5938	-3050	-2856	-3337	-7071	-96
Public administration	100959	95804	41903	44381	44026	42913	44649	44649
Others			76443	95698	103418	103676	107914	110379

Mongolia

Item	1988	1990	1995	2001	2002	2003	2004	2005
Net factor income from abroad	-77191	-67982 I	-18287	29274	57392	55696	104939	111448
GNP	928599	953834 I	868079	1058816	1128073	1185981	1356365	1440903
Growth of Output *annual change, %*								
GDP	5.1	-2.5	...	1.0	4.0	5.6	10.7	6.2
Agriculture	3.4	-1.0	...	-18.3	-12.4	4.9	17.7	7.7
Industry	5.8	-4.9	...	15.5	3.8	4.8	15.0	-0.9
Services	5.9	-2.2	...	6.1	11.6	6.1	6.3	9.1
Investment Financing at current prices								
Gross domestic capital formation	4334	3585 I	174492	402209	399608	555958	698003	804026
Gross national saving	126	-334 I	117606	95209	112849	200858	...	...
Gross domestic saving	1414	836 I	128959	63488	46338	128857	...	...
Net factor income from abroad	-1288	-1170 I	-11353	31722	66511	72001	160238	190000
Foreign saving	4209	3919 I	56887	306999	286759	355100	...	...
Savings and Investment *% of GDP at current prices*								
Gross domestic saving	13.7	8.0	23.4	5.7	3.7	8.8	...	...
Gross national saving	1.2	-3.2	21.4	8.5	9.1	13.7	...	...
Gross domestic capital formation	42.1	34.3	31.7	36.1	32.2	38.0	36.5	35.5
At Current Market Prices, *Tugriks*								
Per capita GDP	5050	5054 I	246237	460055	504590	586768	754365	884524
Per capita GNP	4418	4489 I	241157	473136	531638	615681	817622	958674
PRODUCTION *thousand metric tons; calendar year*								
Agriculture, *crop year*								
1. Milk, *Mn liters*	292	307	359	290	276	292	329	403
2. Wheat	672	596	257	139	123	160	136	76
3. Potatoes	103	131	52	58	52	79	80	83
4. Vegetable and melons	55	42	27	45	40	60	49	64
5. Barley	100	89	4	2	2	3	2	1
6. Oats	37	30	0	1	0	1	1	1
Mining								
1. Lignite and brown coal	7916	6562	3581	5062	5467	5496	6700	7412
2. Coal	690	595	1290	72	78	78	95	105
3. Salt	13	6	1	1	1	0	0	0
Manufacturing								
1. Cement	502	441	109	68	148	162	62	112
2. Sawnwood (coniferous), *'000 cu. m.*	541	509	61	21	10	17	18	13
3. Wheat flour	196	190	159	38	50	54	58	58
4. Meat	59	54	11	12	7	11	4	4
Production Index *period average*								
Agriculture, *1999–2001 = 100*	94.6	96.6	82.5	84.2	76.5	65.0	77.4	75.2
ENERGY *annual values*								
Coal, *'000 m.t.*								
Production	8606	7157	5020	5141	5544	5666	6865	7517
Exports	1041	490	1	–	–	435	1560	2116
Imports	73	73	211	10	0	0	0	0
Consumption [f]	7638	6740	5204	5189	5535	5162	5189	5473
Electricity, *Mn kWh*								
Production	3544	3348	2628	3017	2464	3138	3303	3419
Exports	–	–	–	18	16	7	8	12
Imports	75	228	381	196	167	171	171	168
Consumption [f]	3619	3576	1909	1948	2032	2195	2357	2534
Retail prices, *Tugriks/litre*								
Gasoline, premium [g]	1.3	1.3	...	359.0	334.0	413.0	527.0	674.0
Diesel	1.1	1.1	...	...	...	...	...	...

Mongolia

Item	1988	1990	1995	2001	2002	2003	2004	2005
PRICE INDEXES *period averages*								
Consumer, *January 1991* **I** *December 1995* **I**								
December 2000 = 100	102.1	102.1 **I**	4681.8 **I**	107.9	109.8	114.9	127.5	139.6
Implicit GDP deflator, [d] *2000 = 100*	1.0	1.0	62.1	108.4	115.9	129.3	152.7	170.5
Price Indexes *annual change, %*								
Consumer price index	–	–	53.1	8.0	1.6	4.7	11.0	9.5
Implicit GDP deflator	–	–	59.6	8.4	6.9	11.6	18.1	11.7
MONEY AND BANKING *Mn Tugriks; as of end of period*								
Money supply (M1)	3022	4750	42637	156155	187728	212833	221328	269124
Currency in circulation	526	737	29756	109161	120784	131497	143513	152370
Demand deposits	2496	4013	12881	46995	66944	81337	77815	116755
Quasi-money	1753	883	59408	174909	282398	490499	625705	901014
Money supply (M2)	4774	5633	102045	331064	470126	703332	847032	1170139
Foreign assets (net)	39	-332	51710	220166	308507	256342	311005	570199
Domestic credit	5786	6989	45495	129260	200027	514615	647305	816004
Claims on government sector [h]	5397	6473	-6345	3573	-20254	112891	53067	-9735
Claims on private sector	389	516	51654	114670	203567	365024	533049	754840
Claims on other financial institutions [i]	...	–	186	11016	16715	36700	61190	70899
Other items	-1051	-1024	4840	-18361	-38409	-67624	-111278	-216064
Money supply (M2) *annual change, %*	9.1	10.8	32.9	27.9	42.0	49.6	20.4	38.1
M2 *% of GDP*	46.3	53.8	18.5	29.7	37.9	48.1	44.3	51.6
Interest Rates *percent p.a.; period averages*								
On deposits								
Savings	3.0	3.0	27.3	5.4	6.2	5.9	7.8	8.0
Time: 12 months	4.0	4.0	56.9	13.2	14.0	14.0	13.2	12.6
GOVERNMENT FINANCE *Mn Tugriks; fiscal year ending 31 December*								
Central Government [j]								
Total revenue and grants	...	5329	140902	439290	477049	553889	713114	837858
Total revenue	...	5329	135818	430114	470207	545227	707062	833568
Current revenue	4681	5329	135684	429951	469749	545227	706293	832585
Taxes [k]	4211	4669	105510	328203	359179	420969	583119	692207
Non-taxes [l]	470	660	30174	101748	110569	124258	123174	140378
Capital receipts	...	–	134	162	459	0	769	983
Grants	...	–	5085	9176	6842	8662	6052	4291
Total expenditure and net lending	...	6482	149350	489730	548639	615771	752486	764597
Total expenditure	6742	6482	128167	425836	481567	525297	643586	690107
Current expenditure	5227	5424	101508	366701	413467	434832	538699	600289
Capital expenditure [m]	1515	1057	26659	59135	68100	90465	104887	89818
Net lending [n]	...	0	21183	63894	67072	90474	108900	74490
Current surplus/deficit	-546	-96	34176	63251	56282	110395	167594	232296
Capital account surplus/deficit	-1515	-1057	-26525	-58973	-67642	-90465	-104118	-88835
Overall budgetary surplus/deficit [o]	...	-1153	-8448	-50440	-71590	-61882	-39373	73261
Financing								
Domestic borrowing (net)	...	318	...	-22091	-10183	-96329	-38044	-163241
Foreign borrowing (net)	2067	1098	...	72531	81773	158211	77417	89980
Use of cash balances [p]	-6	0	11456	50440	71590	61882	39373	-73261
Government Finance *% of GDP*								
Total revenue	...	50.9	24.7	38.6	37.9	37.3	37.0	36.8
Total expenditure	65.4	61.9	23.3	38.2	38.8	36.0	33.7	30.4
Overall budgetary surplus/deficit	...	-11.0	-1.5	-4.5	-5.8	-4.2	-2.1	3.2
Expenditure by Function, Central Government								
Total [q]	4547	6482	143856	489730	548639	615771	752486	764597
General public services	813	911	12814	25027	25909	25755	240508	193784
Defence [r]	...	...	16626	25384	28071	27899	32891	35914
Education	...	1203	23525	98709	103709	115354	141020	147792
Health	...	579	15959	53096	57964	58128	73243	80152
Social security and welfare [s]	2372	802	23378	84542	96898	117603	150618	185675
Housing and community amenities [t]	...	656	7456	22130	25086	24534	9630	7968

Mongolia

Item	1988	1990	1995	2001	2002	2003	2004	2005
Economic services [u]	583	447	20278	31314	41367	57269	84888	85119
Agriculture	...	...	...	...	...	...	...	...
Industry	...	...	...	...	...	...	...	...
Electricity, gas, and water	...	...	...	...	...	...	...	...
Transport and communications	...	...	...	...	...	...	...	...
Other economic services	...	...	...	...	...	...	...	...
Others	779	1884	40446	149529	169637	189230	19689	28193
EXTERNAL TRADE *Mn US dollars; calendar year*								
Exports, fob	739.1	660.7	473.3	521.5	524.0	615.9	853.3	1064.9
Imports, cif	1113.6	924.0	415.3	637.7	690.8	801.0	1011.6	1184.4
Trade balance	-374.5	-263.3	58.0	-116.2	-166.8	-185.1	-158.3	-119.5
External Trade *annual change, %*								
Exports	3.0	-8.4	32.9	-2.7	0.5	17.5	38.5	24.8
Imports	0.8	-4.0	60.7	3.8	8.3	16.0	26.3	17.1
Trade balance	3.2	-9.0	-40.6	-47.7	-43.5	-11.0	14.5	24.5
Exports, by HSC								
Animal and animal products	...	...	10.4	26.4	28.9	22.5	18.0	19.6
Vegetable products	...	...	4.9	1.1	2.7	1.1	6.1	0.9
Animal or vegetable fats	...	...	0.0	0.0	0.0	0.1	0.4	0.2
Prepared foodstuffs	...	...	2.5	0.3	0.4	0.2	1.0	1.7
Mineral products	...	...	310.0	175.2	173.4	214.6	346.5	454.7
Chemical products	...	...	1.5	2.9	0.1	0.1	0.1	0.0
Plastics and rubber	...	...	0.1	0.1	0.1	0.3	1.0	1.4
Hides and skins	...	...	23.7	59.1	46.1	54.9	22.6	30.5
Wood and wood products	...	...	4.9	0.2	0.2	0.5	1.2	1.2
Wood pulp products	...	...	0.2	0.1	0.2	0.8	0.8	3.7
Textiles and textile articles	...	...	80.7	171.5	145.1	165.0	194.2	191.4
Footwear, headgear	...	...	0.2	0.0	0.1	0.1	0.9	0.3
Articles of stone, plaster, cement, asbestos	...	...	0.5	0.2	0.0	0.0	0.0	0.0
Pearls, precious or semi-precious stones, metals	...	...	0.0	75.4	119.3	139.9	239.9	331.6
Base metals and articles thereof	...	...	17.1	5.1	4.3	8.6	17.8	18.2
Machinery, mechanical appliances, and electrical equipment	...	...	1.5	1.9	1.7	3.4	1.6	3.2
Transportation equipment	...	...	13.4	1.6	0.7	2.2	1.5	4.8
Instruments–measuring, musical	...	...	0.4	0.1	0.1	0.1	0.1	0.1
Arms and ammunition	...	...	...	...	...	...	...	...
Miscellaneous manufactured articles	...	...	1.2	0.2	0.5	0.5	0.6	1.2
Works of art	...	...	...	0.1	0.0	1.1	0.0	1.8
Imports, by HSC								
Animal and animal products	...	...	1.3	5.0	5.3	6.0	5.7	6.0
Vegetable products	...	...	15.2	51.2	58.3	37.9	69.3	55.9
Animal or vegetable fats	...	...	2.5	6.7	9.4	10.3	9.6	13.1
Prepared foodstuffs	...	...	18.6	53.2	56.6	61.3	72.7	78.4
Mineral products	...	...	83.0	145.4	132.7	166.5	231.3	326.6
Chemical products	...	...	36.7	33.9	34.5	43.0	46.6	54.6
Plastics and rubber	...	...	6.5	15.1	19.1	22.0	25.7	30.0
Hides and skins	...	...	1.3	0.7	0.5	0.5	0.6	0.8
Wood and wood products	...	...	1.1	2.2	3.2	4.4	4.3	5.4
Wood pulp products	...	...	11.9	10.5	14.9	25.5	19.2	30.0
Textiles and textile articles	...	...	28.4	63.2	84.2	83.5	100.9	76.4
Footwear, headgear	...	...	8.2	2.3	1.9	1.7	1.6	1.5
Articles of stone, plaster, cement, asbestos	...	...	5.5	9.8	10.9	17.0	17.1	18.7
Pearls, precious or semi-precious stones, metals	...	...	0.1	0.0	0.1	0.1	0.1	0.2
Base metals and articles thereof	...	...	34.7	29.7	31.4	43.8	71.0	85.6
Machinery, mechanical appliances, and electrical equipment	...	...	85.0	113.4	134.4	168.0	201.5	256.0
Transportation equipment	...	...	63.2	69.1	75.6	87.1	103.9	116.0
Instruments–measuring, musical	...	...	6.0	17.4	9.0	9.9	16.5	14.5
Arms and ammunition	...	...	...	...	...	...	...	...
Miscellaneous manufactured articles	...	...	5.7	8.2	8.9	12.1	13.5	14.3
Works of art	...	...	...	0.1	0.1	0.0	0.0	0.4

Mongolia

Item	1988	1990	1995	2001	2002	2003	2004	2005
Direction of Trade *Mn US dollars; calendar year*								
Exports, total	98.2	90.8	473.3	521.4	524.0	615.9	851.9	888.6
1. China, People's Republic of	7.3	10.3	77.8	231.6	217.3	284.2	407.1	483.6
2. United States	1.2	1.8	25.8	144.5	165.7	142.9	152.9	126.8
3. United Kingdom	3.0	2.6	18.7	12.4	17.5	26.1	134.0	41.9
4. Russian Federation	...	...	68.9	44.9	48.0	41.2	18.1	26.1
5. Japan	20.8	16.0	46.7	15.7	6.3	8.5	33.5	5.6
6. Australia	5.0	0.0	–	10.0	17.7	34.5	0.1	0.3
7. Korea, Republic of	–	–	26.1	20.1	22.5	7.5	7.8	12.1
8. Singapore	...	...	1.8	0.2	0.1	35.0	19.9	0.1
9. Italy	5.9	8.1	11.4	16.9	8.6	9.1	17.3	16.7
10. Germany	1.2	2.9	7.6	2.0	2.7	4.6	11.5	15.8
Imports, total	119.2	144.5	415.3	637.7	690.7	801.4	1011.3	1197.4
1. Russian Federation	...	...	208.0	226.0	237.6	265.4	336.6	400.4
2. China, People's Republic of	18.5	31.1	44.5	120.1	139.5	172.4	238.2	318.8
3. Korea, Republic of	–	–	21.5	58.3	86.3	67.7	60.9	70.3
4. Japan	4.4	15.4	45.3	56.0	42.8	63.4	74.5	78.5
5. Germany	12.1	23.8	18.5	30.3	30.4	38.0	33.5	51.3
6. United States	–	–	14.5	14.9	23.4	23.5	46.9	31.7
7. Hong Kong, China	0.0	1.1	6.1	16.0	28.2	23.9	15.4	7.5
8. Kazakhstan	...	...	0.8	21.3	7.2	4.9	26.6	29.5
9. Australia	0.0	0.1	0.3	1.4	11.3	19.6	15.5	10.9
10. Singapore	...	...	7.4	10.4	11.2	10.4	14.9	17.6
BALANCE OF PAYMENTS *Mn US dollars; calendar year*								
Current account	-1033.3	-639.5	38.9	-61.7	-105.0	-95.9	63.4	104.3
Balance on goods	-872.8	-496.9	25.3	-100.6	-156.2	-227.1	-28.9	-9.2
Exports	829.1	444.8	451.0	523.2	524.0	627.3	872.1	1055.8
Imports	-1701.9	-941.7	-425.7	-623.8	-680.2	-854.4	-901.0	-1065.0
Services and income	-160.2	-150.0	-63.5	-93.5	-86.3	-30.3	-176.3	-111.7
Credit	94.5	53.2	60.3	128.3	198.1	221.8	354.8	425.1
Debit	-254.7	-203.2	-123.8	-221.8	-284.4	-252.1	-531.1	-536.8
Current transfers	-0.3	7.4	77.1	132.4	137.5	161.5	268.7	225.2
Credit	...	...	...	–	-42.3	-53.9	-50.2	266.4
Debit	...	7.4	77.1	132.4	179.8	215.4	318.9	-41.2
Capital account	...	...	...	...	...	...	...	...
Financial account	1019.4	516.7	-16.9	117.7	157.4	4.9	-23.2	43.4
Direct investment	...	–	9.8	63.0	77.8	131.5	92.9	182.3
Portfolio investment, net	...	...	1.0	...	...	50.0	-52.5	...
Other investments	1019.4	516.7	-26.7	54.7	79.6	-176.6	-63.6	-138.9
Net errors and omissions [v]	14.6	-4.8	11.4	-41.3	14.1	-5.8	-5.7	-13.2
Overall balance	0.7	-127.6	33.4	14.7	66.5	-96.8	34.6	134.5
Reserves and related items	-0.7	127.6	-33.4	-14.7	-66.5	96.8	-34.6	-134.5
Reserve assets	-0.7	101.3	-22.7	-17.8	-56.8	89.8	-27.4	-125.4
Use of Fund credit and loans	...	...	-10.7	-1.7	-7.8	7.1	-7.1	-9.1
Others	...	26.3	...	4.8	-1.9	...	...	...
Balance of Payments *% of GDP*								
Exports	24.1	22.7	36.8	51.5	46.9	49.2	54.1	56.1
Imports	-49.6	-45.0	-34.6	-61.4	-60.9	-67.0	-55.9	-56.6
Balance on goods	...	-25.3	2.1	-9.9	-14.0	-17.8	-1.8	-0.5
Current account balance	-30.1	-32.6	3.2	-6.1	-9.4	-7.5	3.9	5.5
Overall balance	...	-6.5	2.7	1.4	6.0	-7.6	2.1	7.2
INTERNATIONAL RESERVES *Mn US dollars; as of end of period*								
Total	19.7	22.9	151.5	256.6	399.4	242.7	250.4	...
Gold, national valuation	19.7	22.9	34.5	50.9	49.8	6.7	14.1	...
Foreign exchange	...	...	114.5	205.6	349.5	235.9	236.1	430.1
Reserve position in the Fund	–	–	0.0	0.1	0.1	0.1	0.2	0.2
SDRs	–	–	2.5	0.0	0.0	0.0	0.0	0.0
EXCHANGE RATES *Tugriks per US dollar*								
End of period	...	5.3	473.6	1102.0	1125.0	1168.0	1209.0	1221.0
Average of period	...	...	448.6	1097.7	1110.3	1146.5	1185.3	1205.3

Mongolia

Item	1988	1990	1995	2001	2002	2003	2004	2005
EXTERNAL INDEBTEDNESS *Mn US dollars; as of end of year*								
Total debt outstanding and disbursed	...	...	530.7	885.0	1035.8	1472.3	1517.0	...
Long-term debt	...	...	472.1	823.7	949.0	1137.5	1305.7	...
Public and publicly guaranteed	...	...	472.1	823.7	949.0	1137.5	1305.7	...
Private non-guaranteed	...	...	0.0	0.0	0.0	0.0	0.0	...
Short-term debt	...	...	11.7	14.4	44.2	285.2	167.0	...
Use of IMF credit	...	...	47.0	46.8	42.6	49.6	44.3	...
External debt *as % of GNI*	...	...	44.1	87.2	93.1	116.6	94.7	...
Total long-term debt *as % of total debt*	...	...	89.0	93.1	91.6	77.3	86.1	...
Short-term debt *as % of total debt*	...	...	2.2	1.6	4.3	19.4	11.0	...
Debt service *as % of exports of goods and services*	...	...	10.1	6.9	7.2	4.4	...	...
Debt service *Mn US dollars; transactions during the year*								
Principal repayments on long-term debt	...	...	32.4	28.1	32.2	265.4	19.9	26.5
Interest on long-term debt	...	...	8.6	9.8	11.8	12.1	13.3	15.3
Interest on short-term debt	...	...	0.4	0.4	0.5	2.0	6.7	...
Average terms of new commitments								
Interest (% p.a.)	...	...	2.2	1.0	1.2	1.2	0.8	...
Maturity (years)	...	...	35.3	34.0	33.5	19.4	39.9	...
Grace period (years)	...	...	10.1	9.1	8.5	5.4	10.0	...
Grant element (%)	...	...	65.4	74.4	71.8	53.9	80.5	...

Footnotes:

Some footnotes apply only to the 18-year series available online.

- a Refers to mid-year estimates based on end of year population data.
- b Refers to economically active population registered at the Employment Regulation Office.
- c Refers to those employed in manufacturing, mining, electricity, gas, and water sectors.
- d There is a series break after 1994 as a result of major revisions made in annual GDP estimates, taking into account among others the use of the Mongolian Standard Industrial Classification and the associated expansion of industrial detail, particularly in services, and the incorporation of the results of the 1998 Census of Establishments and other new surveys such as the 1999 Informal Sector Survey.
- e From 1995 onwards, data include financial intermediation services indirectly measured (FISIM).
- f Includes net stocks.
- g From 1996, data refer to average retail price of premium gasoline A-76.
- h Includes state enterprises.
- i Residual from total domestic credit. From 1994 onward, this includes claims on principal arrears, claims on substandard, doubtful, loss loans, claims on non-bank financial institutions, and claims on share and promissory note.
- j Refers to total budget account of central and local governments.
- k Includes profit, income, and turnover taxes.
- l Refers to non-tax revenues, social security premiums, and others.
- m Classified as investment in material and non-material sectors. Includes net lending until 1990.
- n Refers to Other Expenditures in the Government budget accounts table taken from the Bank of Mongolia website as of 23 March 2005.
- o Figures exclude non-budgetary surplus/deficit; hence the item refers to overall budgetary surplus/deficit.
- p Balance for financing of overall surplus/deficit.
- q For 1988 to 1990, the total for expenditure by function differs from that of current expenditures by the amount of wages and salaries which cannot be allocated to each of the function. For 2001, total excludes expenditure on defence.
- r Includes public order and safety until 1990. For 2001, data on expenditure on defence was not disclosed due to confidentiality.
- s Includes all social and cultural expenditures.
- t Includes recreation, culture, arts, and sports.
- u Includes all national development.
- v For 1996, includes receipts of in-kind transfers by nongovernment sector.

January 2007
IMF Country Report No. 07/30

Mongolia: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Mongolia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with Mongolia, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 12, 2006, with the officials of Mongolia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 18, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 10, 2007 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Mongolia.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publcationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

MONGOLIA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Article IV Consultation

Approved by Daniel Citrin and Adnan Mazarei

December 18, 2006

- The 2006 Article IV consultation discussions were held in Ulaanbaatar during August 30-September 12. The staff team comprised Messrs. Kronenberg (Head), Marciniak, S. Lee (all APD), Wu (PDR), and Klemm (EP-FAD) and was assisted by Mr. Jang (Resident Representative). Mr. H.C. Lee (OED) attended some of the policy meetings. The staff team closely liaised with overlapping MCM and STA technical assistance missions.

- The 2005 Article IV Consultation and discussion of the Ex-Post Assessment of Longer-Term Program Engagement were completed on September 21, 2005, http://www.imf.org/external/np/sec/pn/2005/pn05140htm. Directors considered that a successor PRGF arrangement could provide a useful framework for the authorities to carry forward their reform agenda.

- Discussions on a new PRGF-supported program were conducted in February and May 2006. Resuming program discussions would be contingent upon adopting a 2007 budget consistent with ensuring fiscal sustainability.

- Mongolia's flexible exchange rate regime has served well in absorbing external shocks and the existing arrangement should be maintained.

- Mongolia accepted the obligations of Article VIII, Sections 2, 3, and 4 on February 1, 1996, and has maintained an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

- Mongolia's statistical framework is generally adequate for surveillance and program monitoring purposes. Efforts are underway with STA support to address the remaining weaknesses in the areas of monetary and government finance statistics.

- The authorities are expected to approve the publication of the Staff Report, as occurred for the last consultation, and all accompanying documents.

Contents Page

EXECUTIVE SUMMARY

Background

- **Mongolia's economic performance has been very strong in recent years.** Annual real GDP growth has averaged 7 percent since 2002, underpinned by a run up on copper and gold prices; inflation has been reduced to mid-single digit levels; and the budget and current account balances recorded growing surpluses in 2005-06.
- **The fiscal position is expected to weaken in 2007 due to social spending and wage increases, tax cuts, and somewhat lower copper prices**.
- **Although inflation currently is moderate, there is a clear risk that continued rapid monetary growth and fiscal stimulus could increase inflationary pressures.**
- **The nominal and real effective exchange rates of the togrog have appreciated moderately, reflecting the strong balance of payments and improvement in the terms of trade**. International reserves have increased to nearly 3½ months of imports of goods and services.
- **The authorities have taken initial steps to strengthen central bank governance, in line with Fund recommendations.**

Key Issues and Policy Discussions

- **Mongolia's mineral resource endowment and its location between two large, fast-growing economies provide a good basis for sustained medium-term growth.** Nevertheless, the economy remains vulnerable to external shocks, including the possibility of declining copper prices, and poverty remains troublingly high. Overcoming these vulnerabilities will require continued macroeconomic stability, as well as improvements in infrastructure and structural reforms to promote private sector development.
- **Fiscal policy needs to preserve the recent reduction in the public debt burden.** To do so, there is a need to target social welfare spending more effectively and move forward with civil service reforms. Some of the tax cuts coming into effect in 2007—particularly the 5 percentage point VAT cut—may need to be partly reversed in the future, if copper prices fall as much as the WEO projections.
- **Monetary policy should aim at mopping up excess liquidity.** Also, the central bank should continue its governance reforms, ensure prudent management of its international reserves, develop an exit strategy from gold operations over the medium term, and fully enforce prudential supervision, particularly of banks with rapid lending growth.

I. Background

1. **Mongolia is experiencing an unprecedented period of strong economic performance (Table 1 and Figures 1-4).** Real GDP growth has averaged 7 percent since 2002, aided by sharp increases in copper and gold prices and a recovery of livestock herds after three devastating winters. As incomes have grown, the expansion has spilled over to other sectors of the economy, including construction, financial services, and the retail sector. After a brief upward spike in 2005, inflation has been brought back down to the mid-single digits, and the budget and external current account balances have moved into surplus. International reserves, which were heavily drawn down in late 2003 in connection with the settlement of Mongolia's pre-1991 debt to Russia, have been reconstituted to more comfortable levels. Near-term economic prospects remain favorable, with growth likely to be sustained by still-high minerals prices and large-scale foreign investment in a major new mining project (Box 1). Despite these significant achievements, poverty remains high (36 percent), and much remains to be done to achieve the Millennium Development Goals.

2. **Looking ahead, the authorities' ability to achieve strong growth over the longer term will require the sustained implementation of policies to support macroeconomic stability, address structural weaknesses, and reduce Mongolia's vulnerability to large external shocks.** In particular, there is a need to keep public debt on a stable or downward path. Achievement of these objectives could be made more difficult if copper prices were to decline significantly over the medium term, as currently projected. Other vulnerabilities include a still-high level of public debt, a harsh climate, a large, landlocked and sparsely populated territory, and weak economic infrastructure.

3. **The current coalition government was formed in January 2006.** It comprises the Mongolian People's Revolutionary Party (MPRP) and members from three smaller parties. Although the MPRP gained an absolute (one-seat) majority in Parliament following a local by-election in September 2006, the coalition has remained intact. The Democratic Party (DP), which was a member of the governing coalition prior to January 2006, is now the main opposition party. The government's ability to set and implement its economic reform agenda has sometimes been constrained by the willingness of individual members of Parliament, including some from the governing parties, to break ranks with their party leadership on important issues. Recent examples include Parliament's actions to impose a windfall tax on copper and gold revenues, cut the VAT rate, and increase untargeted social spending, all of which were initially opposed by the government. The next national elections are slated for mid-2008.

4. **The authorities have expressed strong interest in a new PRGF arrangement.** In preliminary discussions, the staff has taken the position that the government should save most of the large revenue windfall from high commodity prices in order to achieve fiscal sustainability without requiring large future cuts in government expenditure, which could disrupt medium-term growth prospects. The staff has also highlighted the need for further reforms to improve central bank governance and strengthen the financial system. Mongolia's track record under the previous PRGF arrangement that expired in July 2005 was mixed, with only two reviews completed. Although the authorities have, in some instances, been unable to implement fully the policies recommended by Executive Directors at last year's Article IV

Box 1. Mongolia: Mining Sector Prospects

Background: Mongolia's non-fuel mineral sector has been the main pillar of Mongolia's development. It is the fourth largest sector, contributing 25 percent of GDP but accounting for about 70 percent of export earnings and 16 percent of tax revenue. Its output, however, is highly vulnerable to mineral price volatility and its direct contribution to employment has been limited (2.4 percent of labor force), due to its highly capital intensive nature. Dutch disease risks are limited because of idle capacity, including high unemployment but continued appreciation of the togrog in connection with increasing capital flows and foreign exchange earnings may impact nonmineral sector competitiveness in the longer run.

There has been an upturn in mineral exploration since 2001, in the wake of the discovery of the large *Oyu Tolgoi* copper/gold deposit and in response to strong world prices for copper and gold since 2004. Exploration, however, has been hampered by poor infrastructure and uncertainties on the new mining tax regime.

Stability Agreements/Investment Contracts. These are important for some mining companies to remove long-term uncertainties on mining taxation, thereby strengthening foreign investors confidence. Eight mining companies have entered Stability Agreements under the previous 1997 Minerals Law. Under the 2006 Minerals Law, such agreements renamed Investment Contracts link agreements' maturities to the investment's size.

Copper output (30 percent of exports in 2005), is currently derived exclusively from the Erdenet mine but is expected to be boosted in the medium term by the coming on stream of the *Oyu Tolgoi* mine and the development of the *Tsagaan Suvarga* deposit.

Erdenet. Mongolia's largest mine, has been in operation since 1978 under a Russian-Mongolian government joint venture. The mine produces copper concentrate together with molybdenum and is also engaged in a variety of non-mining activities (e.g., farming) and provides extensive local social support. The mine's output has been declining and is expected to deteriorate further as copper grade decreases with depth. However, investments are underway to compensate the output decline by producing higher value copper cathode. Erdenet's annual copper concentrate output is about 130,000 tons; its ore reserves of 1.54 billion tons have a 30-year lifespan.

Oyu Tolgoi copper and gold deposit (Ivanhoe). Discussions are underway between the government and Ivanhoe, a Canadian company, to reach agreement on an investment contract that would pave the way for beginning mining the *Oyu Tolgoi* deposit in 2009. Initial annual copper concentrate output would be 300,000 tons with a 1 million ton peak to be reached within six years. Its copper ore reserves would provide for a 40-year lifespan.

Gold output (31 percent of exports in 2005) is also widely mined by Mongolian and Mongolian-Russian joint ventures, comes as a by-product of the Erdenet copper mine and is subject to widespread artisanal mining ("ninjas" miners). Gold prospects depend on timely development of the Oyu Tolgoi (Ivanhoe) and *Gatsuurt* (Boroo) deposits, both of which are critically hinging upon finalizing investment contracts with the government.

Other minerals. Mongolia is also a significant producer of fluorite under *Mongolrostsvetmet*, a Russian-Mongolian joint venture and Mongolia's second largest mining company. In addition, the *Tumurtiinovoo* zinc mine, a Chinese-Mongolian joint venture has been operational since 2005 with an expected 14-year lifespan. Phosphate mining from the *Burenkhaan* deposit is in the process of being developed. In the longer term, considerable coal reserves from the *Tavan Tolgoi* deposit (5 billion tons), and the *Turmurtei* iron deposit (229 million tons), as well as identified natural gas and petroleum reserves are expected to provide further growth impetus.

consultation, they consider that Fund advice and support continue to provide a critically important policy framework which facilitates the development of consensus and political support for reforms.

II. Recent Economic Developments and The Near-Term Outlook

5. **Recent economic performance has been very robust, with strong, broad-based growth, declining inflation, growing budget and balance of payments surpluses, and improving confidence in the banking system.** Real GDP is estimated to have risen by 7 percent in 2006, the same as the average pace achieved during 2002-05. The minerals sector has been a key engine of growth, supported by record high prices for copper and gold, some increases in production volumes, and investment at the new Ivanhoe copper and gold mine, which has not yet come on stream. Outside the mining sector, growth has also been supported by favorable weather conditions, buoyant residential and commercial construction, and rapid growth in financial services. Growth is projected to remain at about 7 percent in 2007.

6. **After spiking higher in the first half of 2005, inflation has since slowed to a moderate rate.** The year-on-year inflation rate jumped from 10½ percent in December 2004 to 17½ percent in June 2005, due partly to a temporary shortage in the supply of meat which sent prices soaring. As the supply shock was reversed, inflation declined to 1.8 percent (year-on-year) in July 2006, the lowest level in four years. With the impact of the supply shock falling, inflation subsequently picked up to 6.5 percent in October 2006, reflecting increases in the prices of petroleum products, and rapid monetary growth.[1]

7. **The fiscal position has improved markedly in recent years, driven by the rapid run up in copper prices and by faster-than-expected economic growth (Table 2, Box 2, and Figure 2).** The overall budget balance shifted from a deficit of 4 percent of GDP in 2003 to a surplus of 3 percent in 2005, which is now projected to widen to 9 percent of GDP in 2006. Underlying the dramatic improvement in fiscal performance has been a sevenfold increase in mining revenues between 2003 and 2006 due to both sharply higher copper and gold prices, as well as the imposition of a new windfall tax on copper and gold in June 2006. Meanwhile, total expenditure has fallen from 42 percent of GDP in 2003 to an estimated 31½ percent in 2006, despite the 2006 introduction of a 30 percent wage increase and an expansion of social welfare transfers. Delays in the execution of some investment projects also slowed the pace of spending. As fiscal performance has improved, the net present value (NPV) of public debt dropped from 80 percent of GDP at end-2003 to 45 percent at end-2005. It is expected to fall further to 35 percent at end-2006.

8. **Monetary aggregates have been growing rapidly (Table 3 and Figure 3).** Reserve money growth picked up from 20 percent (year-on-year) in December 2005 to 27 percent in September 2006. The acceleration in reserve money reflected strong foreign exchange inflows, which more-than-offset a substantial decline in net central bank credit to government. For the banking system as a whole, broad money increased by 38 percent in the year to September

[1] The determinants of inflation in Mongolia are examined in the Selected Issues Paper, Chapter I.

Box 2. Mongolia: The Evolving Fiscal Framework

Mongolia's fiscal framework has evolved significantly since the beginning of 2006. Changes include the addition of new spending measures in the amended budget passed in June, a new mining law, and new personal income tax, corporate income tax, and VAT laws which go into effect on January 1, 2007.

The ***"windfall" tax*** introduced in June 2006 is intended to capture a higher share of the revenues accruing to mining companies from high export prices. The 68 percent tax rate applies to copper revenues from prices exceeding the sum of a base price (US$2,600 per ton) and smelting costs (projected at US$1,580 per ton), and gold revenues from prices exceeding US$500 per ounce.

In addition to the "windfall" tax, the new ***mining regime*** enacted in July 2006 provides for: (i) a ***doubling of royalties*** on metals from 2.5 percent to 5 percent; (ii) an increase in ***mining license fee****s* and a shortening of the license's duration to discourage speculation and under-utilization of mining licenses; and (iii) a doubling (up to 30 years) of the maximum duration for ***investment contracts,*** which may include stability clauses on the tax regime. The mining law also establishes the possibility of ***government equity participation*** up to 34 percent in mines deemed to be "strategic deposits," and up to 50 percent for strategic deposits discovered with government support. A ***Development Fund*** was also established to ensure that revenues from the "windfall" tax are allocated as follows: (i) one third of total for saving; (ii) one third for capital expenditure; and (iii) one third for children and family allowances.

On the ***expenditure side***, the amended 2006 budget contained several important measures: (i) ***wages and salaries*** were raised by 30 percent (retroactive to February 1); (ii) ***minimum pensions*** were increased, and the pensions paid to retirees under different systems were aligned; (iii) ***domestically-financed investment*** was budgeted to more-than-double; and (iv) ***social welfare transfers*** were raised through an increase in the monthly child allowance and the elimination of its means testing, the introduction of lump sum allowances for newlyweds and newborns, and a modest school lunch program.

The amended 2006 budget officially calls for an overall deficit of 3.4 percent of GDP. However, this estimate does not reflect the increase in the mining royalty rate. It also treats all revenue accruing to the Development Fund as expenditure, although on a consolidated central government basis, this is not the case. Taking account of these factors, ***the staff and authorities project that the budget will record a surplus of about 9 percent of GDP in 2006.***

The 2007 budget calls for an overall deficit of 5 percent of GDP. Reflecting the ***new tax laws*** that go into effect on January 1, tax revenues are projected to cost some 3.9 percent of GDP. These measures include: (i) a cut in the **VAT rate** from 15 percent to 10 percent and the abolition of a range of VAT exemptions at an estimated cost of 1.7 percent of GDP; (ii) unification of the **personal income tax** (PIT) at the lowest of the previous rates (10 percent) at an estimated cost of 0.5 percent of GDP; (iii) a five percentage point cut in each of the two corporate income tax (CIT) rates along with a thirty-fold increase in the higher rate's threshold, the elimination of tax holidays for foreign investors, the introduction of loss carry-forward provisions, and the use of investment tax credits in priority sector, at an estimated cost of 1.7 percent of GDP; and increases in excises on vehicles and gambling for an estimated revenue gain of 0.1 percent of GDP. On the ***expenditure side,*** the 2007 budget provides for a further 30 percent increase in civil service wages and a 0.8 percent increase in civil service employment, a substantial additional increase to the child allowance, and an increase in capital spending by 4.4 percent of GDP to address infrastructure needs in areas such as roads and housing.

Looking beyond 2007, Parliament calls for the overall deficit to remain constant at 4 percent of GDP through 2009, which is the deficit ceiling in the government's ***Medium-Term Budget Framework*** (MTBF).

2006, driven entirely by foreign assets. Net domestic assets of the banking system declined in the year to September 2006, as a sharp drop in net credit to government exceeded the impact of rapid growth in credit to the private sector. The subdued response to date of inflation to this rapid monetary growth reflects an ongoing process of reintermediation as incomes have risen and confidence in the banking system has improved and the gradual appreciation of the exchange rate, which has helped keep a lid on the prices of imported goods.

9. **The external current account surplus (including official transfers) is expected to widen from 1½ percent of GDP in 2005 to 5 percent of GDP in 2006 (Table 4 and Figure 4).** The increase in the surplus has been driven by a marked improvement in the terms of trade, which more than offset a pick up in import volume growth and higher investment income payments. With increased inflows of direct investment in the mining sector and a recovery in disbursements of concessional official loans, gross international reserves are expected to reach US$626 million (3½ months of imports of goods and services) by end-2006, while the NPV of external public debt is expected to fall to 32 percent of GDP, half the level at end-2003. Looking ahead to 2007, the current account balance is expected to revert to a deficit (2 percent of GDP) owing to strong growth in investment imports financed by increased foreign direct investment. Gross official reserves are projected to reach 4 months of import cover at end-2007.

10. **Exchange rate developments have reflected the improvements in the terms of trade and capital inflows.** The real effective exchange rate (REER) of the togrog has appreciated by about 18 percent since end-2004. In terms of the U.S. dollar, the togrog depreciated by ½ percent in 2005 but appreciated by 4½ percent during the first nine months of 2006.

III. Policy Discussions

A. Overview of Policy Issues and Macroeconomic Framework

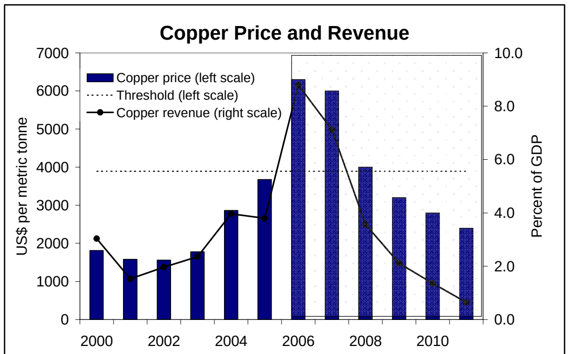
11. **With its ample mineral endowment and location between two large, fast-growing economies, Mongolia has the potential to achieve strong, sustainable growth.** At the same time, the economy remains very vulnerable to external shocks, including the possibility of substantially lower copper prices over the medium term. The discussions, therefore, focused on policies to safeguard recent gains in macroeconomic stability, improve the governance of public sector institutions, strengthen confidence in the financial system, and promote private sector development. The mission encouraged the authorities to save most of the large revenue windfall from high commodity prices to keep public debt on a sustainable path, and it advised the Bank of Mongolia to rein in the rapid pace of monetary growth to bolster confidence in the financial system and prevent an upturn in inflation.

12. **The authorities noted that economic performance has significantly surpassed expectations in recent years.** While partly the result of favorable external factors, this strong performance has also reflected the sustained implementation of far-ranging structural and financial sector reforms and the government's cautious approach to budget planning. While the authorities remained strongly committed to macroeconomic stability, they also stressed that Mongolia would require large-scale infrastructure investments to achieve its growth potential.

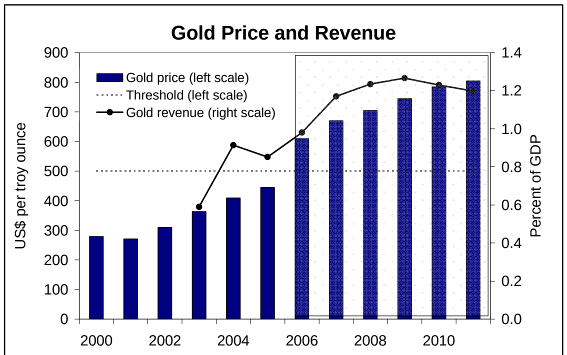
13. **The staff's medium-term scenario (Annex I) envisages that real GDP growth can average 6-7 percent over the medium term, if appropriate policies are pursued.** Inflation is targeted to be contained to 5 percent throughout the period, provided that fiscal and monetary discipline is maintained. Mongolia's external debt is still moderately high, but debt dynamics have improved markedly in recent years. To keep the debt burden manageable, the authorities should continue borrowing solely on concessional terms. Under a baseline scenario providing for sustained output and export growth and continued access to concessional borrowing, Mongolia's external debt ratios would decline in the long term. However, debt distress indicators could deteriorate and become unsustainable under a variety of plausible shocks, especially under a severe terms of trade shock.

B. Fiscal Policy

14. **The latest data suggest that the budget surplus could widen to 9 percent of GDP in 2006.** There are two main reasons for the sharp revision from the 3½ percent of GDP deficit in the amended budget. First, copper prices have remained much stronger than the authorities expected at the time of the amended budget, and collections of the windfall tax and other mining revenues have been correspondingly larger.[2] Secondly, capital spending has continued to fall far short of the amounts budgeted, due in part to teething problems with the introduction of new government procurement procedures.



Sources: IMF, *World Economic Outlook*; and Fund staff estimates.



Sources: IMF, *World Economic Outlook*; and Fund staff estimates.

15. **In sharp contrast, the 2007 budget projects an overall deficit of nearly 5 percent of GDP.** While a part of this deterioration would be due to a decline in copper prices, the nonmineral deficit would also widen from 4½ percent of GDP in 2006 to 16½ percent in 2007.[3] With growth remaining robust, most of the deterioration in the fiscal balance would reflect policy measures in the budget which include: (i) cuts in the Value Added Tax (VAT), the personal income tax (PIT), and the corporate income tax (CIT) which will go into effect on January 1 (Box 2) (a revenue loss of 4 percent of GDP); (ii) a large increase in the untargeted child

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[2] The amended 2006 budget copper price assumption is US$5,200 per ton, while the actual price has generally remained above US$7,000 per ton for the second half of the year.

[3] The authorities assume that the average copper price in 2007 will be US$6,000 per ton. Although this is somewhat higher than the September WEO projection, actual prices in recent months have remained around US$7,000.

allowance (from 1 percent of GDP in 2006 to about 4 percent of GDP in 2007); (iii) a 20 percent increase in civil services wages (30 percent increase for those earning minimum wage) and an increase in civil service employment (raising the wage bill by 1 percent of GDP); and (iv) a sharp pickup in capital spending (4½ percent of GDP).

16. **The mission considered that the loosening of fiscal policy implied by the budget would stimulate demand at a time of generally high resource utilization which would be ill-advised.** Moreover, the budget would set in motion spending policies that could be difficult to reverse over the medium term. The mission believed that it would be feasible and desirable to contain the overall deficit to 2 percent of GDP (a nonmineral deficit of 13½ percent) in 2007. Such a deficit could be financed entirely by concessional foreign borrowing.

17. **Most of the short-term fiscal adjustment recommended by the mission could take place on the expenditure side.** The mission encouraged the authorities to focus new spending on infrastructure improvements and poverty reduction. Therefore, the mission recommends that the very large increase in the child allowance be scaled back and means testing for the benefit be reintroduced.[4] It is also crucial to accelerate the pace of civil service reform. Given the large wage increases granted in 2006 and 2007, the mission recommended that the authorities cap the size of the civil service at current levels until the authorities implement the civil service census and functional ministerial reviews that are being conducted with World Bank assistance. Notwithstanding Mongolia's large infrastructure needs, the mission believes that the country lacks the implementation and absorptive capacities to raise public investment spending by more than 2 percentage points of GDP in the near term.

18. **On revenues, the mission welcomed the important steps taken in the 2007 budget to reduce distortions in the tax system, including the elimination of VAT exemptions and tax holidays.** However, it suggested that the authorities should be prepared to reverse some of the tax rate cuts if minerals prices fall by more than the authorities now project. The mission emphasized that the cuts in nonminerals taxes will make the budget increasingly sensitive to conditions in the minerals sector. With copper prices projected to decline in 2007 and over the medium term, the tax cuts could put pressure on the fiscal position. Should this occur, the mission recommended that the authorities reverse at least part of the 5 percentage point cut in the VAT rate. At the same time, the authorities should ensure that the mining tax regime leaves Mongolia an internationally competitive producer. The authorities' request for technical assistance from the Fund on mining taxation was, therefore, timely. The mission also strongly encouraged the authorities to resist proposals that had been made by some members of Parliament to compensate for the tax cuts by raising import duties.

19. **The mission stressed that fiscal policy should be firmly grounded in a transparent medium-term framework designed to ensure sustainability, reduce the economy's vulnerabilities to shocks, and avoid procyclical impulses to demand.** To reduce vulnerability to a downturn in copper prices, it would be prudent to bring the nonmineral deficit back down to around 7 percent of GDP over the medium term. This would be consistent with a

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[4] The child allowance contained in the 2007 budget would provide the equivalent of 10 percent of per capita GDP to 40 percent of the population.

gradual reduction in the NPV of public debt to below 30 percent of GDP. The mission noted that achievement of such a medium-term objective is likely to require concerted policy action to maintain a broad tax base and contain the growth in spending, as noted above.

20. **The authorities pointed out that budget performance had exceeded expectations by wide margins in recent years, and they said the government remained committed to following prudent fiscal policies.** However, they also emphasized the importance of infrastructure improvements, low tax rates, and social consensus to sustain strong growth. For a resource-rich low-income country, the authorities considered that a budget deficit on the order of 4 percent of GDP would be sustainable and appropriate over the medium term. While acknowledging the need for social programs to focus on poverty alleviation, they considered that there was also a need for the population at large to share the dividends from strong growth and high minerals prices.

21. **The staff team recognized that fiscal performance had been consistently stronger than expected, but it noted that continued large deviations between budget projections and outturns could eventually have an adverse impact on policy credibility.** To help improve transparency, the authorities should consolidate (both numerically and conceptually) the Development Fund with the rest of the budget and clarify how much of the windfall revenues it intends to spend, over what timeframe, and for what purposes. They should also fully align spending of the Development Fund with overall spending priorities. There is also a need to base budget projections on more realistic assessments of capacity constraints and estimates of the pace at which the government will be able to able to implement investment projects.

C. Monetary Policy

22. **Although inflation has come down from the double-digit rates hit in 2005, the authorities and mission team agreed that continuation of the current rapid growth in broad money would eventually feed into higher inflation.** A relaxation of fiscal policy, excessive wage increases, or a depreciation of the exchange rate could further add to inflationary pressures. Against this background, the mission encouraged the authorities to contain reserve money growth to 15 percent in 2007 to keep inflation in the mid-single digits. The authorities agreed that these targets for inflation and reserve money were feasible and appropriate. To achieve this objective, the BOM should increase the issuance of CBBs at market-clearing interest rates.

23. **Institutional strengthening can help improve the effectiveness of monetary policy instruments. The government, in turn, should ensure that the central bank remains adequately capitalized.** The government's recent action of converting a noninterest-bearing central bank advance to government into interest-bearing bonds was a positive step in this regard.[5] The mission also recommended that the BOM should better integrate the operations of

[5] The BOM had provided a 10-year noninterest-bearing advance to the government of US$100 million and a US$37 million, interest free, short-term loan at end-2003 to help finance the government's settlement of the pre-1991 Transferable Ruble debt.

its International and Monetary Policy Departments to ensure that changes to reserve money driven by purchases of gold from domestic producers are appropriately sterilized. A technical assistance mission by MCM to advise on monetary policy instruments is scheduled to take place in December 2006.

24. **The authorities noted the recent decision by the BOM and 10 commercial banks to establish the Mongolian Mortgage Corporation (MIC).** The MIC is expected to provide well-secured lending to the private sector and facilitate the development of a secondary market, which were both seen as important for sustained economic development. The mission welcomed the plans to broaden the capital market but cautioned that the BOM should refrain from providing guarantees or large liquidity injections to support MIC operations.

D. External Policies

25. **Mongolia's flexible exchange rate has facilitated adjustment to large real shocks.** Commodity exports account for more than two thirds of Mongolia's total merchandise exports, and export performance has been closely associated with the movements in the terms of trade. Despite the real appreciation of the togrog over the past two years, the external position looks sustainable, and inflation is lower than it would have been under a less flexible exchange-rate regime. Given these factors, the level of the exchange rate appears to be broadly appropriate and the authorities and mission team agreed that foreign exchange market interventions should remain limited to the smoothing of short-term volatility.[6] Recent business surveys conducted by USAID and the World Bank have highlighted inefficient government administration, burdensome tax and customs regulations, inadequate infrastructure, and corruption as the business community's main concerns for competitiveness. Therefore, the staff team stressed that maintaining competitiveness and promoting export diversification over the medium term will require a combination of sound macroeconomic policies and continued progress in structural reforms aimed at streamlining regulation and eliminating corruption.

26. **Given the relatively high level of external debt and the large amount of borrowing that will continue to be needed to improve infrastructure and strengthen growth prospects, the mission advised the authorities to continue borrowing exclusively on concessional terms.** The mission also recommended that the government should refrain from granting external loan guarantees on behalf of domestic borrowers, and it welcomed the government's ongoing efforts to strengthen the collection of on-lent funds. The authorities stressed that they remained committed to prudent debt management, and they endorsed the assessment under the joint Bank-Fund debt sustainability analysis (Annex I). While the authorities had no immediate plans to tap international capital markets, the central bank saw potential benefits in establishing a good credit rating based on actual experience in the market.

27. **Important steps have been taken to settle some longstanding disputes with foreign creditors.** The pre-1991 transferable ruble debts to Russia and Poland have been settled and discussions are also underway on the arrears of post-1991 Russian debt. Loan arrears to an

[6] Foreign exchange market operations are described in the accompanying Selected Issues Paper, Chapter III.

Italian supplier were cleared in mid-2006 but two longstanding Finnish suppliers' credits remain under dispute.

28. **Mongolia maintains open trade and investment regimes, but pressures for increased protection are on the rise.** The authorities expressed concerns about the potential negative impact on local industries that could result from lowering the export tax on cashmere, and Mongolia's WTO commitment to eliminate the tax by January 2007 is likely to be missed. Some parliamentarians also favor offsetting part of the revenue loss from the VAT rate decline by increasing import duties. The staff urged the authorities to adhere to their original schedule to eliminate the raw cashmere export tax and to resist pressures to raise import duties.

E. Central Bank Governance and Financial Sector Reforms

29. **Weaknesses in central bank governance, in areas including central bank oversight, banking supervision, and the management of international reserves have been viewed as potential risks to financial stability.** The mission was, therefore, encouraged to note that the BOM had made a good start in implementing reforms to strengthen its governance structures. In September 2006, the BOM appointed two non-executive directors to its Board of Directors, in line with technical assistance advice from the Fund. The authorities are also examining possible changes in the Central Bank Law to shift key decision-making authority from the Governor to the Board of Directors, another Fund staff recommendation. The mission welcomed these steps and encouraged the authorities to move forward with other governance reforms, including the strengthening of the BOM's external Supervisory Board, which conducts oversight of the central bank. While commending recent progress in strengthening the BOM governance, the staff encouraged the BOM to move toward full compliance with the 2003 Safeguards Assessment.

30. **Prudent management of international reserves is crucial for safeguarding financial stability.** The staff team stressed that international reserves should be held in low risk, unencumbered assets, and it noted that the BOM's exposures in the gold market could raise risks in this respect. In view of the still-limited capacity and appetite of banks to engage in complex gold operations, there was agreement that an immediate withdrawal of the BOM from domestic gold purchases was not necessarily desirable. However, the BOM should begin preparing a timely exit strategy from the market. Meanwhile, the mission advised the BOM to adopt more prudent guidelines for its gold risk exposures and to cease immediately from taking risky positions in gold derivatives and other speculative instruments.

31. **Progress has been made in strengthening the banking system, although important risks still remain.** Nonperforming loans (NPLs) of the banking system were reduced from 23½ percent of total loans at end-2000 to 9 percent at end-2005, and the ratio has remained relatively stable in 2006. However, NPLs at some small and medium-sized banks have increased, and their profitability has deteriorated. The mission noted that it can be more difficult to detect incipient loan quality problems when loan growth is very rapid, and it encouraged the authorities to intensify their supervision of banks with high credit growth or rising NPLs. Contingency plans should also be drawn up for the resolution of problem banks, and the mission advised the authorities to proceed very cautiously with plans to introduce a bank deposit insurance scheme.

32. **The authorities said they were taking additional steps to strengthen banking supervision.** Several banks with rapid credit growth were already subject to intensified supervision, and the BOM is strengthening its capacity to enforce fit and proper requirements for major bank shareholders. In addition, all 16 banks have complied with the doubling of the minimum capital requirement set by the BOM. The authorities also reported that some progress had been achieved in identifying final borrowers in a fraud scheme involving letters of credit from a Korean supplier.

33. **Solvency problems have emerged at a number of saving and credit cooperatives (SCCs).** The Financial Regulatory Commission (FRC) was established in 2006 to supervise these and other nonbank financial institutions. The FRC is reviewing applications for licenses from SCCs, some of which have already been rejected, and it has initiated on-site examinations. The FRC also plans to intensify the supervision of securities firms, insurance companies, and other nonbank financial institutions. The mission stressed that SCCs and other nonbank financial institutions should be excluded from any deposit insurance scheme for the banking system, if one is developed.

34. **The mission welcomed the recent adoption the AML/CFT Law and the authorities' plans to establish a Financial Intelligence Unit (FIU) within the BOM.** It noted that some issues still needed to be addressed to ensure full compliance with FATF recommendations. The authorities stressed their intention to strengthen further the AML/CFT framework as needed to meet international standards.

F. Structural Reforms, Poverty Reduction, and Statistical Issues

35. **Tax administration, regulatory and public enterprise reforms have been designed to help strengthen private sector development.** The adoption of the Anti-Corruption Law is also expected to pave the way for removing a major impediment to doing business in Mongolia, although the law still needs further strengthening to meet international requirements. The authorities have endorsed the Extractive Industries Transparency Initiative (EITI) to improve governance in mineral resources management. Public enterprise reforms are being pursued. Savings Bank was recently privatized, bidding is underway for the privatization of Gobi Cashmere, and enterprises in the energy sector are slated to undergo comprehensive restructuring under a forthcoming World Bank-supported energy sector reform project.

36. **Socio-Economic Guidelines have been recently finalized with a view to strengthening the poverty reduction strategy.** To address high poverty and widening income gaps, the staff reiterated that poorly targeted social welfare programs, such as the universal child allowance and lump-sum awards to newlyweds and newborns, seriously diluted resources for poverty alleviation.

37. **Mongolia accords high priority to the collection and dissemination of economic statistics, and efforts are underway to further upgrade the statistical base.** Work is well underway to expand the coverage of national accounts data. An STA mission in September 2006 made good progress in reconciling discrepancies on domestic bank financing in the monetary data and government finance statistics. Mongolia is participating in the pilot program for the introduction of the *Government Finance Statistics Manual (GFSM) 2001*

methodology. The authorities have requested World Bank and Fund support to implement their *Program of Official Statistics Development (2006-2010)*.

IV. Staff Appraisal

38. **Mongolia is experiencing a period of unprecedented strong economic performance.** Real GDP growth has averaged 7 percent since 2002, and inflation has been brought back down to the mid-single digits. The budget surplus is expected to widen to over 9 percent of GDP in 2006. The external current account is also in surplus, public debt ratios have declined, and international reserves have been rebuilt to more comfortable levels.

39. **Looking forward, the economy faces both significant opportunities and risks.** Mongolia's rich endowment of mineral resources and its location between two large, fast-growing economies provide a good foundation for strong, sustained growth. Nevertheless, daunting medium-term challenges need to be addressed: infrastructure is weak, the territory is landlocked and sparsely populated, the climate can be extremely harsh, and poverty remains troublingly high. Moreover, the large run up in copper prices on the world market, which has helped fuel the recent vigorous expansion, could be at least partly reversed in coming years. Overcoming these obstacles to sustained growth will require policies conducive to maintaining macroeconomic stability, improving infrastructure, reducing structural rigidities and other impediments to private sector development, and effectively utilizing the strong natural resource base.

40. **The fiscal position has improved markedly in recent years due to strong economic growth, a sharp increase in mining sector revenues, and improved tax administration** However, maintaining these gains, with public debt remaining on a gradually declining path may require policy adjustments, particularly if copper prices decline significantly over the medium term, as expected. The loosening of fiscal policy implied by the 2007 budget would be ill-advised. It could also set in motion spending policies that could be difficult to reverse over the medium term. Therefore, the staff considers that it would be feasible and desirable to contain the overall budget deficit to 2 percent of GDP in 2007.

41. **On the revenue side, the challenge will be to maintain a broadly based tax regime that does not discourage investment and growth and is not overly sensitive to commodity price shocks.** Many of the elements of the tax reform package coming into effect on January 1, 2007, including the elimination of tax holidays, the introduction of loss carry forward, and the deductibility of a fuller range of business expenses, are consistent with this objective and with past technical and policy advice from the Fund. However, the government's decision to place increased reliance on mining taxation while cutting nonmining taxes entails risks. To maintain medium-term fiscal sustainability, the authorities may need to undo some of the tax rate cuts, particularly if copper prices decline significantly. Reversing part of the 5 percentage point cut in the VAT rate would be the least distortionary way to accomplish this. The government should also keep the mining regime under close review to ensure that it is appropriately designed to limit risks to the public sector balance sheet to maintain an internationally competitive fiscal regime.

42. **Expenditure reform should also be an important part of a sustainable fiscal policy strategy.** Government expenditure in Mongolia accounts for a higher share in GDP than in many other low income countries. Although this is warranted, to some degree, by structural factors, there is a need to improve the efficiency and effectiveness of government. Social welfare programs need particular attention. The universal coverage of some welfare benefits, such as the awards for newlyweds and newborns, and the child allowance, is placing a strain on the budget, limiting the government's ability to focus on poverty alleviation for the most vulnerable groups. The staff encourages the authorities to reintroduce means testing, where possible, for social welfare programs. Meanwhile, the very large increase in the child allowance provided in the 2007 budget should be scaled back significantly, and further reductions may be needed in the future. The staff also urges the authorities to move forward more forcefully with civil service reforms to pay for increases in public sector wages.

43. **Rapid monetary growth is an indication of reintermediation and improving confidence in the banking system.** However, a continuation of monetary growth at recent rates will eventually feed into higher inflation. To preclude this, the authorities should step up sales of central bank bills in order to slow the growth in reserve money. The staff welcomes the BOM's request for technical assistance from the Fund to develop additional monetary policy instruments and strengthen liquidity management.

44. **Mongolia's flexible exchange rate regime, prudent external borrowing policies, and open trade regime have facilitated orderly adjustment to external shocks, and these policies should be retained.** The strengthening of the togrog has been warranted by commodity price developments and the strong balance of payments. Achieving this through flexibility in the nominal exchange rate has helped keep inflation lower than it might otherwise have been. Intervention in the foreign exchange market should remain limited to smoothing short-term movements. To prevent an increase in the external debt service burden, the government and central bank should continue to refrain from nonconcessional external borrowing. The staff encourages the authorities to reach prompt agreement with foreign creditors on outstanding obligations and debt disputes. The staff also urges the authorities to phase out the export duty on raw cashmere and to resist calls to raise import duties to protect domestic industries.

45. **The authorities have made a good start at strengthening central bank governance.** The recent appointment of non-executive members to the BOM's Board of Directors was a positive step that should be followed by actions to shift more decision-making authority from the BOM Governor to the Board of Directors. Prudent management of international reserves is crucial for safeguarding Mongolia's financial stability. This should include a reduction in gold risk exposures and preparation of an exit strategy from the gold market .

46. **Further actions are needed to strengthen the financial system.** Rapid credit growth and the case of the fraudulent LCs illustrate the need for vigilant enforcement of prudential regulations. High priority should be given to the monitoring of banks with fast credit growth and rising NPLs, strengthening banks' governance, and establishing contingency plans for problem banks. High bank lending rates reflect the still-high risk premia in the market. The staff urges the authorities to continue resisting calls for administrative measures to reduce these

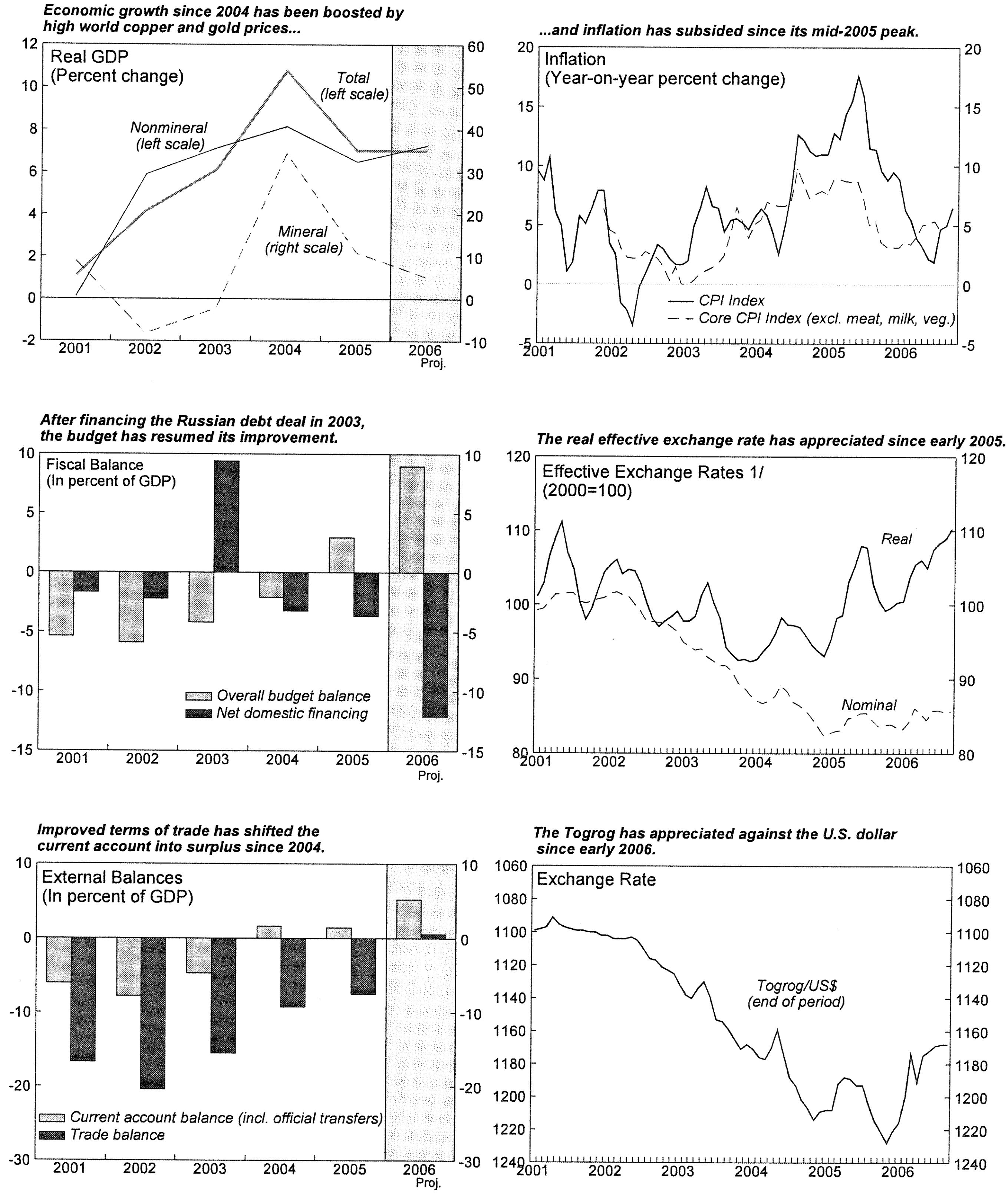
rates. The public sector should not bail out insolvent savings and credit cooperatives, and these institutions are not to be included in any future insurance deposit scheme for banks.

47. **The staff welcomes actions to strengthen the institutional environment for private sector development.** Important recent steps include the adoption of the Anti-Money Laundering Law and the Anti-Corruption Law, although the latter still needs further strengthening. Recent progress in privatization of two of the remaining large public enterprises is also welcome. Further efforts, however, are needed to strengthen the operations of the remaining public enterprises, mainly in the energy sector.

48. **The staff welcomes efforts underway to strengthen data quality for surveillance purposes, including the broadened coverage of national accounts, reconciliation of discrepancies between fiscal and monetary data, and Mongolia's participation in the *GFSM 2001* pilot project.** Further technical assistance will be important to the success of these efforts.

49. **The staff recommends that the next Article IV consultation with Mongolia take place on the standard 12-month cycle.**

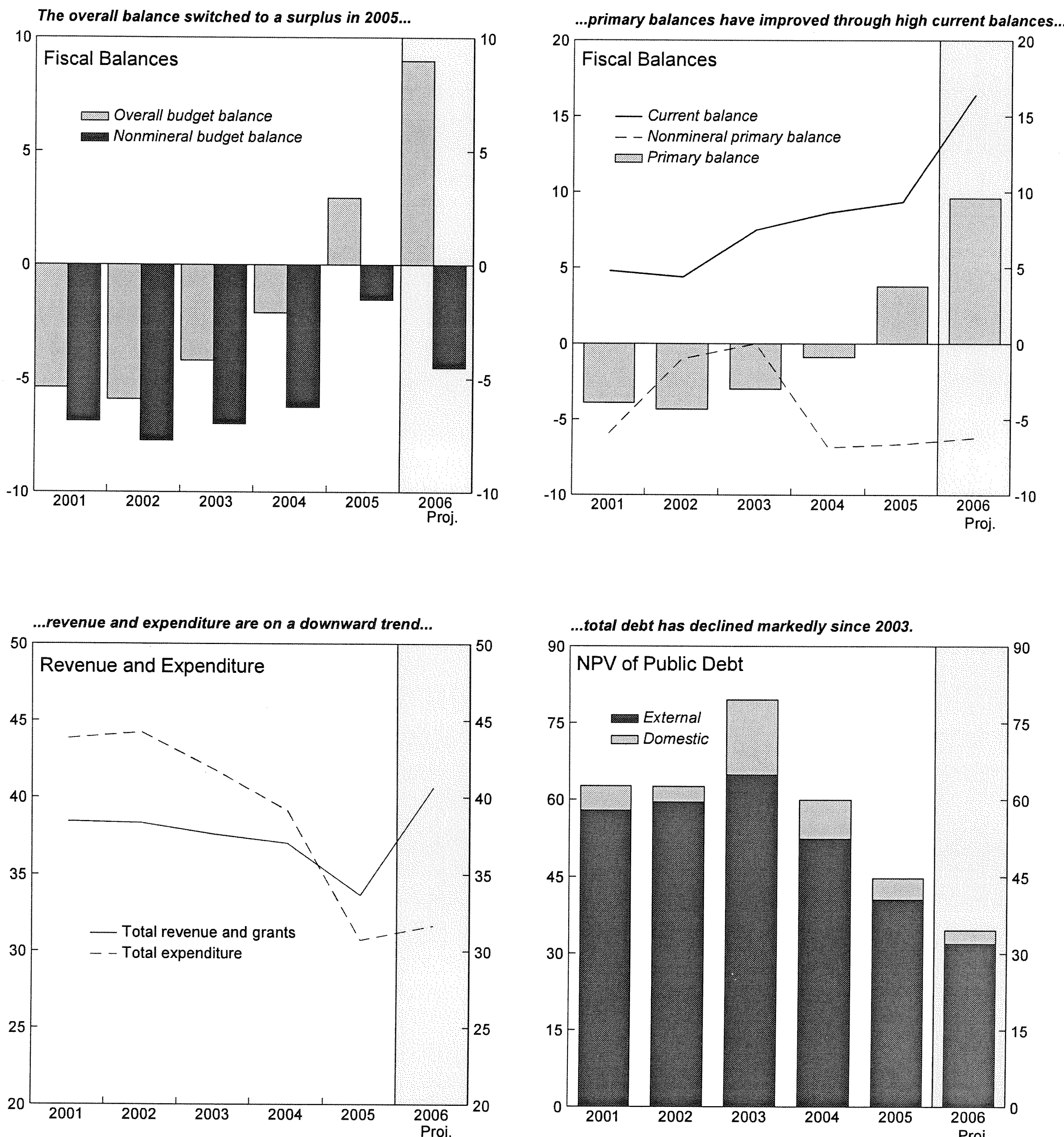
Figure 1. Mongolia: Economic Developments, 2001-06



Sources: Mongolian authorities; and Fund staff estimates.

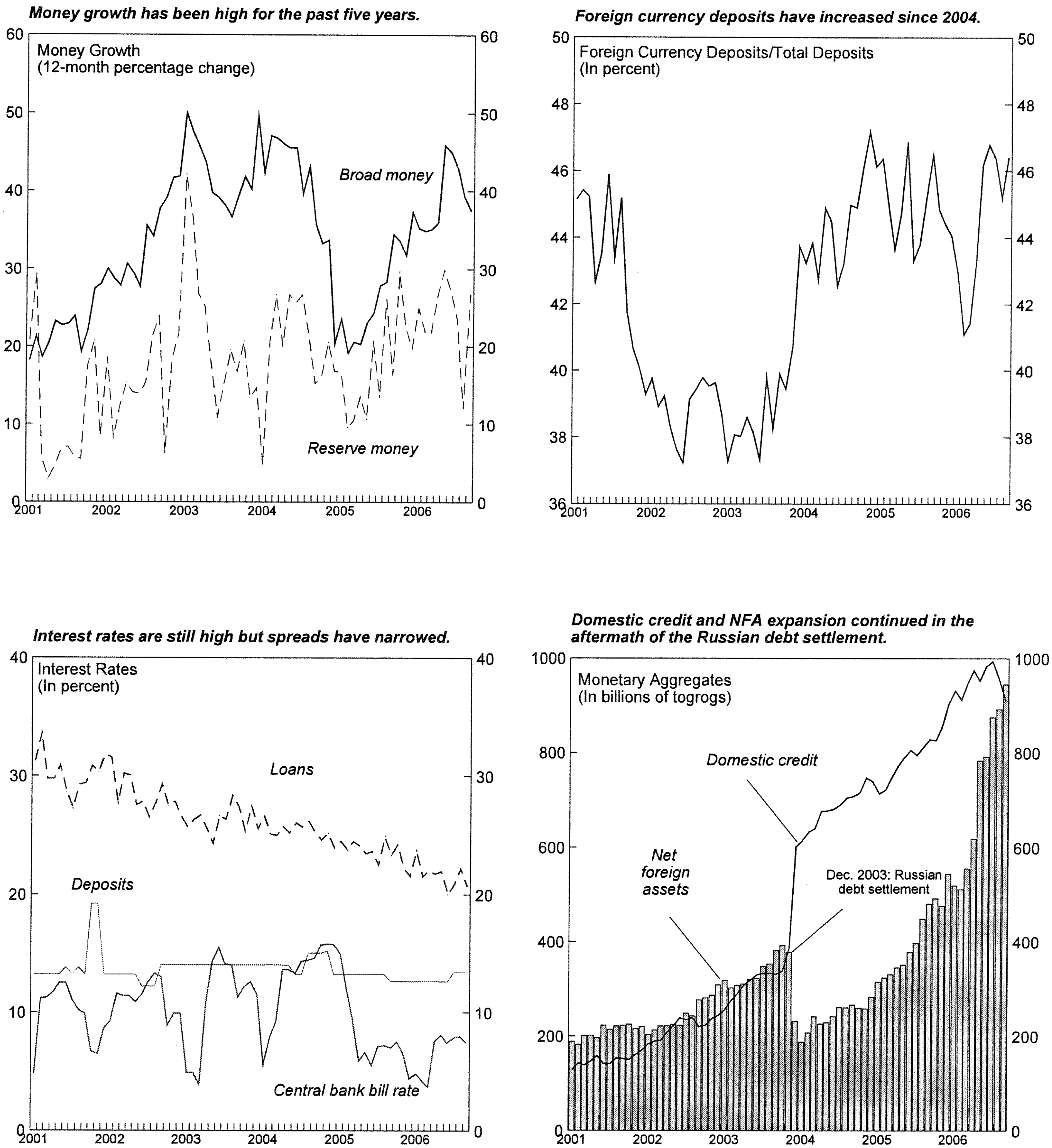
1/ An increase indicates appreciation.

Figure 2. Mongolia: Fiscal Indicators, 2001-06
(In percent of GDP)



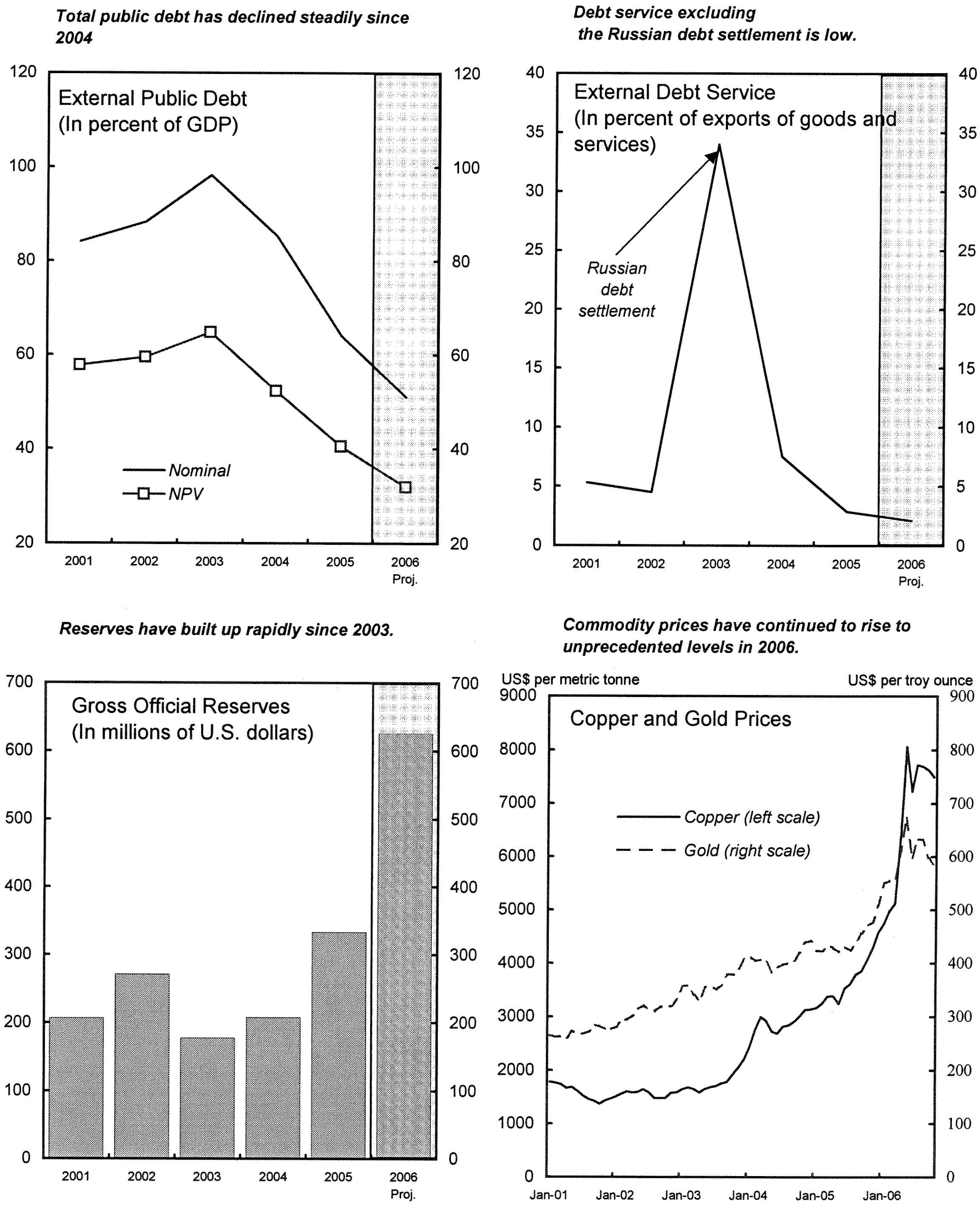
Sources: Mongolian authorities; and Fund staff estimates and projections.

Figure 3. Mongolia: Monetary Developments, 2001-06



Sources: Mongolian authorities; and Fund staff estimates.

Figure 4. Mongolia: External Developments, 2001-06



Sources: Mongolian authorities, Fund staff estimates; and *International Financial Statistics*: IMF.

Table 1. Mongolia: Selected Economic and Financial Indicators, 2003-07

Nominal GDP (2005): $2,066 million
Population (2005): 2.56 million
Per capita GDP (2005): $806
Poverty incidence: 36 percent 1/
Quota: SDR 51.1 million

	2003 2/	2004	2005	2006		2007	
				Amended Budget	Est.	Budget 3/	Proj. 4/
				(Percent change)			
Real sector							
Real GDP growth	6.1	10.8	7.0	6.8	7.0	8.6	7.0
Mineral	-2.3	34.3	10.9	...	5.2	...	5.2
Nonmineral	7.1	8.1	6.5	...	7.3	...	7.3
Consumer prices (period average)	5.1	8.3	12.1	5.6	5.6	...	5.3
Consumer prices (end-period)	4.7	11.0	9.5	7.0	7.0	5.0	5.0
GDP deflator	11.6	18.0	20.7	24.1	24.1	...	6.5
				(In percent of GDP)			
General government budget							
Revenue and grants	37.6	37.0	33.7	33.2	40.6	35.9	35.5
Expenditure and net lending	41.8	39.1	30.7	36.6	31.7	40.9	37.5
Current balance	7.5	8.6	9.3	6.5	16.4	6.8	7.8
Primary balance	-3.0	-0.9	3.8	-2.6	9.6	-4.4	-1.4
Overall balance (including grants)	-4.2	-2.1	2.9	-3.4	9.0	-5.0	-2.0
Nonmineral overall balance	-7.0	-6.3	-1.5	-11.1	-4.5	-16.3	-13.6
Net domestic bank credit to government	9.4	-3.2	-5.8	-1.6	-12.1	2.6	-0.9
				(Percent change)			
Money and credit							
Net foreign assets	-24.9	22.0	92.4	...	85.5	...	33.7
Net domestic assets	191.6	19.5	9.6	...	-9.7	...	30.5
Domestic credit	147.0	23.0	22.3	...	-5.0	...	26.8
Of which: claims on nonbanks	90.3	43.7	40.1	...	39.2	...	20.9
Broad money	49.7	20.3	37.3	...	34.9	...	32.5
Reserve money	14.7	16.8	19.7	...	16.5	...	15.0
Broad money velocity (GDP/BM) 5/	2.1	2.3	2.3	...	2.2	...	1.9
Annual interest rate on central bank bills (percent) 6/	15.0	15.8	3.7	...	5.8	...	...
				(In millions of US dollars; unless otherwise indicated)			
Balance of payments							
Current account balance (excluding official transfers)	-148	-60	-59	...	55	...	-159
(In percent of GDP)	-11.5	-3.7	-2.8	...	2.0	...	-5.2
Current account balance (including official transfers) 7/	-99	27	29	...	145	...	-67
(In percent of GDP)	-7.7	1.6	1.4	...	5.2	...	-2.2
Trade balance	-199	-149	-155	...	16	...	-169
(In percent of GDP)	-15.5	-9.2	-7.5	...	0.6	...	-5.5
Exports, f.o.b.	627	872	1,069	...	1,548	...	1,635
(Percent change)	19.7	39.0	22.5	...	44.8	...	5.6
Imports, cif	827	1,021	1,224	...	1,532	...	1,804
(Percent change)	9.8	23.5	19.8	...	25.2	...	17.7
Foreign direct investment	132	129	258	...	329	...	499
Gross official international reserves (end-period)	178	208	333	...	626	...	800
(In months of next year's imports of goods and services)	1.5	1.6	2.1	...	3.4	...	3.9
Trade prices				...			
Export prices (U.S. dollar, percent change)	6.6	23.1	13.6	...	40.4	...	0.0
Import prices (U.S. dollar, percent change)	5.4	15.1	11.0	...	11.6	...	-0.5
Terms of trade (percent change)	1.1	7.0	2.3	...	25.8	...	0.5
				(In millions of US dollars; unless otherwise indicated)			
Public and publicly guaranteed debt							
Total public debt (In percent of GDP) 8/9/	113.0	93.0	68.3	...	53.6		50.6
Domestic debt (In percent of GDP)	14.8	7.6	4.2	...	2.6		2.0
External debt 7/	1,237	1,361	1,308	...	1,405	...	1,480
(In percent of GDP)	98.2	85.4	64.1	...	51.0	...	48.6
(In percent of total public debt)	86.9	91.8	93.9	...	95.1	...	96.1
Net public debt (In percent of GDP)	105.2	88.0	62.4	50.1	41.2	...	36.9
NPV of total public debt (In percent of GDP) 8/9/10/	79.5	59.9	44.7	...	34.6	...	32.5
Debt service	284.0	91.2	42.8	...	41.8	...	49.8
(In percent of exports of goods and services)	34.0	7.5	2.9	...	2.1	...	2.4
Exchange rate							
Togrogs per US dollar (end-period)	1,170	1,209	1,221	...	1,164		...
Togrogs per U.S. dollar (period-average)	1,147	1,193	1,205	...	1,186		...
Real effective exchange rate (end-period; percent change)	-6.8	0.8	7.7	...	...	...	...
Nominal GDP (billion togrogs)	1,474	1,926	2,489	3,306	3,306	3,768	3,768
Nominal GDP (million U.S. dollars)	1,285	1,615	2,066	2,788	2,788	3,092	3,092

Sources: Data provided by the Mongolian authorities; and Fund staff estimates and projections.

1/ Share of households below national poverty line, 2003 Household Income and Expenditure Survey.
2/ The outturn for 2003 reflects the impact on fiscal, monetary and external accounts of the $250 million settlement of the TR debt.
3/ As approved by Parliament, but subject to ratification by the President.
4/ Fund staff projections based on policy recommendations.
5/ Seasonally adjusted figures for broad money velocity.
6/ Annualized yield on end-period auction of 14-day bills; as of end-September 2006.
7/ From 2004 onwards, revised estimates for remittances in the current account, offset by adjustments, mainly in the capital account.
8/ Includes IMF loans, guarantees and arrears.
9/ Includes treasury bills outstanding, and gross claims of the BoM on the government.
10/ Based on 5 percent discount rate from 2004 onwards.

Table 2. Mongolia: Summary Operations of the General Government, 2003−07

	2003	2004	2005	2006		2007	
				Amended Budget	Est.	Budget 1/	Proj. 2/
				(In billions of togrogs)			
Total revenue and grants	553.9	713.1	837.9	1,097.6	1,343.4	1,353.0	1,336.2
Total expenditure and net lending	615.8	753.7	764.6	1,209.2	1,046.5	1,542.9	1,412.8
Overall balance (incl. grants)	-61.9	-40.6	73.3	-111.6	296.8	-189.9	-76.6
Nonmineral overall balance	-103.1	-120.4	-37.9	-367.9	-149.3	-615.5	-511.1
Financing	51.1	33.8	3.5	111.6	-296.8	189.9	76.6
Foreign (net)	-115.8	81.0	89.8	148.8	87.1	78.2	94.5
Domestic (net)	166.9	-47.1	-86.2	-37.2	-384.0	111.7	-17.9
				(In percent of GDP)			
Total revenue and grants	37.6	37.0	33.7	33.2	40.6	35.9	35.5
Current revenue	37.0	36.7	33.4	33.0	40.5	35.8	35.3
Mineral revenue	2.8	4.1	4.5	7.8	13.5	11.3	11.5
Nonmineral revenue	34.2	32.5	29.0	25.3	27.0	24.5	23.8
Tax revenue and social security contributions	28.6	30.3	27.8	26.6	33.8	30.0	29.5
Income taxes	6.6	7.5	7.2	9.6	15.1	12.1	11.6
Enterprise income tax	4.7	5.1	4.8	4.8	7.0	4.5	4.1
Personal income tax	2.0	2.4	2.3	2.1	2.1	1.8	1.8
"Windfall" tax	0.0	0.0	0.0	2.6	5.9	5.8	5.7
Social security contributions	4.4	4.3	3.8	3.2	3.2	3.6	3.6
Sales tax and VAT	8.3	8.5	7.3	6.3	6.8	5.4	5.3
Excise taxes	4.0	3.6	3.2	2.7	2.8	2.7	2.8
Customs duties and export taxes	2.2	2.3	2.3	1.7	2.1	2.3	2.2
Other taxes	3.1	4.1	4.1	3.2	3.9	4.0	4.0
Nontax revenue	8.4	6.4	5.6	6.4	6.6	5.8	5.8
Capital revenue and grants	0.6	0.4	0.2	0.2	0.2	0.1	0.1
Total expenditure and net lending	41.8	39.1	30.7	36.6	31.7	40.9	37.5
Current expenditure	29.5	28.0	24.1	26.5	24.1	28.9	27.5
Wages and salaries	7.9	7.2	6.2	6.0	5.9	7.1	6.8
Purchase of goods and services	11.9	11.3	9.3	11.7	9.4	8.8	8.8
Subsidies to public enterprises	0.6	0.6	0.3	0.4	0.4	0.4	0.4
Transfers	7.9	7.7	7.4	7.7	7.8	12.0	10.8
Interest payments	1.2	1.2	0.8	0.8	0.6	0.6	0.6
Contingency allocation	...	...	0.0	0.0	0.0	0.0	0.0
Capital expenditure and net lending	12.3	11.1	6.6	10.0	7.6	12.0	10.0
Capital expenditure	6.1	5.4	3.6	6.3	5.4	10.3	8.2
Domestically-financed	4.6	4.3	3.2	5.0	5.1	9.3	7.3
Foreign-financed	1.6	1.2	0.4	1.3	0.3	0.9	0.9
Net lending	6.1	5.7	3.0	3.7	2.2	1.8	1.8
On-lent foreign project loans	5.7	5.5	3.6	4.2	2.7	2.4	2.4
Domestic lending minus repayments	0.4	0.1	-0.6	-0.5	-0.5	-0.7	-0.7
Current balance (excl. privatization receipts)	7.5	8.6	9.3	6.5	16.4	6.8	7.8
Primary Balance	-3.0	-0.9	3.8	-2.6	9.6	-4.4	-1.4
Overall balance (incl. grants)	-4.2	-2.1	2.9	-3.4	9.0	-5.0	-2.0
Nonmineral overall balance	-7.0	-6.3	-1.5	-11.1	-4.5	-16.3	-13.6
Discrepancy between deficit from above and below the li	-0.7	-0.3	0.8	0.0	0.0	0.0	0.0
Financing	3.5	1.8	-2.1	3.4	-9.0	5.0	2.0
Foreign (net)	-7.9	4.2	3.6	4.5	2.6	2.1	2.5
External borrowing (net)	-7.9	3.5	3.4	4.5	2.6	2.1	2.5
Disbursements	13.1	4.9	4.4	5.8	3.3	3.4	3.4
Amortization	20.9	1.4	1.0	1.3	0.7	1.3	0.9
External arrears	0.0	0.7	0.2	0.0	0.0	0.0	0.0
Domestic (net)	11.3	-2.4	-5.7	-1.1	-11.6	3.0	-0.5
Banking system (net)	9.4	-3.2	-5.8	-1.6	-12.1	2.6	-0.9
Nonbank	1.9	0.8	0.0	0.5	0.5	0.4	0.4
Privatization receipts	1.5	0.8	0.2	0.5	0.5	0.4	0.4
Other nonbank (net)	0.5	-0.1	-0.2	0.0	0.0	0.0	0.0
Memoranda items:							
Mineral revenue/total revenue and grants (in percent)	7.4	11.2	13.3	23.4	33.2	31.5	32.6
Nonmineral overall balance 3/	-8.0	-7.7	-2.0	-16.3	-6.6	-23.1	-19.2
Nonmineral primary balance 3/	-6.6	-6.2	-0.9	-15.1	-5.7	-22.2	-18.3
Total public debt (incl. IMF)/GDP	113.0	93.0	68.3	55.4	53.6	50.6	50.6
Foreign debt (incl. IMF)/GDP	98.2	85.4	64.1	52.8	51.0	48.6	48.6
Domestic debt/GDP	14.8	7.6	4.2	2.6	2.6	2.0	2.0
Governments deposits	7.8	5.0	5.9	5.3	16.0	11.2	10.5
Net public debt	105.2	88.0	62.4	50.1	37.6	39.4	40.1
NPV of total public debt	79.5	59.9	44.7	35.7	34.6	33.1	32.5
Nominal GDP	1,474	1,926	2,489	3,306	3,306	3,768	3,768

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Including Development Fund operations. As approved by Parliament, but subject to ratification by the President.
2/ Fund staff projections based on policy recommendations.
3/ In percent of nonmineral GDP.

Table 3. Mongolia: Monetary Aggregates, 2003-07

	2003	2004	2005				2006				2007
	Dec.	Dec.	Mar.	June	Sept.	Dec.	Mar.	Jun.	Sept.	Dec.	Dec.
										Est.	Proj. 1/
	(In billions of togrog; end of period)										
Monetary survey											
Broad Money	704	846	892	1,009	1,112	1,162	1,205	1,463	1,528	1,567	2,076
Currency	131	144	133	177	174	152	145	198	189	165	189
Deposits	572	703	760	832	937	1,009	1,061	1,265	1,339	1,402	1,887
Net foreign assets	232	283	330	377	480	544	555	791	945	1,009	1,348
Net international reserves	278	294	342	389	488	551	564	782	942	1,015	1,355
Bank of Mongolia	151	198	222	253	310	364	411	449	595	696	907
Commercial banks	128	96	120	136	178	187	153	333	347	319	447
Other foreign assets, net	-47	-11	-12	-12	-8	-7	-9	10	3	-7	-7
Net domestic assets	472	564	562	632	632	618	650	672	583	558	728
Domestic credit	601	740	747	805	828	904	946	983	910	859	1,089
Net credit to government 2/	152	94	65	48	7	-1	-50	-121	-267	-400	-434
Claims on nonbanks	449	646	682	757	821	905	996	1,103	1,177	1,260	1,523
Of which:											
Claims on public enterprises	16	13	14	22	21	34	29	30	33	...	...
Claims on the private sector	390	552	581	647	701	776	858	966	1,011	...	...
Nonperforming loans	37	71	76	76	82	79	90	89	110	...	...
Other items, net	-129	-176	-185	-174	-197	-286	-296	-311	-326	-301	-361
Monetary authorities											
Reserve money	201	235	253	296	297	281	308	376	377	328	377
Net foreign assets	151	199	224	254	315	372	415	469	609	704	915
Net international reserves	151	198	222	253	310	364	411	449	595	696	907
Other assets, net	0	1	1	1	5	8	4	20	14	7	7
Net domestic assets	50	36	30	41	-18	-91	-107	-93	-233	-376	-538
Net credit to government	128	106	84	87	45	52	-2	-72	-190	-323	-367
Claims on deposit money banks	13	22	22	19	18	18	18	18	18	18	18
Minus: Central bank bills (net)	76	69	70	82	84	126	110	69	84	104	167
Other items, net	-15	-23	-7	16	3	-35	-13	30	23	33	-22
Of which: precious metals	8	6	12	34	37	10	11	51	43	...	...
Memoranda items:	(In percent; except otherwise indicated)										
Annual broad money growth	49.7	20.3	20.6	24.3	34.4	37.3	35.1	45.0	37.4	34.9	32.5
Annual growth of credit to nonbanks 3/	90.3	43.7	34.1	33.5	34.7	40.1	46.0	45.7	43.3	39.2	20.9
Annual reserve money growth	14.7	16.8	10.5	20.4	16.3	19.7	21.7	27.2	26.8	16.5	15.0
Velocity, seasonally adjusted	2.1	2.3	2.6	2.5	2.4	2.3	2.6	2.2	2.1	2.2	1.9
Broad money/Reserve money	3.5	3.6	3.5	3.4	3.7	4.1	3.9	3.9	4.1	4.8	5.5
Nonperforming loans/total loans (percent)	8.2	10.9	11.2	10.0	10.0	8.8	9.0	8.1	9.3	...	...
Excess reserves (billions of togrogs)	6.4	3.0	33.9	18.3	5.2	15.3	58.0	18.4	18.4	...	...

Sources: Data provided by the Mongolian authorities; and Fund staff estimates and projections.

1/ Fund staff projections based on policy recommendations.
2/ Valued at actual exchange rates and gold prices.
3/ Includes nonperforming loans.

Table 4. Mongolia: Balance of Payments, 2003-11

(In millions of US dollars; unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Est.	Proj. 1/	Proj. 1/			
Current account balance (including official transfers)	-99	27	29	145	-67	-479	-255	-174	-213
Trade balance	-199	-149	-155	16	-169	-554	-492	-161	-76
Exports, f.o.b.	627	872	1,069	1,548	1,635	1,483	1,426	1,835	1,993
Copper	162	284	326	648	623	419	415	533	483
Gold	157	240	331	318	399	441	372	646	821
Imports, c.i.f.	-827	-1,021	-1,224	-1,532	-1,804	-2,037	-1,917	-1,995	-2,069
Services, net	-49	-46	65	66	61	50	68	72	66
Receipts	208	338	414	447	471	497	524	552	580
Payments	-257	-383	-350	-380	-409	-447	-456	-480	-514
Income, net	-12	-48	-106	-191	-224	-251	-119	-393	-522
Official medium- and long-term interest payments	-12	-15	-15	-16	-17	-18	-19	-20	-21
Transfers, net	74	146	134	140	147	156	165	181	190
Official	49	87	88	90	92	94	96	98	100
Private	38	36	3	25	26	27	27	28	29
Financial and capital account	-30	10	88	153	248	575	379	368	365
Direct investment	132	129	258	329	499	727	395	360	360
Portfolio investment	50	-53	0	0	0	0	0	0	0
Loans	-187	49	-14	82	48	73	74	83	81
Medium- and long-term, net	-170	75	61	90	78	103	104	113	111
Disbursements	176	157	91	130	126	157	162	174	175
Public	101	129	90	110	105	135	139	150	150
Private	74	29	1	20	21	22	23	24	26
Amortization	-346	-82	-31	-40	-48	-55	-58	-61	-65
Public	-264	-18	-22	-20	-27	-33	-37	-38	-42
Private	-82	-64	-9	-20	-21	-21	-22	-23	-23
Short-term, net	-17	-27	-75	-8	-30	-30	-30	-30	-30
Currency and deposits, net	-21	-120	-162	-266	-309	-237	-105	-95	-97
Commercial banks, net	-21	0	-72	-120	-110	-40	-40	-60	-60
Other	0	-119	-91	-146	-199	-197	-65	-35	-37
Trade credits, net	-4	4	7	8	10	12	15	20	21
Errors and omissions	31	-5	9	0	0	0	0	0	0
Overall balance	-98	32	126	298	181	96	124	194	152
Financing	98	-32	-126	-298	-181	-96	-124	-194	-152
Increase in net official reserves (-)	97	-37	-131	-298	-181	-96	-124	-194	-152
Use of IMF credit (+)	3	-7	-6	-6	-6	-5	-6	-5	-4
Increase in gross official reserves (-)	94	-30	-125	-292	-174	-91	-118	-190	-148
Arrears accumulation (+) / payments (-) (net) 2/	1	5	5	0	0	0	0	0	0
Exceptional financing / rescheduling	0	0	0	0	0	0	0	0	0
Financing gap	...	...	...	...	0	0	0	0	0
Memoranda items:									
Current account balance (in percent of GDP)									
Excluding official transfers	-11.5	-3.7	-2.8	2.0	-5.2	-17.7	-10.1	-6.9	-7.4
Including official transfers	-7.7	1.6	1.4	5.2	-2.2	-14.8	-7.3	-4.5	-5.1
Exports, f.o.b. (annual growth)	19.7	39.0	22.5	44.8	5.6	-9.3	-3.9	28.7	8.6
Imports, c.i.f. (annual growth)	9.8	23.5	19.8	25.2	17.7	12.9	-5.9	4.1	3.7
Export volume growth	12.3	13.8	7.8	3.1	5.6	4.1	1.4	33.4	9.8
Import volume growth	4.2	7.7	7.9	12.2	18.3	14.2	-4.4	5.4	3.2
Export price index change	6.6	23.1	13.6	40.4	0.0	-12.9	-5.2	-3.5	-3.5
Import price index change	5.4	15.1	11.0	11.6	-0.5	-1.1	-1.6	-1.3	-0.6
Trade balance (in percent of GDP)	-15.5	-9.2	-7.5	0.6	-5.5	-17.2	-14.1	-4.1	-1.8
Gross official reserves (end-period)	178	208	333	626	800	891	1,009	1,198	1,346
(In months of next year's imports of goods and services)	1.5	1.6	2.1	3.4	3.9	4.5	4.9	5.6	5.9
Debt service (in percent of exports of goods and services) 3/	34.0	7.5	2.9	2.1	2.4	2.8	3.2	2.6	2.6

Sources: Data provided by the Mongolian authorities; and Fund staff estimates and projections.

1/ Fund staff projections based on policy recommendations.
2/ Arrears on post-1991 Russian debt. Excluding disputed amounts with Finland.
3/ Public external debt service only.

Table 5. Mongolia: External Debt and Debt Service, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Est.			Proj. 1/		
	(In millions of U.S. dollars; unless otherwise indicated)								
Nominal Debt Stock 2/	1,237	1,361	1,308	1,405	1,480	1,582	1,681	1,792	1,896
IMF	49	44	36	29	23	19	13	8	5
Non-IMF	1,188	1,317	1,271	1,376	1,457	1,563	1,668	1,783	1,892
of which: current outstanding	1,188	1,317	1,271	1,265	1,241	1,211	1,176	1,140	1,097
Multilateral	669	797	770	772	763	750	734	718	700
Official bilateral	456	507	488	493	478	461	442	421	398
Treasury bill in US$ to nonresident	50	0	0	0	0	0	0	0	0
Commercial	13	13	13	0	0	0	0	0	0
of which: additional	0	0	0	111	216	352	492	644	794
Total Debt Service (including TR debt resolution)	284	91	43	42	50	56	62	63	67
Amortization	272	75	28	26	33	38	43	43	45
Interest	12	16	15	16	17	18	19	20	21
Debt Service on Existing Debt									
Amortization	21	25	28	26	33	38	43	43	45
Medium and long term	21	25	28	26	33	38	43	43	45
Multilateral	10	11	12	13	16.7	20	24	23	23
Official Bilateral	11	14	16	13	16.5	18	19	20	22
Commercial	0	0	0	0	0	0	0	0	0
Interest	12	15	15	15	14	14	14	13	13
Medium and long term	12	15	15	15	14	14	14	13	13
Multilateral	6	7	7	7	7	7	7	7	7
Official Bilateral	6	8	8	7	7	7	6	6	6
Commercial	0	0	0	0	0	0	0	0	0
Debt Service on TR settlement									
Amortization	251	50	0	0	0	0	0	0	0
Russia	250	0	0	0	0	0	0	0	0
Slovakia	1	0	0	0	0	0	0	0	0
N. Korea	0	0	0	0	0	0	0	0	0
Treasury Bill	0	50	0	0	0	0	0	0	0
Interest	0	1	0	0	0	0	0	0	0
Russia	0	0	0	0	0	0	0	0	0
Treasury Bill	0	1	0	0	0	0	0	0	0
Debt Service on New Borrowing	0	0	0	1	2	4	5	7	8
Amortization	0	0	0	0	0	0	0	0	0
Interest	0	0	0	1	2	4	5	7	8
Memoranda items:									
Total debt service									
In percent of exports of goods and services	34.0	7.5	2.9	2.1	2.4	2.8	3.2	2.6	2.6
In percent of GDP	22.1	5.6	2.1	1.5	1.6	1.7	1.8	1.6	1.6
Total debt stock									
In percent of exports of goods and services	148.1	112.5	88.2	70.5	70.3	79.9	86.2	75.1	73.7
In percent of GDP	98.2	85.4	64.1	51.0	48.6	49.8	49.1	46.4	45.9
Net present value of debt	808	834	827	872	929	1,001	1,072	1,151	1,228
In percent of exports of goods and services	96.8	68.9	55.8	43.7	44.1	50.6	55.0	48.2	47.7
In percent of GDP	64.2	52.3	40.3	31.7	30.5	31.5	31.3	29.8	29.7

Sources: Data provided by the Mongolian authorities; and IMF staff estimates and projections.

1/ Excluding TR11.4 billion debt to Russia settled in December 2003 with an upfront payment of U.S. $250 million.

Table 6. Mongolia: Medium-Term Macroeconomic Framework, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Est.			Proj. 1/		
	(In percent of GDP; unless otherwise indicated)								
Real sector									
Nominal GDP (in billions of togrogs)	1,474	1,926	2,489	3,306	3,768	4,055	4,504	5,231	5,780
Nominal GDP (in millions of U.S. dollars)	1,285	1,615	2,066	2,788	3,092	3,228	3,477	3,917	4,199
Per capita GDP (in U.S. dollars)	513	637	806	1,075	1,179	1,217	1,296	1,443	1,529
Real GDP (percent change)	6.1	10.8	7.0	7.0	7.0	7.0	7.0	11.0	6.0
Mineral real GDP	-2.3	34.3	10.9	5.2	5.2	5.2	6.5	30.0	4.6
Nonmineral real GDP	7.1	8.1	6.5	7.3	7.3	7.2	7.1	8.4	6.2
GDP deflator (percent change)	11.6	18.0	20.7	24.1	6.5	0.6	3.8	4.6	4.2
Consumer prices (period average; percent change)	5.1	7.9	12.5	5.6	5.3	5.0	5.0	5.0	5.0
Consumer prices (end-period; percent change)	4.7	10.6	9.2	7.0	5.0	5.0	5.0	5.0	5.0
General government accounts									
Total revenue and grants	37.6	37.0	33.7	40.6	35.5	31.4	29.4	27.8	27.3
Mineral revenue	2.8	4.1	4.5	13.5	11.5	4.3	4.2	3.9	2.7
Nonmineral revenue	34.2	32.5	29.0	27.0	23.8	26.9	25.0	23.8	24.5
Capital revenue and grants	0.6	0.4	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Total expenditure and net lending	41.8	39.1	30.7	31.7	37.5	35.5	32.4	30.8	30.4
Current expenditure	29.5	28.0	24.1	24.1	27.5	26.5	24.4	22.8	22.4
Wages and salaries	7.9	7.2	6.2	5.9	6.8	6.7	6.6	6.3	6.3
Goods and services	11.9	11.3	9.3	9.4	8.8	8.6	8.2	7.5	7.2
Interest payments	1.2	1.2	0.8	0.6	0.6	0.7	0.7	0.6	0.6
Other	8.5	8.3	7.7	8.1	11.2	10.5	8.9	8.4	8.3
Capital expenditure and net lending	12.3	11.1	6.6	7.6	10.0	9.0	8.0	8.0	8.0
Current balance	7.5	8.6	9.3	16.4	7.8	4.7	4.9	4.9	4.8
Overall balance (including grants)	-4.2	-2.1	2.9	9.0	-2.0	-4.1	-3.0	-3.0	-3.1
Nonmineral overall balance	-7.0	-6.3	-1.5	-4.5	-13.6	-9.6	-7.3	-7.2	-6.9
Foreign financing (including gap financing)	-7.9	4.2	3.6	2.6	2.5	3.2	3.0	2.8	2.6
Monetary sector									
Broad money (percent change)	49.7	20.3	37.3	34.9	32.5	24.2	20.7	17.3	15.1
Velocity (GDP/M2)	2.1	2.3	2.3	2.2	1.9	1.6	1.4	1.4	1.4
Balance of payments									
Exports (percent change)	19.7	39.0	22.5	44.8	5.6	-9.3	-3.9	28.7	8.6
Imports (percent change)	9.8	23.5	19.8	25.2	17.7	12.9	-5.9	4.1	3.7
Current account balance (excluding official transfers)	-11.5	-3.7	-2.8	2.0	-5.2	-17.7	-10.1	-6.9	-7.4
Current account balance (including official transfers)	-7.7	1.6	1.4	5.2	-2.2	-14.8	-7.3	-4.5	-5.1
Gross official reserves									
(in millions of U.S. dollars)	178	208	333	626	800	891	1,009	1,198	1,346
(in months of next year's imports of goods and services)	1.5	1.6	2.1	3.4	3.9	4.5	4.9	5.6	5.9
Debt indicators									
Total public debt	113.0	93.0	68.3	53.6	50.6	51.3	50.2	47.2	46.3
Domestic debt	14.8	7.6	4.2	2.6	2.0	1.6	1.1	0.8	0.5
External debt	98.2	85.4	64.1	51.0	48.6	49.8	49.1	46.4	45.9
(in millions of U.S. dollars)	1,237	1,361	1,308	1,405	1,480	1,582	1,681	1,792	1,896
NPV of total public debt	79.5	59.9	44.7	34.6	32.5	32.6	31.7	29.6	29.0
of which: external debt	64.2	52.3	40.3	31.7	30.5	31.5	31.3	29.8	29.7
Government deposits in the banking system	7.8	5.0	5.9	16.0	14.4	12.2	10.8	9.0	7.5
External public debt service 2/	34.0	7.5	2.9	2.1	2.4	2.8	3.2	2.6	2.6
Memoranda items									
Copper prices (US$ per ton)	1,779	2,863	3,676	6,300	6,000	4,000	3,200	2,800	2,400
Gold prices (US$ per ounce)	364	409	445	610	670	705	745	785	805

Sources: Data provided by the Mongolian authorities; and Fund staff estimates and projections.

1/ Fund staff projections based on policy recommendations.
2/ In percent of exports of goods and services.

Table 7. Mongolia: Indicators for Vulnerability and Financial Soundness, 2001-05

	2001	2002	2003	2004	2005
Key Economic and Market Indicators					
Real GDP growth (in percent)	1.1	4.2	6.1	10.8	7.0
CPI inflation (end of period; in percent)	7.9	1.7	4.7	10.6	9.2
Short-term interest rate (in percent) 1/	8.8	8.0	15.0	15.8	3.7
Exchange rate, Togrog/US$ (end of period)	1,102	1,125	1,170	1,209	1,221
External Sector					
Exchange rate regime		Floating			
Current account balance (in percent of GDP) 2/	-7.6	-9.6	-7.7	1.6	1.4
Direct investment (in percent of GDP)	4.2	6.9	10.2	8.0	12.5
Export growth (US$ value, percent change)	-2.4	0.1	19.7	39.0	22.5
Real effective exchange rate (end of period; 2000=100)	104.6	99.2	92.4	93.2	100.6
Gross international reserves (in US$ million)	206.8	271.5	177.7	207.8	333.2
NPV of external debt (in percent of GDP)	57.7	59.5	64.2	52.3	40.3
General Government					
Overall balance (in percent of GDP)	-5.4	-5.9	-4.2	-2.1	2.9
Primary balance (in percent of GDP)	-3.9	-4.3	-3.0	-0.9	3.8
General government financing (in percent of GDP)					
Foreign (net)	5.9	6.6	-7.9	4.2	3.6
Domestic (net)	-0.5	-0.9	11.3	-2.4	-5.7
Financial Sector					
Capital adequacy ratio					
Tier I capital ratio	21.6	17.7	18.5	17.4	15.8
Total regulatory capital/risk-weighted assets	24.6	20.0	20.4	20.0	18.2
Total regulatory capital/total assets	14.2	12.4	13.4	15.6	13.6
Asset quality					
Foreign exchange loans/total loans	35.2	32.5	42.8	45.6	47.0
NPLs/total loans	7.9	7.0	8.2	10.9	8.8
Provisions/NPLs 3/	85.8	74.0	57.6	53.9	63.8
Earnings and profitability					
Return on (average) assets	5.9	4.3	3.1	2.5	2.2
Interest margin/gross income	41.3	39.8	35.9	31.5	30.9
Non-interest expenses/gross income	55.4	50.3	49.1	58.8	54.3
Personnel expenses to non-interest expenses	26.0	22.4	22.3	26.7	28.5
Liquidity					
Loans to deposits	92.8	100.0	113.1	116.6	121.8
Liquid assets/total assets	41.3	39.9	35.3	31.6	36.0
Liquid assets/short-term liabilities 4/	80.6	90.9	83.5	28.8	37.7

Sources: Data provided by the Mongolian authorities; and Fund staff estimates.

1/ Annual interest rate on central bank bills at the end of period.
2/ Including official transfers.
3/ NPLs includes past due loans.
4/ Short-term liabilities are defined as the sum of current account and demand deposits.

ANNEX I. Mongolia—Debt Sustainability Analysis

A. Introduction

1. This appendix presents the joint debt sustainability analysis (DSA) of the IMF and the World Bank staff. Mongolia is rated as a medium performer with regard to its policies and institutions under the joint IMF-WB DSA framework for low-income countries (LICs)[7]. The debt sustainability is analyzed in relation to the threshold indicators for countries in this category.

B. Baseline scenario

Assumptions

2. **The baseline scenario is built on the assumption of sustained output and export growth.** Real GDP is assumed to grow by 7 percent in 2006 as well as from 2007 to 2009, partly underpinned by the ongoing development of the Oyu Tolgoi (Ivanhoe) Mine. Real GDP growth is expected to reach 11 percent in 2010 when the main Ivanhoe Mines' production starts, and declines to 6-5.5 percent between 2010 and 2014, before further slowing down to 5 percent after 2015. The growth scenario assumes the start up of additional new mining sector and infrastructure projects and the continued development of the service sector over the medium term and beyond. Regarding the fiscal projections, the 2007 overall budget deficit is assumed to be 2 percent of GDP. This is 3 percentage points lower than the 2007 budget proposal of the Government and assumes that the additional policy measures recommended in the Article IV document are implemented. In the balance of payments, export growth is expected to remain strong in 2006, followed by a slowdown in 2007-09, as copper prices revert to their long-term trend, in line with WEO assumptions. Export growth would then pick up substantially in 2010 when the main Ivanhoe Mine begins production. Imports will also be higher, mainly of equipment associated with mining operations and infrastructure development. Beyond 2015, export growth is assumed to be 6.5-7.5 percent, while imports are assumed to grow at about 7 percent over the long term.

3. **New borrowing is assumed to be only on concessional terms.** New borrowing is projected to remain at around US$150 million annually over the medium term, and to increase by about 2½ percent annually over the longer term. The average concessionality level of new external borrowing is assumed at around 40 percent, which is slightly lower than the current level.

Fiscal DSA (Table 1a)

4. **Under the baseline scenario, public sector debt remain on a downward trend (Table 1a).** Public debt falls from about 68.3 percent of GDP at end-2005 to 46.3 percent at

[7] In the LIC DSA framework, the quality of a country' s policies and institutions is measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index, and classified into three categories: strong, medium and poor. Compared to last year, the overall CPIA index for Mongolia has remained unchanged.

end-2011 and continues to decline thereafter. In net present value (NPV) term, however, public debt, which temporarily decreases to 84.4 percent of revenues in 2006, is expected to rebound to 110.6 percent by the end of the decade, mainly because of the sharp decline in mineral revenue. The debt service-to-revenue ratio is also expected to follow the same pattern, declining below 3.3 percent in 2006 followed by steady increase through the entire forecast period. The NPV of government debt as a share of GDP, however, declines to 30 percent by the end of this decade and remains below 30 percent thereafter (Figure 1).

External DSA (Table 2a)

5. **The NPV of the debt-to-GDP ratio (40 percent at end-2005), which is the only indicator initially above its threshold, is expected to decline to 32 percent in 2006, mostly as a result of the substantial nominal GDP growth.** Nominal GDP (in US dollar) is expected to increase substantially in 2006 (33 percent) driven by high GDP deflator growth as a result of the buoyant export prices. The ratio is expected to stay at similar levels in the near term before further dropping down in the longer term. Reflecting Mongolia's high export-to-GDP ratio, the NPV of debt-to-export ratio would stay well below the corresponding threshold (150 percent) during the entire projection period, although it is expected to increase in the near term with the slowdown of export growth. Also, given that most of the external debt is on concessional terms, the debt service ratio would stay below 3.5 percent of exports under the baseline scenario, against the 20 percent threshold. Finally, the NPV of debt-to-revenue ratio and debt service-to-revenue ratio would also stay well below the 250 percent and 30 percent thresholds, respectively.

C. Alternative scenarios and bound tests

Fiscal DSA (Table 1b)

6. **The debt indicators based on alternative scenarios imply that a decline in GDP growth would be the main risk to fiscal debt sustainability (Table 2a).** A decline in growth rates to the last decade's average would push up debt levels, so that the NPV of debt-to-revenue ratio would reach around 170 percent at end-2011 and continue to increase to an alarming level of about 270 percent at end-2026. The scenario assuming an unchanged nonmineral primary balance,[8] however, yields much lower debt indicators. This is because this scenario does not include the recently passed tax cuts, which will apply from 2007.

7. **The bound tests confirm that the largest deterioration of debt indicators could be observed with lower growth rates.** Against this background, the authorities should continue to strengthen competitiveness of their private sectors and improve the business climate to support baseline growth.

[8] The assumption of an unchanged primary balance, which is typically used in debt sustainability assessments to represent a scenario without policy reforms, is not considered relevant for Mongolia, because export prices are currently exceptionally high and the budget has a substantial surplus. Instead, the no-reform scenario assumes an unchanged nonmineral balance.

External DSA (Table 2b)

8. **The bound tests suggest that external debt indicators could deteriorate considerably in the face of adverse external developments, especially terms of trade shocks.** Given that copper and gold account for more than half of Mongolia's total exports, the impact of exogenous shocks on these commodities is simulated as a Mongolia-specific bound test. Specifically, the test assumes that copper and gold prices decline by 35 and 25 percent, respectively, in 2010, and each rises by 1 percent annually thereafter (case B.2 in Table 2b). The test also assumes that as a consequence of these terms of trade shocks and their income effects, the real GDP growth rate is reduced by 0.5 percent in 2010, and by 0.25 percent thereafter compared with the baseline scenario. Under these assumptions, both NPV of debt-to-GDP ratio and debt-to-export ratio would deteriorate substantially: NPV of debt-to-GDP ratio will stay above the 40 percent threshold even in the long term, and debt-to-export ratio will reach 119 percent by 2026.

9. **Other adverse shocks would also lead to heavier debt burden in the medium term, although debt level would remain manageable in the long term.** For example, if the interest rate on new borrowing is 2 percentage points higher than in the baseline (with unchanged grace and maturity periods), the NPV of debt-to-GDP ratio would reach 34 percent by 2009, before declining to 25 percent by 2026. Lower growth and current account balance, as well as lower non-debt inflows, among others, would also lead to higher debt distress in the medium term.

D. Conclusion

10. **Mongolia is at moderate risk of debt distress over the medium term, although the debt burden is likely to remain sustainable over the long term, if the authorities continue to borrow exclusively on concessional terms and the external economic environment evolves broadly as envisaged in the baseline scenario.**[9] Under this scenario, all debt indicators would stay below their respective thresholds through the medium-to-long term. However, the NPV of debt-to-GDP ratio would breach its threshold in the medium term under various shock scenarios. In particular, debt sustainability is vulnerable to severe terms-of-trade shocks. The analysis calls for continued prudent debt management and close watch of debt sustainability. The government should also refrain from any nonconcessional borrowing or loan guarantees.

[9] This risk classification will not change if the three-year-average CPIA Index is used (2003-05) instead of the 2005 CPIA Index.

Table 1a. Mongolia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2003-26

	Actual			Historical Average 5/	Standard Deviation 5/	Projections									
	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
Public sector debt 1/	113.0	93.0	68.3			53.6	50.6	51.3	50.2	47.2	46.3		38.6	36.9	
o/w foreign-currency denominated	98.2	85.4	64.1			51.0	48.6	49.8	49.1	46.4	45.9		38.9	24.3	
Change in public sector debt	21.6	-19.9	-24.7			-14.7	-3.0	0.7	-1.1	-3.0	-0.9		-1.0	0.2	
Identified debt-creating flows	-8.4	-22.7	-23.5			-27.2	-3.6	1.7	-0.9	-2.9	-0.3		-0.8	0.5	
Primary deficit	3.0	0.9	-3.8	5.1	4.7	-9.6	1.4	3.5	2.3	2.4	2.5	0.4	2.0	2.5	2.5
Revenue and grants	37.6	37.0	33.7			40.6	35.5	31.4	29.4	27.8	27.3		26.9	25.1	
of which : grants	0.6	0.3	0.2			0.1	0.1	0.1	0.1	0.1	0.1		0.1	0.1	
Primary (noninterest) expenditure	40.6	37.9	29.9			31.0	36.8	34.8	31.7	30.2	29.8		28.8	27.7	
Automatic debt dynamics	-10.0	-22.8	-19.5			-17.1	-4.5	-1.5	-3.1	-5.0	-2.6		-2.7	-2.0	
Contribution from interest rate/growth differential	-5.9	-13.9	-8.5			-6.1	-3.9	-3.6	-3.7	-5.3	-2.9		-2.2	-1.6	
of which : contribution from average real interest rate	-0.7	-3.0	-2.4			-1.7	-0.4	-0.3	-0.3	-0.3	-0.3		-0.3	0.1	
of which : contribution from real GDP growth	-5.3	-11.0	-6.1			-4.5	-3.5	-3.3	-3.4	-5.0	-2.7		-1.9	-1.7	
Contribution from real exchange rate depreciation	-4.0	-8.9	-11.0			-11.0	-0.6	2.1	0.6	0.2	0.4		...	...	
Other identified debt-creating flows	-1.5	-0.8	-0.2			-0.5	-0.4	-0.2	-0.2	-0.2	-0.2		-0.1	0.0	
Privatization receipts (negative)	-1.5	-0.8	-0.2			-0.5	-0.4	-0.2	-0.2	-0.2	-0.2		-0.1	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	30.0	2.8	-1.2			12.5	0.5	-1.0	-0.1	-0.2	-0.6		-0.2	-0.3	
NPV of public sector debt	14.8	7.6	44.5			34.3	32.5	33.1	32.4	30.6	30.2		25.9	29.6	
o/w foreign-currency denominated	0.0	0.0	40.3			31.7	30.5	31.5	31.3	29.8	29.7		26.2	17.0	
o/w external	...	...	40.3			31.7	30.5	31.5	31.3	29.8	29.7		26.2	17.0	
NPV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	24.7	3.2	-1.9			-8.3	2.9	5.2	4.0	4.0	4.1		3.2	4.5	
NPV of public sector debt-to-revenue ratio (in percent) 3/	39.3	20.5	132.2			84.4	91.6	105.4	110.3	110.0	110.6		96.5	117.8	
o/w external	…	…	119.8			77.9	86.0	100.4	106.4	107.2	108.8		97.5	67.6	
Debt service-to-revenue ratio (in percent) 3/ 4/	57.8	6.3	5.6			3.3	4.3	5.4	5.8	5.8	5.9		4.7	7.8	
Primary deficit that stabilizes the debt-to-GDP ratio	-18.6	20.8	20.9			5.1	4.4	2.7	3.4	5.4	3.3		3.0	2.3	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	6.1	10.8	7.0	4.3	2.9	7.0	7.0	7.0	7.0	11.0	6.0	7.5	5.0	5.0	5.1
Average nominal interest rate on forex debt (in percent)	1.2	1.2	1.1	1.4	0.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.1	1.2
Average real interest rate on domestic currency debt (in percent)	-0.9	-13.0	-15.9	-2.7	8.5	-18.3	-1.8	5.1	3.6	5.9	5.3	0.0	3.4	3.1	3.1
Real exchange rate depreciation (in percent, + indicates depreciatior	-4.9	-10.1	-14.0	1.3	13.7	-18.6	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	11.6	18.0	20.7	11.8	8.2	24.1	6.5	0.6	3.8	4.6	4.2	7.3	6.5	6.7	6.6
Growth of real primary spending (deflated by GDP deflator, in percer	1.0	3.5	-15.7	4.4	11.6	11.1	27.0	1.1	-2.5	5.5	4.6	7.8	4.4	4.7	4.6
Grant element of new external borrowing (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...

Sources: Data provided by the Mongolian authorities; and Fund staff estimates and projections.

1/ Gross debt of the general government sector.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues including grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

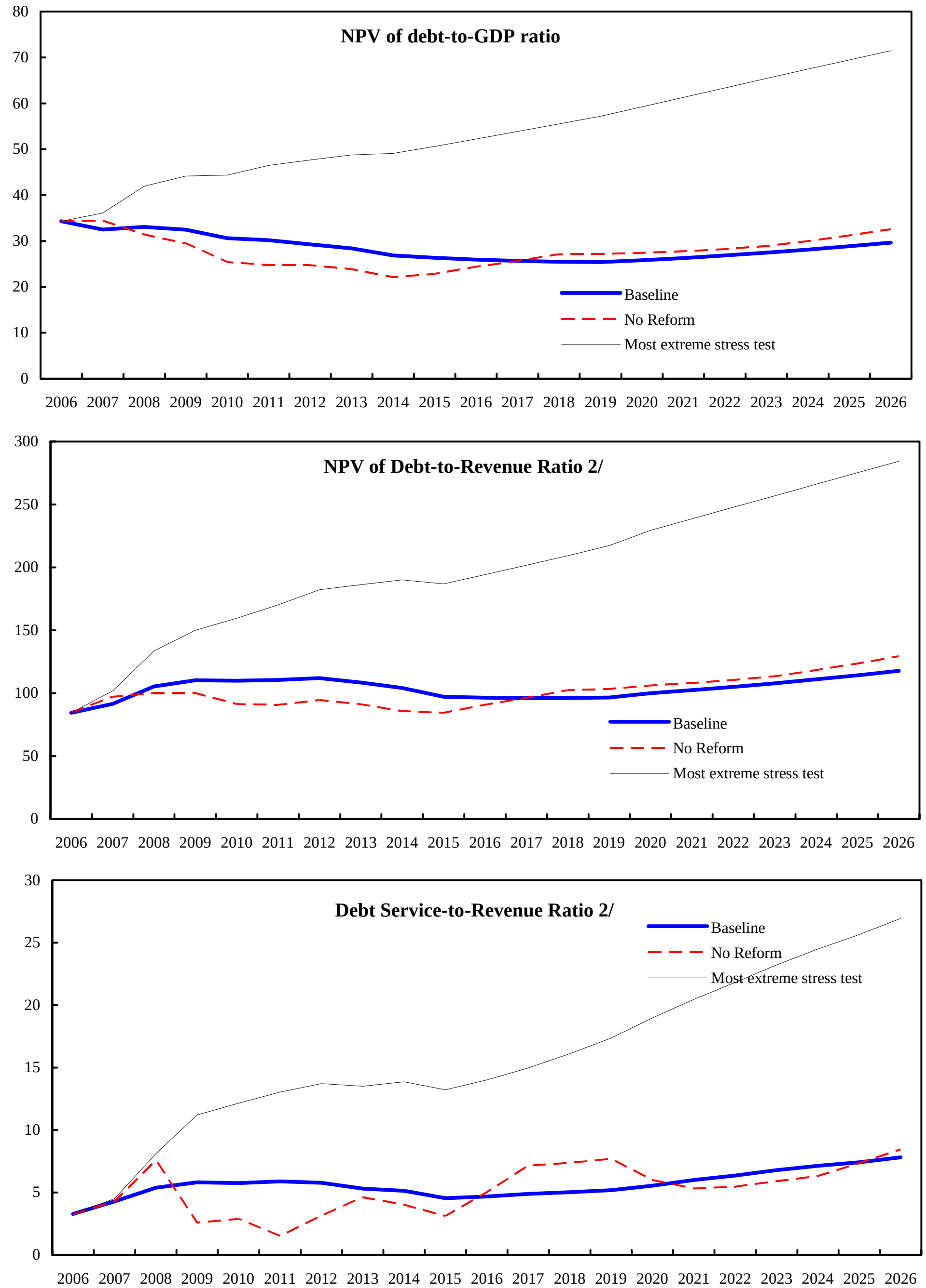
Table 1b. Mongolia: Sensitivity Analysis for Key Indicators of Public Debt, 2006-26

	Projections							
	2006	2007	2008	2009	2010	2011	2016	2026
NPV of Debt-to-GDP Ratio								
Baseline	34	32	33	32	31	30	26	30
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	34	37	39	42	44	46	49	67
A2. Primary nonmineral balance is unchanged from 2006	34	34	31	29	25	25	24	33
A3. Permanently lower GDP growth 1/	34	33	34	34	33	33	35	60
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	34	36	42	44	44	46	52	71
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	34	40	46	45	43	42	36	36
B3. Combination of B1-B2 using one half standard deviation shocks	34	39	45	44	41	40	33	34
B4. One-time 30 percent real depreciation in 2007	34	45	45	44	41	40	33	35
B5. 10 percent of GDP increase in other debt-creating flows in 2007	34	42	42	41	39	38	32	34
NPV of Debt-to-Revenue Ratio 2/								
Baseline	84	92	105	110	110	111	96	118
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	84	103	126	143	159	169	181	266
A2. Primary nonmineral balance is unchanged from 2006	84	97	100	100	91	91	91	129
A3. Permanently lower GDP growth 1/	84	93	108	116	118	123	132	240
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	84	102	134	150	159	170	194	284
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	84	114	148	154	153	153	132	143
B3. Combination of B1-B2 using one half standard deviation shocks	84	111	143	148	147	146	123	134
B4. One-time 30 percent real depreciation in 2007	84	128	145	149	146	145	122	138
B5. 10 percent of GDP increase in other debt-creating flows in 2007	84	118	134	140	139	140	121	135
Debt Service-to-Revenue Ratio 2/								
Baseline	3.3	4.3	5.4	5.8	5.8	5.9	4.7	7.8
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	3.3	4.4	9.5	9.5	11.3	12.1	12.1	23.4
A2. Primary nonmineral balance is unchanged from 2006	3.3	4.3	7.6	2.6	2.9	1.5	5.0	8.5
A3. Permanently lower GDP growth 1/	3.3	4.3	5.7	6.4	6.7	7.3	8.5	21.0
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	3.3	4.5	8.1	11.2	12.1	13.0	14.0	26.9
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	3.3	4.3	13.9	16.3	10.6	9.1	6.8	11.8
B3. Combination of B1-B2 using one half standard deviation shocks	3.3	4.5	12.2	12.9	9.1	8.1	5.9	9.9
B4. One-time 30 percent real depreciation in 2007	3.3	4.6	6.3	7.0	7.0	7.2	6.0	9.4
B5. 10 percent of GDP increase in other debt-creating flows in 2007	3.3	4.3	15.6	10.1	8.2	7.8	6.1	10.5

Sources: Data provided by the Mongolian authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
2/ Revenues are defined inclusive of grants.

Figure 1a. Mongolia: Indicators of Public Debt Under Alternative Scenarios, 2006-26 1/



Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2016.
2/ Revenue including grants.

Table 2a. Mongolia: External Debt Sustainability Framework, Baseline Scenario, 2006-26 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
External debt (nominal) 1/	**98.2**	**85.4**	**64.1**			**51.0**	**48.6**	**49.8**	**49.1**	**46.4**	**45.9**		**38.9**	**24.3**	
o/w public and publicly guaranteed (PPG)	98.2	85.4	64.1			51.0	48.6	49.8	49.1	46.4	45.9		38.9	24.3	
Change in external debt	9.2	-12.8	-21.3			-13.1	-2.4	1.2	-0.7	-2.7	-0.6		-1.4	-1.4	
Identified net debt-creating flows	-13.4	-30.3	-32.7			-20.6	-17.4	-11.1	-7.3	-9.6	-6.2		-3.8	-2.6	
Non-interest current account deficit	**6.9**	**-2.6**	**-2.2**	**3.1**	**5.8**	**-5.9**	**1.7**	**14.5**	**6.9**	**4.0**	**4.6**	4.3	**1.1**	**0.2**	1.3
Deficit in balance of goods and services	19.7	12.2	4.4			-3.0	3.5	15.9	12.4	2.3	0.2		-2.5	-0.2	
Exports	66.3	75.9	72.7			72.4	69.1	62.3	56.9	61.9	62.2		56.7	46.4	
Imports	86.0	88.2	77.2			69.4	72.7	78.1	69.3	64.2	62.4		54.3	46.1	
Net current transfers (negative = inflow)	-12.8	-14.6	-10.9	-10.2	2.9	-8.3	-7.8	-7.8	-7.6	-7.2	-7.0		-5.2	-2.6	-4.4
Other current account flows (negative = net inflow)	0.0	-0.2	4.3			5.5	6.0	6.5	2.1	8.9	11.3		8.8	3.0	
Net FDI (negative = inflow)	**-10.4**	**-8.1**	**-12.6**	**-5.6**	**3.8**	**-12.0**	**-16.4**	**-22.9**	**-11.5**	**-9.3**	**-8.7**		**-3.6**	**-2.0**	-3.3
Endogenous debt dynamics 2/	**-9.9**	**-19.6**	**-17.9**			**-2.7**	**-2.7**	**-2.7**	**-2.7**	**-4.2**	**-2.0**		**-1.3**	**-0.8**	
Contribution from nominal interest rate	0.9	1.0	0.8			0.6	0.5	0.6	0.6	0.6	0.6		0.5	0.4	
Contribution from real GDP growth	-4.8	-8.4	-4.7			-3.3	-3.2	-3.3	-3.2	-4.8	-2.6		-1.9	-1.2	
Contribution from price and exchange rate changes	-6.0	-12.2	-14.0			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**22.6**	**17.6**	**11.5**			**7.4**	**15.0**	**12.2**	**6.7**	**6.9**	**5.6**		**2.4**	**1.2**	
o/w exceptional financing	-0.1	-0.3	-0.2			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
change in gross foreign assets	-5.7	9.3	13.9			20.0	15.6	10.2	6.4	7.3	5.8		4.1	2.6	
NPV of external debt 4/	...	...	40.3			31.7	30.5	31.5	31.3	29.8	29.7		26.2	17.0	
In percent of exports	...	...	55.5			43.7	44.1	50.6	55.0	48.2	47.7		46.2	36.7	
NPV of PPG external debt	**...**	**...**	**40.3**			**31.7**	**30.5**	**31.5**	**31.3**	**29.8**	**29.7**		**26.2**	**17.0**	
In percent of exports	...	...	55.5			43.7	44.1	50.6	55.0	48.2	47.7		46.2	36.7	
Debt service-to-exports ratio (in percent)	33.9	7.5	2.9			2.1	2.3	2.8	3.2	2.7	2.7		2.5	2.4	
PPG debt service-to-exports ratio (in percent)	33.9	7.5	2.9			2.1	2.3	2.8	3.2	2.7	2.7		2.5	2.4	
Total gross financing need (billions of U.S. dollars)	0.2	0.0	-0.3			-0.4	-0.4	-0.2	-0.1	-0.1	-0.1		-0.1	-0.1	
Non-interest current account deficit that stabilizes debt ratio	-2.2	10.1	19.1			7.3	4.1	13.3	7.5	6.6	5.1		2.5	1.6	
Key macroeconomic assumptions															
Real GDP growth (in percent)	6.1	10.8	7.0	4.3	2.9	7.0	7.0	7.0	7.0	11.0	6.0	7.5	5.0	5.0	5.1
GDP deflator in US dollar terms (change in percent)	7.3	14.2	19.6	2.2	12.8	26.3	3.3	-2.5	0.7	1.5	1.1	5.1	3.3	3.5	3.4
Effective interest rate (percent) 5/	1.1	1.2	1.1	1.2	0.1	1.2	1.2	1.2	1.3	1.3	1.3	1.2	1.5	1.6	1.5
Growth of exports of G&S (US dollar terms, in percent)	17.9	44.9	22.6	12.4	19.1	34.5	5.6	-6.0	-1.5	22.4	7.8	10.5	6.4	7.4	6.6
Growth of imports of G&S (US dollar terms, in percent)	14.2	29.6	12.0	11.3	8.3	21.6	15.7	12.2	-4.5	4.3	4.3	9.0	6.9	6.8	6.5
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	39	39	40	40	40	40	40	40	40	40
Memorandum item:															
Nominal GDP (billions of US dollars)	1.3	1.6	2.0			2.8	3.0	3.2	3.4	3.9	4.1		6.3	14.4	

Sources: Data provided by the Mongolian authorities; and Fund staff estimates and projections.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets (of the central bank, commercial banks, and enterprises); and valuation adjustments.
For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

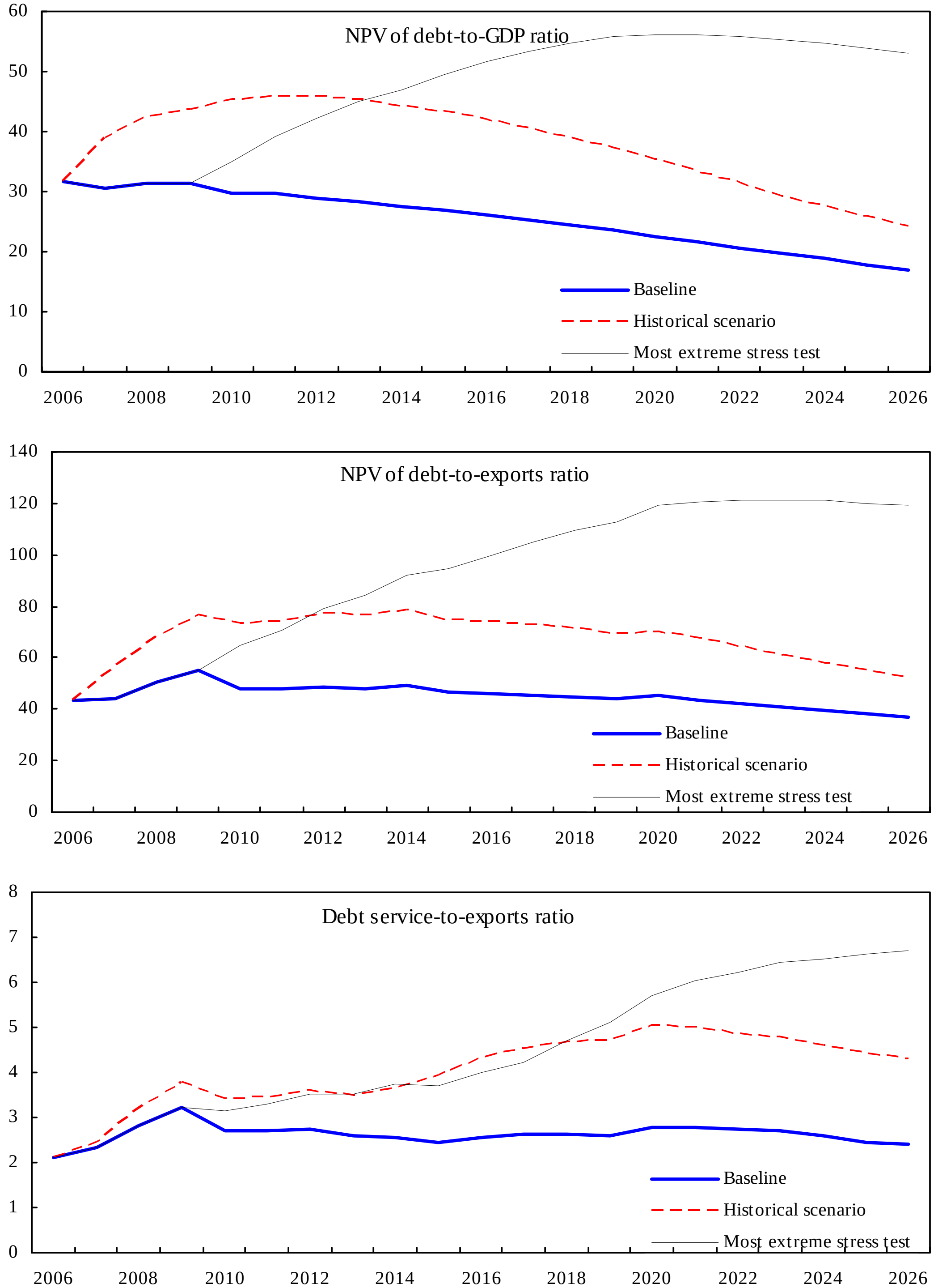
Table 2b. Mongolia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006-26
(In percent)

		Projections						
	2006	2007	2008	2009	2010	2011	**2016**	2026
NPV of debt-to-GDP ratio								
Baseline	32	30	31	31	30	30	**26**	17
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	32	39	43	44	45	46	**42**	24
A2. New public sector loans on less favorable terms in 2007-26 2/	32	31	33	34	33	34	**33**	25
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	32	32	35	35	33	33	**29**	19
B2. Terms of trade shocks on copper and gold exports in 2010 and lower growth thereafter 3/	32	30	31	31	35	39	**52**	53
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	32	35	40	40	38	37	**33**	21
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4	32	40	54	53	49	49	**40**	22
B5. Combination of B1-B4 using one-half standard deviation shocks	32	35	36	36	34	34	**30**	20
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	32	43	44	44	42	42	**37**	24
NPV of debt-to-exports ratio								
Baseline	44	44	51	55	48	48	**46**	37
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	44	56	68	77	73	74	**74**	52
A2. New public sector loans on less favorable terms in 2007-26 2/	44	45	54	60	54	55	**58**	55
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	44	44	51	55	48	48	**46**	37
B2. Terms of trade shocks on copper and gold exports in 2010 and lower growth thereafter 3/	44	44	51	55	65	71	**100**	119
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	44	44	51	55	48	48	**46**	37
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4	44	57	86	92	80	78	**71**	48
B5. Combination of B1-B4 using one-half standard deviation shocks	44	47	46	50	44	44	**42**	34
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	44	44	51	55	48	48	**46**	37
Debt service ratio								
Baseline	2.1	2.3	2.8	3.2	2.7	2.7	**2.5**	2.4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	2.1	2.4	3.2	3.8	3.4	3.5	**4.3**	4.3
A2. New public sector loans on less favorable terms in 2007-26 2/	2.1	2.3	2.8	3.4	3.0	3.0	**3.2**	3.7
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	2.1	2.3	2.8	3.2	2.7	2.7	**2.6**	2.5
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	2.1	2.3	2.8	3.2	3.1	3.3	**4.0**	6.7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	2.1	2.3	2.8	3.2	2.7	2.7	**2.6**	2.5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4	2.1	2.3	3.2	4.2	3.5	3.5	**4.5**	3.6
B5. Combination of B1-B4 using one-half standard deviation shocks	2.1	2.4	2.7	3.0	2.5	2.5	**2.4**	2.3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	2.1	2.3	2.8	3.2	2.7	2.7	**2.6**	2.5
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	40	40	40	40	40	40	**40**	40

Sources: Data provided by the Mongolian authorities; and Fund staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Assumes that copper and gold prices decline by 35 percent and 25 percent respectively in 2010 on top of the WEO assumptions of sharp decline in copper prices through 2007-09, and each rises by 1 percent in 2011-26. As a consequence of these terms of trade shocks, assumes that the real GDP growth rate is less by 0.5 percent in 2010 and by 0.25 percent thereafter compared to baseline scenario.
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 2a. Mongolia: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006-26
(In percent)



Source: Staff projections and simulations. Thresholds for the three indicators are 40 percent, 150 percent, and 20 percent, respectively.

ANNEX II. Mongolia—Fund Relations
(As of November 30, 2006)

I. **Membership Status**: Joined: 02/14/1991; Article VIII

II. **General Resources Account**:	**SDR Million**	**percent Quota**
Quota	51.10	100.0
Fund Holdings of Currency	50.97	99.74
Reserve Position in Fund	0.14	0.27

III. **SDR Department**:	**SDR Million**	**percent Allocation**
Holdings	0.06	N/A

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**Percent Quota**
ESAF/PRGF Arrangements	21.04	41.17

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
PRGF	09/28/2001	07/31/2005	28.49	12.21
ESAF/PRGF	07/30/1997	07/29/2000	33.39	17.44
ESAF	06/25/1993	06/24/1996	40.81	29.68

VI. **Projected Obligations to Fund**: (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	**2007**	**2008**	**2009**	**2010**
Principal	0.59	4.30	3.19	4.22	3.04
Charges/interest	0.05	0.09	0.07	0.05	0.03
Total	0.65	4.39	3.26	4.28	3.07

VII. **Safeguards Assessments**:

Under the Fund's safeguards assessment policy, the Bank of Mongolia (BOM) was subject to a full safeguards assessment with respect to the PRGF arrangement that was approved by the Executive Board on September 28, 2001. An on-site safeguards assessment of the BOM was completed on September 10, 2003. Staff recommended that the BOM implement measures to strengthen its external audit mechanism and financial reporting framework. The BOM has so far implemented several of the recommendations. Staff continues to monitor the BOM's efforts to: (i) commit to the full adoption of International Accounting Standards (IAS) and to disclose its guarantees and pledges in its financial statements; and (ii) disclose the fair value of derivatives in its net international reserve position and financial statements. At the conclusion of the December 2002 PRGF discussions, the BOM agreed to implement special semi-annual audits of NIR to provide further assurance on the NIR position and to identify any related pledges or guarantees.

VIII. **Exchange Arrangement**:

On May 27, 1993, Mongolia moved from a fixed exchange rate against the U.S. dollar to a floating exchange rate system. The official exchange rate is now set daily on the basis of transactions in the interbank market. At end-November 2006, the official midpoint rate was Tog 1,164 per U.S. dollar. The official exchange rate is applied to State budget and customs transactions, including debt-service payments, and to trade and service transactions conducted under bilateral payments arrangements. Mongolia accepted the obligations of Article VIII, Sections 2, 3, and 4 on February 1, 1996, and maintains an exchange system that is free from restrictions on payments and transfers for current international transactions. Mongolia imposes exchange restrictions for security reasons in accordance with United Nations Security Council Resolution No. 92/757 concerning certain transactions with the Federal Republic of Yugoslavia (Serbia and Montenegro) that have been notified to the Fund under Decision 144-(52/51).

IX. **Article IV Consultation**:

The 2005 Article IV consultation (Country Report No. 05/396) was concluded by the Executive Board on September 21, 2005. Mongolia will be on the 12–month cycle.

X. **ROSC Assessments**:

- ROSC, Data Module, May 4, 2001 (www.imf.org)
- ROSC, Fiscal Transparency Module, November 8, 2001 (Country Report No. 01/218)
- ROSC, Fiscal update, May, 2005

XI. **Recent Financial Arrangements**:

A three-year arrangement under the Enhanced Structural Adjustment Facility in an amount equivalent to SDR 40.81 million (80 percent of quota) with a first annual arrangement in an amount of SDR 18.55 million (36.3 percent of quota), was approved on June 25, 1993. The second annual arrangement in an amount of SDR 11.13 million (21.8 percent of quota) was approved on November 23, 1994. The ESAF arrangement lapsed on June 24, 1996.

A three-year arrangement under the ESAF/PRGF in an amount equivalent to SDR 33.4 million (65.4 percent of quota), with a first annual arrangement in an amount of SDR 11.13 million (21.8 percent of quota), was approved by the Executive Board on July 30, 1997. The first year arrangement lapsed on July 30, 1998. The second annual arrangement of SDR 14.8 million (29 percent of quota) was approved on June 16, 1999. The first review under that arrangement was completed in January 2000 and the arrangement lapsed on June 15, 2000. The ESAF/PRGF arrangement lapsed on July 29, 2000.

A three-year arrangement under the PRGF in an amount equivalent to SDR 28.49 million (55.8 percent of quota), with the first year of the arrangement in an amount of SDR 12.21 million (23.9 percent of quota), was approved by the Executive Board on September 28, 2001. The first and second review under the PRGF was completed on September 12, 2003, and the Executive Board approved the extension of the PRGF through July 31, 2005. The arrangement expired on that date without the completion of the third and subsequent reviews.

XII. **Technical Assistance**:

Missions:

- Government Finance and Monetary and Financial Statistics (STA), September 2006
- Improving Banking Supervision and Reserve Management (MCM), September 2006
- Value Added Tax, Income Tax and Excise Tax Legislation (LEG), August 2006
- Cooperation between Mongolia's NSO and STA, May 2006
- Management Structure of the Bank of Mongolia (MFD), April 2006
- Monetary and Financial Statistics (STA), October 2005.
- Banking supervision and payment systems (MFD), June 2005.
- Options for Expenditure Savings and Efficiency Improvements (FAD), January 2005.
- Banking supervision and prudential framework (MFD), October 2004.
- Reforms of Tax Policies (FAD), October 2004.
- Government Finance Statistics (STA), August 2004.
- Balance of Payments Statistics (STA), July-August 2004.
- Banking supervision and prudential framework, (MFD), May-June 2004.
- AML/CFT Action Plan and legislative awareness, May 2004.
- Banking supervision and accounting (MFD), October 2003.
- Government Finance Statistics (STA), August 2003.
- AML/CFT (MFD), June 2003.
- Banking supervision and accounting (MAE), November 2002.
- Revenue administration (FAD), September 2002.
- Banking supervision and accounting (MAE), May 2002.
- Review of treasury and intergovernmental fiscal reforms (FAD), August 2001.
- Banking supervision and accounting (MAE), May–June 2001.
- Money and banking statistics (STA), May 2001.
- Government finance statistics (STA), March 2001.
- Fiscal transparency and ROSC (FAD), March 2001.
- Intergovernmental fiscal relations and budget reform (FAD), January 2001.
- Visits by MAE peripatetic experts on banking supervision, payments system, monetary policy, and accounting and audit, November 2000.
- Consumer price statistics (STA), September–October 2000.
- ROSC: data module (STA), May 2000.
- Restructuring bonds and other securities (MAE), March 2000.
- National accounts statistics (STA), February 2000.

Resident Advisors:

- National accounts statistics (STA), August 2001–September 2003
- Treasury reform (FAD), June 1999–November 2003
- Balance of payments (STA), March 1999–May 2001

Technical assistance for the period May 1995–October 1999 is reported in Annex II of the Staff Report for the 1999 Article IV Consultation.

XIII. **Resident Representative**:

Mr. Jang has been the Fund's resident representative in Mongolia since April 1, 2006.

ANNEX III. Mongolia—Relations with the World Bank Group[10]

Mongolia, an IDA only country, became a member of the World Bank Group in February 1991. Bank lending to Mongolia currently represents about 11 percent of the country's overall official development assistance flows. The current Country Assistance Strategy (CAS), covering the period 2004-07, was approved by the World Bank Board on 29 April 2004. The CAS is broadly aligned with Mongolia's Economic Growth Support and Poverty Reduction Strategy (EGSPRS) and supports policies in areas where the World Bank has a comparative advantage. The CAS uses a "results-based approach" that relates outcomes to the country's longer-term goals, including the MDGs.

A Governance Assistance Project was approved on May 23, 2006 to pave the way for a possible series of annual Poverty Reduction Support Credits (PRSCs), as envisaged initially in the CAS. The project will help improve governance in the areas of public financial management (budget execution, debt management, civil service), transparency and accountability, anti-corruption, poverty monitoring, and the investment climate.

The Bank's main sectoral activities also include:

- *Public Sector and Fiscal framework*. The Bank is working with the Government to strengthen the public finance management framework and civil service administration through the provision of analytical advice, and an investment and technical assistance project (The Economic Capacity building Technical Assistance project).

- *Financial sector*. After closure of a Financial Sector Adjustment Credit, the Bank continues working with the government and selected commercial banks to strengthen the banking system's capacity in credit risk management, automated payments system and Savings Bank resolution under the Financial Capacity Development Project (FCDP). Meanwhile, the second Private Sector Development Credit (PSDC II) continues to provide technical assistance in developing risk management and term-lending capacity in selected Mongolian banks, and enhancing central bank supervision capacity, in addition to financing private sector capital investment. A mid-term review is under way with a view to updating the Bank's assistance program to address the new challenges, and renewing the government's long-term strategy for financial sector reform and development.

- *Private Sector Development (PSD)*. The findings from an Investment Climate study initiated in mid-2004 will feed directly into the development of a PSD strategy and measures in the series of PRSCs to improve the business environment. New lending operations to encourage private sector participation in infrastructure sector are also being considered for the next three to four years.

- *Social sectors*. A Poverty Assessment was completed in 2006. In *education*, the Bank launched a rural education project that will build classroom libraries in all rural elementary

[10] Questions may be addressed to Ms. Boyreau, 473-8541.

schools. In addition, the analysis of the 2005 Public Expenditure Tracking Survey was completed. Analytical work by the Bank is underway on the quality of the educational system in Mongolia and the implications of the ongoing transition to an 11-grade system. In *social protection,* a study was carried out to assess the targeting efficiency of the *social assistance* schemes and of the Child Money Program. The Bank also supported the creation of a beneficiary data base for monitoring and evaluation of this program.

- *Rural and Urban development*. The Bank is assisting the government in the development of rural strategies and promotes secure and sustainable livelihoods through activities in pastoral risk management, microfinance services, basic infrastructure investment (through community-driven approaches), and the piloting of a new index-based livestock insurance product. In the area of urban development, the focus is on city development strategy. The Bank is also supporting the improvement of services delivery, particularly on improvement of water supply and *ger* area upgrading.[11]

- *Infrastructure.* An Information and Communication Infrastructure Development Project was approved on June 8, 2006. The Bank is working with the government in improving the technical and financial operation of electricity and water utilities through two projects: Energy Project and UB2 respectively. A Renewable Energy and Access Project is expected to be approved in November, 2006. The Infrastructure Strategy report—including sectoral background notes is under preparation.

- *Judicial and legal reforms*. The Bank is supporting efforts to enhance public confidence in the legal system, with a focus on the judiciary system. Challenges remain in enhancing access to justice, especially for the poor; disseminating new laws to the public; and enforcing existing laws.

- *Supreme Audit Institutions*. The Bank continues to work with the Mongolia National Audit Office to strengthen its technical audit capacity.

IFC became a minority owner of two Mongolian banks in 2004. The IFC is also providing technical assistance for developing a leasing industry.

MIGA: Mongolia signed the MIGA convention in 1991 and ratified it the following year. MIGA will be able to assist the country in attracting foreign investment through its marketing and guarantee activities.

[11] A Ger is the traditional dwelling tent of Mongolian people.

ANNEX IV. Mongolia—Relations with the Asian Development Bank[12]

Mongolia became a member of the Asian Development Bank (ADB) in February 1991. In line with ADB's poverty reduction strategy, ADB entered into a Poverty Partnership Agreement (PPA) with the Government of Mongolia in 2000. Within the framework of the PPA, ADB formulated in October 2005, its Country Strategy and Program (CSP) for 2006–08. The new CSP concentrates on achieving poverty reduction by supporting (i) stable, broad based growth and (ii) socially inclusive development. An indicative lending level of $85 million from ADB's concessional Asian Development Fund resources is programmed for 2006-2008, supplemented by an additional $40 million from ADB's regional fund. The CSP formulates a program that includes assistance in agriculture, transport, education, health, and urban development and support for administrative consolidation in support of interventions in these sectors. A CSP Update for 2007-2009 maintains the overall directions of the CSP while increasing the focus of projects on the Government's own strategic objectives, accounting for the need for better governance, the potential for increased levels of grant funding from other agencies, and ADB's own Medium Term Strategy II and its Managing for Development Results Agenda. Since March 2002, Mongolia has been a full member of the ADB-supported Central Asia Regional Economic Cooperation program for the Central Asian Republics and People's Republic of China (PRC).

ADB has provided loans for 36 projects totaling $615.8 million in the agriculture, education, energy, financial, health, industry, telecommunications, transport, and urban development sectors. Fourteen loans were active at the end of 2005. ADB has also provided one private sector equity investment in the amount of $6.1 million. Technical assistance grants have totaled close to $60 million, and grants funded by the Japan Fund for Poverty Reduction and Japan Fund for Information and Communication Technology total $8.2 million. Most early ADB support was in the form of quick-disbursing loans and investments in ailing infrastructure sectors. Governance and poverty were identified as the major development objectives in later years.

ADB allocates its concessional ADF resources to eligible member countries, including Mongolia, based on an annual country performance assessment. The assessment focuses on indicators of sustainable economic growth, socially inclusive development, governance and public sector management, and portfolio performance.

[12] Prepared by Asian Development Bank staff.

ANNEX V. Mongolia: Statistical Issues

1. Progress to Date

The authorities have established a framework for monitoring macroeconomic developments and made substantial improvements in all statistical areas with extensive technical assistance, including from the Fund. Core data are provided to the Fund on a timely basis and are adequate for surveillance, but some outstanding issues remain, as detailed below. Mongolia has been participating in the General Data Dissemination System (GDDS) since August 2000. A data ROSC mission visited Mongolia in May 2000 to assess data dissemination practices in relation to the *GDDS;* the data ROSC report was published on the IMF website in May 2001.[13]

An advisor assisted the National Statistical Office (NSO) during August 2001-September 2003, in improving primary data collection and compilation systems for **national accounts** (NA) and price statistics. While much was achieved, deficiencies persist in the annual and quarterly production accounts that detract from the accuracy of the data, including the use of inappropriate techniques to estimate capital formation and inconsistent deflators to derive the annual estimates of GDP volumes. The advisor also assisted the NSO in preparing a work program for developing a producer price index (PPI), useful for deriving constant price GDP estimates.

The IMF Statistics Department is providing support to the NSO in implementing its Program of Statistics Development for 2006–2010. It aims to strengthen the statistical capacity in conformity with the GDDS plans for improvement and to place Mongolia in a position to subscribe the Special Data Dissemination Standard.

Based on the recommendations of the 2000 STA mission on **consumer price statistics**, the methodology utilized to compile the CPI was substantially revised in January 2001, and included: (i) the CPI basket was updated with the results of the 1999 Household Income and Expenditure Survey (HIES); (ii) the CPI weights were updated using the results of the 1999 HIES and the 2000 HIES, with the latter update done in March 2002; and (iii) the CPI was rebased from December 1995 to December 2000. The CPI was recently rebased from December 2000 to December 2005.

For the **fiscal statistics**, the authorities have adopted systematic procedures for compiling annual reports for the general government and each of its subsectors. Government Finance Statistics (GFS) are also compiled on a monthly basis for all subsectors, except the extrabudgetary central government. All extrabudgetary agencies and funds should be examined to determine whether they should be included in the central government sector or the public corporations sector. The authorities also completed an inventory of all

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[13] As the ROSC was not prepared on the basis of the Data Quality Assessment Framework, no ratings were given. Consequently, the Table of Common Indicators Required for Surveillance (TCIRS) does not include memo items on data quality.

government bank accounts and instituted stricter standards for registering bank accounts for government agencies to facilitate reconciliation between the government accounts and banking data. However, complete reconciliation of monetary and fiscal data and implementation of other technical assistance recommendations are pending.

In September 2006, a **government finance and monetary and financial statistics** mission found that the underreporting of government deposits by five commercial banks to the Bank of Mongolia (BOM), coupled with the overestimation of government deposits by the Ministry of Finance, had given rise to a significant discrepancy on the level of bank financing to the government sector for 2005. The mission identified sources of this discrepancy on both monetary and fiscal sides, and prepared a work plan for its resolution. Moreover, the mission made progress on the implementation of projects in both GFS and MFS: it advanced the Pilot Project on the application of *GFSM2001* methodology with Mongolian data, and also prepared monetary data based on the Standardized Report Forms (SRFs) which could be used in future for reporting monetary statistics to STA.

Improvements to **balance of payments** statistics have been made subsequent to a short-term technical assistance mission to the BOM in 2004. The coverage of balance of payments statistics has been expanded through the introduction of a survey of enterprises. Key improvements include: implementation of a revised standard format for balance of payments reporting; implementation of 19 new surveys to improve the collection of external statistics in weak areas, including surveys of enterprises, travel, workers' remittances, the international investment position, private sector external debt, the cost and insurance component of imports c.i.f., services, income, aid transfers, foreign direct investment, government debt forgiveness, and the foreign exchange reporting system; and preparation of a balance of payments sources and methods manual. In addition, a working group with key official and private data providers and users has been established and commercial bank staff has been given training in data reporting.

2. **Outstanding Issues**

While some progress has been made in developing a national accounts framework, the quality of GDP estimates, particularly with respect to the current deflation methods for constant price estimates, could be improved further. While a proper methodological treatment of animal losses due to harsh winters has been finalized, efforts are needed to improve coverage of the informal sector and small-scale activity, especially in the services sector. Raw data could be refined with a view to producing reliable quarterly estimates of GDP. Furthermore, the construction of expenditure-based national accounts in constant price terms would serve as a useful check for the production side estimates.

Progress in implementing STA recommendations to develop a producer price index has been limited mainly due to resource and capacity constraints.

There are deficiencies in the data on wages and earnings. The development of labor market statistics through the establishment of quarterly sample surveys would help mitigate these shortcomings. The government conducted a survey of the civil service in May 2002, which should help to produce a detailed database on civil service employment and wages.

The September 2006 GFS and MFS mission identified a number of issues to ensure that the monetary statistics would conform with the *Monetary and Financial Statistics Manual*, and the fiscal data with the *GFSM2001* methodology. The BOM and MOF are following up on the recommendations of the mission and, as noted above, these agencies are also addressing the large discrepancy between the fiscal and monetary statistics for 2005.

Work has commenced on revising the register of businesses for balance of payments statistics, which was last updated in 2002. Also, the authorities plan to produce and publish a complete international investment position statement in the period ahead.

3. **Publications**

The NSO publishes monthly and annual *Statistical Bulletins* in English and Mongolian. These bulletins include data on population, employment, national accounts, prices, household income and expenditure, central and local government revenue and expenditure, and external trade. The BOM publishes a monthly *Statistical Bulletin* (within 15 days of the end of the month, which includes summary statistics for the central bank, consolidated balance sheet of commercial banks, and interest and exchange rate data) and *Annual Reports*.

ANNEX V. Mongolia: Table of Common Indicators Required for Surveillance

As of November 30, 2006

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	11/29/06	11/30/06	D	M	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	10/31/06	11/14/06	D	M	M
Reserve/Base Money	10/31/06	11/14/06	W	M	M
Broad Money	10/31/06	11/14/06	M	M	M
Central Bank Balance Sheet	10/31/06	11/14/06	W	M	M
Consolidated Balance Sheet of the Banking System	10/31/06	11/14/06	M	M	M
Interest Rates[2]	10/31/06	11/14/06	W	M	M
Consumer Price Index	Oct. 2006	11/09/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Oct. 2006	11/08/2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Oct. 2006	11/08/2006	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2005	Feb 2006	A	A	A
External Current Account Balance	Q2 2006	9/5/06	Q	Q	Q
Exports and Imports of Goods	Oct. 2006	11/13/05	M	M	M
GDP/GNI	2005	May 2006	A	A	A
Gross External Debt	2005	Feb 2006	A	A	A

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA)

ANNEX VI. Mongolia—Millennium Development Goals

	1990	1995	1998	2001	2004
Eradicate extreme poverty and hunger 1/	(2015 target = halve 1990 $1 a day poverty and malnutrition rates)				
Population below $1 a day (in percent)	..	14	27	..	..
Prevalence of undernourishment (in percent of population)	..	..	45	..	28
Poverty gap ratio at $1 a day (in percent)	..	3	8	..	..
Poverty headcount, national (in percent of population)	..	36	43	..	36
Malnutrition prevalence, underweight children (in percent of children under 5)	..	..	13	13	..
Achieve universal primary education 2/	(2015 target = net enrollment to 100)				
Net primary enrollment ratio (in percent of relevant age group)	90	..	90	90	84
Primary completion rate, total (in percent of relevant age group)	..	..	87	91	96
Youth literacy rate (in percent ages 15-24)	..	..	..	..	98
Promote gender equality and empower women 3/	(2005 target = education rate to 100)				
Proportion of seats held by women in national parliament (in percent)	25	..	8	11	11
Ratio of girls to boys in primary and secondary education (in percent)	109	..	117	112	108
Ratio of young literate females to males (in percent ages 15-24)	..	..	..	..	102
Share of women employed in the nonagricultural sector (in percent)	48	47	48	49	49
Reduce child mortality 4/	(2015 target = reduce 1990 under 5 motality by two thirds)				
Immunization, measles (in percent of children ages 12-23 months)	92	85	93	95	96
Infant mortality rate (per 1,000 live births)	78	64	..	50	41
Under 5 mortality rate (per 1,000)	108	87	..	65	52
Improved maternal health 5/	(2015 target = reduce 1990 maternal mortality by three fourths)				
Births attended by skilled health staff (in percent of total)	..	..	94	97	99
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	110	..
Combat HIV/AIDS, malaria, and other diseases 6/	(2015 target = halt, and begin to reverse, AIDS, etc.)				
Contraceptive prevalence rate (in percent of women ages 15-49)	..	..	60	67	69
Incidence of tuberculosis (per 100,000 people)	220	..	..	..	192
Tuberculosis cases detected under DOTS (in percent)	..	7	60	73	80
Ensure environmental sustainability 7/	(2015 target = various)				
Access to an improved water source (in percent of population)	63	..	..	..	62
Access to improved sanitation (in percent of population)	..	..	..	..	59
CO2 emissions (metric tons per capita)	5	4	3	3	..
Forest area (in percent of total land area)	7	..	..	7	7
Nationally protected areas (in percent of total land area)	..	..	..	..	12
Develop a global partnership for development 8/	(2015 target = various)				
Aid per capita (current US$)	6	93	87	87	104
Debt service (in percent of exports of goods and services)	0	10	5	7	3
Fixed line and mobile phone subscribers (per 1,000 people)	32	34	48	132	184
Internet users (per 1,000 people)	..	0	1	17	80
Personal computers (per 1,000 people)	..	3	8	17	124
Total debt service (in percent of exports of goods, services and income)	..	10	6	7	3
Unemployment, youth female (in percent of female labor force ages 15-24)	..	..	..	21	..
Unemployment, youth male (in percent of male labor force ages 15-24)	..	..	..	20	..
Unemployment, youth total (in percent of total labor force ages 15-24)	..	..	..	20	..
General indicators					
Fertility rate, total (births per woman)	4	3	3	2	2
GNI per capita, Atlas method (current US$)	..	330	460	400	600
GNI, Atlas method (current US$, in billions)	..	0.7	1.1	1.0	1.5
Gross capital formation (in percent of GDP)	38	32	35	36	37
Life expectancy at birth, total (years)	63	64	65	63	65
Literacy rate, adult total (in percent of people ages 15 and above)	..	..	..	..	98
Population, total (in thousands)	2,106	2,275	2,398	2,480	2,500
Trade (in percent of GDP)	77	97	124	120	162

Source: World Bank: *World Development Indicators Database* , and UNDP and NSO: Living Standard Measurement Survey 2002/2003.

1/ Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day, and the proportion of people who suffer from hunger.

2/ Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

3/ Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

4/ Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

5/ Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

6/ Have halted by 2015, and begun to reverse, the spread of HIV/AIDS and the incidence of malaria and other major diseases.

7/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water.

8/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states.

INTERNATIONAL MONETARY FUND
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IMF Executive Board Concludes 2006 Article IV Consultation with Mongolia

On January 10, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mongolia.[1]

Background

Mongolia's macroeconomic performance in 2005-06 has been robust, underpinned by a run-up on copper and gold prices, declining inflation, and budget and external current account surpluses. Real GDP growth in 2005-06 is estimated at 7 percent, in line with the average pace since 2002. The mineral sector has been a key engine of growth, supported by favorable weather conditions, and buoyant recovery in the construction and services sectors. Inflation has eased to about 7 percent in October 2006 (year-on-year), following a spike at about 17½ percent in June 2005. The current account balance (including official transfers) recorded a surplus (1.4 percent of GDP) in 2005, which is expected to widen further to 5.2 percent of GDP in 2006. Gross international reserves have been rebuilt from their end-2003 low level in the aftermath of the settlement of the pre-1991 Russian debt, and are expected to reach this year about 3.4 months of next year's imports of goods and services.

The fiscal position has improved markedly in 2005-06. The budget deficit, which had narrowed significantly during 2000-04, switched to a 2.9 percent of GDP surplus in 2005 for the first time ever, and is expected to widen to 9.0 percent of GDP in 2006. This reflected a sevenfold increase in mining revenue since 2003 in concert with a 10 percentage point of GDP decline in

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

total expenditure over the period, despite a 30 percent public sector wage increase and a significant expansion in social welfare transfers in 2006. Mirroring the improved fiscal performance, the debt burden has eased significantly, with the net present value (NPV) of public external debt halved from 64 percent of GDP end-2003 to an estimated 32 percent at end-2006. The 2007 budget calls for a significant easing in the fiscal policy stance, reflecting large tax cuts and further increases in wages and social welfare transfers.

Monetary aggregates have expanded rapidly in recent years, driven by strong foreign exchange inflows and improved confidence in the banking system. Broad money and reserve money growth accelerated to 37.3 percent and 19.7 percent, respectively, in 2005 and are expected to slow only slightly in 2006. Private credit continued to expand rapidly (40 percent) in 2005, and is expected to rise broadly at the same pace in 2006. Fast private credit growth in 2006, however, has been broadly offset by a sharp decline in net credit to government, as government deposits built up markedly and debt to the central bank was partly redeemed. The subdued inflationary response to date to rapid monetary growth primarily reflects a strong reintermediation process and a gradual exchange rate appreciation.

Strides have been made in strengthening the banking system, but vulnerabilities remain. Nonperforming loans (NPLs) were reduced from 23.4 percent of total loans at end-2000 to 8.8 percent at end-2005, and the ratio has remained broadly stable in 2006. To safeguard the soundness of the banking system, the enforcement of prudential requirements has been intensified, especially for banks with rapid credit growth. Actions are also underway, under the newly-created Financial Regulatory Commission, to address the solvency of a number of credit and saving cooperatives and to strengthen the supervisory framework for nonbanks.

On the structural front, progress has been made to strengthen central bank governance and promote private sector development. The Bank of Mongolia appointed in September 2006 two non-executive directors to its Board of Directors, thus paving the way for further changes to shift decision-making authority from the Governor to the Board of Directors. An AML/CFT Law was adopted in mid-2006, providing for the establishment of a Financial Intelligence Unit within the Bank of Mongolia. An Anti-Corruption Law aimed at strengthening the business environment was also adopted at that time. Public sector reform is proceeding, with the recent privatization of the Savings Bank and bidding underway for the Gobi cashmere factory.

Mongolia’s medium-term outlook for sustained growth and poverty reduction is broadly favorable, but subject to risks. With its considerable mineral endowment and location between two large and fast-growing economies, Mongolia has the potential to achieve real GDP growth averaging 6-7 percent of GDP over the medium term. Inflation could be contained to below 5 percent, provided that appropriate fiscal and monetary policies are in place. The main challenge, however, will be to ensure fiscal sustainability through sound management of the country’s mineral resources and steadfast expenditure restructuring, especially civil service reform and social expenditure restraint. Assuming continued fiscal consolidation, Mongolia’s external debt ratio would decline substantially over the medium term. In addition to policy risks, medium-term prospects are vulnerable to adverse weather conditions, and terms-of-trade shocks triggered by sharp declines in copper and gold prices and soaring oil prices.

Executive Board Assessment

Executive Directors commended the authorities for Mongolia's robust economic performance in recent years, including vigorous growth, a decline in inflation, the emergence of fiscal and current account surpluses, and reduced debt ratios. Mongolia's mineral wealth and improved macroeconomic stability provide a good foundation for sustained growth. Nevertheless, challenges remain to mitigate the economy's vulnerability to shocks, including harsh weather and a decline in copper prices, and to reduce the high poverty rate. Directors encouraged the authorities to focus on managing mineral wealth efficiently, improving infrastructure and the business environment, and targeting poverty alleviation policies carefully, in the context of continued macroeconomic stability.

Directors welcomed the marked improvement in the fiscal position in recent years. They cautioned, however, that the loosening of the fiscal stance in the 2007 budget could jeopardize fiscal sustainability and revive inflationary pressures. To ensure that public debt remains on a declining path, the non-mineral fiscal deficit should be reduced by containing the growth in the civil service wage bill, better targeting social welfare spending, and moving forward with civil service reforms. Directors stressed the importance of realistically planning and prioritizing capital spending. They recommended that the authorities consider formulating a medium-term fiscal framework, which could facilitate consistency in budget preparation.

Directors broadly supported the recent efficiency-enhancing tax reform, including the elimination of most VAT exemptions and new tax holidays, but observed that some tax cuts might need to be partially reversed to ensure fiscal sustainability, starting with the cut in the VAT rate. Also, cuts in non-mining tax rates could increase the sensitivity of revenues to commodity price shocks. Directors encouraged the authorities to keep the mining regime under review to ensure an internationally competitive tax regime, and they supported Fund technical assistance in this area.

Directors welcomed signs of improving confidence in the banking system, including significant reintermediation. They cautioned, however, that continued rapid monetary growth could raise inflationary pressures, and called for increased sales of central bank bills to absorb excess liquidity. They welcomed Fund technical assistance to upgrade the monetary policy framework and develop sound liquidity management instruments.

Directors commended recent steps to strengthen central bank governance, including the appointment of outside members to the Bank of Mongolia's Board of Directors, and they encouraged the authorities to move forward with plans to shift decision-making authority to the Bank of Mongolia's Board of Directors. Directors called for upgrading the management of international reserves, including reducing gold risk exposures and preparing a strategy to exit the gold market over the medium term.

Directors emphasized that, despite recent progress, the financial system remains vulnerable. As rapid credit growth can cause loan quality to deteriorate, enforcement of prudential regulations at weaker banks should be strengthened. Directors counseled the authorities against using administrative measures to lower bank lending rates, bailing out insolvent savings and credit cooperatives, or including these cooperatives in any future bank deposit insurance scheme.

Directors considered that Mongolia's flexible exchange rate has facilitated orderly adjustments to external shocks, and that the recent appreciation of the togrog reflects the improving external position. They supported the authorities' plan to continue limiting interventions in the foreign exchange market to smoothing short-term volatility. While welcoming Mongolia's continued commitment to an open trade regime, Directors encouraged the authorities to phase out the export duty on raw cashmere and resist pressures to raise import duties to protect domestic industries. Directors underscored the importance of maintaining a prudent debt management strategy, with most Directors emphasizing reliance on concessional borrowing. Directors also looked forward to the resolution of remaining outstanding obligations to foreign creditors.

Directors supported actions to foster good governance and private sector development, including the adoption of Anti-Money Laundering and Anti-Corruption Laws, and the privatization of two large public enterprises. They urged the authorities to proceed further with energy sector reform.

Directors welcomed the progress made in strengthening data quality for surveillance, and called for continued efforts to improve national account, fiscal, and monetary data.

Mongolia: Selected Economic Indicators, 2003-06

	2003	2004	2005	2006 Est.
Real Sector (percent change)				
Real GDP growth	6.1	10.8	7.0	7.0
Mineral	-2.3	34.3	10.9	5.2
Nonmineral	7.1	8.1	6.5	7.3
Consumer prices (end-period)	4.7	11.0	9.5	7.0
General Government Budget (in percent of GDP)				
Revenue and grants	37.6	37.0	33.7	40.6
Mineral revenue	2.8	4.1	4.5	13.5
Nonmineral revenue	34.2	32.5	29.0	27.0
Expenditure and net lending	41.8	39.1	30.7	31.7
Overall balance (including grants)	-4.2	-2.1	2.9	9.0
Nonmineral overall balance	-7.0	-6.3	-1.5	-4.5
Money and Credit (percent change)				
Broad money	49.7	20.3	37.3	34.9
Domestic credit	147.0	23.0	22.3	-5.0
Of which: claims on nonbanks	90.3	43.7	40.1	39.2
Reserve money	14.7	16.8	19.7	16.5
Interest rate on central bank bills (percent per annum) 1/	15.0	15.8	3.7	5.8
	(in millions US dollars; unless otherwise indicated)			
Balance of Payments				
Current account balance (in percent of GDP)				
Including official transfers	-7.7	1.6	1.4	5.2
Excluding official transfers	-11.5	-3.7	-2.8	2.0
Exports, f.o.b.	627	872	1,069	1,548
Mineral (in percent of total exports)	58.5	65.1	71.0	...
Nonmineral (in percent of total exports)	41.5	34.9	29.0	...
Imports, c.i.f.	827	1,021	1,224	1,532
Terms of trade (percent change)	1.1	7.0	2.3	25.8
Gross international reserves (end-period)	178	208	333	626
(in months of next year's imports of goods and services)	1.5	1.6	2.1	3.4
Public and Publicly Guaranteed Debt (in percent of GDP)				
Total public debt	113.0	93.0	68.3	53.6
External debt	98.2	85.4	64.1	51.0
Domestic debt	14.8	7.6	4.2	2.6
NPV of external debt	64.2	52.3	40.3	31.7
External debt service (in percent of exports of goods and services)	34.0	7.5	2.9	2.1
Exchange Rate				
Togrogs per US dollar (end-period)	1,170	1,209	1,221	1,164
Real effective exchange rate (end-period; percent change)	-6.8	0.8	7.7	...

Sources: Data provided by the Mongolian authorities; and IMF staff estimates.
1/ Annualized yield on end-period auction of 14-day bills; as of end-September 2006.

Statement by Richard Murray, Executive Director for Mongolia and Hyun Cheol Lee, Advisor to the Executive Director
January 10, 2007

Overall Economic Performance and Medium-Term Outlook

Mongolia's recent economic performance has been solid. Real GDP growth has averaged 7 percent annually since 2002. After the Russian debt settlement in December 2003, total debt has declined steadily and substantially. Since 2004, the external current account has shifted into surplus. In 2005 the overall and primary fiscal balance moved markedly into surplus. Inflation peaked in mid-2005 mainly owing to the devastating weather conditions and the consequent meat shortage. The solid economic performance is mainly attributable to the record-high world copper and gold prices as well as the authorities' commitment to prudent macroeconomic policies in line with the policy recommendations and technical assistance by the Fund and Bank.

In 2006, Mongolia's economy has shown even more solid performance. It is commendable not just because the growth was fueled by "unprecedented" high mineral prices, but because the growth was also broad-based, in particular in non-mineral sectors, such as construction and financial services. By mid-year, inflation had declined to the lowest level (1.8 percent y-o-y) in four years and now remains at a moderate level in the order of 6 percent. The overall fiscal balance is estimated again as a solid surplus and the NPV of total public debt continues on its downwards projectory.

The near-term outlook for the economy remains very positive. As the mineral sector has been the main engine of Mongolia's growth, economic prospects will be substantially affected by commodity price developments. While the WEO projection of copper prices in 2007 is US$5,500 per ton, the authorities assume that the average copper price in 2007 will be US$6,000 per ton. The authorities' projection is also supported by the fact that the 15-month future (buyers) price for copper recorded on January 2, 2007 in the London Metal Exchange was US$6,050 per ton. While the projected price may look much lower than recent market prices, it still is more than three-times the price level during 2000 to 2003. The staff's medium-term scenario envisages that real GDP growth can average 6-7 percent over the medium-term, if appropriate policies are pursued. Furthermore, in addition to already-rich mineral production, Mongolia has a long list of projects for development, including Oyu Tolgoi (copper and gold), Burenkhaan (phosphate), Tavan Tolgoi (5 billion tons of coal), Turmurtei (229 million tons of iron), as well as yet to be developed natural gas and petroleum reserves.

Fiscal policy

The staff assesses Mongolia's 2007 fiscal stance as a "loosening of fiscal policy." However, it should be recalled that the amended 2006 budget had projected the overall fiscal deficit at 3½ percent of GDP, whereas the overall fiscal outcome for 2006 is significantly better than budgeted, mainly due to substantially stronger-than-expected world mineral prices, a surge in windfall tax collections and the under execution of capital spending. This 2006 surplus outcome is obviously not sustainable as the commodity price cycle matures in 2007 and beyond. The 2007 budget projects an overall deficit of 3.9 percent of GDP[1]. Mongolia's Parliament calls for the overall deficit to remain constant at 4 percent of GDP through to 2009, which would allow a sharing of the benefits of the terms of trade across the community, while still maintaining a steady decline in public debt to GDP.

On the public expenditure side, the staff argues against the large increase in child allowances. However, the Mongolian authorities have established the Development Fund specifically for the deposit of the windfall tax proceeds, and the authorities have agreed in principle to allocate expenditures from the Development Fund to areas such as infrastructure and child allowance only after the revenues to the Fund are accumulated. Mongolia is a sparsely populated country with a high poverty ratio. Only 2.5 million people are living in a country with the territory equal to one-sixth of that of China. Mainly due to a nomadic life style, the authorities had no resident registration system until recently. The child allowance has helped establish the resident registration system as well as the tax paper database. More importantly, it shifts part of the windfall from the highly non labor-intensive mineral sector (employing only 2.4 percent of the labor force) to all under 18 year olds in a non-discriminating manner. In that sense, the child allowance is redistributive rather than "untargeted" as the staff states. Means testing would require a substantial administrative apparatus for a relatively small fiscal saving.

The 2007 budget provides for a 20 percent increase in civil service wages. While the private sector salary and consumer prices have increased substantially in recent years, public sector salaries have been suppressed. Even with the proposed increase, the absolute level of the public sector wages is still relatively low. The Mongolian authorities recognize the need for on-going public sector reform as part of medium term improvements for the delivery of public sector services.

On the revenue side, it should be noted that the authorities have taken measures for broadening the non-mineral tax base and cutting tax rates. It should help diversify and increase efficiency of the economy through reducing distortions in the tax system. The

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[1] It is based on the final 2007 budget approved by Parliament. The 5 percent fiscal deficit of GDP in 2007 in the staff paper is calculated by the staff using Fund methodology.

reforms are intended to create favorable conditions for entrepreneurs, individuals and foreign and domestic investors and are viewed by the authorities as an important step towards supporting economic growth and the future expansion of the tax base. The staff recommends that the authorities reverse at least part of the 5 percentage point cut in the VAT rate. This simply seems to be politically impracticable at this stage and would risk unraveling other parts of tax reform. Nevertheless, the Mongolian authorities are keeping the whole tax area under review and are seeking FAD technical assistance on addressing the mineral tax issues.

In terms of further addressing medium to longer term fiscal sustainability, the Mongolian authorities agree with the approach of seeking to stabilize usable revenues and to provide for the accumulation of financial resources that would make up for the depletion of national resources. Moreover, the authorities recognize the steady upward trend in budget expenditures, and are planning to implement budget expenditure reforms which aims at ensuring a rational allocation of budget financing.

Monetary policy and Financial System

The authorities share the staff's concern that the current rapid growth in broad money could fuel higher inflation. They note, however, that rapid monetary growth is an indication of deepening intermediation and improving confidence in the banking system. The authorities note the staff's recommendations that the Bank of Mongolia (BOM) should increase the issuance of CBBs at market-clearing interest rates as a monetary policy tool.

The BOM has taken many important steps to strengthen its governance structure. Two non-executive directors were appointed to the BOM's Board of Directors. The authorities agree with the staff that the shift of weight from the Governor to the Board of Directors and strengthening of the external Supervisory Board will help improve the central bank governance.

The authorities maintain ongoing commitments to the flexible exchange rate, including limiting foreign exchange market interventions to the smoothing of short-term volatility. The exchange rate regime has let the economy cope with terms of trade movements through the cycle. As the staff rightly pointed out, international reserves should be held in low risk, unencumbered assets. In this regard, the authorities agree that the BOM should phase down the domestic gold purchases as practicable in the medium to long term.

Progress in strengthening the banking system is one of the most notable developments of the economy in 2006. Nonperforming loans (NPLs) of the banking system as a whole have been substantially reduced during recent years. High priority will be given to monitoring banks with fast credit growth and bank lending rates should continue to reflect market forces. The authorities agree with the staff that the plans to introduce a bank deposit insurance scheme should be preceded with in a very cautious manner. Against this background, the BOM has now requested to subscribe to the Financial Sector Assessment Program (FSAP) and for the assessment to commence as soon as possible.

Structural reforms

All structural reform measures are geared toward improving the climate for private investment and diversifying the economy. The Anti-Corruption Law was newly adopted. Privatization of State Owned Enterprises (SOEs) is slowly but steadily being pursued. In particular, SOEs in the energy sector are planned for comprehensive restructuring under a Bank-supported energy sector reform project.

In order to strengthen the poverty reduction strategy, the Socio-Economic Guidelines have been finalized. The authorities are trying to have social welfare programs more targeted in line with the Fund recommendations.

Public Debt

The authorities are trying to reach agreements with bilateral creditors on disputed claims. Loan arrears to an Italian supplier were cleared in mid-2006. Bilateral discussions are underway with Russia on the arrears of post-1991 Russian debt (US$16.7 million in principal as of end-2005). The authorities are seeking to reach agreement with Finnvera, the export credit guarantee agency of Finland, to normalize a loan dating back to the early 1990s.

According to the Debt Sustainability Analysis (DSA) by the Fund and Bank staff, under the baseline scenario, all public and publicly guaranteed external debt indicators would be in downward trends and stay well below their respective thresholds through the medium-to-long term.

Public and Publicly Guaranteed External Debt Sustainability Analysis

	NPV of debt in percent of		Debt Service in percent of
	Exports	GDP	Exports
Thresholds for Medium Performer	**150**	**40**	**20**
2007 Baseline Projections	44	30	2.3
2016 Baseline Projections	46	26	2.5

*source: Fund staff paper

The staff should be commended for the DSA, which will be very useful in informing public debate on the need for continuing fiscal prudence particularly given the risks of debt distress in the face of adverse external developments, particularly terms of trade shocks. The authorities have noted the Fund advice on refraining from non-concessional external borrowings. They have also pointed out, however, the benefits of some market exposure on external borrowings at some point in the future in order to establish a good credit rating.

AML/CFT

Last year Mongolia passed the legislation for anti-money laundering and combating the financing of terrorism (AML/CFT). To further strengthen the AML/CFT framework in compliance with international standards, the authorities recently set up a Financial Intelligence Unit within the BOM. The Legal Department is having dialogue with the authorities about possible technical assistance.

Statistics

While there are still outstanding issues like the quality of GDP estimates, the authorities have achieved continued improvement in statistics. For further progress, the authorities are seeking ongoing technical assistance from the Fund's Statistical Department.

Mongolia

In 2005, the economy grew at a robust 6.2%. High global prices for copper and gold boosted the mining industry, but manufacturing was hit by the end of global textile and clothing quotas. Inflation rose to double-digit levels. Growth in the medium term is projected at around 5%. Given its narrow base, the economy remains vulnerable to swings in the prices of a few commodities and to weather conditions. Stronger links to neighboring markets would facilitate development.

Economic performance

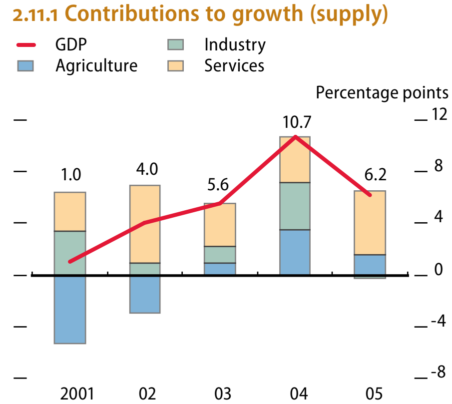
Gross domestic product (GDP) grew by a solid 6.2% in 2005, although this was below the very rapid pace of 2004 when GDP surged on the rebuilding of livestock herds and expansion of mining. The services sector made the biggest contribution to growth in 2005 (Figure 2.11.1.), bolstered by increased tourism and transit trade. Agriculture also contributed to growth. However, industrial production was hit by cutbacks in the clothing industry after the end of global quotas in major export markets (Box 2.11.1) The mining subsector was supported by high world copper and gold prices and foreign direct investment.

Inflation, spurred to double digits by higher prices for fuel, utilities, and food, eased later in the year as food price inflation slowed. Imports of lower-priced consumer goods from the People's Republic of China (PRC) reduced prices of clothing and footwear. Consumer inflation averaged 12.7% in 2005. Broad money growth (Figure 2.11.2) exceeded growth of nominal GDP. The Bank of Mongolia, which had been selling central bank bills to contain growth in broad money, held back from this practice in 2005. Net domestic credit continued to rise rapidly, particularly to the wholesale and retail trading, construction, and mining industries. The nonperforming loan ratio at banks increased as credit expanded, heightening concerns about related-party lending and corporate governance at banks. Nevertheless, confidence in the financial system improved, and the savings rate continued its recovery from a sharp decline after banking crises in the 1990s.

Increased corporate tax revenues, a result of the robust economic growth and higher commodity prices, swung the budget into a surplus equivalent to 2.7% of GDP (Figure 2.11.3), the first surplus in many years. Expenditure was broadly maintained as announced in the 2005 budget. An assistance program for poor families with children, which cost about 1% of GDP, was put under review to assess whether it effectively reaches the needy.

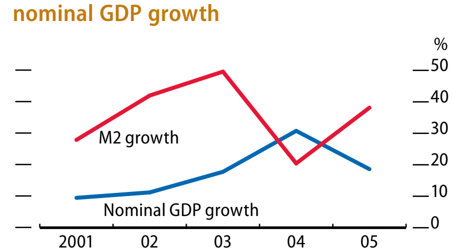
Strong copper and gold export prices also helped shrink the trade deficit to an estimated $95 million (Figure 2.11.4). Mongolia's exports comprise mainly minerals, cashmere, and clothing, with the PRC buying more than half of the total. Shipments of clothing plunged last year as predominantly foreign-owned textile companies stopped production

2.11.1 Contributions to growth (supply)



Source: National Statistical Office.

2.11.2 Money supply (M2) and nominal GDP growth



Sources: National Statistical Office; Bank of Mongolia, *Monthly Bulletin*, December 2005, available: www.mongolbank.mn/monthlybul2005.htm, downloaded 1 February 2006.

2.11.1 Loss of trading preferences—and potential growth areas

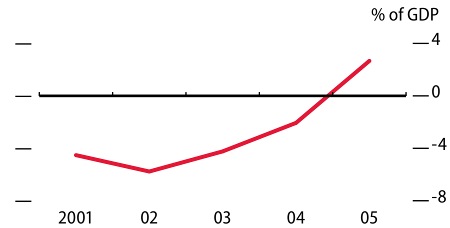
The end of international clothing quotas resulted in the closure of many clothing manufacturers and the loss of significant employment in Mongolia. This experience illustrates the risk in basing trade on preferences.

The clothing industry was built on foreign direct investment, mostly from the People's Republic of China (PRC), motivated primarily by the absence of quota restrictions on imports from Mongolia under World Trade Organization agreements. Exports, dominated by products for which quota utilization rates of the PRC were high, were aimed primarily at the United States market. Clothing exports grew rapidly over 2000–2004 to 11.3% of total exports, and the industry employed an estimated 20,000 Mongolian workers, mostly women, as well as illegal immigrants. During 2005, most of the PRC-based producers stopped production in Mongolia and almost half of the workers lost their jobs. The Government tried to support the industry by reducing clothing makers' social security contributions and exempting them from import taxes on raw materials, but these measures failed to arrest the decline. Clothing exports to the United States dropped by about 40% in value in 2005, and total clothing exports plunged by nearly 60%. The high import content (almost 70% of export value) limited the damage to the trade deficit, but the social and employment impacts were serious.

A large foreign stake in the clothing industry, in itself, does not explain this outcome, as other countries with foreign ownership were able to increase exports. A possible explanation is that investments in the Mongolian clothing industry were undertaken under an implicit time horizon that ended with the full implementation of the Agreement on Textiles and Clothing on 31 December 2004. It is likely that with most of their equipment fully depreciated and faced with the choice of renewing their investments or ceasing production and relocating to sites where costs are lower, most investors followed the latter path. This reflects the basic competitive disadvantages of Mongolia posed by its distance from major markets, reliance on imported raw materials, lack of infrastructure, and poor skills base. The sudden contraction in production and exports of clothing, and subsequent loss of jobs, have highlighted the importance of developing trade on the basis of comparative advantage, because preferences or concessions cannot be counted on in the long term to overcome basic disadvantages.

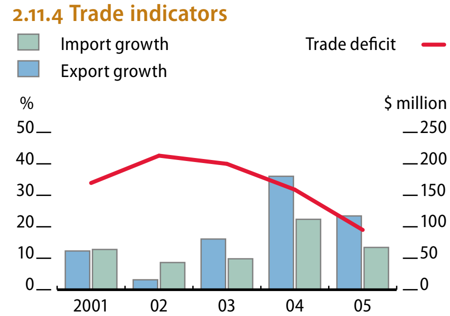
The economy may well have a comparative advantage in the resources of its remote areas, particularly the western region, which accounts for over 30% of national livestock. Most of this was raised organically, and has the potential to target niche markets in Europe and the Middle East. This region is also well positioned to supply food to the PRC, Kazakhstan, Kyrgyz Republic, and the Russian Federation. It also has considerable potential for tourism, given the area's cultural diversity and natural beauty. However, as the remote areas often have fragile natural environments, environmental protection measures that involve cooperation with neighboring economies should be part of development plans. Development will depend on establishing stronger links to these relatively nearby markets, as well as building the capacity to access distant markets. Improved transport to neighbors, combined with cross-border agreements, would be a first step. Additional transit agreements, harmonization of customs procedures, and other trade facilitation measures would reduce transaction costs that form a barrier to trade.

2.11.3 Budget balance



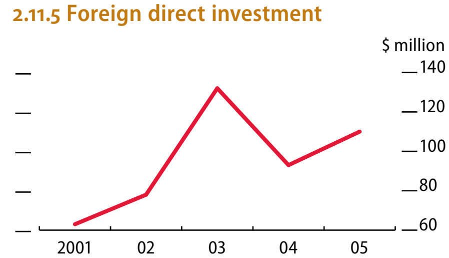
Source: Ministry of Finance.

2.11.4 Trade indicators



Source: National Statistical Office.

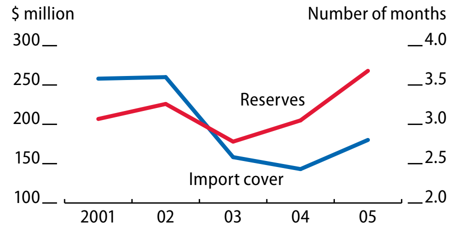
2.11.5 Foreign direct investment



Sources: Asian Development Outlook database; International Monetary Fund, *Article IV Consultation on Mongolia*, November 2005.

after the global textile and clothing trade quota system ended on 31 December 2004. The net impact on total trade was modest because most inputs for clothing manufacture are imported. The smaller trade deficit, together with capital flows into mining, remittances, and tourism receipts, narrowed the current account deficit for a third consecutive year. The togrog remained relatively stable against the United States dollar in 2005, implying a real effective appreciation of about 4%, which reflects the higher mineral export prices, remittance and foreign direct investment inflows (Figure 2.11.5), and the rebuilding of foreign reserves (Figure 2.11.6).

2.11.6 Gross official reserves



Sources: Asian DevelopmentOutlook database; International Monetary Fund, *Article IV Consultation on Mongolia*, November 2005.

Economic outlook

This analysis assumes that prices of copper and gold—the most important of Mongolia's commodity exports—will decline from the highs reached in 2005. The price of cashmere is expected to remain stable, while price increases for imported oil are expected to moderate. The baseline assumes that the Government will sustain supportive fiscal policies and that any policy changes will not be an additional constraint to private sector development. Another important assumption is that the Bank of Mongolia tightens monetary policy, resuming its sale of bills as needed to rein in inflation, and maintains confidence in the banking system.

2.11.1 Selected economic indicators

	2006	2007
GDP growth	6.0	5.0
Inflation	5.5	5.0
Current account balance (% of GDP)	-8.5	-8.5

Source: Staff estimates.

Prospects for 2006 and 2007

GDP growth in 2006 is projected at 6.0%, slowing to 5.0% in 2007 (Figure 2.11.7), as the livestock sector returns to its trend growth rate after high volume-led growth over 2004–2005. An expected easing in high global copper prices is likely to affect growth in mining. Income from tourism is expected to rise in 2006 as Mongolia holds celebrations for 800 years of statehood. Transport and telecommunications are projected to expand, with an increase in transit trade and extension of telecoms services to the growing urban population.

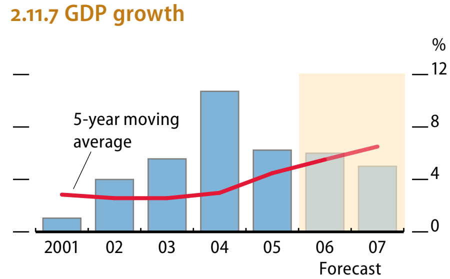
After last year's surge in prices, inflation is forecast to decelerate to 5.5% in 2006 (Figure 2.11.8) because of reduced upward pressure from oil prices and expected policy action by the Bank of Mongolia, primarily through market transactions. The current account deficit should be fairly stable at around 8.5% of GDP.

Medium-term outlook

GDP growth over 2006–2010 is forecast to average about 5%. The primary sector is likely to be a more significant contributor to growth in this period. Some medium-sized mines are expected to increase output and new mineral deposits have been discovered, though their commercial viability has yet to be established. Development of larger mineral deposits may be constrained by weaknesses in infrastructure, including power and transport, and by the capacity and commitment of some holders of exploration licenses to develop large deposits. The livestock sector is likely to maintain its trend growth.

In the services sector, tourism, transport, and telecoms are expected to expand over 2006–2010. Growth in tourism could get a lift over the medium term from private sector investments in tourist facilities for this

2.11.7 GDP growth

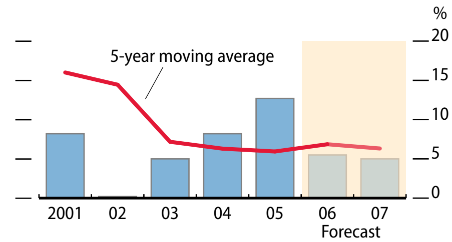


Sources: National Statistical Office; staff estimates.

year's 800th anniversary celebrations. Transit trade should be encouraged by the signing of an agreement between Mongolia, PRC, and the Russian Federation in late 2005. PRC–Russian trade that currently goes via Kazakhstan is expected to be diverted through Mongolia, provided that improvements in infrastructure are made. Development of manufacturing and other nonresource industries will depend partly on overcoming low labor productivity through education and training.

Mongolia's narrowly based economy is vulnerable to weather-related natural disasters and declines in commodity prices. Agricultural production depends heavily on the weather, which in the past has destroyed as much as 20% of the livestock herd, exacerbated rural poverty, and cut economic growth. Natural disasters also strain the budget and derail development programs, as they did in 2000–2002. The recent credit expansion and associated rise in nonperforming loans have increased the vulnerability of the banking system. As Mongolia accelerates the exploitation of its mineral resources, so the risk of environmental harm increases, particularly given that safeguards are not yet adequate.

2.11.8 Inflation



Sources: Bank of Mongolia, *Monthly Bulletin*, December 2005, available: www.mongolbank.mn/monthlybul2005.htm, downloaded 1 February 2006; staff estimates.

GOVERNMENT OF MONGOLIA

ECONOMIC GROWTH SUPPORT and POVERTY REDUCTION STRATEGY

ULAANBAATAR
July 3, 2003

Executive summary

The Economic Growth and Poverty Reduction Strategy (EGPRS) is a strategy paper, which presents main policy directions of the government for the medium term with a focus on economic growth acceleration and poverty reduction efforts.

Since 1990 Mongolia has embarked on a path of building a democratic society which respects human rights and is committed to developing a market economy, undertaking sweeping changes and reforms touching all spheres of social life. Mongolia, with the assistance of international financial institutions and the wider donor community, has made substantial progress over the past decade of democratic restructuring in laying down sustainable macroeconomic foundations and creating a private sector-led open economy. For the medium term economic growth rate targeted at 5.5 per annum, which will be achieved through economic restructuring, including public sector reforms, improving public expenditure management and rationalization of social safety nets with clear implications on improving public service delivery.

The overall transitional transition period of Mongolia covered all spheres of life, and the past decade was a decade of securing foundations for market-based transactions and implementing policies oriented toward sustainable growth and poverty reduction. In 2002, economic growth reached 3.9 percent with modest increase compare to the previous 3 years. The results of the 1995 Living Standards Measurement Survey (LSMS) concluded that 36 percent of the total population of Mongolia was living in poverty. The 1998 LSMS showed a poverty level of 35.6 percent, with 39.4 percent for the urban population and 32.6 percent for the rural population. However, natural disasters occurred during last three years and intensive migration of rural population to the urban has led to changes in the spatial distribution of poor from rural localities to capital city and other large towns.

Based on the poverty diagnosis the government of Mongolia is implementing a series of policy reforms oriented to enhance economic growth and reduce poverty with more pro-poor orientation during last three years. In the medium term the Government will implement policies aimed at accelerating private sector-led economic growth through the stablisation of macroeconomy, low and stable inflation, development of free market competition, and appropriate monetary, credit and tax policies, thus raising the living standards of the population. A further central goal of the EGSPRS in the medium term will be redistribution of the benefits of growth to the population equally, with a distictly pro-poor focus. However, this distribution will not be done in a passive manner, but through implementing specific projects and programs aimed at increasing employment among the poor and the near-poor to take their own initiatives to improve their situation.

Enhancement of economic growth and poverty reduction

Carrying-out restructuring as well as reforms undertaken within the social and political sphere have became an essential resource for ensuring economic growth. The prevalence of the private sector in the economy is another major source for ensuring enhanced economic growth. The Government has set itself the goal of reducing poverty through higher economic growth, which will be based on active private sector participation and an export oriented trade policy. Regional and sustainable development concepts will be incorporated in the general economic growth strategy. In addition a stable macroeconomic situation, investment and the building of human capital factors will play a significant role in ensuring growth and sustainable human development. Moreover, the development of more efficient mechanisms of budget and financial management as well as reforms in the public sector will be another important ingredient in securing economic growth.

Development framework

The following are the priorities defined in short term within the framework of Mongolian development goals:

- to deepen the reforms for ensuring macroeconomic stability, and to intensify the restructuring process;
- to improve the health of the banking and financial sectors;
- to recover and develop national industry, to ensure economic growth through supporting export oriented industry;
- to support regional as well as rural development, to intensively develop infrastructure;
- to create an equitable environment for ensuring human development, to improve all levels of education, its quality, health service provision and its accessibility;
- to reduce unemployment and poverty, to generally improve the living standards of population;
- to ensure sustainable development and ecological balance, to mainstream nature conservation and environmental policies as priorities within regional socio-economic development;
- to speed up the land reforms;
- to reduce the air, water and soil pollution in large cities and settlements; to improve the living environment of the people through the reprocessing of waste;
- to improve governance to ensure human security;
- To create a fair, moral and democratic society that protects concepts of democracy, basic human rights and the freedom of each citizen;
- To mainstream gender dimensions in poverty interventions to promote gender equality.

Private sector led growth support

The Government of Mongolia aims to enhance economic growth and maintain sustainable livelihoods of the population based on three main pillars, namely macroeconomic stability, improving business climate, and human capital enhancement.

The Government places a focus improving Mongolian Laws and Legislation up to Year 2004, including institutional and economic management laws. The reforms in the economic legislation will be aimed to create favorable and competitive business environment for all types of enterprises, eliminate unnecessary licenses and other administrative impediments. In addition access to the financial resources will be expanded, especially for rural entities and SMEs. The government policy priorities should be re-oriented towards those population groups most affected by natural disasters through expanding financial and banking services in rural areas, developing small and middle-size enterprises, stabilisation and expansion of agricultural activities.

Development of energy, road, communication and information is of vital significance for creating a favorable environment for businesses. The energy sector development, a major foundation for the business expansion, will be to ensure sustainable development of the energy sector, create environment for efficient production of energy, increase the economic efficiency of the sector, support the use of renewable energy resources and commercialize, and furthermore privatize in a step-by-step manner state owned shareholding companies of the energy sector. In the medium term the transportation sector development will be focused on rural area road network expansion with active participation of local communities, enhancing competition among transport service providers, improving the technical capacity through replacement of engines, expansion of freight and transit capacity. While ICT sector will focus on (i) establishing the appropriate policy, legal and regulatory framework; (ii) developing the key telecommunications and information infrastructure necessary for providing access to reliable and affordable connectivity; (iii) establishing an economic and business framework for the utilization of ICTs in governance and other applications; and (iv) developing human resources to effectively utilize ICTs.

Another pillar for the economic growth support is promotion of foreign direct investment and external trade facilitation, including maintaining stability of regulatory framework, simplification of business licensing, effective utilization of mechanisms to strengthen its position in the international arena, protect its rights, and determine and facilitation of its foreign trade policies in line with global and regional development trends.

The medium term policy will be focused on expansion of sources of economic growth, in particular the government is giving priority to the development of processing industry based on domestic raw materials, mining and extraction, tourism, IT, and infrastructure.

Joint efforts aimed to accelerate economic growth and reduce poverty by the government alongside civil society and the private sector will be expanded.

Economic restructuring

The economic restructuring policy will be focused on privatization of large valuable entities, which enables an increase in the economic and financial efficiency of the companies, bringing in new technology, know-how and bridging them with new export markets. The restructuring in the energy sector will be continued by enhancing independent regulatory mechanisms, promoting private sector into the energy market, strengthening self-sustainability of energy companies and efficiency of their operations. Land reforms will be deepened to turn land into a productive asset to create opportunities for all people to create sustainable sources of income, in particular to implement land ownership and possession reforms. Social sectors restructuring, including education, health, culture and arts, will be carried out gradually without undermining public service delivery through management contract, management buyout, lease contracts. The reform measures will be supplemented by specific pro-poor measures to minimize negative consequences of the reform agenda.

Ensuring fiscal sustainability

Improvement in the access and quality of public services, and ensuring fiscal sustainability in the medium term are the main expected outcomes of the public sector reforms, which are underway. The public sector reform will comprise of 6 components, namely, treasury management, budgeting, accounting and reporting, output based management and auditing. The legislative basis for the reform is the Public Sector Finance and Management Law, the Law on the Consolidated Budget and other legislative acts and programs issued in conformity with the above. Implementation of these laws and programs will enable improvement of budget planning, raising efficiency of fiscal expenditures, consequently releasing public resources for low-income people and enabling implementation of pro-poor policies. The medium term public sector reforms will be concentrated on carrying out comprehensive civil service reform aimed to increase accountability and credibility of civil servants, reporting and monitoring of performance based management. The securities market will be developed in accordance to the international standards to support economic growth through rationalization of the institutional framework, encouragement of private sector participation, increase their awareness. In line with reforms in the securities market activities the Trust fund law will be enforced. The insurance policy priorities will be focused on improving the legal environment, rationalization of management and enhancing monitoring of the insurance companies activities, expanding the types and coverage by the insurance activities, and introduction of international standards.

Ensuring sustainable human development

Although achievement of the sustainable livelihood and reduction of poverty depends on the level of economic growth, it is also closely associated and interrelated with the ensuring sustainable human development, improvement of the access to, and quality of public services, and creation of sound governance. The human development objectives as they relate to the economic growth and poverty reduction strategy, are aimed at creating income-generation opportunities for the poor, engaging them in decision-making processes and thus securing their social protection. The policies for social services are focused on priorities in education, health, social welfare and employment sectors, including improving basic service delivery with pro-poor focus, better targetting, enhancing professional capabilities of the service providers, introducing accredation system for the public and private institutions. A special focus will be on improving maternal and infant health care, rationalization of financing schemes. The social welfare system reforms will be aimed to create foundations for the pension system reforms, expanding coverage and monitoring of the insurance system, re-organizing the social assistance management through pursuing the principle of community based services and streamlining criteria for better targeting and service delivery based on new type of household assistance benefits.

Employment promotion activities will be aimed to enhance capacity of skills of people and labor market operation.

Extending particpation

Further participation of the civil society will be sought in the process of making adjustments to the PRSP after a certain period of time and ensuring its sustainable implementation. In particular, working groups could be formed at aimag and soum levels with civil society and business representation to monitor and intensify the process of implementation of the PRS. Also, non-governmental organizations will be involved in monitoring and evaluation of the process of PRS implementation.

Implementation and monitoring

The overall implementation and monitoring of the EPSPRS will be coordinated by the MOFE. Within MOFE the Poverty Research Group will be a main acting body to coordinate implementation, monitoring and reporting for the EGSPRSP. The line ministries will be responsible for attaining of targets set for particular time period and implementation of specific programs within the framework of objectives. The local government and civil society will be involved through the working groups established during the I-PRSP dissemination. The progress report will be prepared on an annual basis and the strategy itself will be revised every three years and presented at the donor meetings to coordinate activities and funds of the donor community.

The prerequisite for the successful strategy is implementation of efficient monitoring and evaluation by two types of assessment, namely through monitoring benchmarks set by the government and civil society oversight. The Government, in order to monitor and evaluate the implementation of the poverty reduction strategy, will develop a system of appropriate tools and benchmarks for regular collection, monitoring, publishing of statistical indicators on the level of livelihood. However, civil society oversight, including NGOs, private sector, parliamentarians, citizens, donor representatives, will be conducted through various methods and approaches for monitoring and evaluation and the government will assist them in building of capacities to undertake monitoring and carry out the relevant assessments.

The government medium term main policy documents are the Government Action Plan, Medium term budget framework, the Socio-Economic Guidelines, sectoral papers and other policy papers / programs, signed agreements with international agencies. In addition following international practice the Government of Mongolia started an active participation in global initiatives such as PRSP process, MDG attainment, and Millennium Challenge account, specific programs to address greatest obstacles to the national development to spur economic growth and reduce poverty with an active participation of national stakeholders and coordination of external assistance. The MOFE will be a leading coordinating body to formulate, adopt, implement, and monitor these programs. Successful implementation of programs depends on efficient coordination of policy documents, reporting and alignment of processes, in particular the budgetary allocation in line with development priorities plays an important role in overall macroeconomic and sectoral management.

Financial requirements .

An implementation of the policy objectives included in the Economic Growth Support and Poverty Reduction Strategy requires resources equal to 40-45 percent of GDP per annum. These estimates are made based on targets included in the Medium term budget framework.

Mongolia: Promoting investment and job creation

An investment climate assessment and trade integration study

EXECUTIVE SUMMARY OF WORLD BANK REPORT

For discussion at a workshop
with the private sector, donors, and government

Ulaanbaatar
June 14, 2006

Poverty Reduction and Economic Management Department
East Asia and Pacific Region

The World Bank

Preface

The planning for this study was initiated in the summer of 2003 at the request of the Government of Mongolia. In its PRSP, the Economic Growth Support and Poverty Reduction Strategy (EGSPRS) paper released in July 2003, the government recognized the critical role of a dynamic private-sector as the driving force behind sustainable growth and poverty reduction (Government of Mongolia, 2003). Accordingly, it adopted as one of the central pillars of the EGSPRS the aim of establishing a sound institutional and regulatory environment to complete the transition to a market economy and enable the private sector to become an engine of growth.

But, as the Joint Staff Assessment of the EGSPRS notes, the broad policy statements made in the EGSPRS need to be translated into a coherent private sector development strategy that clearly identifies specific steps that the government might undertake, in partnership with the private sector and international donors (World Bank, 2003). This report is meant to assist in this process.

Executive summary

What this report is about

The aim of this report is to identify a set of concrete steps that the government of Mongolia—in partnership with the private sector and the international donor community—might take to promote private-sector activity and greater integration with the global economy in a way that leads to job creation, broad-based growth and most importantly, poverty reduction. It does this by combining an assessment of the investment climate faced by firms (through analyses of firm and household surveys and supply chains in selected sectors) with a diagnostic trade integration study.

Like in many transition economies with limited traditions of market-oriented private-sector activity, the obstacles to private-sector development in Mongolia are many. There has been no shortage of studies and surveys documenting the challenges that the Mongolian private sector faces. From the burden of taxes, bureaucratic harassment and corruption, to the high cost of and limited access to finance, and the logistical and infrastructural difficulties of getting goods to markets (especially export markets), there is little disagreement about the range of impediments that Mongolian businesses face.

Where there is less consensus, however, is on what needs to be done and on which, of the many things that need to be done, ought to be done first. This report aims to contribute to the ongoing debate and to building a consensus.

Two things distinguish the analytic approach adopted in this report. First, to a greater extent than most past studies, the analysis is based on quantitative data, not just on the perceptions of businesses but also on their actual practices and performance. Second, wherever possible, reference is made to comparable data from other countries, which helps to benchmark the investment climate in Mongolia against international standards. The hope is that in doing these two things, more diagnostic insights can be obtained into the underlying causes of the range of impediments that have been well-documented over the years. And that, in turn, should help to prioritize what needs to be done, and in what order.

The diagnosis: corruption and a lack of transparency and accountability in government-business interactions are the central impediments, but not the only ones

The basic diagnosis, which results from this analysis, is this: corruption and the lack of transparency and accountability in government-business interactions that allows corruption to flourish are the central impediments to the development of a robust and dynamic private sector in Mongolia.

This basic diagnosis does not mean that other impediments are unimportant or that corruption is the only problem confronting the Mongolian private sector. On the contrary, it is clear from the study that Mongolian firms face considerable obstacles—logistical, infrastructural and institutional, within Mongolia, at the border and beyond the border in China and Russia—in getting goods to and from external markets. Like in other land-locked countries, and perhaps even more so than most, the transport options that Mongolian firms have are limited, costly and unreliable.

But these “natural” difficulties, which stem from Mongolia’s geography and location and which undoubtedly need to be addressed, are overshadowed by the “man-made” obstacles that Mongolian firms face.

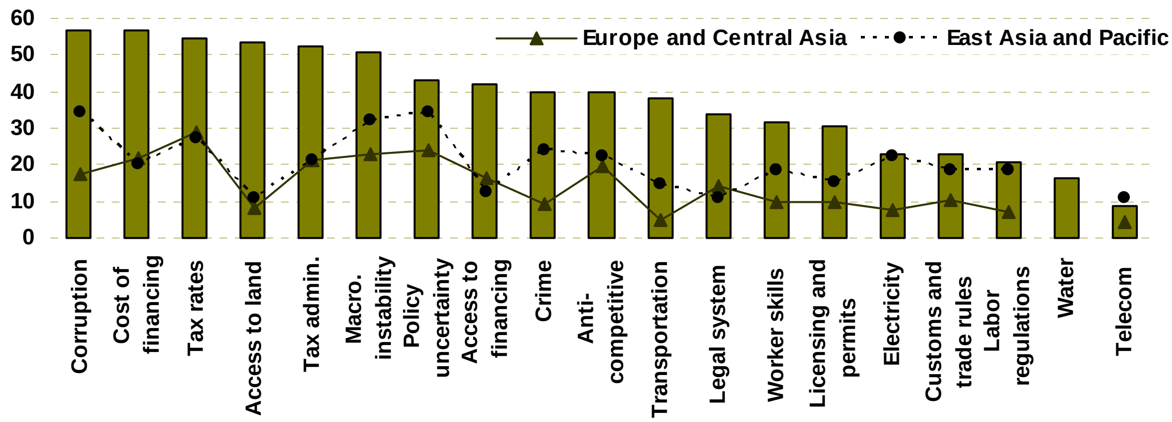
Table 1 : Corruption pervades every sphere of business activity

% of firms that view corruption as a major or severe obstacle	56.5	**% of firms paying bribes for electricity connection**	26.0
Value of gift expected to secure government contract (% of contract)	4.3	**% of firms paying bribes for telephone line**	23.0
% of firms indicating that political ties are important for business	47.1	**% of firms paying bribes for water connection**	15.0
% of cases where unofficial payments needed for registration	15.2	**% of exporters paying bribes for customs clearance of exports**	25.0
% of cases where unofficial payments needed to obtain licenses and permits	22.2	**% of importers paying bribes for customs clearance of imports**	22.6

Source: Mongolia Productivity and Investment Climate Survey, 2004.

The evidence indicates that corruption and a lack of transparency and accountability pervade almost every sphere of business activity. Mongolian businesses recognize this, and corruption is the most frequently cited impediment to doing business in Mongolia. The analysis further suggests that the consequence of this has been the growth of a culture of operating in the "shadow", which has gotten in the way of firms accessing finance, building market relationships, enhancing productivity, growing and creating jobs.

Figure 1 : Perceptions of Mongolian firms regarding the main investment climate impediments
(% of firms that perceives the particular constraint to be a major or severe obstacle)



Source: Mongolia Productivity and Investment Climate Survey (PICS), 2004, and similar firm-level investment climate surveys carried out by the World Bank and local partners in other countries in Europe and Central Asia and East Asia.

Because of its geography and history, Mongolia can less "afford" corruption than most countries

Mongolia is not the only economy and certainly not the only transition economy where corruption is prevalent. But Mongolia can less "afford" corruption than most countries. Mongolian firms are already at a substantial disadvantage because Mongolia's geography and history—the lack of proximity to large and prosperous markets and ocean-shipping access to export markets, the limited tradition of market-oriented private sector activity, and the relatively narrow economic base—make its investment climate more difficult to begin with. Corruption and a lack of transparency and accountability greatly compound this initial disadvantage.

The prescription: focus reform on key government-business interfaces, most importantly, the tax system

The prescription that follows from this diagnosis is that the top priority ought to be to focus reform efforts on the government-business interfaces that are the key loci of corruption. In Mongolia, that is, first and foremost, the tax system, but also customs and the licensing and inspections regimes.

To tackle corruption, legislation is needed, in particular, a tax bill and an anti-corruption law

To tackle corruption in these government-business interactions, certainly, laws will need to be either introduced or modified. A tax bill and an anti-corruption law requiring income and asset disclosure by government officials and sanctioning conflicts of interest are the two main legislative priorities.

But laws alone will not suffice. Administrative processes need to be reformed

But legislative action by itself will not be sufficient. Reform efforts need to go beyond changes to the tax code or passage of anti-corruption legislation to restructuring the operations of the key agencies—the tax department, the customs administration, and the inspections agency—that directly interact with private firms and individuals.

Public disclosure initiatives will facilitate administrative reform

Comprehensive reform of administrative processes takes time. By adopting immediate measures to promote transparency in government-business interactions, Mongolia can facilitate and strengthen these reform initiatives by enabling private businesses, industry associations and civil society groups to monitor the progress of reforms and the degree to which actual practices conform to prescribed law. In particular, the government should consider constituting an "Open Government Taskforce" with a broad mandate to collect and make publicly available, information on the plans and activities of key government agencies as well as the rules under which they are meant to operate and the rights of private businesses and citizens in their interactions with these agencies.

At the same time, efforts have to be made to help Mongolian firms connect to external markets

At the same time, the need to help Mongolian firms connect to external markets cannot be ignored. Efforts should therefore be made to improve the transport options available to firms for getting goods to and from these markets.

Initiatives in three areas hold the most promise:
- **reform of customs**
- **completion of the Agreement on Transit Transport with Russia and China**
- **adoption of a (partial) open-skies policy**

This will not be easy, and it will take time. Completion of the road connecting Ulaan Baatar with the Chinese border, construction of which is underway, will help. What can be done in the meantime? Initiatives in three areas hold the most promise. The first is reform of customs processes with a view to reducing delays and rent-seeking. The second is completion of the tripartite Agreement on Transit Transport with China and Russia. And third, the government may wish to consider adopting a (partial) open skies policy towards charter flights for tourists and air freight services.

Below, a summary is given of the analysis and evidence that led to this particular diagnosis and prescription, starting with a brief description of where things stand, followed by an analysis of the main investment climate impediments and barriers to trade integration, followed by a more detailed, though still abbreviated, listing of the most important things that need to be done.

Where things stand

There has been considerable progress towards a market-economy since 1990

Mongolia has come a long way in its transition from a centrally planned economy to a market economy and has done so while navigating a remarkably successful (and rare) transition to a democratic political system. Many, though far from all, of the basic prerequisites for a successful transition and subsequent sustained private-sector led growth have been met. The macro-economy has been stabilized. Efforts to rationalize and strengthen the financial sector have been initiated and are ongoing. Through liberalization of prices and privatization of most small and medium enterprises, the structure of the command economy has largely been dismantled, and the basic framework of laws, policies and regulations to support a market-based system has been put in place.

Some recent trends

The economy has grown continuously since 1993, and since 2002 has been

provide reasons for optimism…

growing at over 5%. In fact, in 2004, the economy grew at a rate of 10.6%, the highest in the East Asian region. The contribution of the private sector has risen to just under 80% of GDP. FDI flows have picked up in recent years. The banking sector has recovered from the crises of the late 1990s and the volume of domestic credit has increased substantially.

…but others are reasons for concern.

The expansion in exports has been narrowly based and triggered by favorable (and perhaps temporary) terms of trade shocks. Much of the increase in domestic credit has been in the form of short-term loans for wholesale and retail trading activities, suggesting a consumption boom whose origins are unclear and sustainability uncertain. Value-added per worker is low by international standards and most firms are operating well below capacity.

In particular…

Growth does not appear to have been broad-based

Of particular concern is the fact that the growth in recent years does not appear to have been broad-based. The changes in the last few years in the sectoral composition of GDP and employment indicates that the sectors that have grown the most rapidly in terms of their GDP share—mining, whose share of GDP rose by 8.3 percentage points being the prime example—are not the ones where much employment has been created, at least judging by changes in sectoral employment shares.

Private domestic investment remains low

Despite the nearly fivefold increase in lending to the private sector, investment by domestic private firms remains low, constituting only 26% of all investment in 2004. Bank-financed private investment is even lower, representing only 8% of all investment.

Job creation, the hallmark of a robust and dynamic private sector, has been limited

Job creation is the hallmark of a robust and dynamic private sector. The evidence, both indirect from information on the size distribution of firms, and direct, from the job creation records of the PICS firms, suggests that job creation has been limited.

The challenge: promoting investment and job creation by the private sector

If Mongolia is to achieve its aim of sustained private-sector led growth and in doing so, generate incomes and jobs for the poor, the private sector has to grow, and that growth has to be broad-based. For there to be growth, there has to be investment by the private sector, and for the growth to be broad-based there has to be job creation by the private sector. Not enough of either is happening in Mongolia currently. To achieve its aims therefore, Mongolia needs to promote investment and job creation by the private sector.

The tasks:

- **improve the business environment**
- **facilitate trade integration**

To do this, the first task is to improve the environment in which private businesses operate. But improving the domestic business environment will, by itself, not be enough. For an economy the size of Mongolia's, with its narrow endowment base and limited domestic markets, private-sector led growth must be anchored in greater trade and integration with the global economy. And so, a second task is to facilitate trade integration.

What the main obstacles are

The most frequently cited impediments to doing business in Mongolia are:

- **corruption**
- **the burden of taxes**
- **a lack of finance**

Corruption and the lack of transparency and accountability that allows it to flourish, tax rates and tax administration, and the high cost of and limited access to finance are the three aspects of the investment climate in Mongolia that are most frequently cited as the most severe impediments to doing business. And while taxes, access to finance and corruption are common complaints of firms in many countries, the share of firms that view these three constraints as major or severe obstacles is higher in Mongolia than in most of the 62 other countries for which comparable investment climate survey data are available.

On other dimensions as well, the investment climate in Mongolia appears to be less hospitable, or at least perceived to be so by a greater fraction of firms, than in most countries in East Asia, a region to which Mongolia is increasingly looking to integrate with, and many countries in Europe and Central Asia that have undergone similar transitions from centrally planned economies.

Taxes are perceived to be burdensome, and with good cause

Taxes are perceived to be burdensome by Mongolian firms, and with good cause. The burden of taxes stems from multiple sources, among them certain provisions of the corporate tax code, the corporate tax rate structure, and the range of taxes that Mongolian businesses are subject to:

At over 32%, the tax-to-GDP ratio in Mongolia is extremely high for a country with its level of per-capita income. Effective tax rates faced by firms are higher than the nominal rates indicated in the tax code because deductibility of certain business expenses is not permitted. The lack of a loss carry forward provision in the tax code discourages investments. The dual tax rate structure creates an incentive to avoid taxes by staying “small” or appearing to be small by splitting up. Tax avoidance appears to be common though it is costly. Labor taxes, in particular, social security taxes, are unusually high.

The burden of taxes rarely stems from the tax code alone—problems of tax administration also matter

Problems with taxes are rarely limited to the tax code itself. Cross-country evidence indicates that dissatisfaction with the tax code and tax rates goes hand-in-hand with complaints about the tax administration. The burden of taxes tends to come equally from inconsistencies in tax administration. That appears to be the case in Mongolia as well.

The burden of tax inspections in Mongolia is high. Because tax inspections and audits are not conducted within a risk-management framework, in 2004, of the roughly 26,000 registered corporate tax payers, 10,770 were visited and inspected by tax inspectors, and nearly four-fifths of these firms were assessed fines and interest. And the average number of days—9 days—spent meeting with tax inspectors—was considerably higher than in most other countries in both East Asia and Central Asia.

Despite (and perhaps because of) the frequency of tax inspections, the corporate tax base is narrow and compliance rates low. Moreover, there is substantial variation in the effective tax rates faced by individual firms. For instance, in the group of firms that reported net income of between 10 and 25 million MNT, the effective tax rate implied by the tax payments these firms actually made, ranged from a low of 3.3% to a high of nearly 30%. These variations suggest inconsistencies in tax administration.

The inconsistencies in tax administration stem from the excessive discretion enjoyed by tax inspectors and the rent-seeking this invites. Because of this, tax evasion is widespread. Over a third of the firms appear to be under-reporting sales. Under-reporting of labor costs is even more widespread and much more severe in degree, reflecting the efforts of firms to lower the excessive burden that social security taxes place on them. Tax evasion has hidden long-term costs for the firms that evade taxes. In particular, tax evaders are much less likely to have access to finance.

Bureaucratic and political corruption is becoming entrenched

Nearly four-fifths of the registered Mongolian firms surveyed perceive corruption to be an obstacle to the operation and growth of their business, with over half reporting that it is a major or severe obstacle. Corruption is the investment climate constraint most widely perceived to be a major or severe obstacle.

Perceptions of corruption as an adverse feature of the business climate are more widespread in Mongolia than in several comparator countries as well as some current and future competitor countries. The problem of corruption appears to have worsened considerably in the last five years. Government procurement processes are seen as particularly opaque and corruption-ridden. Corruption amongst the political elite appears to be on the rise. Cross-country comparisons indicate that having political ties is relatively more important for doing business in Mongolia than elsewhere. Land registration and allocation has become a locus of corruption.

The cost of finance is high

The cost of credit was second only to corruption as the most frequently cited impediment to business. And indeed the cost of finance in Mongolia is higher than in most of its comparator and competitor countries.

Interest rates have declined in recent years, but they continue to be 10-15% higher in real terms than in other countries. The degree of bank-based financial intermediation in business activity is low. Less than a third of the firms have a bank loan. Unlike firms in China and Malaysia, Mongolian firms rely largely on internal funds and finance from informal sources for their investment and working capital needs. Long-term credit remains scarce in Mongolia.

Lack of access to credit is also a common complaint

Lack of access to credit is a common complaint, and access to credit is indeed difficult. Bank lending in Mongolia is almost exclusively collateral-based and immovable assets are the predominant form of collateral. Collateral to loan values are higher in Mongolia than in any other country. But the limited use of credit may also in many cases be self-imposed. Many firms do not apply for loans and many state no need for loans.

Structural weaknesses make bank lending a risky activity and that, more than a scarcity of capital, is the reason for the high cost of and limited access to finance

In growing economies with high interest rates, the presumption is often that an economy-wide scarcity of capital, relative to the demands for working capital and investment funds, is the binding constraint—i.e., the main reason why interest rates are high. Mongolia does indeed need additional capital from abroad. The evidence, however, suggests that the interest rates are high not only, or even primarily, because of a scarcity of capital. Rather, the high interest rates are due as much to systemic and structural factors that make bank lending a risky activity and limit the range of financial products that are available.

The stringent collateral requirements are a direct indication that bankers perceive lending to be risky. The fact that the spread between deposit rates and lending rates is amongst the highest in the world also suggests that the risks inherent in lending are high. Poor corporate governance and a culture of operating in the shadow make it difficult for banks to assess creditworthiness, forcing them to rely almost entirely on collateralized lending. The weaknesses in the legal and administrative framework for bankruptcy and debt recovery make even collateral-based lending risky and costly. The legal framework for leasing is also weak, limiting the range of financial products available to firms. On average, less than 1% of the investment funds of firms comes from lease financing.

The trade and foreign investment regime is remarkably open, but…

Mongolia, which joined the WTO in 1997, is a remarkably open economy, with an uniform tariff of 5% on almost all items, few export taxes and no quantitative restrictions. It has a minimum level I trade restrictiveness rating on the scale computed by the IMF. Import tariffs levels are among the lowest in Asia. The foreign investment regime is equally liberal.

In principle, this simple and relatively liberal trade and investment regime has the potential to enhance transparency, simplify customs procedures, and reduce market distortions. In practice a number of problems have prevented this potential from being realized.

Customs processes cause delays and are unpredictable

The unpredictability of the time it will take to clear customs is a key concern of businesses engaged in trade, who are much more likely to perceive customs processes to be a serious impediment than firms that do not engage in trade. Paper-based processes are the main source of delay in customs. Past automation efforts have not solved the problem.

Corruption in the customs valuation and exemptions process is an even larger problem

Customs valuation processes appear to be a locus of corruption. A quarter of firms that export and just over a fifth of the firms that import report having to pay a bribe in order to expedite customs clearance or avoid excessive duties. Incentive structures and administrative processes within the Customs General Administration facilitate corrupt practices. The granting of import duty exemptions also provides opportunities for rent-seeking.

The transport options Mongolian firms have for getting goods to and from external markets are limited, costly and unreliable.

The surface transport options available to Mongolian exporters and importers are limited, costly and unreliable. Mongolia's external trade is almost entirely dependent on a single rail link running from Sukhbaatar in the north on the border with Russia, through Ulaan Baatar to Zamyn Uud in the south on the border with China. Because of the difference in gauge of Mongolian and Chinese Railways, at the border either the axles on the wagons need to be changed, or the containers need to be transferred. Access to third-country markets is through this rail link to ports outside Mongolia. The shortest and most widely used corridor is one to the port of Tianjin in China.

Simply crossing the border into/from China is costly and time-consuming. Border crossing charges (because of the difference in gauge) make up nearly 25% of overall costs of transport to the port. The imbalance between exports and imports in the containerized rail freight traffic along this corridor (exports are 10% of imports) further adds to the cost because of the cost of returning empty containers to port. Transit times to port are uncertain because of the unpredictability of delays at the border. The unpredictability stems partly from the lack of a dedicated (China Railways) wagon service for Mongolia's trade, with the result that the availability of rail-wagons at the border is subject to the vagaries of China's domestic freight service needs. Compounding this uncertainty is the unpredictability of the time needed for completion of customs formalities and the handover of paperwork across the border. The uncertainty in transit times adversely affects the competitiveness of Mongolian exporters and can result in substantial costs for importers as well.

Technical and other barriers to trade beyond the border in China and Russia are serious impediments to Mongolia's trade integration

Technical and other barriers to trade beyond the border in China and Russia are serious impediments to Mongolia's trade integration. Inadequate harmonization of customs procedures with Russia and China is a major cause of the delays, unpredictability and high costs Mongolian firms face. As mentioned above, shortage of China Railways wagons cause unpredictable delays in transit times to and from Tianjin port. Cross-border road linkages with China are hampered by restrictions on the movement of trucks.

Tariffs in China and Russia are higher for processed products. Exporters of meat, wool, cashmere and processed skins face additional barriers due to restrictions imposed by Russia and China on products of animal origin. Direct exports of meat to China and Russia are possible in principle, but difficult in practice. Third country exports and imports of animal products from Mongolia via China are even more difficult.

Inefficiencies in transport and logistics are particular problems for the tourism and livestock-based industries

Regardless of their position in the supply chain—tour operators, ger camps, guesthouses or hotels—firms in the tourism industry identify the lack of adequate and reliable air transport services, both domestic and international, as the main impediments to the growth of their businesses. Exporters of livestock-based products, and in particular meat, face a different type of transport constraint, and that is the lack of refrigerated transport and logistics options.

What needs to be done

Reform of the tax code is rightly on top of the government's reform agenda

A major tax bill is rightly on the top of the government's reform agenda. Elements of the corporate tax code discourage investment and the adoption of modern business practices, which Mongolia can ill-afford, and encourages tax avoidance and tax evasion, which Mongolia needs less of. Reform of the corporate tax code must address these limitations.

Legitimate business expenses should be deductible. The corporate tax law should include a loss-carry forward provision. Unification of the tax rate is the first-best option for reducing tax avoidance, but in the second-best situation currently prevailing in Mongolia, an increase in the threshold above which the higher rate applies is a reasonable compromise. Special exemptions and tax holidays for certain sectors or categories of firms should be replaced by a system of investment tax credits available to all firms. A thorough review of the social security system is needed, with the aim of identifying ways to reduce the burden of social security taxes on firms.

But reform of the tax administration is equally urgent

Reform of the tax code along the lines described above will not by itself fully alleviate the excessive burden of taxes faced by the Mongolian private sector. The analysis indicates that this burden stems as much from the inconsistencies in the administration of the tax code. Without reforms in tax administration to eliminate these inconsistencies and lower the exposure of firms to arbitrary and predatory behavior on the part of tax inspectors, reforms in the tax code are unlikely to achieve their aim. A comprehensive reform of the tax administration is therefore an equally urgent task.

A detailed listing of the specific reforms that need to take place is beyond the scope of analysis of this report. However, the general thrust or strategic direction of the needed reforms is clear. The tax administration needs to move from a culture of "policing" (and the arbitrariness and rent-seeking behavior that accompanies it) to a culture of "service" and compliance mentality. An essential element of such a reorientation is the adoption of a risk-management approach to tax inspections and audits.

To coordinate and implement measures to promote transparency in government-business interactions, the government should consider constituting an "Open Government" taskforce

To coordinate and implement measures to promote transparency in government-business interactions, the government should consider constituting an Open Government taskforce composed of senior representatives from the key agencies that deal most directly with private businesses as well as representatives from the private sector, civil society and the parliament. This taskforce would have a broad mandate to collect and make publicly available, information on the plans and activities of key government agencies as well as the rules under which they are meant to operate and the rights of private businesses and citizens in their interactions with these agencies. For this taskforce to fulfill its envisioned mandate, secrecy laws governing access to information would need to be reviewed and where necessary, revised.

An anti-corruption law needs to be passed and it needs to require income and asset disclosure

An Anti-Corruption Law needs to be passed and it should provide for the development and implementation of an enforceable and transparent system of asset/income declaration by government officials, including investigation and sanction in cases of conflict of interest.

Addressing the legal and institutional gaps that make lending risky would lower the costs of finance and improve access

Existing gaps in the institutional and legal framework for contract enforcement in Mongolia, primarily in the area of bankruptcy, debt collection, and the liquidation of collateralized assets make bank lending risky for all banks and limit the range of financial products that are offered. Measures to address some of these gaps would, by lowering the risks associated with lending, lower the risk premiums that are in part responsible for the high cost of finance, and lower the high collateral requirements that reduce access to finance.

The procedures for debt collection in Mongolia need reform. The problem is not with the laws per se, but with the administrative arrangements in place—involving both the courts and local government functionaries—for implementing the law. In some other countries, specialized quasi-legal institutions have been set up to facilitate the process of debt collection. Mongolia may want to consider establishing such debt recovery tribunals. Collateral foreclosure and bankruptcy laws and procedures need reform. Creating a movable assets registry would improve access to finance. Strengthening the legal and administrative framework for leasing would also improve access.

The licensing and inspections regime needs to be reviewed, rationalized, and appropriately resourced

The evidence indicates that the licensing and inspections regime in Mongolia suffers from red-tape and rent-seeking, just as the tax and customs administrations, the other specialized agencies that deal with the private sector, do. There is clearly a need for reform. But because licensing and inspections involve technical details that vary from activity to activity, and because they serve an underlying public purpose, which risks being undermined in a hasty attempt to eliminate red tape, the reform agenda needs to be elaborated more carefully. There are instances, such as in the case of veterinary and hygienic inspections in the livestock sector, where the need is for more and better inspections, not fewer. The same may be said for environmental inspections.

The first step in formulating a more detailed and nuanced agenda therefore is to undertake a thorough review of the licensing and inspections regime, to identify where it needs to be rationalized, as well as where it might need to be additionally resourced.

Customs processes need to be reformed with a view to reducing delays and reducing rent-seeking

Reform of customs processes is needed with the twofold aim of reducing delays and reducing rent-seeking. To reduce rent-seeking, administrative processes and incentive and compensation schemes within the customs administration need to be reformed. To reduce delays will require, in addition, automation of key processes, harmonization of procedures with customs in Russia and China, and more efficient linkages with other domestic agencies such as the SPIA and GDNT. The introduction of a customs-single-window, spanning the different agencies from which clearances are needed, would help in this regard.

A tripartite Agreement on Transit Transport between Mongolia, Russia and China is essential

A tripartite Agreement on Transit Transportation between Mongolia, Russia and China is essential for Mongolia's trade integration. Negotiations on such an agreement have been ongoing for over a decade. Completion of these negotiations has to be the government's top trade policy priority.

Mongolia has limited human, technical, and financial resources for trade

Scarce resources and capacity for negotiating international agreements should be appropriately allocated

negotiations. With China's accession to the WTO and the pending Russian accession, Mongolia needs to build capacity and conserve resources to negotiate trade conditions with its two neighbors to increase trade facilitation. But the government also plans to actively negotiate a number of other bilateral preferential trade agreements. Preferential trade agreements are bureaucratically demanding, for instance, because they require customs authorities to administer rules of origin regulations. And because preferential agreements involve protection they inevitably expose domestic firms to adjustment pressures when the preferential arrangements come to an end, as was revealed with the end of the MFA in early 2005. The government needs to choose wisely where to allocate its scarce negotiating capacity.

A (partial) open-skies policy is worth considering

The government might want to consider a (partial) open skies policy towards charter flights for tourists and air freight services. Such a policy would directly alleviate the critical barriers faced by the tourism industry—the inadequacy and unreliability of scheduled air services—and the livestock-based industries—barriers to movement of animal origin products through China and Russia. If the policy were coupled with a lifting of the ceiling on domestic air tariffs, it would have the potential to significantly jumpstart the tourism industry. And while there remain other technical barriers to the export of animal origin products that would need to be resolved, the availability of air freight services would eliminate a major disincentive to foreign investment.

There are examples of other low-income countries that have successfully adopted such policies. Cambodia's decision in 2000 to partially open up its skies led to a dramatic increase in the number of tourists visiting Cambodia. Similarly, liberalization of Kenya's civil aviation sector has led to Kenya becoming the largest exporter of perishables (cut flowers and leguminous vegetables) transported through air freight to Europe.

In formulating trade and investment policy, it is important to avoid misdiagnoses

The government of Mongolia has understandably sought to identify ways through which to promote a diversification of Mongolia's production base in an effort to reduce the vulnerabilities associated with being a primary commodity exporter. However, in formulating trade and investment policies in support of these objectives, it is important that the government avoid misdiagnoses that would lead to, and has sometimes led to, inappropriate policies.

The continued imposition of the export tax on cashmere, and the prohibitions on the exports of raw hides and skins are examples of existing policy that reflect such misdiagnoses. More worrying are indications that the government "aims to impose differentiated import duties in order to promote domestic production, encourage the transfer of advanced technology, as well as for the concerns related to food security and better quality foodstuffs."

The misdiagnosis lies in attributing the difficulties of the domestic processing industries to the low uniform tariff regime. This report provides compelling evidence that Mongolian businesses, including processing firms, face multiple other constraints, from the inconsistencies in tax administration and the prevalence of corruption to the high costs of finance. Low import tariffs are not the problem. Mongolia's open liberal trade regime is a plus and ought to be maintained.

Chapter 2: ENABLING ENVIRONMENT FOR PRIVATE SECTOR DEVELOPMENT

44. To determine the overall direction of Mongolia's economic reform program and the anticipated role of the private sector, this chapter reviews the core policy statements and positions of the Government. The chapter next (i) reviews the institutional framework to determine the extent to which it accommodates PSD initiatives, (ii) identifies significant challenges to developing a more conducive enabling environment, and (iii) discusses constraints imposed by the limited access to capital, along with significant internal constraints, which might limit the extent to which the private sector responds to improvements in the enabling environment.

A. Policy Framework

45. After the collapse of COMECON and the transition to a democratically elected government, a constitution was adopted to provide for, inter alia, a framework based on the rule of law; and new institutions were created to implement this framework. Successive Mongolian governments undertook important steps to reorient the economy toward a market-based system though liberalization of prices, elimination of market distortions, introduction of private ownership, and facilitation of resource flows.

1. Monetary Policy

46. BOM manages monetary policy and implements the broad guidelines established by the Government. Money supply is managed by a series of measures, including the establishment by BOM of deposit reserve requirements for commercial banks (14% of deposit liabilities in 2002), the issuance of central bank bills,[31] and, since 2001, entry into repurchase agreements.[32] Exchange rates are managed by the sale, through an auction system, of BOM foreign exchange reserves. The BOM keeps the exchange rate stable by intervening periodically in foreign exchange markets.

2. Fiscal Policy

47. To improve fiscal management and accountability, Parliament approved in June of 2002 the Public Sector Management and Finance Law, which was drafted with ADB assistance[33] and began to be implemented gradually in January 2003. This law requires, among other things, that annual expenditure priorities be set forth in strategic business plans and outputs be delivered based on agreements. Planning is based on a 3-year, medium-term fiscal framework. Procedures for budget preparation, approval, and enforcement are set forth in the law.

48. **Revenue.** The Revenue Section of the Fiscal Policy and Coordination Department of the Ministry of Finance and Economy (MOFE) undertakes tax revenue projections. In preparing such projections, MOFE receives information from and consults with GDNT, CGA, and certain large taxpayers. Recent tax forecasting performance has been mixed. But since 1999 the trend has been one of increased conservatism and hence accuracy in forecasts.

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31 Central bank bills are sold through an auction system, largely to commercial banks, and in May 2003 yielded an effective interest rate of 13.65–14.85%, depending on maturity.

32 During 2001, BOM entered into repurchase agreements to buy/sell local government securities valued at MNT16.5 billion ($15 million).

33 ADB. 1997. *Technical Assistance to Mongolia for Program Preparation for Governance Reforms*. Manila.

49. **Expenditure.** The Government's overall strategic development and expenditure priorities are outlined in the Development Vision for 2004–06, the Economic and Social Development Guidelines for 2002, and the Action Plan of the Government of Mongolia for 2000–2004 and are reflected in the annual budget and the medium-term fiscal framework statement. This statement is prepared initially by MOFE, and then is reviewed and finalized by a high-level Public Expenditure Review Committee chaired by the prime minister. Based on priorities determined in the statement, current and capital expenditure ceilings are established for key budget entities for the forthcoming budget year. Forward estimates for 2 additional years also are covered. This rolling document is linked closely to the Medium Term Macroeconomic Policy Framework Statement.

50. Deficit-to-GDP targets have been set for over a decade within annual budgets, but debt-to-GDP ratios have been considered only more recently, after the emergence of potential debt problems. Fiscal deficit levels have been excessively high in Mongolia throughout the past decade, but in general have been budgeted for. Overruns occurred in 1995, 1996, 1998, and 1999 whereas better-than-budgeted performance occurred in 1997, 2000, and 2001. The Government, which covers structural deficits or short-term cash shortages by selling securities, sold MNT21.63 billion ($18.5 million) worth to banks (99.6% of total security sales) in 2003.

51. **Taxation.** No other subject is of greater concern to the private sector or more important to the functioning of public administration than taxation. It ranked as the principal business constraint in the 2001 USAID-financed Manual for Action in the Private Sector Survey (MAPS Survey),[34] with 35% of business respondents ranking it a significant obstacle, and the same percentage ranking it a major obstacle. As will be discussed, the problem is not so much the scope of taxation but the effective rate of corporate tax and the manner of applying tax regulations.[35]

52. The General Tax Law, Corporate Income Tax Law, Organizations Tax Law, and Customs Tariff Law determine tax regime, which is administered by GDNT and CGA. Principal company taxes include corporate tax, VAT, social security deductions, import tariffs, and excise taxes.

53. **Corporate Tax.** Company income tax is calculated using International Accounting Standards (IAS) and is levied, after the deduction of allowable expenses, on profits of all business entities registered with GDNT. Exemptions and tax holidays are provided for foreign investment in certain sectors and for foreign investors who export more than 50% of production.

54. Before finalization of their accounts and audit, companies are required to submit to GDNT in advance of the tax year a budget indicating expected sales, expenditure, and profit;

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[34] This survey of 375 businesses was conducted under the USAID Competitiveness Initiative Project, with World Bank and ADB collaboration.

[35] Recent independent external reviews of the Taxation Department by IMF (2001) and Korea Institute of Public Finance (2002) suggest that whereas tax rates are generally high in Mongolia there is still considerable scope for raising collection levels by improving tax administration, practices, and efficiency. The Korean study made recommendations in a number of efficiency-related areas, including (i) enhancing computerization; (ii) improving staff recruitment and training practices, including integrity and ethics training; (iii) simplifying the tax system, especially VAT procedures; (iv) enhancing attention to assessing and auditing activities with special attention to compliance; (v) improving coordination with other government regulatory agencies; (vi) preparing manuals to standardize legal interpretations and to decrease discretionary powers of inspectors; and (vii) bringing more small businesses into the tax net through notional assessments and other means.

thus the tax system for corporations is essentially an advanced payment system.[36] Estimated taxes are payable every quarter at the rate of 15% of profit up to MNT100 million, and at 30% (recently decreased from 40%) on levels above that. Based on a number of factors, the effective rate of corporate tax in Mongolia may be closer to 60% than 30%. For example, pursuant to specific regulations, business expenses may be offset against corporate income tax whereas losses in 1 year may not be offset against profits for tax purposes in another. Advertising and training expenses are limited to 10% of total taxable income (increased recently from 5%), and any expenditure in excess of budgeted levels is not allowable against tax. The inability to carry forward losses, except where an exemption is made for foreign-invested mining companies, is a major disincentive to business investment, especially at start-up. The tax depreciation schedule allows straight-line depreciation only over 5, 10, or 40 years[37] although advanced depreciation schedules are allowable for foreign-invested firms importing export-oriented and scientific equipment. This regulation is extremely limiting and inhibits indigenous investment in both fixed and moveable assets.

55. Although dual rates are found elsewhere (e.g., Canada), the taxation system in Mongolia results in companies' splitting operations among a number of small companies, each with the same business coverage and ownership. Although they complicate company management and decrease efficiency of operation, such registration practices are legal. This system is under active review, and the two rates have been decreased.

56. Given the number of small companies reporting to the tax authorities,[38] the company income tax take is particularly low and there is a general perception of large-scale tax evasion. Companies are acknowledged widely to run at least two sets of books: one for the tax authorities and the other for credit and personal purposes. Companies justify evasion by pointing out the onerous regulations concerning qualifying expenses, the dual corporate tax regime, and the allegedly arbitrary assessments and actions of tax collectors.

57. **Value-Added Tax and Duties.** Accounting in 2003 for 25.2% of tax revenues, VAT is an important source of government revenues. VAT at the rate of 15% is charged on company sales when turnover is above the threshold of MNT10 million ($9,000)/year although exemptions exist for financial services (including insurance and leasing), residential rentals, tourism, and educational and medical services, excluding drug and equipment sales. VAT at the rate of 5% is also charged at the border on imports and is payable within three days of assessment.[39] Textile companies reliant on imported raw materials to produce exported goods, oil exploration and production companies, and companies temporarily importing equipment such as drilling rigs can claim exemption, but procedures for doing so are onerous. For most importers, the VAT imposition is essentially an additional import tariff.

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[36] This requirement reflects the cash needs of the Government and the goal of tax inspectors to deliver expected tax revenues.

[37] One audit company interviewed reported that tax officials may allow other depreciation methods.

[38] In 2003, 18,078 registered companies submitted tax returns, up from 16,330 in 2002, or an 11% increase. Similarly, the percentage of total tax revenues collected from companies increased from 12.6% in 2002 to 27.3% in 2003.

[39] A seasonal import duty (from 1 August–1 April, after the harvesting period) of 15% is imposed on flour and vegetables. Fixed excise duties denominated in US dollars are confined to certain categories, including alcohol, tobacco, and oil and petroleum. *Investment Policy Statement of Mongolia*. Available: www.investmongolia.com.

58. With the exception of certain raw materials including cashmere,[40] wool, scrap iron, copper, brass, and aluminium, which are taxed based on weight, goods exported from Mongolia are not subject to export duties.

59. Valuation for VAT and duty purposes is carried out by CGA, which has broad powers under the Customs Law.[41] Although tariff nomenclature is based on the Harmonized System, various valuation methods are used because Mongolia is not yet a signatory to the Brussels Definition of Value or the General Agreement on Tariffs and Trade/World Trade Organization (WTO) Valuation Code. Each quarter, typical or guide prices for various categories of imports are circulated to customs offices but are not made available publicly, a situation leading to disputes between customs officers and importers. Guide prices are imposed if agreement cannot be reached with the importer on valuation. The private sector claims that customs procedures are onerous, arbitrary, and delay production whereas CGA claims that importers and exporters are often not equipped with the appropriate paperwork and that goods are held up because of delays in paying duties or VAT.[42]

3. Trade Policy

60. Because of Mongolia's landlocked position and the limited size and range of products available in its internal market, trade liberalization was essential to the establishment of fully functioning markets. Mongolia acceded to WTO in 1997 and, in connection therewith, adopted, inter alia, a neutral and simple tariff policy, relaxed its border controls, removed restrictions on travel and foreign currency purchases, and abolished export licenses and the gold tax.

61. In 2003, ADB conducted an assessment of the policy, legal, and institutional constraints to trade.[43] The report recommended, among other things, that Mongolia consider the benefits of regional trade agreements with the Asian Free Trade Area, the North American Free Trade Agreement, and—bilaterally—with the PRC, already a WTO member, and Russia, which is planning on acceding to WTO in the near future. Specific topics might include decreasing transhipment costs of Mongolian exports through Russia and improving treatment of Mongolian meat exports into the PRC and Russia.

4. Competition

62. Early reforms eliminated central planning of input and output prices, and most price controls were removed by 1996. Evolving markets then were allowed to determine price levels. Currently, a degree of price control remains within publicly owned utilities (telecommunications, electricity and water supply, and internal air travel), but prices are set mainly with a view to allowing state providers to run commercial operations, make a return on capital employed, and prepare for future private sector involvement. An exception is internal airfares, which Mongolian Airlines (MIAT) is required to cross subsidize from foreign flight revenue.

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[40] To avoid payment of export duties, cashmere often is smuggled across the border to the PRC. USAID Competitiveness Initiative. 2002. *Discussion Paper on Fiber Certification Market Promoting Mongolian Cashmere*, April.

[41] For example, customs officials can slow any shipment on the grounds that it needs additional inspection and requires post clearance examination.

[42] Businesses in the 2001 USAID MAPS Survey rated customs administration as the fourth most important constraint to PSD, 28% of survey participants ranking it a significant obstacle, and 22%, a major obstacle.

[43] ADB. 2003. *Final Report on Technical Assistance to Mongolia for Trade Policy Review.* Manila.

63. State production orders were eliminated in 1991 to enable SOEs to set production levels at the economically optimum level. In reality, however, state influence on key SOE decisions remained strong. Directed credits from state-owned commercial banks continued well into the 1990s and were to a great extent responsible for the very high percentage of bad loans and the subsequent liquidation of a number of these banks (Appendix 5). Although the Government undertook wide-scale privatization, SOEs often were sold as complete entities, with no separate sale of constituent parts—despite the fact that many SOEs had effective monopolies.

64. In 1993, Parliament adopted a fair-competition law that (i) prohibits unfair behavior, including central and local government decisions that limit entry, divide markets, or manipulate prices; (ii) regulates pricing and output decisions for natural monopolies; (iii) regulates mergers and takeovers involving dominant businesses; and (iv) provides for the establishment of the Unfair Competition Supervisory and Regulatory Agency.[44] The agency has not been established yet.[45]

65. There has been progress in promoting private sector competition, especially in the production of consumer items such as bakery products and the award of government contracts.[46] But partly because the small size of the domestic market makes profitable operation of a significant number of businesses in certain sectors unlikely, the degree of competition remains limited (Box 1).

Box 1: Competition Concerns

Competition concerns arise in a number of areas where the State continues to own key assets. For example, in the telecommunications sector, the Government continues to own 60% of Mongol Telecom along with key network and housing facilities, which it leases to other telecom providers with limited recourse regarding the granting or denial of access rights and tariff charges.

With respect to domestic air transportation, the Government seems to be granting a future monopoly for domestic air transport (respecting profitable routes) to a new private domestic air carrier, Aero Mongolia. The five domestic routes flown by Aero Mongolia are also serviced by Mongolian Airlines, which is government owned but scheduled for privatization. Mongolian Airlines is more restricted in the amount of tariffs it may charge and is required, based on age limitations, to retire all its planes in the next few years.

5. Privatization

66. Privatization in Mongolia, launched in 1991, proceeded more rapidly than in many other former communist countries. In January 1991, the Government created the Privatization

[44] Law of Mongolia on Prohibiting Unfair Competition, as amended in 2000.

[45] In May of 2003, USAID assisted in identifying implementation issues under this law and helped develop proposals regarding size, staffing needs, structure, and guidelines for the new regulatory agency.

[46] The Public Procurement Law of 2000, adopted with ADB assistance (ADB. 1998. *Technical Assistance to Mongolia for Development of Procurement Legislation and Guidelines.* Manila), and related guidelines regulate the procurement of works, goods, and consulting services. ADB also assisted in setting up a procurement monitoring unit in MOFE. Adoption of this law recently enabled 15 Mongolian companies to prequalify and bid for a contract to print schoolbooks. Until late 2002, the practice for schoolbooks was to award a contract to an agent who would then seek to fill the order in the PRC or elsewhere outside Mongolia.

Commission to manage the privatization process. The May 1991 Privatization Law laid down the purpose, forms, principles, and procedures for privatization.

67. Privatization took place in three stages. During the first stage (1991–1995), it was conducted mainly by means of vouchers. Four thousand five hundred entities, mostly SMEs, were privatized in this manner, along with livestock. Employees were given priority in purchasing shares of newly privatized enterprises at discounted prices.

68. During the second stage (1996–2000), 942 enterprises were privatized through sealed-bid auctions that raised approximately MNT58 billion ($65 million) in revenues.[47] In 1998, sealed bidding for large-scale enterprises was introduced. From September 1998–December 2000, the Government sold its holdings in 44 large enterprises,[48] most of which had been majority state-owned. These companies employed 8,743 staff, and share sales raised $15.4 million in receipts. The purpose of divestiture was not primarily that of raising revenue, however, or even of decreasing state budget transfers to loss-making SOEs, but of introducing private sector management, capital, and risk taking. Only four companies realized more than $1 million in revenue, two of which were gold mining operations, a fact indicating the low asset levels supporting these business operations and their poor financial performances. Offers reflected the experiences of earlier SOE buyers, who frequently had found that stated assets were overvalued or unrealizable while liabilities were understated.[49]

69. The Government's privatization strategy for 2001–2004 (third stage) focuses on privatization of the country's largest and most valuable enterprises. Table 7 summarizes the status of this stage.

Table 7: Privatization of Most Valuable Enterprises as of December 2003

Company	State Shares Being Privatized	Status
APU Ltd. (alcohol and beverage company)	51% (30% owned by a number of individuals and remaining 19% by employees). Publicly listed on MSE.	Sold to Tuul International, a Mongolian–Russian–German consortium for $4.5 million at the end of 2001.
Trade and Development Bank	76% (13% is owned by a number of individuals and the remaining 11% owned by employees).	Sold to a US–Swiss consortium in 2002 for $12.23 along with an agreement by the purchaser to invest a further $28 million within 2 years of the transaction closing date.

MSE = Mongolian Stock Exchange
Continued on next page

47 Background of Privatization Process in Mongolia. Available: www.spc.gov.cn. Barents Group has been engaged as advisor to SPC for the privatization under a contract signed between USAID and the Government.
48 USAID–SEGIR Mongolian Privatization Project. Three companies employing fewer than 50 staff have been removed from the list for the purposes of this analysis.
49 USAID Competitiveness Initiative, 2001. *Debts and Receivables: Problems of Privatised Companies*.

Table 7—Continued

Company	State Shares Being Privatized	Status
Gobi JSC (Cashmere Production)	74.9%, of which 70% to be privatized through international tender and 4.9% through MSE. (remaining shares owned by a number of individuals and employees).	Original tender in 2001 was unsuccessful based on a high reserve price of $18.5 million and build-up of company debt. Re-offered in 2003 for a minimum price of $11.6 million. Expressions of interest received from companies in Mongolia, Australia, Austria, Germany, and Japan. Tender failed due to incomplete bid submission. Possible re-launch in late 2004.
Agricultural Bank	100%.	Sold to a Japanese bidder, HS Securities, in January 2003 for $6.85 million plus additional committed investments of $13 million. The closing took place in March 2003. Management team from DAI to remain in place, paid by HS Securities.
Neft Import Concern (Oil and Gas Distribution)	80% (20% owned by a number of individuals and employees).	Sold in July 2003 to a consortium composed of Russian, Cypriot and Mongolian investors for $7.32 million, but cancelled by the Government in September 2003 based on security concerns. Re-offered on October 1, 2003 for a minimum price of $6.13 million. Government stake sold to Petrovis for $8.5 million in April 2004.

Continued on next page

Table 7—Continued

Company	State Shares Being Privatized	Status
Mongol Daatgal Insurance Company	100%.	Tendered in April 2003 with a floor price of $1.2 million. Seven expressions of interest received by September 2003. Mongol Daatgal Insurance Company successfully privatized on 2 December. Sold to consortium of Angara Insurance CKB, a Russian Insurance Company, and Chinggis Khaan Bank, for $5.8 million, almost five times the original $1.2 million asking price.

Source: USAID Mongolia Privatization Program, BearingPoint, Inc.

70. In preparation for the privatization of MIAT in 2004, the Government recently entered into a foreign management contract with Air Consulting International of Ireland, funded by the European Bank for Reconstruction and Development (EBRD). Two of Mongolia's most valuable enterprises, Erdenet,[50] 51% owned by the Mongolian Government and 49% by the Russian Government, and Mongolia National Railways (MNR), 50% owned by the Mongolian and 50% by the Russian Government, are not expected to be privatized in the near future.[51]

71. In 2003, as part of a comprehensive program to improve the performance of public utilities through private sector participation, the Government of Mongolia requested EBRD to provide assistance in preparing government-owned energy sector entities for privatization. A US consulting firm, Applied Technologies International, was selected to implement the EBRD-funded project. In January 2004, the Government of Mongolia made the decision to privatize CHP No. III and Ulaanbaatar Electricity Distribution Network. Because of upcoming parliamentary elections, the project was extended through December 2004.

6. Foreign Direct Investment

72. The Government of Mongolia has placed considerable emphasis on the attraction of FDI and has met with a measure of success (Appendix 4). The principal incentives offered to foreign investors are provided for under the Law on Foreign Investment of 1993 (amended in 2002) and include corporate tax holidays for a given duration (e.g., 10 years for infrastructure investment, 5 years in mining and electronics), followed by a subsequent period at 50% reduction, and selective VAT exemptions on imported equipment.[52] These incentives are supplemented by ad-hoc incentives such as rollover of year-one losses against future profits and corporate tax in the

50 Erdenet employs approximately 9,000 people, spends approximately $10 million a year on local social infrastructure, and accounts for approximately 25% of foreign exchange earnings. EBRD is providing an external adviser to Erdenet to help it improve performance.

51 Privatization of these companies would require resolution of Mongolia's outstanding sovereign debt to Russia.

52 The VAT exemption previously was provided on all imported materials, but the selective approach attempts to stimulate investments on technology.

mining industry (excluding precious metals).[53]

73. For investments above $2 million, FIFTA also may negotiate Stability Agreements written for a period of 10 years for investments of $2 million–$10 million and for 15 years on investments greater than $10 million. A Stability Agreement guarantees the concessions granted, irrespective of future modifications to the law. GDNT has contested Stability Agreements in the past, on the grounds that there was no provision for such Agreements in the Tax Law. This issue was clarified, however, in recent amendments to the Tax Law that specifically allow for the issue of such agreements.

74. FIFTA has the dual and conflicting role of both attracting and regulating foreign investment in Mongolia. Having attracted foreign investment and negotiated tax and other concessions, FIFTA must ensure that the operations of the company and its level of actual investment justify continuation of concessions. Sleeping or phantom foreign investors are clearly beneficial for local companies if they are sufficiently credible to persuade FIFTA to grant concessions. It is rumored that in the manufacturing sector, and especially in the textiles sector, companies with FDI close down after the 3 years of full tax exemption and reregister under a different name, thereby benefiting from another 3 years of full exemption. To enable FIFTA to concentrate on promotion, attraction, and negotiation of FDI, and to monitor the use of such concessions more carefully, it might be beneficial to transfer the role of FDI regulation to a separate organization. World Bank is in discussion with FIFTA and its supervisory ministry, MIT, on this issue.

75. Parliament recently adopted a new Regional Development Strategy that divides the country into five economic zones with two designated cities serving as pillars in each zone. The strategy is largely a central planning approach designed by the Government to direct investors. An ongoing technical assistance (TA) project[54] has produced a comprehensive analysis of the strategy. In March 2004, the Government of Mongolia announced a tender for strategic investors to establish, develop, and manage the Zamyn-Uud Free Enterprise Zone.

7. Small and Medium Enterprises

76. Although aware of the actual and the potential contributions of SMEs, including micro businesses and informal businesses, to employment creation and growth, the Government has neither adopted an explicit SME policy nor designated a ministry to "champion" small business development. Nevertheless, there are a number of measures under way that might constitute the beginnings of a strategy.

77. First, the formal registration of a business is relatively straightforward and inexpensive and provides no barrier to SME development. Second, very small businesses can operate without registering with GDNT or paying corporate income tax. Instead, such businesses register with local activities and pay a flat-rate levy scaled according to the nature of the business. Third, an attempt has been made to lighten the tax burden for small companies by instituting a two-tiered corporate income tax rate. This means that small companies pay less tax

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[53] The ad-hoc concessions being offered to foreign investors serve principally to level the playing field at an international level. A review of tax and accounting laws might conclude that carry-over of losses against corporate income tax, more rapid schedules of depreciation, and permission for investment in new enterprises, as a tax-deductible expense, might be appropriate reforms for the economy as a whole.

[54] ADB. 2002. *Technical Assistance to Mongolia for Capacity Building for Integrated Regional Development Planning.* Manila.

although the side effects of the two-tier policy in terms of the frequent splitting of larger companies have been undesirable.

78. Small-business incentive or support structures that often are available in Western countries largely are absent from Mongolia. Additionally, because the VAT threshold is low, most small businesses are obliged to register and to submit returns, and no legally recognized system for simplifying the accounting of small business statutory returns exists.

B. Institutional Framework

79. There are three main branches of government in Mongolia that adopt and implement the rule of law framework: Parliament (legislative), prime minister (executive), and Judiciary (Table 8).

Table 8: Central Government Bodies That Interface with the Private Sector

Parliament	Prime Minister	Executive Agencies	Judiciary
• BOM • MSEC	• SPC • SPIA • State Agency for the Administration of Property Registration • State Professional Supervision Department (Insurance Supervisory Agency is a unit of this department) **Cabinet** • MOFE • MOI • MIT • MOJ • Ministry of Environment • Ministry of Education, Culture and Science • Ministry of Health • Ministry of Food and Agriculture	• GDNT • CGA • Civil Aviation Authority • Coal and Energy Regulatory Authority • Road Authority • Construction, Urban Development, Public Utility Agency • Tourism Board • Transport Authority • Railway Authority • Postal and Telecom-munications Authority • FIFTA • Mongolian Resource Authority • Petroleum Authority • Intellectual Property Office • General Authority for Implementing Court Decisions • Nature, Water and Forest Resources • Medical Services Authority • State Veterinary Agency	• Supreme Court • Administrative Courts

BOM = Bank of Mongolia, CGA = Customs General Administration, FIFTA = Foreign Investment and Foreign Trade Agency, GDNT = General Department of National Taxation, MIT = Ministry of Industry and Trade, MOFE = Ministry of Finance and Economy, MOI = Ministry of Infrastructure, MOJ = Ministry of Justice and Home Affairs, MSEC = Mongolian Securities and Exchange Commission, SPC = State Property Committee, SPIA = State Professional Inspection Agency,
Source: ADB research.

80. Policy is formulated largely within Parliament, with input from the executive branch. Parliament writes laws to be implemented by the responsible ministry or implementing agency through guidelines and regulations. In practice, these guidelines and regulations often allow

implementing agencies considerable discretion. Ineffective checks on the powers of such agencies raise the cost of doing business in Mongolia, which lacks an effective forum for dispute resolution.

1. National Government

81. **Parliament and the Prime Minister.** Under the Constitution, the Ikh Hural, the National Parliament, is the highest organ of state power. The 76-seat unicameral Parliament is elected by universal suffrage on a 4-year cycle. The largest political party forms a government with the approval of the president,[55] electing a prime minister who appoints cabinet ministers, who may be parliament members.[56] Ministries have the power to develop state policy on issues for which they are responsible and to implement laws, presidential decrees, and government decisions; and are accountable to the prime minister and Parliament. The key ministry as far as the macroeconomic environment is concerned is MOFE whereas MOI, MIT, and a number of other ministries influence the business environment in key sectors.

82. Parliament operates seven standing committees (economy, legal affairs, state structures, social affairs, national security and foreign affairs, national budget, and environment and rural development), which carry out investigations, recommend policies, and prepare legislation. These committees have formed a number of subcommittees and working groups including participants from the executive branch (e.g., a Working Group on Corporate Governance has been convened by the Economic Standing Committee). Under the Law on the State Great Hural, parliamentary sessions are open to the public.

83. As reflected in Table 8 above, Parliament has established a number of subordinate bodies that report directly to it, including BOM and the Mongolian Securities and Exchange Commission (MSEC). Parliament's functions also include defining the Government's monetary policies, developing guidelines for its economic development, and approving its action program and budget.

84. **Judiciary.** The Mongolian Constitution provides for an independent judiciary that includes Courts of General Jurisdiction and other specialized courts that may be created by Parliament. There are three levels of the Court of General Jurisdiction: (i) *soum, inter-soum,* and other district courts, which have first-instance jurisdiction in cases involving matters of less serious and criminal nature and in civil cases with claims of less than MNT10 million; (ii) *aimag* (i.e., provincial), city, and capital city courts, which deal with first-instance cases of more serious crimes and civil matters with claims of more than MNT10 million, in addition to appeals on cases coming from lower courts; and (iii) the Supreme Court, which deals with any first-instance case not covered above and appeals on all cases. An Administrative Court is being established at the *aimag*, city, and capital city level in order to deal with cases involving infringements of citizen's rights by any public-sector agency or official. All courts are presided over by a panel of three judges.

85. To ensure that there is no backlog of cases in Mongolia, civil cases must be concluded within 60 calendar days of filing. The presiding judge is required to issue an opinion within 43

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[55] The president is elected every four years by direct vote, may veto, wholly or partly, laws or other decisions adopted by Parliament, but can be overturned by a two-thirds majority of that body, and upon nomination by it appoints the prime minister and Supreme Court judges.

[56] Members of Parliament may serve as cabinet ministers.

days of filing and a written decision within three days of issuing an opinion, which triggers the 10-day period within which to bring an appeal.

86. To ensure judicial independence, a General Council of Courts was established under the Constitution and is headed by the chief justice of the Supreme Court and 11 other members (seven judges from different levels, a member of Parliament, the Ministry of Justice and Home Affairs (MOJ), the general prosecutor, and a representative of the president). The General Council of Courts nominates candidates for judicial appointment to the president; formulates and submits proposals to Parliament on the judiciary's budget, judges' salaries, infrastructure, and other requirements; and initiates disciplinary proceedings against erring judges.

87. The Constitution sets out the basic requirements for judicial appointment. Candidates for appointment to the lower courts should be at least 25 years old and have a higher legal education and at least 3 years of legal experience; those to the Supreme Court should be at least 35 years old with a higher level of education and at least 10 years of judicial experience. Although the pay level for judges compares favorably with civil service salaries,[57] private sector legal positions pay at least two to three times these levels, a situation making it difficult to attract and to retain qualified candidates.

88. The Court Decision Enforcement Agency, under MOJ, oversees enforcement of court orders and arbitration decisions. Bailiffs are offered incentives for executing judgments, based on a percentage of the judgment amount (5%).

2. Local Government

89. Under the Constitution, local governments have the autonomy and flexibility to manage economic matters in their respective jurisdictions though free operation of the local governments is limited by heavy dependence on the central Government for funding.[58] Local governments in Mongolia have their own legislative and executive branches at the *aimag*, *soum*, and *bag* (subdistrict) levels. *Aimag* and capital city governors are appointed by the Prime Minister after parliamentary nomination. *Soum* governors, appointed by *aimag* governors, appoint *bag* officials.

3. Implementation of the Rule of Law Framework

a. Rule of Law

90. Mongolia has adopted, but has not yet implemented fully, a rule of law framework. As generally understood, the rule of law consists of the promulgation of easily accessible, objective, and clearly understandable laws and regulations, with communication and participation by affected parties; and the fair, reliable, and nondiscriminatory application of both laws and contracts.[59] The rule of law is expected to usher transparency, predictability, and consistency into the business environment.

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[57] The chief justice of the Supreme Court receives a total salary of $170 per month while judges at the lower levels receive $120 per month.

[58] Local governments are responsible for providing education and health care; developing culture, art, science, and technology; and protecting historical and cultural sites, natural resources, and the environment. Local governments can make policy in relation to the supply of water and electricity and implement such policies in coordination with the relevant central government bodies, protect the genetic sources of livestock, introduce veterinary and sanitary control, and build and maintain roads and bridges.

[59] American Chamber of Commerce. 2001 White Paper. People's Republic of China.

91. **Legislative and Regulatory Process.** Participation by affected parties in the legislative and regulatory process requires a shift in the perception that legislative and regulatory drafting is an internal government process. Investors in Mongolia cite many cases in which important laws and/or amendments have been adopted without such participation or a clear understanding of negative market effects.

92. No public mechanism currently exists to promote actively or to formalize public involvement in the legislative process. Draft legislation is not published routinely although procedures are in place for consulting the public.[60] Most NGOs lack the capacity to participate in the legislative process effectively.[61]

Box 2: The Mongolian Minerals Law:
Efforts to Change a "World-Class Law"

The Minerals Law was enacted in July 1997 and is regarded widely among mining investors as one of the most investor-friendly laws in the mining world. The law simplifies the procedures for mining exploration and decreases license fees. Under the law, the State has the right to grant exploration and mining licenses, and license holders have the exclusive right to obtain a mining license and to mine all minerals discovered within the license area. Mineral licenses in whole or in part can be freely transferred, sold, or used as collateral by license holders. Exploration licenses can be held for 7 years and mining licenses for 100 years. Under this law, processing of exploration license applications takes no more than 10 business days, and mining license applications take no more than 20 business days. An application for a mineral license can be rejected only if the requested area overlaps with a national park, nature reserve, other special needs land, areas already covered by valid mineral licenses, or areas within disputed mineral license titles subject to a court ruling. This world-class law, along with other incentives granted to attract investors to the sector (e.g., tax concessions) has attracted foreign investors to Mongolia in an internationally competitive sector.

In mid-2001, the Ministry of Industry and Trade proposed a series of fundamental amendments to the Minerals Law. Strong objections were raised, and a public seminar was organized to discuss the amendments. The results of the seminar were communicated to the Prime Minister's office, and in late 2001 the amendments were revoked.

Continued on next page

60 USAID has been working with the Government to open up parliamentary hearings to the public. USAID's "Open Government Initiative" (www.open-government.mn) provides a mechanism for the public to address questions to the prime minister, as well as to the Parliament, and to review draft legislation. Although this mechanism provides a framework for consultation, initiatives to address specific legislative issues seem more effective. For example, the Tax Roundtable, an initiative of the North America–Mongolian Business Group, involves the participation of the Chairman of the Standing Committee of the Economy, representatives of the GDNT, accountants, businesspeople, and lawyers.

61 In addition to the North America-Mongolian Business Group, a number of other NGOs are lobbying the government on behalf of their members. One of the larger NGOs, the Mongolia Chamber of Commerce and Industry (MCCI), regularly convenes its Public-Private Sector Committee, which includes representatives from MOFE, to discuss business legislation issues affecting the private sector.

Box 2—Continued

However, in January 2002, a Special Licensing Law, which became effective in January 2002, began to require regional governments (*aimags*) to approve the issuance of an exploration or mining license even though the applicant already had obtained approval from the Mineral Resource Authority of Mongolia. Based on the new requirement to obtain local government approval, licensing procedures now may take up to 50 business days. A number of attempts to shorten or to eliminate the power of local governments to approve license applications have failed. In mid-2002, the Ministry of Industry and Trade introduced to the cabinet proposals to amend the Minerals Law and the Licensing Law to require the Mineral Resource Authority to liaise with *aimag* governors with respect to licensing applications. If no response was received within 15 business days, the application was to be deemed granted. These proposals never were presented to Parliament. In June 2003, proposed Licensing Law amendments that would decrease the response period of local governments from 30 to 10 business days for an exploration license were submitted by the Cabinet to Parliament for deliberation. Parliament postponed deliberation in conjunction with other related laws to a later time.

93. New laws and amendments also have been used to implement the policies of successive administrations and have given rise to an increasing level of ambiguity. Laws often are coordinated poorly;[62] adopted on an ad-hoc basis; and based on laws from more-developed markets, [63] some with different legal systems. Some laws may reflect local realities (e.g., a weak judiciary) inadequately and/or may cater to a narrow interest group.

94. **Regulatory Compliance Burden.** The civil law system, which has been adopted by Mongolia, assumes that codified law will regulate all cases.[64] But Mongolian laws tend to be general, descriptive and vague, with few implementing guidelines or official clarifications published to facilitate an understanding of them, [65] a situation resulting in a confusing framework that leaves ample room for interpretation by regulated persons and regulators.[66] Difficulties often surface during government inspections, identified as a significant obstacle and cost to doing business in Mongolia in the 2001 USAID MAPS survey (Box 3). Moreover, judges are not bound by earlier decisions on similar matters.[67] Thus, it might not be uncommon for courts to reach opposite conclusions in similar cases.

62 The Law on the Procedures for Developing and Submitting Draft Laws and Other Decisions of the National Parliament (last amended in 2001) and the Law on Government Service define the process for developing laws and government resolutions. Under these laws, ministries prepare draft laws by first consulting MOJ, with both ministries approving the concept for the proposed law. The draft then is distributed to other ministries for comment. A working group may be set up. Financial implications of the new proposal must be taken into account, as must legal implication of the proposals.

63 An observer states, “Mongolia’s legal system consists of a European Constitution, US commercial law, Indonesian Petroleum Law, German Civil Code, Swedish Administrative Law, and Canadian Bankruptcy Law.” World Bank. 1999 and 2000. *Mongolia Legal Needs Assessment Report.* Chicago, June 1999/May 2000.

64 When the law does not clearly address all issues presented, judges may consider common practices of business (rule by analogy). See Article 198.6 of the Civil Code, which governs contract interpretation.

65 No guidance is provided on the power of the Government to issue implementing regulations. In practice, individual ministries and executing agencies administer the laws and regulations for which they are responsible. The Cabinet approves implementing regulations, and related legislative interpretations are submitted to the relevant parliamentary committee for review. See US Department of State, *Country Commerce Guide*, 2000, p. 18.

66 For example, in the area of customs and taxation, at least 10 separate laws exist. Exemptions from these laws are found in many separate laws. New amendments to these laws are discussed in almost every legislative session. See ADB. 2002. *Governance: Progress and Challenges in Mongolia*. Manila.

67 In contrast, common law systems build upon case law (legal precedents).

Box 3: Government Inspections

As a result of reviewing its inspection function after decreasing the licensing burden from more than 600 to 87 agencies, the Government recently restructured its inspection framework. The number of agencies involved in inspections was decreased from 49 to 41, still a significant number for a small economy. A new regulatory agency under the control of the prime minister, the State Professional Inspection Agency (SPIA), was established by bringing together 11 agencies that had employed 328 people, including employees from border checkpoints.[68] SPIA is expected to employ approximately 180 persons, including 66 of the former senior and national inspectors from previous agencies.

SPIA's scope remains extensive, and several of its functions affect private sector operations. It is reasonable for private businesses to be inspected to protect employees, customers, and the public interest more broadly; but there is concern that the structure of the Government's inspection framework, which still encompasses overlapping jurisdictions and roles and is accompanied by allegations of corruption, will remain unchanged. Inspections often are viewed as a means of extracting official payments from companies, rather than of enforcing regulations. Regulations may be widely interpreted by inspectors, who impose fines. More commitment to the spirit, rather than the letter, of recent reform efforts is necessary to enable the private sector to benefit from the consolidation of functions.

95. Although laws and regulations, once passed, are accessible in printed form in the state law journal and newspapers, the volume of legislative and regulatory activity that has accompanied transition, combined with ongoing restructuring of the Government, further limits the transparency of regulatory requirements and imposes a significant compliance burden on private businesses.[69]

96. **Enforcement.** Weak and inconsistent enforcement of laws and regulations is an area in which investors have expressed concern. Weak and inconsistent enforcement is based on several factors: (i) inadequate checks and balances on enforcement actions; (ii) ineffective sanctions and penalties to deter violations; and (iii) general weakness of the court system.

97. The Law on Administrative Courts, adopted in 2002, should provide some protection to private enterprises against arbitrary interference by government authorities. Under this law, specialized courts were to begin operation on 1 June 2004 and to be responsible for reviewing, and changing or canceling if necessary, government decisions or actions.

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68 State Financial Control and Inspection Agency; State Education, Culture and Science Inspection Agency; State Unit for Nature and Environment Protection; State Control Authority for Infrastructure; State Labour and Social Welfare Inspection Agency; State Industry and Trade Inspection Agency; State Food Safety and Agricultural Inspection Agency; State Health Inspection Agency; National Standardization and Measurement Center's Division for Implementation of Government Inspection Function on Standards, Quality and Measures; Defense Management Inspection Unit; Radiation Inspection Unit of the Atomic Energy Commission.

69 There is no legal information system or register of laws. ADB originated the idea of a Legal Retraining Center to help train legal professionals in modern commercial law. ADB. 1997. *Technical Assistance to Mongolia for Retraining of Legal Officials in a Market Economy*. Manila. This assistance was followed up by the ongoing World Bank Legal and Judicial Reform project, which is improving access to legal information through the establishment of a center for legal and judicial research and by enhancing the dissemination of legal and judicial information. ADB also provided training under the "DIAL" project, to familiarize lawyers with researching law on the Internet. See ADB. 1998. *Regional Technical Assistance for Development of the Internet for Asian Law.* Manila.

98. **Dispute Resolution.** Disputes between foreign and Mongolian investors are resolved in the Mongolian courts unless otherwise provided for by international treaties to which Mongolia is a signatory, or by a contract between the parties to the dispute.[70]

99. Judicial competence to rule on commercial matters also is a concern. Before the transition to a market economy, judicial work was predominantly criminal; now it is increasingly commercial.

100. Public opinion surveys reflect a widespread perception of corruption in the judiciary.[71] Judgments made in a small number of recent cases involving foreign investors have been regarded with suspicion both at the highest levels of government and within the private sector (Box 4).

101. A number of foreign donors, including ADB, have documented the problems associated with the judiciary. Several TAs already are underway or are planned to address this issue. The largest is the USAID-funded Judicial Reform Project, which is designed to help the Government implement its strategic plan for the justice system, with a focus on criminal cases. Work in the area of managing the courts; training jurists; establishing a qualification system and a code of ethics for Judges; and clarifying the organization, structure, jurisdiction, and responsibilities of court system agencies is entailed. A World Bank Legal and Judicial Reform Project with an emphasis on creation of a new administrative court system will complement this effort.[72]

102. Until recently, there were few alternatives to the court system in Mongolia: the MCCI Arbitration Tribunal was the only alternative forum for formal resolution of commercial disputes between Mongolian and foreign entities.[73] In May 2003, however, a new Law on Arbitration was adopted. This law, modeled after the 1985 Model International Commercial Arbitration Law recommended by the United Nations Committee on International Trade Law, provides for arbitration in private-business disputes, including those involving domestic entities. Under this law, arbitration decisions are final, with no right of judicial review or appeal to the courts. If the losing party fails to execute the arbitration award, the winning party may submit a request for enforcement to the Court Enforcement Authority.

103. For disputes arbitrated overseas, Mongolia has acceded to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Difficulties have arisen in enforcing foreign judgments, however (Box 4).

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70 World Bank. 2002. *Investors Forum 2002: Mining and Oil Sector Profile*. Chicago. Note that the Law of Judicial Procedure for Business Disputes has not been translated into English. See 1995 Foreign Trade Arbitration Law (Article 15).

71 UNDP. 1994. *Public Perception of Corruption, Public Opinion Survey, Academy of Public Administration*, supported by the Soros Foundation; MCCI. 2000. *Survey of Corruption in the Business Sector*; USAID. 2001. *Public Perception of Corruption Survey* by Sant-Marcel Foundation and supported by USAID Mongolia Judicial Reform Project.

72 Some of the same problems undermining the credibility of the judicial system (salary issues, low public prestige, and difficulty in attracting and retaining qualified candidates) also may affect this new court.

73 On average, the MCCI Tribunal deals with 15 arbitrations a year, using a panel of approximately 15 arbitrators appointed by MCCI, all of whom are lawyers. On average, cases require approximately two months to resolve.

Box 4: Enforceability of Judgments Issued by Arbitration Tribunals: The Marubeni Case

In 1996, Marubeni–Hong Kong and South China Ltd (Marubeni) extended a deferred payment facility in the amount of $18 million to Buyan Holding Ltd. (Buyan), a Mongolian cashmere processing and knitting enterprise. In issuing the deferred-payment facility, Marubeni relied on a letter of guarantee from the Ministry of Finance and Economy. This letter was issued in 1996 and provided an unconditional guarantee to pay any amount under the deferred payment facility if not paid when due. The validity of the guarantee was warranted by a legal opinion issued by the Ministry of Justice and Home Affairs. In 2000, Buyan defaulted on the loan after having paid some $6 million of the facility. The succeeding new Government delayed acknowledgement of the guarantee, despite repeated attempts by Marubeni to resolve the matter. Marubeni subsequently initiated a lawsuit in England, pursuant to the jurisdiction clause in the agreement between Marubeni and Buyan. In late 2002, an English court affirmed its jurisdiction in the matter following a jurisdictional challenge from the Government of Mongolia. Notwithstanding, the Government continues to deny the validity of the previous government guarantee, insisting that it was outside the power of the Ministry of Finance and Economy, notwithstanding the legal opinion of the Ministry of Justice and Home Affairs. The case is tentatively scheduled for hearing in Mongolia in February 2004. In the interim, efforts are being made to find an amicable solution.

104. **Legal Professionals.** There is a shortage of qualified lawyers in Mongolia. Most legal professionals are unfamiliar with new legal concepts and requirements and lack the ability to operate in the new system. Although a small number recently received training in Western countries, most lawyers were trained in the former Soviet Union. For lawyers practicing in the commercial area, graduation from law school is the only prerequisite.[74]

105. Legal education has not remedied this problem. Although remedial education for midlevel professionals is widespread, it has not been institutionalized. Because resources are lacking in educational institutions, new professionals often receive inadequate training. To address this gap in education, World Bank is providing assistance to train trainers at law schools in Mongolia and is helping establish new teaching mechanisms and curricula.

106. Notwithstanding, private companies do not cite legal constraints as a major impediment to doing business.[75] This may be so because most businesses have not been involved in legal proceedings and/or because appreciation is lacking that other, more pressing issues, such as corruption and cronyism, might be removed with a more effective legal system.

b. Commercial Law Framework

107. To enable private-property owners to uphold their rights against third-party claims and to dispose of or pledge such rights in whatever way they choose, an effective legal framework and dispute resolution system is needed. In Mongolia, private-property rights are protected under the Mongolia Civil Code (amended in 2002) and a number of specific laws, discussed below, which generally have been harmonized or are in the process of being harmonized with the Civil Code.

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74 A newly developed bar examination will test only newly entering prosecutors, judges, and advocates.

75 The 2001 USAID MAPS survey reported that 10 constraints facing companies were considered more severe; only business registration, employment, and business service issues ranked below judicial and legal concerns.

108. **Land.** Until promulgation of recent amendments to the Land Law, effective 1 January 2003, and adoption of the new Law on Mongolian Citizens' Ownership of Land, effective 1 May 2003, Mongolians had the right only to use land, but were not permitted to transfer, sell, or pledge such rights.

109. The Land Law provides local governors and mayors with the power to lease small land parcels to Mongolian citizens and companies, with authority given to regional legislatures to grant larger plots. Leases are valid for 15–60 years, with one extension possible of up to 40 years. Parliament alone has the authority to issue leases to foreign entities. The Law on Mongolian Citizens' Ownership of Land allows private ownership of land by Mongolian citizens.[76] Under these laws, citizens may use, lease, pledge, or sell their right to lease or to own land, subject to registration of their rights with the Administration of Property Registration Agency, which was formed from the recent merger of three government agencies.[77]

110. **Intellectual Property Rights.** In addition to the Civil Code, intellectual property rights (IPRs) are protected under the Patent Law and the Law on Trade Names and Trademarks. Mongolia is a signatory to the Paris Convention on the Protection of Industrial Property and to the Madrid Convention Concerning International Registration of Trademarks and is a member of the World Intellectual Property Organization. IPRs are administered by the Intellectual Property Office of Mongolia, established in 1996 as an implementing agency of MOJ. By 2002, the Intellectual Property Office of Mongolia had issued 577 patents and had registered 162 innovations, 55 new products, 408 local and 1,800 international trademarks, and 140 industrial designs. Because of the small market, IPR infringement is not a major problem in Mongolia.

111. **Investor Protection.** The legal framework for protecting investors is set forth in the Law on Registration of the Right to Own Property and Other Property Rights Related to It, Bankruptcy Law, Company Law, and Securities Law, in addition to the Civil Code.

112. **Creditors.** Under the Law on Registration of the Right to Own Property and Other Property Rights Related to It, adopted in June 2003, creditors can register their security interest in both immovable and movable collateral with the Administration of Property Registration Agency. This agency maintains a central registry to record leases, pledges, and liens on, and transfers of, immovable and movable property. Banks and NBFIs with secured interests in movable collateral can foreclose on such collateral outside the court system, provided that such foreclosure is provided in the agreement with the debtor. Foreclosure of immovable collateral requires a court order and bailiff's action procedure, however, and, with respect to real property, is permitted only during the summer. Judicial procedures are risky due to a weak judiciary, which may tend to be sympathetic where eviction from real property is involved.

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[76] ADB is providing assistance in the carrying out of a cadastral survey and the establishment of a national land information system scheduled to be completed by July 2007. ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Cadastral Survey and Land Registration Project.* Manila.

[77] Cartography Agency under MOI, Land Agency under the Ministry of the Environment, and State Immovable Property Registration Agency under MOJ.

113. With respect to insolvent companies, creditors are provided with limited protection under the 1997 Bankruptcy Law.[78] Under this law, creditors may petition the court for the involuntary liquidation of an insolvent company and propose a rehabilitation plan before being approved or dismissed by the courts.[79] By not stipulating how many creditors must vote for a rehabilitation plan, the law seems to raise the possibility of a small group of junior creditors imposing a plan on senior creditors. The law seems, moreover, to provide precedence to debtors' over creditors' plans. The rights of various groups of creditors is not clear, with claims for injury or death against the company having a higher priority than secured claims. To address some of these concerns and to harmonize this law with recent amendments to the Civil Code, MOJ has scheduled the law for revision in the near term with assistance from the German Agency for Technical Cooperation (GTZ).

114. **Shareholder Rights.** Shareholder rights are defined in the 1999 Company Law and Securities Law (amended in 2002) for MSE-listed companies. The Company Law is considered to have been drafted well but to be enforced poorly. Under this law, shareholders have the power to authorize share buy-backs, to exchange debt for equity, and to liquidate, sell, merge or consolidate the company. The Annual General Meeting of shareholders appoints the Board of Directors and approves its financial reports and Board remuneration. Holders of ordinary shares also have preemptive right to purchase additional ordinary shares *pari passu* to their original holding or to sell those rights.

115. Shareholder rights under the Securities Law are based on the provision of full and fair disclosure by listed companies and by companies making a public offering. Compliance with current disclosure requirements, including accounting regulations, is rare to nonexistent, and sanctions are insufficient. For example, most MSE-listed companies (70%) did not hold an annual general meeting of shareholders in 2000. Although the situation improved in 2001 (noncompliance declined to 62%), it became worse in 2002 (72%).[80] Resistance to holding general meetings of shareholders may reflect the fact that shares often are closely held among relatives or insiders. Higher penalties for noncompliance included in recent Securities Law amendments were rejected by Parliament, and fines for the failure to hold an annual general meeting remain quite low. After both an initial World Bank study on corporate governance and a government review of Organization for Economic Cooperation and Development norms, EBRD is providing assistance to a working group on corporate governance convened by the Economic Standing Committee of Parliament. Areas examined include the service of independent directors on company boards and the strengthening of sanctions for noncompliance.

116. With respect to the banking sector, BOM recently adopted, based on Bank of International Settlements Principles for "Enhancing Corporate Governance for Banking Organizations," Guidelines for Corporate Governance for commercial banks and issued a Governor's Order obliging banks to adopt these principles.

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78 The BOM regulates bankruptcy of banks under the Banking Law. The decision to liquidate or to restructure a private bank is made by shareholders and requires BOM consent. BOM appoints conservators and receivers, who may be appealed to by shareholders, creditors, and depositors. Upon appointment, conservators and receivers have complete authority over such banks, resulting in the suspension of bank officers' and shareholders' authority.

79 Bankruptcy is seldom initiated. In addition to cultural factors and unfamiliarity with related procedures, the Bankruptcy Law is considered by some experts to be onerous and unclear. ADB consultants reviewed this law in detail in connection with ADB. 2000. *Technical Assistance to Mongolia for Strengthening Financial Sector Development.* Manila.

80 Interviews with MSEC and MSE Chairs.

C. Labor Laws and Social Safety Nets

117. The business community does not seem to view the Labor Law, adopted in 1999, as a limitation to PSD.[81] This law defines labor rights and imposes labor obligations on all entities operating in Mongolia. Sanctions for violations set forth in the law are low, ranging from MNT5,000 ($4) for an officer involved in illegal practices, to MNT250,000 ($228) for a company, depending on type and severity of offence.

118. The Law on Social Insurance, adopted in 1994 and amended in 1996, 1997, and 1999, provides for the payment of benefits to insured persons in the areas of pensions, industrial injury, unemployment, and sickness. Cost of the program is covered by a 19% employer levy on formal sector wages, a 7% contribution by employees, and voluntary contributions from those outside the formal sector. Although the percentage of contributions is relatively high by transition and developing country standards, benefits are modest. Concern persists regarding the number of people who are not covered by the legislation,[82] whose employers do not comply with the law, and/or whose employers are in arrears.

D. Environmental Laws

119. Environmental pollution is a serious concern in Ulaanbaatar and other locations in which specific industries pollute the environment. In the capital city, carbon monoxide, nitrous oxide, and dust build-ups cause concern, particularly from October to March, when domestic and power station combustion levels increase and when climatic conditions prevent dispersal. River-water quality in Ulaanbaatar is poor, with average contents of mineral nitrogen, phosphorous, and other soluble organic substances exceeding the maximum permissible levels by 2–14 times. The capital also produces 195,000 tons of waste/year, with virtually no recycling or waste processing. In rural areas, pasture and land degradation are especially worrisome (Box 6).

120. A strong legal framework for environmental protection has been adopted. The Environmental Protection Law of 1995, as amended in 1998 and 2002, regulates the pollution of air, water, and land resources by toxins or waste products and covers chemical traces in food and maximum applications of agricultural chemicals. Under this Law, the Ministry of Nature and the Environment is responsible for developing appropriate indicators and maintaining records of environmental measurements. Inspectors from other agencies may be designated environmental inspectors and instructed to carry out specific inspections. Businesses are obliged to keep records of toxins used or discharged into the environment and to rehabilitate damaged areas at their own cost. Licenses are required for the discharge of toxic waste and for the use of natural resources, which are not defined in the law. Fines for noncompliance range from MNT10,000–20,000 ($9–18) for an individual to MNT150,000–200,000 ($136–181) for a business.

E. Access to Capital

121. In Mongolia, private sector access to capital, especially among SMEs, is quite limited. Because a diversified financial sector does not exist, private enterprises depend on the banking system as the primary source of capital. Banks have relatively undeveloped credit appraisal

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[81] The 2001 USAID MAPS survey placed employment issues next to the bottom of its list of concerns within the business environment.

[82] Herders are covered as “contracted workers” if formally employed. But because most are individually employed, contributions are voluntary.

systems and rely extensively on collateral, of which SMEs, especially those within the service sector, may have little. What is more, the unit cost of granting credit to small businesses is relatively high and in a high-risk environment may make lending to small businesses unattractive. Banks also prefer lending on a short-term basis. It is very difficult, therefore, for start-up businesses to raise investment loan financing from banks. Moreover, limits are imposed on the amount that can be lent each borrower (20% of share capital).

122. Because of the absence of transparent and reliable financial statements (discussed below–Internal Constraints to PSD) and on the presence of weak corporate governance, equity finance is severely lacking. There have been no initial public offerings on MSE since its creation in 1995, and no formal venture capital funds operate in Mongolia.

F. Internal Constraints to Private Sector Development

123. A number of significant internal constraints to PSD limit the private sector's capacity to respond to business and investment opportunities.

124. **Business Culture.** The business culture in Mongolia has been formed mainly under a command economy even though most businesses have been established post-transition. Business culture is evolving. On the positive side, a "culture of repayment" of bank loans by private businesses is fully evident. Increasing links with other countries and foreign businesses have provided a rich source of business information and creative ideas. Many bright young entrepreneurs have opened new businesses. Certain negative aspects of business culture, however, including fairly low levels of accountancy skills and a lack of familiarity with international currents in marketing, management, and investment analysis, represent significant impediments to business growth and development. Many businesspeople are oriented to production rather than to customer requirements and have a bureaucratic approach to management and business development. Entrepreneurship, at least within the formal sector, thus is limited.[83]

125. **Financial Control and Accounting.** Although the Accounting Law (1993, amended 2002) requires all companies to adopt IAS and submit audited financial statements to MOFE, and although the Auditing Law (1997) requires adoption of international standards of auditing (ISA),[84] compliance is quite weak. Most companies employ few if any managerial accounts, i.e., revenues and costs broken down by activity, product, or line of business. Control in the modern business sense is poorly understood, and accounts generally provide insufficient detail or are improperly prepared, irrespective of deliberate obfuscation. As a result, potential investors are unable to evaluate businesses, and commercial lending is carried out on the basis of collateral coverage rather than cash flow.

126. Advances in accountancy, auditing, and control are constrained severely by lack of skilled practitioners. As of 2 September 2003, there were 840 certified public accountants

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83 The Dutch-financed Enterprise Restructuring Project, which worked with 10 former-SOE enterprises in its first phase (1999–2002), identified the key factors of company success in Mongolia as (i) an increase in control over internal procedures; i.e., strong management supported by committed shareholders; (ii) an ability to develop a company vision and to drive the company toward it; and (iii) a reorientation of approach away from production control and towards customer satisfaction.

84 World Bank is translating ISA standards into Mongolian.

(CPAs), including 320 auditors[85], but only a few accountants have a reasonable understanding of IAS and of how to apply these standards. CPAs certified before 1997 were only required to pass a general examination. Most CPAs fail to undergo additional training to update their skills, and the number of qualified accounting professors and lecturers are small. Accounting specialists often only verify whether financial reports have been filed in the correct format and do not examine source materials for appropriate treatment.[86]

127. Three organizations currently oversee implementation of accounting standards: MOFE and the two professional accounting bodies known as the Mongolian Institute of Certified Public Accountants (MICPA), which administers the CPA examination and provides ongoing training, and the Mongolian Professional Accounting Council, which is authorized under the Auditing Law to license accounting firms and strengthens and regulates the accounting profession.

128. Implementation of IAS and ISA is a long-term process and, in addition to capacity building, depends on the resolution of outstanding tax issues currently discouraging the appropriate reporting of accounts and encouraging the splitting of businesses. ADB assistance in this area has been ongoing since 1995. An early ADB TA in 1995 supported the drafting of the legal framework and the constitution and bylaws of MICPA (ADB. 1995. *Technical Assistance to Mongolia for Improving Accounting and Auditing Systems*). A second TA was provided in 1997 to help 18 accountants qualify for the CPA examination, to train 200 accountants in IAS generally and 36 in IAS applicable to banks and financial institutions, and to help MICPA develop a new syllabus for CPA examinations (ADB. 1997. *Technical Assistance to Mongolia for Improving Accounting and Auditing Systems 2).* More recently, an ongoing ADB TA approved in 2002 will help 100 private SMEs adopt IAS and will provide assistance to MOFE to develop criteria for monitoring compliance with IAS (ADB. 2002. *Technical Assistance to Mongolia for Capacity Building for Accounting and Auditing Professionals*. Manila).

129. **Human Resources.** Skilled managers, finance professionals, and technologists are in short supply. Although private involvement in the tertiary education sector has led to a large increase in the number of graduates, many have no practical skills.[87] Foreign investors in the garment industry cite a lack of work ethic among workers, which leads to low productivity. In an employer survey carried out in 2001,[88] 48% of company respondents said that high school graduates lacked interest in business, and 24% said that graduates of higher education had poor levels of technical knowledge. Inadequate human resources are therefore a significant constraint to PSD.

130. **Technology.** Many businesses, particularly in the manufacturing sector, rely on old, sometimes obsolete, technology and are only able to operate internationally because of a comparative advantage based on natural resources, relatively low labor costs, and/or international trade agreements (e.g., the textile industry). Technological constraints may be overcome to some extent by foreign investment and leasing, but medium-term finance for

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85 Two international accounting firms operate in Mongolia: Ernst & Young, through a branch of its Malaysian office, and KPMG, through a branch of its Vietnam operation. Arthur Andersen maintained a small practice in Mongolia until its dissolution in 2002.

86 Companies using IAS may encounter difficulties with respect to deductions based on lack of understanding of IAS by tax authorities. American-Mongolian Business Group. 2000. *Obstacles to Doing Business in Mongolia*, 9 August.

87 For example, the GTZ SME Promotion Project noted a situation in which graduate printing engineers had never seen a printing machine, much less operated one. Interview.

88 Survey of 57 businesses in Ulaanbaatar and Darkhan under the ADB CAPE Economic Diversification and Reorientation Case Study, 2002.

upgrading technology is in short supply. Market uncertainty, especially for exporters, also limits the desire to invest. Where investment in technology has taken place, it has not always been appropriate or correctly installed, calibrated, and operated. Obsolete technology, as well as lax quality-assurance procedures, often limits Mongolian producers to semi-finished products.[89]

131. **Business Corruption.** In a 2000 MCCI report on business corruption carried out largely within the SME sector,[90] 32% of respondents admitted to having evaded income taxes,[91] 31% to having evaded customs' duties, and 26% to having evaded VAT payments. Two thirds of respondents agreed that they "sometimes have to bribe," paying as much as 6–10% of revenue (26% of those making payments). It seems unlikely that the incidence of corruption has decreased since the study was conducted.

Box 5: Company Success Story

Darkhan Nekhii was established in 1973, and in 1990 had the capacity to treat 1.5 million sheepskins/year. It exported skins and garments throughout the former Soviet Union. In 1992, it was privatized through the voucher system, resulting in a diffused base of shareholders and full control by management. The company accrued debt (MNT1.2 billion) at the same time as it was losing production and incurring losses. The CEO was replaced five times in 7 years. In January 1998, production ceased and workers were laid off.

In late 1999, external donor assistance permitted the development of a realistic business plan centered on the export of semi-finished skins and on the production of garments for the local market. In 2000 a new CEO began work and one of the largest shareholders, Gazar Holdings, invested MNT50 million in working capital. Working practices were changed, a market study was carried out, management attended the Hong Kong China Leather Fair, and technical assistance in processing technology was sourced. Gazar Holdings factored bank debt, tax arrears were renegotiated, and the company paid off MNT147 million to suppliers. A strategic partnership was agreed to with a Spanish company.

By the end of 2001, more than 200 workers were employed, debt was nearly eliminated, and the business had become profitable. These changes were achieved without major investment but required commitments to finding and exploiting a market niche, improving quality, controlling costs, and being confident enough to admit deficiencies and to learn.

G. Industry Representative Bodies

132. A number of industry representative bodies, a few of which have been effective in presenting private sector concerns to Parliament (e.g., the mining sector) and/or lobbying for tax concessions (e.g., the tourism sector), exist (Table 9).

89 A gradual move from raw material production, to semi-finished, to finished production may, however, be sensible commercially (Box 5).
90 MCCI. 2000. *Survey of Corruption in the Business Sector.*
91 The word "avoid" is used in the report whereas discussions with MCCI researchers indicate that the word "evade" should be used. The first is legal, the second is not.

Table 9: Selection of Industry Representative Bodies

Name	Membership	Background
MCCI	600 large and medium enterprises in all sectors.	Funded through membership fees. Provides information to members, offers commercial market research, established Public-Private Consultative Committee with representatives from MOFE, and produces a Top Mongolian Companies chart, which scores companies on a variety of characteristics. Organizes arbitration forum for disputes between foreign investors and local entities.
North America–Mongolia Business Council	American and Canadian companies and professionals.	Founded in 1991. Advocates members' trade and investment interests, with permanent headquarters in Washington, DC.
Mongolian National Mining Association	Geologists, miners, processing engineers, metallurgists and scientists, mine operators, technical universities and schools, science and research organizations, and other professional associations.	Established in 1994. Actively involved in representing members' interests to Parliament with respect to legislation, provides members with information related to mineral resources, and addresses safety, sanitary and social welfare issues of employees and workers in the mineral sector.
Mongolian Tourism Association	96 members consisting of hotels, tour operators, travel agents, gher (tent) camps, and restaurants and other catering establishments.	Involved in policy development, training, marketing and promotion, market research, provision of information, and training of tourism operators. Received assistance from GTZ and USAID to improve their products and services and to increase staff skills and professionalism. Full-time staff hired in 1997.
Mongolian Wool & Cashmere Association	40 members engaged in wool and cashmere production.	Addresses sector problems and needs, incorporates suggestions and proposals of members and forwards them to the government. Also organizes exhibits and trade fairs for its members. Has four full-time staff.

GTZ = German Agency for Technical Cooperation, MOFE = Ministry of Finance and Economy, USAID = United States Agency for International Development MCCI = Mongolian Chamber of Commerce and Industry.
Source: ADB research.

Table 10: Recommendations to Address Overriding Constraints to Private Sector Development

Constraints to PSD	Recommended Government Action
Legal Environment	Formalize/institutionalize procedures for public consultation on legislation and regulations and promote such participation. Implement a more effective mechanism for publicly disseminating legal and regulatory requirements on an on-going basis. Provide a clear set of rules and guidelines on regulatory requirements for public officials and the business community. Develop an efficient and fair judicial system that disposes of cases in a reasonable, timely, and impartial manner. Make judicial decisions publicly available to ensure transparency. Promote use of alternative dispute resolution forums that are efficient and fair. Ensure enforceability of foreign arbitration awards.
Tax Policy	Review and simplify the tax system and review effective tax rates to meet government revenue requirements and promote private sector development.
Inspection Regime	Clarify requirements (e.g., remove discretion where reasonable) and implement systems (computerization) and procedures to ensure transparency of fee collection. Train regulatory officials who interface with the private sector on legislation and regulations. Require all inspectors (of health, fire, tax, etc.) to present a letter signed by their agency authorizing them to conduct an inspection. Consolidate inspections wherever and whenever possible.
Financial Intermediation	Deepen financial sector reforms and promote an enabling environment to diversify alternative financing options for domestic private firms. • Continue reforms in financial sector, • Promote development of sustainable alternative financing vehicles, • Promote development of the land market, • Develop a more effective monitoring and enforcement program to promote higher standards of corporate governance for publicly listed firms, • Review accounting standards applicable to SMEs (cost-burden issue), • Effectively enforce compliance with accounting and auditing requirements,

SME = small and medium enterprise

Continued on next page

Table 10—Continued

Constraints to PSD	Recommended Government Action
	• Adopt and implement more effective sanctions to ensure compliance, • Continue to provide training on accounting requirements to companies, accountants, regulators (who supervise), and persons who oversee dispute resolution. Require accountants to undergo continual training (e.g., mandatory continuing education requirement), • Continue with capacity building of local audit firms
Management and Technical Skills	Improve the quality of tertiary institutions by promoting and enforcing higher education-standards. Promote educational programs that address private sector needs.

Source: ADB research.

Chapter 3: SECTOR PROFILES

A. Overview

133. This chapter summarizes the situation in respect to key productive sectors (agriculture, natural resources, tourism, manufacturing) and the supportive sectors of infrastructure, finance, and social services. The systemic constraints presented in Chapter 2 affect each of the individual sectors presented, in unique ways (Table 11).

Table 11: Mongolia GDP by Sector, 1999–2002
(% of GDP)

Sector	1999	2000	2001	2002
Agriculture	40.3	34.2	27.8	20.7
Industry	22.3	22.6	24.9	21.4
Transport and Communications	7.5	9.3	10.4	14.0
Construction	1.5	1.3	1.4	2.1
Trade	17.2	21.4	23.7	27.6
Other services	11.2	11.3	11.8	14.3

Sources: *World Bank Business and Investment Guide for Mongolia*, 2002; *Mongolia Statistical Yearbook 2002.*

B. Agriculture

134. The private sector accounts for 98% of the agricultural sector (Appendix 3), which is dominated by animal production.[92] This sector contributed 20.7% to GDP in 2002 and employed almost 45% of the total labor force in rural areas.

135. **Livestock.** Cashmere and meat are the main export products in this subsector. Following privatization of livestock (Box 6), the production of raw cashmere more than doubled from 1,500 tons in 1990 to 3,288 tons in 2000, but production declined in 2001 and 2002 to 3,100 and 2,900 tons, respectively. The rapid increase from 1990–2000 had been tied to an increase in animal numbers and to the receipt by herders of a higher percentage of value based on increasing buyer competition—which, in turn, had been based on the entry of buyers from the PRC into the local market and on a growing number of local traders and manufacturers.[93]

136. The export of raw cashmere from Mongolia has been the subject of fierce debate since the early 1990s. To protect local spinners and manufacturers, an export ban was in place from 1991–1996 despite pressure from ADB and others for its removal. This ban was replaced in 1997 by a flat export tax of MNT4,000/kg. Although declining in real terms, this tax still represents a significant percentage of herder prices.

137. To promote the competitiveness of Mongolian cashmere, the government, with USAID assistance, recently developed an internationally recognized certification trademark to

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92 Production of animals (sheep, goats, cattle, horses, and camels) accounts for approximately 79% of sector GDP.

93 Although producers have received a higher percentage of value since privatization, cashmere world prices have fluctuated since 1989. In that year, prices for Mongolian dehaired (semi-finished) cashmere reached $60/kg, only to fall to $14/kg in 1993. Current prices are $51–$53 kg, cif Europe. *See Wool Record Weekly Market Report*, quotes for 13 February 2002.

distinguish high-quality Mongolian cashmere (which generally is 15% longer than cashmere from the PRC, pills less, and is softer) from lower-quality cashmere products. A new Fiber Certification Board will be established to certify such products.[94]

138. With respect to meat production, export growth is limited by current slaughter and by veterinary and meat packing standards, which are in the process of being improved with assistance from ADB and other donors.[95] Although exports to Russia of largely unprocessed meat products have averaged nearly 20,000 tons annually, the PRC has banned Mongolian meat and dairy exports since an outbreak of foot and mouth disease in 2001.

Box 6: Sustainability of Livestock Production

Before privatization, herders were employees of state farms, which provided necessary support services, controlling the number of livestock produced and the quality of livestock, and maintaining the delicate ecological balance. After privatization, support to the livestock industry collapsed. Number of herders increased due to the lack of other employment options. Based on the limited number of livestock owned by individual herders, livestock production moved to more of a household-based subsistence system.

As number of herders increased and quality of livestock decreased as a result of inadequate breeding methods and veterinary care, herders began to increase the size of their herds beyond the optimal herd size (nationwide, this is considered to be around 22 million), which led to overgrazing and degradation of pastures. Fodder (hay) production also decreased as a result of inadequate irrigation, which no longer was maintained. Three consecutive years of severe weather (2000–2002) resulted in the loss of 11 million livestock. As of 2003, there were approximately 25.3 million livestock, a slight decrease from the 1994 stock numbers following privatization (26 million). Herds rapidly increased to 33.6 m head in 1999, followed by sharp decreases to 26.1 million, a figure reflecting harsh climatic conditions in 2001 and 2002.

Herders who live far from Ulaanbaatar lack access to the central market, in which higher prices are paid for cashmere. Thus, they barter and sell their cashmere for lower prices, often to traders from the PRC, a practice that decreases the amount of raw cashmere available to local producers.

With donor assistance, the Government is adopting a number of policies (e.g., regarding livestock health, fodder production, infectious disease control, water supply improvement) to address these constraints, and continues to work to develop a more effective long-term strategy for the subsector.

Sources: *Rural Development Strategy for Mongolia*, Centre for Policy Research, October 2002; World Bank; Food and Agriculture Organization; Department for International Development; United Nations Development Programme; Economist Intelligence Unit Country Report, May 2003.

[94] USAID Competitive Initiative. 2002. *Discussion Paper on Fiber Certification Mark–Promoting Mongolian Cashmere*, April.

[95] ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Agricultural Sector Development Program.* Manila. This loan supports improvement of veterinary standards through the Ministry of Agriculture and training of veterinary inspectors of meat hygiene through the Veterinary Inspection Agency.

139. **Crops.** Inadequate rainfall, limited access to finance, high cost of irrigation, lack of adequate management, low-quality seed material, outdated equipment and technology, brief growing season, and availability of inexpensive imports from the PRC are factors affecting crop production in Mongolia. The sustainability of wide-scale production of cereals, principally wheat, the main food staple in Mongolia, is highly questionable. In the 1980s, the Government dedicated significant resources to wheat production, which grew to approximately 600,000 tons in 1991. During 1990–1996, all state-owned crop farms were corporatized in an effort to promote private ownership. Investors avoided this industry, and production dropped steadily to 139,000 tons in 2000 and 2001, a figure that appears, in light of the factors listed above, to represent a rational resource allocation. The remaining domestic wheat production is supported by Government subsidies. Russia, although not self sufficient in wheat, and Kazakhstan periodically provide Mongolia with wheat priced to compete with or to undercut domestic wheat prices.

140. Horticulture production, which includes potatoes and vegetables, increasingly is carried out on small family-plots and small commercial greenhouses. Private investment in vegetable growing (excluding potatoes), where the Government does not intervene and capital requirements are relatively modest, has grown strongly. This area of crop production grew throughout the 1990s, reaching a peak of 5,600 ha and 45,000 tons in 2001. Production fell to 39,700 tons in 2002 but rebounded to 59,600 tons in 2003.

141. **Agro-processing.** Mongolia's small and medium-scale agro-processing industries are not competitive domestically, let alone in the position to export. Although Mongolia had a few large agro-processing industries, a combination of factors including outdated equipment and technology and lack of financial capacity caused their collapse. According to a 2002 survey conducted by NSO, 407 agricultural raw material and processing industries operate in Mongolia, primarily in urban areas. Approximately 30% produce meat, meat products, and casings; 27%, milk and milk products; 7%, skins and hides; 1%, animal and plant oils; 31%, flour and flour products; 2%, fruit and vegetables; and 2%, livestock feed and starches. Most industries use only 50% of their total operating capacity.

142. With the exception of Darkhan Meat Export Company, which is 50% owned by the State, all meat slaughter, packing, and processing facilities are owned by the private sector. Three major vertically integrated cashmere producers currently operate in Mongolia. One is financed privately, one is in the process of being privatized (Gobi JSC), and one remains state owned. Overall, the level of raw-material utilization and processing remains low and the finished-goods industry is based mainly on imported raw materials.

143. **Initiatives Required.** The future of Mongolian agriculture lies in the exploitation of its extensive grazing lands and in the selling of animal products into local industries and foreign markets, principally, although not exclusively, those of neighboring countries. Animal production must be complemented by niche arable production in areas where season length, product value, and product enable effective competition with imports. Arable production is likely to be concentrated in vegetables rather than in cereals although the latter likely are still viable in certain geographic zones.

144. ADB has provided considerable resources to agricultural policy reform, capacity building, and technical analysis (Appendixes 6 and 7). A number of fundamental reforms have been carried out under these programs—and with additional assistance provided by UNDP, USAID, European Union Technical Assistance for the Commonwealth of Independent States (EU

TACIS), and GTZ; but structural reforms seem not to have led to significant improvements in production or quality.

145. A viable model for crop production (wheat and potatoes) in Mongolia has not yet appeared, and no policy or other intervention may be able to overcome the formidable nexus of natural barriers to such production. With respect to wheat, future assistance should be conditioned on ongoing policy dialogue with the Government regarding the long-term viability of the subsector. Further technical and financial assistance is required for the livestock industry. One of the most important constraints facing it concerns veterinary care, which is necessary to ensure not only the survival of animals but also the quality of their skin, meat, and milk. Comprehensive programs should include continued strengthening of private veterinary services; improvement of private feedstock management; improved health monitoring and slaughter control; implementation of meat hygiene codes under the Codex Alimentarius; introduction of more compelling incentives for clean meat, skins, and hides; and improved management of pastureland. In relation to the foregoing, there remains broad scope for large-scale public-sector support. Strengthened supply-chain management links with processing industries and exporters also should be introduced, and Mongolian produce should be promoted actively in neighboring countries. (With respect to agro-processing, see initiatives proposed under the Manufacturing Sector, discussed below.)

C. Natural Resources

146. Mongolia has significant mineral resources, including gold, copper, coal, and oil. In 2003, the mining sector accounted for approximately 8.5% of GDP and for 34.58% (down from 57% in 2002) of foreign exchange earnings (of which gold production comprised 24%) and employed approximately 3% of the national labor force.

147. **Coal.** Mongolia has coal reserves estimated at 150 billion tons, of which 25% has been confirmed by geological survey. Over the last 5 to 7 years, production has been relatively constant at 5m–5.2m ton/annually.[96] The State continues to own majority interests in Baganuur JSC, Sharyn Gol JSC, and Shivee Ovoo JSC (75, 80, and 90% state owned, respectively); all other coal-mining companies are privately owned. Both Baganuur JSC and Shivee Ovoo JSC are benefiting from rehabilitation and development with World Bank and Japan International Cooperation Agency (JICA) assistance. Newly discovered coal deposits in the South Gobi are generating a great deal of interest from the PRC, where demand for coal is high.

148. **Gold and Copper.** Geological surveys carried out in the 1960s reveal substantial mineral resources, especially gold and copper. More recent and advanced searches during the 1990s by international mining groups including Ivanhoe Mines (Ivanhoe) and Cameco Mines (Cameco), Canadian exploration companies, confirmed more extensive and richer deposits.[97] These companies have invested extensively in further exploration.[98]

[96] 80–85% of production is used by thermal power stations.

[97] This year, drilling at the Ivanhoe concessions at Oyu Tolgoi, a mine in Omnogov *aimag* in southern Mongolia, indicates that deposits of copper and gold are 50% and 20% larger, respectively, than expected. This is good news for the Government, which will receive 2% royalties from Ivanhoe when the project is in full production.

[98] For example, Boroo Gold Mine received a $50m investment in resource verification and construction by Cameco, which owns a controlling interest in the mine. Ivanhoe announced major and rich deposits in the South Gobi and raised around $47m in equity and loan finance in 2002 to continue exploration and quantification of deposits. At a presentation in London in September 2002, the Deputy Chairman of Ivanhoe estimated that the initial concept of an open pit development at Oyu Tolgoi (Turquoise Hill) and an underground development at S.W. Oyu would require $450 million–$550 million and $230 million–$270 million in investment respectively although it is unclear to what extent these figures include the development of essential infrastructure.

149. Most domestic mining companies are owned by the private sector although the domestic share of two Mongolian-Russian JVs (Monrostsvetmet LLC and Erdenet) remain state-owned,[99] Berkh-Uul JSC remains 100% state owned; Mongol Bulgar Geo and Mongolia CzechMetall are JVs each 50% state owned; and Mongol Gazaar, Altandornod Mongolia, and Shijir Alt are each 20% state owned. As well as formal mining companies, a significant amount of informal gold mining takes place, which may involve as many as 100,000 persons or more.[100]

150. Mineral licenses are managed by the Mineral Resource Authority of Mongolia under the 1997 Minerals Law (Box 2), under which the number of licenses granted private operators expanded rapidly. For example, in the past 2 years, the number of prospecting licenses tripled to 3,000 while mining production licenses increased from a few dozen to 650.[101] This law requires mining license holders to pay royalties equal to 2.5% to central and local governments on the sale of minerals extracted; 7.5% is charged on gold.

151. **Oil.** Since the late 1990s, Mongolia has produced crude oil, the production of which had reached 71,000 barrels from the Tamsag Basin field by June 2002.[102] All this oil is exported in crude form because no domestic refining capacity exists.[103]

152. The Petroleum Law of 1991 allows for production sharing contracts (PSCs) with private operators. In the event that a find is exploited, the PSC determines the respective revenue shares of the state and the contractor and requires the latter to carry out exploration using its own finances. Through the use of PSCs, domestic oil production has been developed with little or no operational input from the Government. SOCO,[104] an American owned company, holds 85% of the interest in the Tamsag Basin, along with Hubei Oilfield Services, a company from the PRC that provides drilling services, and Petrovietnam, the Vietnamese national oil company. Tamsag Basin reserve estimates range from 300 million–1.5 billion barrels.

153. **Initiatives Required.** The IFIs have not been much involved in the mining sector, where substantial private sector investment has stimulated mineral and precious metal production. One exception is the mining sector study launched in April 2003 by the World Bank. Generally, Mongolian firms lack the financial resources to carry out large scale mining operations. The Government is aware that Mongolia must remain an attractive market for exploration and extraction by foreign mining firms. This is ensured by creating a taxation and licensing regime that offsets exploration costs, which are elavated by geographical isolation and harsh climate.

D. Tourism

154. Mongolia's enormous unfenced open spaces, stunning scenery, centuries-old nomadic culture that has survived relatively unchanged, and extensive opportunities for leisure and sport,

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99 Although Erdenet remains profitable and physical quantities of ore mined have increased modestly in recent years, resource quality has declined. It is unclear what the remaining economic life of the mine will be under present technological, market, or management conditions and what its life might be if sufficient investment is made available to upgrade facilities. EBRD is providing an external adviser to introduce better management to Erdenet and to assess the scope for technical improvements and investments.

100 Cameco reports individuals' accessing old workings on the site to mine small amounts of gold bearing rock. The physical danger is significant, but company safety warnings and local police patrolling have done little to halt incursions by these "ninja miners."

101 *International Herald Tribune*. 2003. Mining Booms in Mongolia. 4–5 October.

102 Mongolia's Mining and Oil Sector Profile. Prepared for IFC for *Mongolia Investors Forum 2002.*

103 Crude oil in Mongolia is not of commercial quality, and refinement is costly.

104 Soco found reserves of 500 million barrels of oil in Dornod (EIU. 2003. Country Report, November).

create opportunities for the development of tourism. Notwithstanding this huge potential, official foreign investment in the sector is estimated at only $10 million since 1990.

155. The size of the tourism industry is unknown, and estimates differ greatly. For example, the EIU estimated that nearly 78,800 tourists entered the country in the first 7 months of 2003. In contrast, the government-managed Mongolian Tourism Board (MTB) estimated the figure at around 130,000; the Mongolia Tourism Association, an NGO, placed the figure at 10,000–11,000; and the *2003 Statistical Yearbook* included a figure of 21,890. The discrepancies may depend in part on the definition of *tourist* and *tourism activity*. For example, the Mongolia Tourism Association considers a *tourist* a foreign visitor entering Mongolia for the "sole" purpose of tourism. It does not consider local residents tourists when they visit other areas of the country, nor does it consider a business visitor a tourist when spending the weekend in a countryside camp. Based on this narrow definition, the figure 10,000–11,000 may be accurate. Further attention to definitions and monitoring are needed.

156. Company registration data for 2001 (Table 3) indicate that 855 companies declared their principal business as tourism, hotels, and restaurants whereas 2,889 specified these activities as subsidiary or secondary activities. Of these latter, however, most probably are restaurant rather than tourism operators. Four-hundred-and-fifteen companies are licensed with MSE as tour operators, and a further one-hundred-and-eight are licensed as tourist camp operators. In 2002, income from the tourism sector was estimated at $130.1 million (9.8% of GDP), and employment comprised 1.0% of total employment.[105]

157. The tourism industry enjoys a number of benefits, introduced in the 2000 Tourism Law, including an exemption from charging VAT for hotels accommodating tourists booked through a tourist operator.

158. A number of factors, in addition to those identified in Chapter 2, impede development of this sector (Box 7). Based on harsh weather conditions, the tourism season in Mongolia is very short, and tourism companies are required to diversify or to develop new year-round tourism products. This sector has not been promoted effectively overseas, nor have adequate tour packages been developed. Many tourists discover Mongolia through personal references and make their own arrangements. Furthermore, Mongolia is a relatively expensive tourist destination: only those persons in the bordering areas of Russia[106] and of the PRC can realistically travel overland to Mongolia, and air travel is expensive. Within Mongolia, overland travel involves long and uncomfortable journeys, and internal air travel options are limited and raise safety concerns.

159. Moreover, no international hotel chains operate in Mongolia although more than 100 hotels (with a total of 5,000 beds) are registered in Ulaanbaatar, 81 hotels are registered at the *aimag* level, and an estimated 118 tourist camps, of which approximately one third provide traditional *gher*-type accommodations, exist in 16 *aimags*. All facilities are majority owned or fully owned by private interests.

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[105] MTB estimates.

[106] Mongolia and Russia have agreed to develop a tourist area encompassing Lake Baikal in eastern Siberia and Lake Khovsgol, 250 km away in northwestern Mongolia. The project completion date, originally planned for 2009, has been advanced to 2004–2005. Because they must now travel via Ulaanbaatar, it is quite difficult for foreign visitors who are neither Mongolian nor Russian to visit both lakes in one trip. The border station at Khankh Mond, a four-hour journey from Irkutsk, in Siberia, is to be granted international status and this will facilitate traffic between the lakes. The Mongolian government will invest MNT400 million ($355,000) in the project.

160. MTB, the government agency in charge of tourism development and regulation, has not been viewed as effective either in promoting Mongolia as an international tourist destination or in ensuring high standards of quality for the industry.

Box 7: Tourists' Perceptions of Mongolia

To better understand the type of tourists visiting Mongolia and their perceptions of it as a tourist destination, the Mongolian Tourism Association conducted, with the assistance of USAID, a survey in 2002 of 3,700 persons who had traveled to Mongolia by air. The survey found the following:

- More than half of all foreign tourists visit Mongolia on vacation while one third of all tourists are business travelers. Vacation tourists choose Mongolia over its competitors (primarily the PRC) because of the landscape, culture, history, religion, adventure opportunities, open spaces, nomadic lifestyle, and festivals. Many tourists visit Mongolia based on recommendations from friends and relatives and view Mongolia as an exotic and relatively new and unspoiled destination.

- More than half the vacation tourists were from Western Europe while one third of business travelers were from Japan or Korea. Most tourists were male (65%), and more than half were more than 40 years of age. Approximately 72% were first-time visitors; only 14% had traveled to Mongolia before. Sixty percent made independent travel arrangements to Mongolia, and only half used tour operators. Tourists stayed on average 12.74 nights, and spent approximately $1,137/person, or $87/day. Tourists traveling on package tours spent $2,133/person, or $181/day whereas independent travelers spent on average $832/person, or $60/day. Japanese tourists spent the most per day ($126), followed by American ($98) and Korean tourists ($69).

- The most pleasant memories of tourists relate to nature, landscape, people, and hospitality; the least pleasant memories, to infrastructure, sanitary facilities, service standards, and environmental issues.

Source: Mongolian Tourism Association & USAID Competitiveness Initiative, International Tourism Survey 2002 Report of Results.

161. **Initiatives Required.** Tourism development provides a way (i) to promote and to manage Mongolia's significant ecological, environmental, and cultural assets; (ii) to raise the demand for goods and services through increased tourist arrivals and higher spending; and (iii) to decrease poverty by generating employment in tourism and related services. Unlikely ever to be a mass market, except possibly for neighboring countries, adventure and ecological tourism nevertheless offers real opportunities. To develop the industry, the Government and the private sector need to collaborate on a comprehensive strategy incorporating the following activities: (i) upgrading tourism infrastructure and facilities to create higher-quality accommodations and more cost-effective transport services (an area that ADB has been significantly involved with through its work in the aviation sector and its financing of major roads); (ii) expanding and upgrading variety and type of tourism products; (iii) developing and implementing higher product and service standards; and (iv) promoting overseas the opportunities for tourists in Mongolia.

162. MTB has been ineffectual in promoting this industry and in addressing tourist concerns; and the private sector, which is fragmented in this area, lacks adequate funding and expertise. To pool limited resources effectively, a collaborative relationship between government and industry should be developed. The public-private interface may be served better by an autonomous Tourism Board that is comprised of government and private sector representatives and is responsible for coordinating sector development, including project planning, funding, and implementation. Such a board certainly would benefit from a twinning arrangement in a similar organization in a non-competitive tourist destination. A Tourism Promotion Fund, along with adequate sector regulation, also could be developed in line with international best practice standards.

E. Manufacturing

163. The manufacturing sector is largely privately owned. Gobi Cashmere JSC, which is in the process of being privatized (Table 7), dominates in terms of size, with a turnover of MNT12.3 billion ($11 million).

164. Analysis of this sector has been assisted by the preparation of a November 2002 United Nations Industrial Development Organization (UNIDO)/United Nations Development Programme (UNDP) study.[107] From 1989–2002, the manufacturing sector index declined significantly, from 100 in 1989 to 35 in 1994, and to 27 in 1999, but increased to 36 in 2001 and to 46 in 2002. The latter increase occurred when the MNT was appreciating against many currencies and thus may have been linked to the concentration of share ownership and direction, the increase in credit availability, and the effect of three SME-oriented development projects.[108] Increased activity also led to a change in the composition of manufacturing production. Food and beverage production increased from 33%–46%, and textile production from 18%–30% of manufacturing value added from 1990–2001 while the leather and footwear industries declined from 12% to almost 0%.

165. In parallel, employment in manufacturing declined from 27%–7% of all employment despite the growth of small businesses and microenterprises in the 1990s. The garment industry accounted for 35% of manufacturing employment in 2001 (this industry is expected to collapse after the December 2004 expiry of the WTO quota agreement unless a special status can be negotiated with major markets). Food and beverages, and textiles were ranked second and third in terms of employment. Together the three industries providing the greatest employment accounted for 78% of all manufacturing jobs.

166. The UNIDO study calculates a declining trend in labor productivity from 1993–1999, with an average value added of $1,669 against a wage rate of $549 annually. Interestingly, the study calculates that wage rates in the Mongolian manufacturing sector were just half those in the PRC and Indonesia in 1999, but the data may not include social security contributions, which are believed to be higher in Mongolia (19%) than in the other two countries.[109]

167. **Initiatives Required.** The manufacturing sector has suffered from difficulties at the public-private interface and especially from difficulties with taxation, import and export, and business inspections. Moreover, within the manufacturing sector, management, marketing, and

[107] UNDP/UNIDO. 2002. *Mongolia: Industrial and Trade Development Policy Review*, November.
[108] The Dutch-funded Enterprise Restructuring Project, the EBRD Turn Around Management Project, and the GTZ SME Promotion Project.
[109] As of 1999. See World Development Indicators 2003.

technological changes are required urgently. Progress has been achieved when consolidation of ownership in entrepreneurial hands has led to improvements in management, finance, marketing, design, and technology. Although managing to stay in business, many manufacturing companies make scant progress towards international competitiveness.

168. A number of initiatives are required to ensure that entrepreneurs have increased access to equity capital. Measures are needed to improve the stock market's performance and to promote venture capital. Development of other financial services (innovative loan products, investment banking, leasing, and insurance) also would benefit this sector significantly, which in turn would affect the broader economy positively.

169. Some local consulting companies are beginning to emerge, but these are concerned primarily with providing financial advice. The Chamber of Commerce structure has a limited membership and is able to provide limited assistance with respect to exposure to international manufacturing trends and norms. Exposing developing SMEs to international fairs and matchmaking events, encouraging investment in new technology, and stimulating practical research and development might benefit certain businesses and industries.

170. Of more general benefit, however, would be stimulation of the investment environment through decreasing effective tax rates, improving import and export procedures, and lightening the inspection burden in a real sense.

F. Infrastructure

1. General

171. Private sector financing for infrastructure decreases the fiscal burden on the Government, lowers the cost of providing infrastructure services by introducing competition and providing market-based incentives to encourage efficiency improvements, and helps allocate and mitigate investment risks between public and private sectors. The private sector brings capital, managerial experience, and technological innovation, thereby facilitating infrastructure and capital market development.

172. In the past two decades, significant funding has been channelled by the Government into infrastructure. In very limited areas, the Government is supporting private investment in this sector although inadequate pricing reforms may render private investment in certain subsectors, e.g., power, unattractive. Moreover, the Government has adopted no overall legal and regulatory framework for private participation in infrastructure.

2. Transport

173. Because Mongolia occupies a remote geographical position and is sparsely populated, the state-maintained road network is limited, rail infrastructure serves only areas of significant economic production and external trade routes, and air transport depends on internal and external commerce.

174. **Roads.** Of a nominal network of 49,250 km of roads, only 5,517 km has been engineered.[110] Although many roads are impassable in bad weather, this network provides the

[110] 1,711 km is paved, 1,877 km is gravel, and 1,924 km is improved earth roads. See Mongolia's Investor's Forum 2002: Infrastructure Sector.

only surface transport link to 16 of the 21 *aimags*. Ground transport from provincial centers to the capital can take up to one week and in winter is, for most purposes, impossible. Although 95.5% of passenger journeys were carried out by road in 2001, road transport provided only 18.8% of passenger km traveled and 2.4% of all freight moved as measured in kilometer tons.[111]

175. Since 1991, road improvements to link Mongolia to its two largest neighbors have been financed by a number of IFIs, including ADB.[112] The road north from Ulaanbaatar, through Darkhan to Altanbulag on the Russian border, and its spur to Erdenet, passes through the economic heartland of Mongolia, where an estimated 60% of GDP is generated. Upgrading and reconstructing this road led, over the period 1997–2000, to a 67% increase in traffic between Ulaanbaatar and Darkhan and to a 17% increase between Darkhan and Altanbulag.[113] Resulting in improved access and decreased journey times, such improvements have led to a higher rate of business development in the Darkhan–Uul *aimag*.[114]

176. The road from east of Ulaanbaatar running southeast to the PRC border is being improved with ADB loans.[115] The Government and ADB are discussing upgrading a second Russia–PRC road link through western Mongolia, part of a network expected to link Novosibirsk in Russia to Urumchi in northwestern PRC and to pass through some of the most disadvantaged areas of Mongolia. The Government of Mongolia is preparing a third road project from Choir to Zamyn Uud.

177. The Road Authority of Mongolia, under the Department of Roads and Transport at MOI, manages the road network. Reform of this department in the mid-1990s, carried out under the ADB's First Roads Project, achieved the separation of government functions (policy formulation, planning, regulation, and licensing) from road building, maintenance, and transport operations, which were transferred to a number of newly-formed JSCs into which private capital was in many instances injected. Ten such JSCs remain in the SPC portfolio, of which at least five have minority private sector participation.[116]

178. Financing of road maintenance is done through the Road Fund, which receives revenue from the levy of a fixed sum per liter of gasoline and diesel imported. But increased import volume has failed to compensate for the declining real value of the levy, which has been fixed for a number of years and is inadequate to fund road maintenance. For example, Road Fund expenditure in 2001 amounted to MNT4,746 million ($4.27 million) compared with total taxes on petrol and diesel imports of MNT16,626 million ($15.1 million). Road maintenance support thus has become increasingly dependent on growing central budget support. Even with this support, however, maintenance continues at inadequate levels. The Department of Roads and Transport focuses on contracting maintenance for roads reconstructed using donor finance and for which maintenance covenants exist; as a result, many other roads are under-maintained.[117]

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[111] In 2002, road transport provided 18% and 2% of passenger km traveled and freight turnover, respectively. National Statistics Office.

[112] ADB. 1995. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Roads Development Project*. Manila.

[113] Data from surveys carried out by the Roads Department of MOI, quoted in the ADB Mongolia CAPE, 2002.

[114] The rate of increase of limited liability company formation in Darkhan–Uul in 2001 was 30.6%, compared with 13.2% for the country as a whole.

[115] ADB. 1999. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Second Roads Development*. Manila.

[116] Seven of the 10 reported profits in 2001. The Government intends to sell packages of state-owned shares of these companies through MSE before the end of 2004.

[117] Moreover, currently only a fraction of the Road Fund is used for road maintenance. Much of the fund is used for financing new road development under ADB and World Bank projects.

179. Road transport is managed largely by the private sector. All urban taxi services and urban and inter-urban bus services are private. Most freight is hauled by private sector operators although the four state-owned trading companies have their own transport fleets.

a. Rail

180. The only rail operator in Mongolia, MNR, is a 50/50 JV of the Mongolian and Russian Governments. MNR manages the spurs to Erdenet and links Sukhbaatar on the Russian border with Zamiin Uud on the PRC border, passing through Darkhan and Ulaanbaatar and through the eastern city of Choibalsan to the Russian trans-Siberian line at Borzya. MNR transports most imports and exports and transit cargo, as well as a large portion of domestic and international passengers,[118] and dominates freight turnover, accounting for 97.4% as measured in kilometer tons.[119] MNR turned over MNT95.1 billion (approximately $86.5 million) in 2001 and made a profit of MNT1.5 billion ($1.37 million).

181. There are no plans to privatize MNR. The possibility of leasing rolling stock to train operating companies is being left open, and the Mongolian Railway Administration, the government agency responsible for managing the railway system, plans to allow other train operating companies to provide services using their own rolling stock.

182. Development of this subsector is constrained by the state monopoly and by the (i) limited or irregular access to services by most Mongolian companies,[120] (ii) use of a single railway track; (iii) use of the wide Soviet rail gauge of 1520 mm, which causes significant border delays when the wheels on passenger and freight cars are changed to accommodate the standard narrow gauge of 1435mm used by the PRC; and (iv) lack of spare parts due to obsolete equipment.

b. Civil Aviation

183. Two ADB-financed projects during the mid to late 1990s have facilitated division of air traffic regulation and infrastructure provision from airline operations, spinning off the 100% state-owned airline company MIAT[121] and establishing the Civil Aviation Authority (CAA) under MOI. MIAT is the only Mongolian international airline linking Mongolia to Korea, Japan, Russia, the PRC, and Germany on a year-round basis. MIAT's market share in international flights has

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[118] The system handles just 4.2% of passenger journeys but 53.9% of passenger turnover measured in passenger km. *American Business Guide to Mongolia*, 2003. Third Edition.

[119] Of total rail freight turnover, local freight transport has risen only moderately since 1995 while international trade, driven by a 16-fold explosion in transit traffic between Russia and the PRC between 1995 and 2001, has expanded rapidly and now comprises 68.8% of total turnover. The expansion of international freight has led to significant opportunities for local private-owned freight forwarders such as Tuushin Freight Forwarders and for international companies such as Maersk Sealand, which has a representative office in Ulaanbaatar but is not registered locally.

[120] Given the domination of railway transit traffic between Russia and the PRC, schedules are arranged primarily to suit large traders and freight forwarders. Mongolian companies on the route, with the exception of Erdenet, complain that they have irregular or no access to services.

[121] ADB. 1993. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for the Ulaanbaatar Airport.* Manila; and ADB. 1993. *Technical Assistance to Mongolia for Institutional Strengthening of the Civil Aviation Sector and National Air Safety Master Plan*. Manila. ADB. 1995. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for the National Air Navigation Development Project*. Manila; ADB. 1995. *Technical Assistance to Mongolia for Phase II Institutional Strengthening of the Civil Aviation Sector*. Manila.

shrunk, however, as a result of the increased competition provided by international airlines such as Aeroflot, Korean Airlines, Japan Airlines, and Air China. Passenger air transport is highly seasonal and some airlines (e.g., Japan Airlines) operate only during peak summer season.

184. MIAT also runs a network of national routes linking Ulaanbaatar with 21 *aimag* centers, only four of which have paved runways with basic lighting systems. MIAT's domestic airplane fleet averages nearly 30 years' service (the mandatory retirement age imposed by CAA) and are not fuel-efficient. MIAT lacks funds to replace its domestic fleet, and the cost—and cash flow—strain is aggravated by the CAA requirement that MIAT serve low-volume routes even at a loss. Restrictions on domestic tariffs mean that the value of ticket prices on these routes have fallen by 40% since 1994.[122]

185. In 2001, MIAT reported revenues of MNT45 billion ($40.9 million), reflecting an increase of 15.7% in international passenger numbers since 2000 and of 72.4% since 1995, and declared a profit of MNT1.0 billion (approximately $0.91 million). In 2002, MIAT reported revenues of MNT52.9 billion ($447 million) and declared a pretax profit of MNT1.01 billion ($898 million), figures based largely on international airline revenues.[123] Lower-than-expected tourist arrivals in 2003, a result of the SARS outbreak,[124] have affected MIAT's bottomline adversely.

186. In 2003, a new domestic airline, Aero Mongolia, a private, foreign-Mongolian JV, commenced operations with two Fokker aircrafts. Aero Mongolia received permission to increase tariffs by 15% this year, and subsequent increases are promised annually. By operating flights among the five busiest domestic airports, Aero Mongolia is competing directly with MIAT, which has not been permitted to increase its tariff.

187. In addition to regulating airlines (entry, safety), CAA provides airport and support services (ground handling, maintaining aircraft, catering, fuel supply,[125] airport management, and air traffic control) and has benefited greatly from improvements to the national Buyant Ukha airport and associated air traffic control systems financed by ADB between 1994 and 2000.[126] As a result of improved air traffic control systems, which now meet international standards, revenues from overflying rights have increased dramatically. Further substantial investment is required if regional airports are to be improved, the fleet upgraded, and booking systems brought up to international standards. It is unlikely that such investment can be mobilized from state operators and the central budget. This is especially the case insofar as international agreements on overflying rights are due to be renegotiated shortly, possibly leading to a drop in CAA revenue. In 2001, CAA had lower operational revenues than the prior year (MNT23.8 billion, or approximately $21.6 million) and declared profits of MNT3.9 billion (approximately $3.5 million).

188. ADB is providing TA to CAA in developing a forward-looking aviation policy, including a regulatory framework and new private sector management and finance. ADB is working closely

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[122] Mongolian travellers obtain a 79% discount on published domestic tariffs whereas foreign travellers pay the full-published fare.

[123] In 2002, domestic airline services lost approximately MNT2.8 billion. See Phase I report of ADB. 2002. *Technical Assistance to Mongolia for Civil Aviation Policy Development*. Manila.

[124] In the first seven months of 2003, the number of foreign visitors fell by 21% year on year, to 78,800, and tourist income declined by 26%, to $16 million (EIU Country Report. 2003, November).

[125] Fuel supply has been partly privatized. Privately owned A Jet JSC handles certain activities in this area. See Phase II report of ADB. 2002. *Technical Assistance to Mongolia for Civil Aviation Policy Development*. Manila, 25 August 2003.

[126] See Phase I report of ADB. 2002. *Technical Assistance to Mongolia for Civil Aviation Policy Development*. Manila, Nathan Associates, 30 May 2003.

with EBRD, which recently prepared a roadmap for the sector and began financing a foreign management team for MIAT[127] for 1 year, to advance the possibility of sale.

c. Initiatives Required

189. Generally speaking, reform within the transport sector has been significant. A number of key roads have been upgraded, public road transport services have been privatized, and the private sector is involved in road construction and maintenance. The extent of this reform, however, is limited by the Government's reluctance to finance the Road Fund to a level sufficient to maintain the existing road network fully. Rail transport has grown impressively while technical and managerial improvements made within the civil aviation subsector have permitted rapid revenue growth. Major challenges remain, however.

190. State reluctance to challenge the rail monopoly has, arguably, limited both service innovation within the railways and user choice. If the rail network is to expand, then the private sector will need to be involved in both its finance and operation. Within the civil aviation subsector, the possible abolition of overflying fees will require strategic planning on the part of the Government. Assistance in this area will help safeguard the technical and financial advances already made. Orderly development of the aviation sector depends on the future of the loss making domestic market, an issue that will need to be resolved before MIAT is privatized. Additional attention to institutional reform and to regional infrastructure would be economically beneficial given that surface transport in Mongolia will never be able to provide comprehensive geographical coverage.

3. Power

191. The private sector has not played a major role in power generation.[128] During the last decade, the Government has concentrated on rehabilitating aging infrastructure, extending the working lives of power plants, and extracting short-term supplies. MOI remains focused on new power generation through hydropower projects, but the sustainability of these plans is doubtful.

192. Mongolia has a central power system consisting of five coal-fired cogeneration power plants, which serve a majority of electricity needs. Smaller electricity and heating systems, including the Western system, are connected to Russia's Siberian grid and to the Eastern system and serve remote *aimags* and towns. Diesel generators provide power in urban centers. One third of the population receives no electricity and must rely on renewable energy equipment (e.g., solar and wind generators).

193. Significant foreign-donor (approximately $409 million)[129] and Government funding has been committed to this sector—most to the coal-fired generation plants in Ulaanbaatar. This assistance has resulted in significant improvements in technical performance over the last

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[127] The team has not been allowed to increase domestic tariffs. In order to run their profitable ground handling service, CAA wants to take back equipment, purchased with ADB funds, that they are leasing.

[128] The only exception remains the import and sale of private solar power units used by certain nomadic herders.

[129] EBRD is financing a long-term privatization advisor. Darkhan Selenge network was privatized in November. The next major target for privatization, Ulaanbaatar Distribution Company, is obtaining assistance for financial management under a World Bank credit.

decade.[130] Supply losses due to shutdowns were decreased to around 5% of levels seen in 1992, and power imports from Russia were decreased from 381 giga-watt hours in 1995 to 196 giga-watt hours in 2001. The system remains quite inefficient, however. Losses have increased and most generating, transmission, and delivery companies do not break even. Current tariffs, combined with such inefficiencies, do not cover cost. Only small firms can make a profit under current circumstances.

194. A new Energy Law was adopted in 2001 to enable reform of this sector through the processes of unbundling, commercializing, and privatizing. The process, supported principally by World Bank and USAID, resulted in 2001 in the break-up of the energy complex, previously under the sole control of the Energy Authority, into a regulatory body (the Energy Regulatory Authority) and 18 independent entities that have been corporatized.[131] The Energy Regulatory Authority is responsible for supervising commercialization and privatization of the industry and for collecting the debt accrued to date, including systemwide financial issues such as tariffs and return on capital employed.

195. Initiatives Required. A comprehensive government strategy supported by a number of IFIs and bilateral donors is in place to develop this sector, which may lead to the possible involvement of private capital and management within the next few years. Whether private capital will be attracted remains to be seen, but currently new donor initiatives, like activities already planned, are not required to attract private sector involvement or to service private sector users more effectively.

4. Water

196. Public water-intake and treatment facilities in Mongolia have a capacity of greater than 550,000 cubic meters/day and serve 81% of the urban population, but only 3% of *soum* populations. More than 100 piped-water systems drawing on deep well supplies serve the latter; water tankers often serve peri-urban consumers.

197. Most cities and towns are served by sewage systems with a treatment capacity of 400,000 cu.m. Most urban areas have solid-waste collection and disposal systems although funding shortages often prevent full compliance with environmental standards. At the end of 2000, only 37% of the urban population had access to waste disposal services.

198. The private sector has no role in the provision of water and sanitation services. Construction, urban development, and public utility agencies, which report to the provincial government and are responsible for tariff setting, delivery, and system management, are facing considerable technical and financial difficulties in providing services. The ADB-financed Second Urban Services project, now working with eight towns in the eastern part of Mongolia to upgrade

[130] In 1991, this sector not only suffered from lack of generation investment, but was also impeded by systematic inabilities to measure output, transmission, and distribution volumes, as a result of the absence of meters at substations and end-users. Users could not be charged according to use, but only according to their size or type. Although the situation is now much more equitably managed, metering is far from universal.

[131] The 18 companies include 8 generating companies, 4 electricity distribution companies, 2 heat distribution companies, the central electricity transmission network, the national dispatch center, the eastern electricity center (a stand-alone power system), and the western electricity transmission network (also a stand-alone center). See USAID. *USAID 2003–2010 Report: Contributions to Mongolia's Sustainable Energy Strategy.*

municipal services, envisages the development of a strategy for private sector involvement in such services during 2004.[132]

5. Communications

199. **Telecommunications.** Structural reform in the telecommunications sector, which began in 1994, separated telecommunication operations from postal services and from regulation now overseen by the Communications Regulatory Commission under the Telecommunications Law.[133] These reforms led to significant improvements in telecommunications infrastructure.[134] The Government sold 40% of Mongol Telecom (MT) to Korea Telecom in 1995, but continued to own and to manage network and housing facilities, which it leased to other telecom providers.

200. Several JVs with private foreign mobile phone operators began to enter the market in 1995. Mobicom, a JV between private Japanese and Mongolian investors, was the first and continues to hold the largest market share, followed by the entry of Skytel, a JV between Mongolian and Korean investors, and most recently by MT in January 2003. At the end of 2002, there were 256,000 cellular phone users, compared with 48,200 in 1999. Entry of private telecom operators resulted in the significant lowering of international tariffs. For example, international tariffs were in the range of $1.40–$1.80/min in 2001 compared with $2.20–$6.00/min in 1996.

201. The Government is restructuring MT with a view toward preparing it for full privatization in the near term, but debate continues regarding the extent to which government-owned infrastructure should be privatized.

202. **Information and Communications Technology.** Rapid improvements in telecommunications infrastructure and pricing led to an equally rapid expansion in the information and communications technology (ICT) industry. In 1996, the first Internet link was established. Currently, 11 companies are licensed as Internet service providers. MagicNet seems to dominate the industry. Private Internet cafes and noncommercial Internet centers, financed by UNDP and the Open Society Foundation, offer inexpensive access to the general public and to small businesses in the capital and Darkhan; outside these cities access is more limited.

203. Approximately 60 private companies and 60 developers are involved in software development.[135] Annual revenue for the industry is estimated at $3 million. The industry is highly fragmented, however; its workers have limited specialization, management, and marketing skills; and most of its large projects are outsourced to Russia or to India.

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[132] ADB. 2001. *Technical Assistance to Mongolia for Preparing the Integrated Development of Basic Urban Services in Secondary Towns*. Manila.

[133] ADB assisted in restructuring this sector. ADB. 1992. *Technical Assistance to Mongolia for Telecommunications Development Plan*. Manila; ADB. 1994. *Technical Assistance to Mongolia for Sector Reform*. Manila; ADB. 1994. *Technical Assistance to Mongolia for Accounting and Management Systems and Tariff Reform.* Manila; and ADB. 1994. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Telecommunications*. Manila.

[134] In the late 1990s, new exchange lines, external lines, and digital links were installed that resulted in enormous growth in the volume of traffic that could be handled by MT and the speed at which it could be handled. The number of landline calls made in the five *aimags* covered by the first phase of modernization grew by a factor of 4.1 over the 1997–2001 period at the same time as time-based tariffs for local calls were introduced. A second phase of development in the last 2–3 years has seen the benefits of modernization extended to a number of *aimag* centers.

[135] Information drawn from a Profile of the ICT sector in Mongolia. IFC. 2002, August.

204. Through establishment of a National ICT Committee headed by the prime minister, and through publication of ICT Vision 2010, an initiative to improve and expand ICT in Mongolia, which was endorsed by Parliament in 2000, the Government has underlined the importance of ICT. Although the private sector is driving the industry, the Government plans to upgrade ICT capacity within schools and CGA.[136] These initiatives are supported by and executed in part through the Mongolian Development Gateway, which aims to promote technology to facilitate governance and management in public and private sectors. Infodev and World Bank are cofinancing the gateway. World Bank also is providing assistance in the drafting of the new E-Commerce Law.

205. **Initiatives Required.** Progress made in the telecommunications sector, supported by the ADB in the mid-1990s, has been impressive. Technical improvements and liberalization encouraged foreign capital, tariffs dropped, and usage soared. Subsequent improvements in the regions spread modern telecommunications more widely. But the Government's reluctance to privatize core assets, and weak and unpredictable regulation (e.g., tariffs), constrain further development. Consideration of alternative strategies is required if the private sector is to keep pace with international developments in this area.

206. Information technology has yet to have a noteworthy effect on the efficiency of public services. Improved systems within GDNT and CGA could aid in effectiveness and efficiency of revenue collection while improving transparency and allowing more sophisticated analyses of the revenue base. Within the private sector, further technical and personnel development will enable the industry to capture an increasing share of the local market for software development, but it is unlikely that Mongolia will be able to compete for the IT outsourcing business of international companies.

G. Finance

207. In 2002, the financial sector was relatively small in terms of its contribution to GDP (3.2%) and total employment (1.1%). In recent years, the informal financial sector has expanded rapidly while the commercial banking sector has undergone significant restructuring.[137] Capital markets, insurance, and leasing remain underdeveloped.

1. Commercial Banks

208. **Banking.** Accounting for 81% of total financial assets of $439 million in 2002, and reaching 40% of GDP (an increase of 48% from 2001 figures [MNT332.7 billion, or $302.4 million]), commercial banks dominate the financial system.[138] At the end of 2002, 16 commercial banks operated in Mongolia. The top five banks, all privately owned, included TDB (which is foreign owned), Golomt, Anod Bank, Agricultural Bank (Ag Bank, also foreign owned), and Zoos Bank. TDB had the largest asset base (33% total in March 2002) and loan portfolio,

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[136] ICT in schools will be assisted under the ADB-financed loan. ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Second Education Development Project.* Manila.

[137] For a more extensive discussion of this sector, see ADB. 2000. *Technical Assistance to Mongolia for Strengthening Financial Sector Development.* Manila, and the annex to the 2002 ADB Country Assistance Programme Evaluation (CAPE), which deals with financial system development.

[138] Reforms during the early 1990s, supported extensively by IFIs, saw the original state bank broken up into five commercial banks, only one of which, Trade and Development Bank, remains. Starting in 1996, the insolvency and failure of the state-owned banks dramatically reduced public confidence in the banking sector. That confidence (as measured by growing deposit levels) has been restored and strengthened considerably.

the majority of which was denominated in foreign currency. ADB's board has been presented with a proposal for ADB to acquire a $10 million ownership stake in TDB. The state-owned Savings Bank has the largest amount of retail deposits although its asset base, equal to 14% of total commercial bank assets, is composed largely of nontradable government bonds.[139] Ag Bank has the largest number of branch networks (371) and extends into rural areas; it also has the largest portfolio of individual borrowers.

209. **Background.** Reforms during the 1990s, supported extensively by IFIs, witnessed the subdivision of the original state bank into five commercial banks, only one of which, TDB, remains (Appendix 5). Liquidation of insolvent state banks in the 1990s, and the physical shortage of bank notes that limited withdrawals, diminished public confidence in the banking sector. Liquidation left a number of large borrowers with capital that has been difficult to reclaim.[140] It is only in the last 2–3 years that confidence has been restored.

210. **Regulation.** Banks in Mongolia are regulated primarily under the Banking Law of Mongolia and by BOM. BOM has received significant assistance from ADB, World Bank, and other donors to upgrade, inter alia, legal and regulatory frameworks, and onsite examination and offsite surveillance tools and techniques. Much of this donor assistance was provided in the context of bank restructuring/liquidation. BOM has been able to maintain a core staff of qualified individuals, many of whom have studied finance and economics in Western countries and received advanced degrees. As of April 2003, the Supervision Department of BOM employed 40 staff overseeing 16 commercial banks and 66 NBFIs.

211. **Lending.** In 2002, loans to the private sector grew by 78%, from MNT114.7 billion ($104.3 million) in 2001 to MNT203.6 billion ($180.9 million), and represented 88% of total outstanding loans (MNT231 billion, or $205.7 million)[141] (Appendix 8). As of March 2002, 97% of all outstanding loans were given by privately owned banks, and 84% of loans went to the private sector. More than 70% of commercial bank lending was made to finance working capital activities, typically short-term inventory financing followed by raw-material processing (e.g., animal skins) and mining (Appendix 9).

212. Because borrower financial statements regarding cash flow are often unreliable, lending decisions generally are based on personal references, physical evidence, and the availability of collateral, which is generally more than 1.5 times the loan amount. The BOM requires banks to register basic borrower information with all loans with its Credit Information Bureau.[142] The most recent reliable year-end rate for nonperforming loans is quite low, but the rapid expansion of lending (60% annual growth rate in banking assets since 2000) may have been accompanied by more lax credit underwriting standards.[143] Commercial banks clearly have improved the level of service to consumers and to the private sector dramatically; in turn, confidence in banks as depository institutions has grown. Improved confidence in the sector is due to the strong leadership of BOM, the dramatic turnaround of Ag Bank, the emergence of Xac Bank, and the

[139] Annex to the 2002 CAPE on Financial System Development.

[140] Approximately MNT48 billion ($43.6 million) of assets were transferred to the Mongolian Asset Restructuring Agency, an SOE, from five insolvent banks. As of September 2002, only MNT7 billion ($6.4 million) had been realized although court judgments had been obtained for repayment of a further MNT19.7 million ($17,900).

[141] In 2002, a total of MNT469.9 billion of loans were granted.

[142] With World Bank assistance, BOM credit information bureau's software system is being upgraded.

[143] In 2002, the rate of nonperforming loans stood at 7.2%, down 0.8% from 2001. This rate may have risen above 10% at the end of 2003, according to a very concerned CEO of one of the country's largest banks, who reported this possibility to ADB staff. Fears of deteriorating credit quality were shared widely by other bankers with whom ADB staff held detailed conversations in early 2004.

continued solid performance of TDB and Golomt Bank. Improved public perception of commercial banks is a signal achievement, but the recent rapid credit expansion, fueled by a rise in deposits, is cause for alarm. Noteworthy consolidation and strengthening of the banking sector over the past 5 years could be undone if bank loan portfolios are not being soundly managed. BOM is duly alarmed and has taken measures to slow lending growth; it will impose higher minimum capital requirements ($6 million) on banks before the close of 2004.

2. Capital Market

213. The stock market in Mongolia does not play a meaningful role in the economy. The MSE, founded in 1991 as a government agency reporting to Parliament, has facilitated reallocation of property rights but has never provided a venue to raise capital.[144] Based on its limited role, MSE has operated at a loss for several years and requires support of the state budget to maintain solvency.[145]

214. Although approximately 1.3 million persons (86% of the population) became shareholders as a result of privatization, some years passed before share ownership became consolidated. Consolidation of ownership has, in some cases, led to an increase in shareholder pressure on management, changes in management, and an upturn in company performance. Currently 2,400 shareholders own 83% of the shares of MSE-listed companies, and companies owned by three to eight large shareholders constitute a majority of MSE-listed companies. The concentration of share ownership has not led to improved transparency of better corporate governance.

215. At the end of 2002, 403 companies that had been privatized through the mass voucher privatization scheme were listed on MSE, of which 61 remained state owned.[146] Many are not operating, most remain unprofitable,[147] and fewer than 20 pay dividends or are traded regularly. No newly formed private companies have been listed on MSE.

216. Since 1995, there have been approximately 34 issues of equity by listed companies, raising some MNT4 billion ($3.6 million), and 50 commercial bond issues, raising almost MNT30 billion ($26.7 million). In 2002, there were three issues of corporate bonds valued at $1.9 million, all issued to finance apartment construction. Although sales were carried out through MSE, they were preplaced and not offered to the public at large. Trading in listed shares has declined steadily from its peak value in 1997 (MNT12.2 billion) and from its peak volume in 2000 (35.4 million shares). Currently, liquidity in the market is low to nonexistent. Between 2001 and 2002, trading volume declined nearly 40%, to just 9.2 million shares valued at MNT1.4 billion. In 2002, trade in the top 30 stocks accounted for 97.1% of all trades.

217. Since BOM stopped issuing debt directly to banks in November 2000, short-term government securities have been auctioned on MSE through securities company members and

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144 Secondary trading did not begin until 1995.

145 The ADB-financed Financial Sector Improvement Project report discusses options for improving MSE's structure and management.

146 Listed companies are categorized by MSE according to performance: Class A shares are required to generate greater than a 5% return on assets, to have a minimum market capitalization of MNT30 million, to have no fewer than 200 shareholders, and to have been in business for at least five years. The A category shares comprise Spirt Bal Buram, MT, Ulaanbaatar Hotel, and Bayangol Hotel; the B category shares comprise APU, Atar Urguu, Darkhan MakhExpo, and Tahi Company.

147 Approximately 60 listed companies are insolvent but have not yet been delisted. Interview with MSEC and MSE Chairmen.

have been placed primarily with commercial banks. These auctions have succeeded in increasing competition on the primary market and now dominate MSE business, representing 91.3% of all business by value (MNT86.26 billion, or $76.6 million) in 2002, a 76% increase in value from 2001 levels.[148]

218. At the end of 2002, MSE trades had been executed through 34 registered securities companies, down from 42 in 2001. Based on new net capital requirements under the recently amended Securities Law (increased from MNT10 million to 50 million), only eight brokers, all of which are private, are currently registered with MSEC and qualify for MSE membership. There is one investment fund member of MSE, down from sixteen in 2001.[149]

219. MSE is regulated by MSEC, which does not have the capacity to carry out fully its functions stipulated under the Law on Securities Markets, which was enacted in December 2002. Currently MSEC has 20 staff, including 4 lawyers and 13 accountants. It is viewed as an ineffective market regulator partly as a result of the lack of transparency in company reporting. This lack of transparency is the result of poorly developed accounting, auditing, and corporate governance standards, combined with a corporate culture that would avoid the responsibilities of regulation and taxation. The current tax structure, with higher taxes levied on larger companies, may encourage firms to split their businesses into smaller units. This practice undermines transparency insofar as smaller firms actually are operating as a coordinated unit.[150]

220. As companies grow and new opportunities arise, enterprises require risk capital in the form of equity financing. Given the state of MSE, large companies may look at issuing capital on foreign stock markets (at best, an unlikely avenue) or employ a tactic that has gained wide currency, namely, finding a foreign investment partner. There may be ways to expand the role of MSE, but the lack of strong corporate governance, accounting, and auditing standards represent substantial impediments to the development of a public stock exchange. Upgrading of skills within the accounting and auditing professions, leading to increased transparency, and widespread adoption of good governance practices, are necessary preconditions for MSE to develop as a venue for raising equity capital. It would be worthwhile to develop alternative mechanisms, e.g., investment or pension funds, for channeling risk capital to deserving companies. Furthermore, in such a small market and in the absence of other investment vehicles, universal banking may be a more appropriate model than a stock exchange for developing equity finance. Mongolia's commercial banks are demonstrating increasing mastery of basic front and back office functions and these same banks might be able to develop, slowly and carefully, corporate finance and equity-related businesses. Well-run commercial banks have advantages in terms of market and client information, can build on evolving risk management systems, and may be able to deepen staff capacities in finance.

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148 The short maturity of the bonds means that there has been no secondary trading and no government debt yield curve, important for guiding commercial lending beyond the very short term.

149 Investment funds were established in each *aimag* at the time of mass privatization in order to allow voucher holders to invest in a broad selection of shares, rather than to invest in individual companies. Currently there is little or no demand for broad-based investment funds.

150 Though this feature of the tax code and its ill effects are often commented upon, there are no figures available to show either how many firms have split to avoid taxation or the extent of the negative impact on tax collections. Certain government observers believe that the tax code is an excuse used to justify simple tax evasion.

3. Insurance and Pension

221. The insurance industry in Mongolia remains underdeveloped despite the existence of 18 licensed insurance companies.[151] Annual premium income for 2002 amounted to MNT6.1 billion ($5.5 million) (0.5% of GDP), of which the largest insurance company, Mongol Daatgal Insurance Company, accounted for 79.3%. The industry does not enjoy a good reputation, for claims often go unpaid and most if not all companies offering insurance products are unable to manage significant risks. Although the Insurance Law, originally adopted in 2001 and recently amended,[152] allows insurance companies to use up to 30% of their required reserves (60% of their premiums) to invest in government securities and other reliable long-term securities, including company shares, most insurance companies keep their money in various bank accounts and cash. Alternative long-term, low-risk liquid securities are not available to them.

222. A unit of the Professional Supervision Service within the Prime Minister's Office plays the role of insurance regulator. The regulator has very limited capability and currently has only six full-time staff, none of whom are trained insurance professionals. To date, little attention has been paid this subsector by international donors. Although the draft law on insurance prepared under ADB's Second Financial Sector Program Loan incorporates solvency and prudential requirements in line with international standards, further assistance is required to develop the regulatory framework and to ensure compliance.

223. The national pension scheme is a government budget supported, pay-as-you-go system open to private-company employees. The fund is severely underfinanced due to large contribution arrears and to the narrow base of pension contributions relative to the coverage of pension recipients. In view of the important role that institutional investors can play in catalyzing capital market development, the promotion of insurance and pension funds should be an integral part of the medium-term financial development strategy. The present system, like most pay-as-you-go systems in other transitional economies, is not viable and ultimately must be replaced. Defined contribution schemes are unknown in the country, and no enabling legislation exists to allow for their formation, as in the case of Kazakhstan, where the legal framework for pension reform was laid in 1996–1997 and private pension funds are now operating. A dearth of life insurance products, combined with a lack of commercial pension schemes means that citizens of Mongolia have practically no long-term savings option other than that of maintaining savings accounts at banks.

4. Microfinance

224. Mongolia's microfinance sector is fairly robust. Both Ag Bank and Xac Bank serve a large and growing micro-enterprise clientele. In addition to these large, profitable financial institutions, SCCs have expanded rapidly in recent years, in a largely unregulated environment,

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151 After the sale of Mongol Daatgal insurance Company to Russian interests in alliance with Chinggis Khan Bank in December 2003 ($5.8 million purchase price), the insurance firm Tushig Daatgal, which underwrites only agricultural risks, alone remained state owned. The other 16 insurers are private companies.

152 Under this law, prudential guidelines do not exist though basic licensing criteria do. Barriers to entry are low. To promote development of this market, MOFE initially prepared a new draft Insurance Law that was rejected by MOJ. With USAID assistance, MOJ subsequently developed a new draft framework incorporating international best practice standards. See Carpenter, Richard. 2003. Mongolia Insurance Law Review. Draft Final Report. Development Alternatives, Inc., USAID, 19 February 2003. ADB provided additional assistance, which resulted in preparation of a new draft that was submitted to Parliament for approval by the Cabinet of Ministers in September 2003. See TA 3459-MON (footnote 137). The revised insurance law was approved in April 2004.

to fill a void in the provision of credit in rural areas. Some NGOs also are active providers of microcredit, particularly in more isolated rural areas where commercial opportunities are fewer.

225. NBFIs, which are prohibited from accepting deposits, are regulated by BOM under the 2002 Law on Non Bank Financial Activities, which imposes related accounting and prudential standards (e.g., minimum capital of $100,000). Under this law, each NBFI is licensed for specific activities. At the end of 2002, there were 66 NBFIs, of which 64 were licensed to engage in lending. Of these 64, 60 are located in Ulaanbaatar, reflecting the urban nature of such institutions. The largest, Chinggis Khan, which has recently applied for a banking license, accounts for $30 million of the total asset size ($40 million) of NBFIs. Apart from Chinggis Khaan, most NBFIs have little more than the required minimum capital, are incorporated as limited liability companies, and are owned by a single individual, family, or group of closely related individuals. Lending consists of small, short-term loans to SMEs, mainly for working capital. Loans are collateralized heavily.

226. SCCs began to develop in 1996, with assistance from ADB's Employment Generation Project.[153] Five-hundred-and-seventy SCCs, up from 6 in 1996 and 98 in 2000, have been registered in Mongolia, though only 282 are believed to be operating. Of these 282 functioning SCCs, 166 are located in Ulaanbaatar; the remaining 116 operate outside the capital. Fourteen of the SCCs have total assets of greater than MNT500 million ($425,000), and another 24 have assets between MNT100 million and MNT500 million. This group of SCCs accounts for more than 87% of total SCC assets, and all 38 SCCs are located in Ulaanbaatar. Average asset size of the rural SCCs is quite small, at MNT22 million ($19,000). In terms of membership, there are 22,200 SCC members nationwide, of which 6,800 are in rural areas and 15,400 are in Ulaanbaatar. Total loans and deposits within the SCC system have increased three times since 2002, and the total assets of Mongolian SCCs now amount to more than 6% of total banking sector assets.[154]

227. Netmon, a licensed NBFI owned by Xac Bank, lends to 51 SCCs (comprised of 4,780 members) through its wholesale lending program.[155] Applicants are screened through an evaluation system based on World Council of Credit Unions principles. Netmon charges 2–3%/month on wholesale loans, depending on loan conditions. At the end of 2002, Netmon had $118,000 of loans outstanding to SCCs, of which 13.5% were considered at risk. Netmon has disbursed a cumulative $515,000 since start-up, of which 52% has been lent to rural SCCs. Xac Bank's management is interested in developing this business model further, with SCC clients serving as de facto retail “affiliates” serviced by Xac Bank. At the same time, Netmon has been absorbed into Xac, with its activities fully integrated into Xac Bank's.

228. Although no data are available on the use of loan proceeds by SCC clients, it is assumed that demand is primarily for consumption, MSE working capital, and agriculture-related purposes. As such, SCCs play a useful role in bridging the gap between commercial banks, on the one hand, and Lombards, on the other—the former requiring travel to a branch facility, a formal application, security and preferably a credit history; the latter requiring collateral deposits and demanding a very high rate of interest.

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153 ADB. 1993. *Technical Assistance to Mongolia for Employment Generation*. Manila. See also Moyes, R. T. and Ira Singh. 2000. *Mongolia Microfinance Market Assessment: Towards an Efficient and Private Sector Led Microfinance Market.* Abridged Version. Prepared for IFC, Market Study, July (DAI).

154 Data from an unpublished May 2004 draft of a country diagnostic report on rural finance in Mongolia, sponsored under a regional TA, REG–6078: Rural Finance in Central Asian Republics. Robert Vogel.

155 Netmon, which was established in 2000 with a grant of $12,000 from UNDP, is responsible for wholesale financing of SCCs.

229. The ADB-financed Rural Finance Project[156] is assisting in the development of a regulatory and supervisory environment for SCCs. MOJ is currently drafting a new law to govern SCCs, which are now covered under the Cooperative Law.[157] The project team provided a model SCC law to MOJ in May 2004. BOM has been given the mandate to regulate SCCs by Parliament until new legislation is in place; SCCs have been operating essentially in regulatory vacuum since the first SCCs were set up in 1995 under the ADB Employment Generation Project. The recently enacted Insurance Law (April 2004) calls for the creation of a Financial Regulatory Commission that would assume responsibility for regulation and supervision of all NBFIs, including SCCs. Arguably, even after the Financial Regulatory Commission begins operations, it may be advisable that BOM retain responsibility for the SCCs because SCCs operate essentially like small banks. In any event, the ADB Rural Finance Project to date has been helpful in providing a conceptually sound draft law and an appropriate set of regulations, and is engaged in creating some practical supervisory systems. The project is also delivering capacity building and training to rural SCCs in 4 pilot *aimags*.

5. Leasing

230. One licensed leasing company currently operates in Mongolia. This private company leases office equipment, vehicles, and other assets and competes with large but unlicensed machinery and vehicle sales companies. IFC is planning to provide assistance to this subsector, following an earlier study of leasing operations and collaboration with the Government on a draft leasing legislation. IFC plans to link the project with the successful IFC-supported Russia Leasing Development Group, operational since 1997.[158]

6. Initiatives Required

231. Recognizing the importance of the financial sector to the development of the economy as a whole, the Government has placed considerable emphasis on development of this sector. BOM is enforcing higher commercial-bank capital requirements, which are expected to lead to further industry consolidation; the State has largely divested itself of its bank interests; and foreign capital and expertise have entered the sector. Banks need to strengthen lending procedures, develop their corporate cultures, and introduce new loan products. Foreign investor involvement and competitive pressures should lead to improved financial services. Certainly, there is now less scope for government or donor intervention in the commercial banking sector, except to enforce prudential regulations and to provide strong supervision.

232. Most of the external assistance provided has been concentrated on commercial banks, and their performance indeed improved dramatically from 1999 through the end of 2002. Solvency is high, lending has expanded dramatically, and bank profitability has permitted further investment in, for example, ATMs, computerization, and ameliorated employee conditions.

233. Although the financial sector, mainly banks, has developed dramatically in recent years, reform momentum must be sustained and financial markets broadened and deepened. Now that commercial banks are providing basic financial services, it may be time to pay closer attention to development of NBFIs. Mongolian enterprises need equity and venture capital. A lack of

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156 ADB. 2001. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Rural Finance Project.* Manila.

157 The Cooperative Law sets out registration and other legal requirements governing SCCs and is overseen by GDNT, an administrative unit under MOFE.

158 The proposed Mongolia Leasing Development Project is a 2-year TA initiative based on an earlier IFC study of the Mongolian situation carried out by S. Amembal and S. Gilyeart.

equity finance is a critical and chronic constraint to business development and negatively affects both employment growth and poverty alleviation. Improved financial reporting within private companies is essential to the creation of an investment culture. Financial skills, transparency, and governance must be improved to create an environment that can attract institutional, strategic, and portfolio investors. Equity markets can be developed through commercial bank subsidiaries, investment and pension funds, legal and management improvements to the stock exchange, and insurance companies.

234. Focused almost exclusively on property and casualty coverage, and failing to tap its leasing potential, the insurance industry is in an early stage of development. That insurance and leasing products often are sourced internationally highlights the inefficiency of local providers. Leasing and insurance companies need assistance in product development and management whereas potential customers need more accurate and comprehensive information about the features and benefits of these products. Like commercial banking, insurance is a sector to which foreign investors can contribute technical, financial, and marketing know-how.

235. The microfinance sector has expanded rapidly, and there are clear indications that credit is increasingly available in poor rural areas, where SCCs play a potentially important role. To promote development of SCCs in a safe and sound manner, the Government is adopting a legal and regulatory framework to be implemented by BOM through a framework supported by the ADB's Rural Finance Project.[159]

236. ADB approved a TA in December 2003 to assist the Government of Mongolia in strengthening NBFIs. This $589,000 Project Preparatory TA (PPTA) supports development of a follow-on program loan for 2005. In addition to creating a long-terms strategy, the TA will produce governance and regulatory and supervisory standards for NBFIs and will streamline the regulatory and supervisory framework.[160]

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[159] SCCs are required to register with GDNT. Under the project, GDNT and BOM undertook a census of the exact number of SCCs that are (i) registered and (ii) actually operating, resulting in the numbers reported in para. 226.

[160] ADB. 2003. *Technical Assistance to Mongolia for Preparing the Third Financial Sector Program Loan*. Manila. There is substantial rationale for streamlining and improving the regulatory and supervisory regimes related to different parts of the financial sector. Capacity constraints of individual regulatory agencies, and small market size, particularly of the nonbank financial sector, provide a strong rationale for consolidating regulation and supervision of NBFIs and capital markets. Based on concerns regarding lack of information about this subsector, the rapid growth of SCCs and the potential for abuse, in April the Ikh Hural resolved to create a Financial Regulatory Committee (FRC). ADB, through this PPTA, is working with parliamentarians to develop the framework law to govern FRC activities. At present, FRC would encompass regulation of all NBFIs, including SCCs. Commercial bank supervision has been the traditional preserve of BOM, but, arguably, supervision of commercial banks might be improved significantly by removing it from the central bank's jurisdiction. Some countries, notably, the UK and Kazakhstan, have unified all financial sector regulation within one agency. Mongolia might consider establishing one financial regulatory authority, which would combine FRC with BOM's supervision department. BOM has succeeded in developing a strong supervision capacity for Mongolia, a uniquely firm foundation upon which to build other, specialized supervisory structures. In a very small country, where individual and organizational capacity constraints are prevalent, it is particularly useful to build on success. Despite the success of BOM's supervisory efforts, these activities may still be subject to undue political pressure. Placing supervision within an institution dedicated only to such activities may provide more insulation from political pressure in dealing with vested interests. Finally, it is sensible to move SCC regulation under BOM, as SCCs are similar in nature to commercial banks, rather than to have SCC regulation carried out within FRC, which would be dealing with quite different types of nonbank financial institutions.

H. Social Services

237. **Education.** The Education Law of 1995 anticipated greater private sector involvement in the education sector, particularly in the tertiary sector. This law paved the way for the ADB-financed Education Sector Development Program and Project (ESDP) in 1996,[161] under which an Education Sector Strategy 2000–2005 was drawn up by the Ministry of Education, Culture and Science in 1999. The Second ESDP "supports initiatives to explore contracting out to the private sector, but advises caution on the extent of privatization, especially in poor, rural areas" (footnote 136). The ESDP sees opportunities for private sector involvement at all levels of the educational system (e.g., publication and provision of textbooks, ICT provision, teacher training, and facilities maintenance and rehabilitation).

238. Private sector involvement has increased at the tertiary level. The Institute of Finance and Economics reports 178 tertiary institutions in which there was private involvement in the 2001–2002 academic year, 160 of which were located in Ulaanbaatar. Of this number, which excludes technical and vocational training institutes (32 in 2001), 76 were registered as "private universities" and had 29,893 students enrolled in the prior academic year. At an average tuition fee of MNT320,000 ($291), the turnover of "private universities" was estimated at MNT9.6 billion ($8.7 million). The Government subsidizes private institutes and universities by financing the fees of students accepted to licensed education providers. Removal of a license by the authorities is, therefore, a substantial business blow; four educational establishments are reported to have had their licenses rescinded in March 2003.

239. Tertiary institutions cover a range of disciplines from law to textile technology, but their rapid expansion has raised questions about quality and accreditation. In a sample survey carried out during the Mongolian CAPE in 2002 among both public and private tertiary institutions, 70.2% of previous year's graduates reported being employed, 12.9% reported being unemployed, and 16.9% could not be contacted. In a parallel survey of 57 businesses in Ulaanbaatar and Darkhan, however, employers expressed dissatisfaction with new school and university entrants, indicating that 41% of employees recently graduating from secondary school were "not very suitable" or "not at all suitable" compared with 26% of employees graduating from technical and vocational training and 12% graduating with a higher education degree. Moreover, higher-education graduates were said to suffer from a lack of business experience (33% of business respondents) and poor technical knowledge (24%). In conclusion, privatization of tertiary educational institutions as a goal in and of itself does not seem to have a positive effect on PSD.

240. **Health.** There has been significant investment in recent years in the establishment of private clinics. According to the government-financed Directorate of Medical Services (Directorate), an implementing agency established in December 2002 to provide quality assurance services for health organizations, there were 536 private clinics and hospitals operating in 2002,[162] which provided dental, gynecological, and traditional medical care. Of these, 375 were in Ulaanbaatar. In the first 3 months of the Directorate's activities, 20 private clinics and hospitals were accredited.

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[161] ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan for Education Sector Development Program*, and ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan for Education Sector Development Project*. Manila.

[162] Local terminology differentiates between clinics (361) with no beds, and hospitals with beds (122). Average number of beds in private hospitals was 6.8 in 1999.

241. Progress in facilitating private involvement at the level of hospital services has been slow. Management contracts were entered into in 1997–1998 with a number of private sector operators at the *soum* level but were unsuccessful because they were entered into with inappropriate organizations and/or with insufficient specification of outputs. Reportedly, although financial performance has improved, clinical standards have dropped and all but one contract, the management of Bayanzurkh District Hospital in Ulaanbaatar, has been rescinded. The Health Sector Development Program (HSDP) also envisaged that public buildings would be sold and leased back and that support services such as catering and laundry would be tendered to the private sector. There has been no sale and leaseback to date, but a Ministerial Order of 2000 allows for the subcontracting of nonmedical services and has led to trials in Ulaanbaatar and in the regions.

242. Private hospitals are free to set patient fees and may bill the health insurance fund (HIF) for patients covered by the service (approximately 87% of the population) although no budget funds are used to support private hospitals. Full privatization of *soum* and *aimag* hospitals is considered infeasible at present; for both types would lose budgetary support, and co-payment charges to patients would have to rise dramatically to supplement HIF payments, where available. Such changes would hit the poor particularly hard. Prospects for asset sale and leaseback (possibly following renovation), subcontracting of nonclinical services, management contracts, and placement of private doctors in public facilities are all plausible strategies for maintaining or improving services while lowering costs.

243. The Ministry of Health estimates that $30 million–$35 million is spent annually by Mongolians seeking treatment from top-flight medical facilities abroad. Thus, there exists the potential for Mongolian entrepreneurs to attract foreign investment to set up a center of excellence in the country to attract those currently traveling overseas.

244. During the first ADB-financed HSDP, primary-care facilities at the local level were reorganized into family group practices (FGPs), which are privately owned but receive financial support from government funds.[163] As of September 2002, there were throughout Mongolia[164] 238 FGPs providing primary health care for 45–55% of the total population.[165]

245. Drug availability is a difficulty for most FGPs, especially in rural areas, for 85% of all drugs are imported and only 7% of drugs are on the Ministry of Health essential drugs list. There are now 40 companies licensed to import pharmaceuticals, up from 20 in 1998, and 28, mostly small, drug manufacturing companies. Government involvement in the sector continues through the ownership of Mongolemimpex, a pharmaceutical trading company with MNT3.4 billion ($3.1 million) in annual sales, and Emiin Uildver, a pharmaceutical manufacturing company with MNT515.7 million ($468,000) in annual sales.

246. **Initiatives Required.** The results of reforms being introduced in the social sectors are not yet completely clear. Private operators play a very significant role in the independent provision of tertiary education and health services in Ulaanbaatar in particular, but efforts to

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[163] ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Health Sector Development Program*. Manila, and ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Health Sector Development Project*. Manila.

[164] *HSDP Quarterly Progress Report*. 2002, October.

[165] From January 2003, FGPs are financed through capitation fees funded 60% from the HIF and 40% from the state budget, following approval in 2002 to appropriate modifications to the Citizens' Health Insurance Law and the Health Law.

subcontract functions in both sectors have been hampered by a lack of guidelines, training, and contract standardization.

247. In the education sector, the explosion of tertiary institutions as a result of liberalization has led to a plethora of degree or diploma courses for which there is limited demand within the Mongolian economy. Businesses continue to find it difficult to recruit experienced and capable technicians and managers. The business and the education sectors need to collaborate more closely to ensure that appropriate signals are sent to tertiary establishments with respect to qualifications in demand, and to develop forms of attachment and sponsorship favoring both parties. Clearly, it is too early to ascribe a leading role to private sector institutions, particularly in tertiary education. Indeed, it seems evident that the Government must play a stronger role in concentrating resources to improve the quality of tertiary education. At present, it is likely that only the Government of Mongolia has the wherewithal to develop a technical institute or a business school based upon international standards.

248. In the health sector, there are indications that, with appropriate improvements, private provision may allow government budgetary contributions to be concentrated increasingly on facilities serving the poor. A parallel, fully private system of clinics and hospitals would likely have a positive effect on all health care professions and prevent bright medical professionals from seeking employment outside the country, or outside the medical profession. It would be important to ensure that public funding was not diverted to inadvertently subsidize new for-profit ventures. Given the recent introduction of the Directorate to supervise quality standards within the sector, reforms need to be given time to have a real impact, and contractual conditions between state and provider need to be improved, where necessary.

II. TRADE POLICY REGIME: FRAMEWORK AND OBJECTIVES

(1) GENERAL INSTITUTIONAL FRAMEWORK

1. Mongolia is a parliamentary democracy. It's Constitution, adopted on 13 January 1992, provides for free elections on the basis of universal, equal and direct suffrage by secret ballot; the minimum age for voting is 18 years.[1] Parliament consists of a single house (the State Great Hural); its 76 members are directly elected for a fixed term of four years.[2] Parliament is the sole body vested with legislative authority, based on the Constitution. Parliament appoints or removes the Prime Minister (with the consent of the President), senior officials of the Government (e.g. ministers), and members of other bodies accountable to Parliament as provided for by law.[3] Parliament approves the Government's annual fiscal policy plans and the Central Bank's annual monetary policy plans; it also has authority to ratify international treaties or withdraw from them.

2. The President of Mongolia is the Head of State; presidential elections are held every four years.[4] Presidential candidates are nominated by political parties that have at least one seat in Parliament.[5] The President has the right to veto laws and resolutions of Parliament; the veto can be overruled if two thirds of the members of Parliament present do not accept it. The President has the right to propose to Parliament a candidate for the Prime Minister, as well as the dissolution of the Government.[6] The President may issue decrees in conformity with laws[7], and may conclude international treaties. The Constitutional Court, which consists of parliamentarians, may remove the President if it decides that he/she has violated the Constitution, abused power, or breached his/her oath.

3. The Government of Mongolia, headed by the Prime Minister, is the executive body of state power; it also directs the activities of local administrations, and concludes and implements international and intergovernmental treaties. The Prime Minister, in consultation with the President, submits their proposals on the structure and composition of the Government to Parliament, which then approves/disapproves the proposal. The mandate of the Government is for four years.

4. Governance of administrative and territorial units of Mongolia is conducted by central and local governments. The Central Government's local policy is conducted through regional governors, who are responsible for the implementation of national policy and exercising administrative control at regional level, in addition to formulating and implementing the region's own policies. Mongolia is divided administratively into *aimags* (provinces) and the capital city (Ulaanbaatar); *aimags* are subdivided into *soums* (districts at the provincial level), which are further divided into *baghs* (villages, or sub-districts at the provincial level); the capital city is divided into districts and sub-districts (*horoos)*.

5. The Constitution guarantees the independence of the judiciary. The judicial system consists of the Supreme Court, two capital city courts, and eight district courts. According to Article 48 of the

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[1] The most recent parliamentary election was held on 27 June 2004.

[2] Parliament may dissolve itself if two thirds or more of its members agree to do so; the President, in consultation with the Chairman of Parliament, may also propose to do so.

[3] These include the President of Mongol Bank and members of the Constitutional Court.

[4] The President can be re-elected only once. The President is also a head of the armed forces.

[5] Presidential candidates must be at least 45 years of age, be born Mongolian, and have resided in Mongolia in the five recent years.

[6] The dissolution of the Government entails the resignation of the Prime Minister and all other ministers.

[7] If Parliament decides that such decrees are inconsistent with laws, it may declare them void.

Constitution, specialized courts such as criminal, civil, and administrative courts may be formed.[8] The Supreme Court interprets all laws with the exception of the Constitution; the Constitutional Court exercises supreme supervision over the implementation of the Constitution, makes judgements on the violation of its provisions, and resolves disputes related to the Constitution.[9] If the Constitutional Court decides that laws, decrees, or other decisions of Parliament and the President as well as Government decisions and international treaties concluded by Mongolia are incongruous with the Constitution, the laws, decrees, instruments of ratification and decisions in question are invalidated. Cases are brought to the Constitutional Court upon its own initiative based on petitions received from citizens, or at the request of Parliament, the President, the Prime Minister, the Supreme Court, or the Prosecutor General.

6. A General Council of Courts, whose 12 members include the President, Chief Justice of the Supreme Court, a member of Parliament, and a member of the Government, ensures the independence of the judiciary. The Council deals primarily with the selection of judges; budget, financing, and human resources of courts; protection of judges' rights; and other matters concerning the independence of the judiciary.

(2) TRADE POLICY FORMULATION AND IMPLEMENTATION

7. Any legislation, including on trade and trade-related issues, may be initiated by a member of Parliament, the President, or the Government. Ministries and agencies of the Government prepare a draft bill for laws and regulations related to their executive jurisdiction. A draft bill is referred by the Chairperson of Parliament for submission to the relevant Standing Committee of Parliament, where it is discussed with the participation of ministries in charge. The Standing Committee on Economic Policy deals with Mongolia's main economic policy issues including trade policies. Upon final approval by the Standing Committee, the bill is introduced to Parliament for discussion.

8. According to Article 38 of the Constitution, the specific powers, structure, and procedure of the Government are determined by law. The current Government consists of the Prime Minister, the Deputy Prime Minister, the Prime Minister's Office, and 13 ministries in accordance with the Law on the Composition of the Government of Mongolia, enacted on 22 September 2004.[10] The formulation and implementation of trade policies is carried out by several ministries and agencies in consultation with representatives from the private sector. Currently, Mongolian trade policy is formulated and coordinated by the Ministry of Industry and Trade (MIT). The Ministry has the main responsibility for all issues related to trade, including trade promotion/facilitation and export development. Within the MIT, the Trade Policy and Cooperation Department is responsible for coordinating trade policy. The MIT supervises the Foreign Investment and Foreign Trade Agency (FIFTA) and the Mineral Resources and Petroleum Authority. The FIFTA is responsible for promoting and facilitating foreign direct investment and foreign trade.

9. The Customs Tariff Council is responsible for making proposals and judgments relating to the development of the customs and tariff policy, formulation of a proper tariff system, the adoption of tariff rates, and the imposition of additional duties. The Minister for Finance chairs the Customs Tariff Council. The Customs General Administration, established under the Ministry of Finance

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[8] Administrative courts were created at the end of 2002 to adjudicate administrative disputes involving the Government and its agencies. There are 21 such courts in Mongolia.

[9] The Constitutional Court consists of nine members appointed by Parliament for six-years; three members are nominated by Parliament, three by the President, and the remaining three by the Supreme Court. The Constitution guarantees private property rights as provided by various laws (Articles 6 and 16).

[10] This Law terminated the previous Law on the Composition of the previous Government of Mongolia (enacted on 3 August 2000).

(MOF), is responsible for enforcing the customs legislation, levying and collecting customs duties and other taxes, and preparing and submitting customs statistical data to the National Statistical Office.

10. The Mongolian National Centre for Standardization and Metrology (MNCSM) coordinates and manages issues related to standardization, quality certification, testing, surveillance, and metrology throughout the country. The MNCSM is under the responsibility of the Deputy Prime Minister; 80% of its income is from the provision of certification and other services. The State Professional Inspection Agency is responsible for: inspection of imported and exported goods on grounds of food safety; agricultural inspections, such as for seeds and plants; enforcement of laws and regulations related to trade, industry, service, geology, and mining; and supervising the observation of standards.

11. The Mongolian Intellectual Property Office is in charge of all trade-related aspects of the intellectual property, including copyright, patents, and trade marks; it is under the Deputy Prime Minister.

12. The Bank of Mongolia (the Central Bank) is responsible for overall monetary and exchange rate policies; it also supervises banks and is required to maintain, *inter alia*, financial market and banking system stability. The Bank formally reports to Parliament.

13. Other ministries that participate in the trade policy formulation include: the Ministry of Construction and Urbanization; the Ministry of Roads, Transportation and Tourism; the Ministry of Fuel and Energy; the Ministry of Food and Agriculture (for trade-related issues in the agricultural sector); and the Ministry of Justice and Domestic Affairs (for the drafting of laws and regulations, and for the trade-related aspects of intellectual property).

14. In the non-governmental sector, the Mongolian National Chamber of Commerce and Industry (MNCCI) provides a number of trade support services, including issuing certificates of origin; registration of patents and trade marks; arbitration of foreign trade and investment disputes; independent inspection of exported and imported goods; providing export-market research and intelligence; organizing trade fairs, exhibitions and business missions; and project development.

15. In addition, several sectoral business associations were set up in the 1990s to collect and share information, identify and deal with industry problems, discuss the trade policy issues that affect their industries, and represent their sectors in relation to Government. These include the Mongolian Association of National Producers, the Mongolian Wool and Cashmere Federation, the Mongolian Meat Exporters Association, the Mongolian Textile Producers Federation, and the Mongolian Association of Hides and Skins.

16. Regular consultations between the Government and the private sector are conducted in a Government and Private Sector Consultative Committee; the main objective of the Committee is to improve the business and legal environment for the private sector. The Minister of Finance and the Chief Executive Officer of the Mongolian National Chamber of Commerce and Industry co-chair this Committee.

(3) TRADE RELATED LAWS AND REGULATIONS

17. Since its accession to the WTO in 1997, most of Mongolia's laws covering trade, trade-related policies, and investment have been revised, updated or newly created to enable Mongolia to meet its commitments as a member of the multilateral trading system (Table II.1). The new laws concern: free-trade zones, standards, sanitation, food safety, pharmaceuticals, trade marks and geographical indications, technology transfer, business registration and licensing, bankruptcy, VAT, civil legal

relations (Civil Code 2002), government procurement, insurance, postal services, and rights over land and land fees. Amendments have been made to several laws, e.g: Business Entity and Organization Taxation (1992), Banks (1996), Companies (1999), Copyright (1993), Customs and Customs Tariff (both 1996), General Taxation (1993), Excise Taxation (1993), Export Customs Duty (1996), Foreign Trade Arbitration (1995), Stamp Duty (1993), and Patent (1993).

Table II.1
Main trade-related legislation

Legislation	Date	Description
The Customs Law of Mongolia	16 May 1996	Regulates issues related to the organizational structure and legal basis of Customs, defining the procedures for customs control as well as customs clearance procedures and enforcement of the customs legislation.
Customs Tariff Law of Mongolia	20 May 1996	Regulated matters relating to the creation of the customs tariff system of Mongolia, principles for the adoption of customs duty rates, valuation and rules for levying and collecting customs duties.
Excise Tax Law of Mongolia	21 January 1993	Imposes excise tax on certain imported and domestic goods and governs relations in respect of payment of such tax to the budget.
Value-added Tax Law of Mongolia	8 December 1998	Regulates the imposition of a value-added tax on imported and exported goods, goods sold, jobs performed, and services rendered in the territory of Mongolia, sale of imported goods by citizens and legal entities in Mongolia, and to payment of value-added tax to the budget.
Law of Mongolia Determining the amount of Export Customs Duty to be imposed on Certain Commodities	29 March 1996	Imposes specific export customs duties on a number of commodities.
Law of Mongolia on Free Zones	28 June 2002	Regulates the establishment of free zones and their form, powers of governing bodies, monitoring mechanisms, determines the legal basis for and the realization of special tax and custom conditions.
Law on the legal status of "Altanbulag" Free Trade Zone	2 July 2000	Determines the legal status of the Altanbulag zone and regulates issues related to its implementation.
Foreign Investment Law of Mongolia	10 May 1993	Encourages foreign investment, protects the rights and property of foreign investors in Mongolia, and regulates matters relating to foreign investment.
Government Resolution of Mongolia on Approving the Model of the Stability Agreement, No. 46	24 March 2001	Regulates issues connected with ensuring stable tax conditions during a certain period for business entities with foreign investments engaged in exploration of mineral resources deposits.
Copyright Law of Mongolia	22 June 1993	Regulates matters related to the protection of copyright and use of the works that are subject to copyright.
Patent Law of Mongolia	25 June 1993	Regulates matters related to protection of the rights of authors of inventions, industrial designs, and innovations and of patent owners, and to the use of inventions, industrial designs and innovations.
Law of Mongolia on Trade Names and Trademarks	19 December 1996	Ensures legal guarantees for trade marks and trade names, protects the rights and legal interests of their owners, and regulates issues concerning the ownership, use and disposal of trademarks and trade names.
Law of Mongolia Prohibiting Unfair Competition	12 May 2000	Creates conditions for fair competition on the market among the legal persons engaged in business activities, and regulates matters concerning the legal and organizational basis for prohibition and/or prevention of any activities that are contrary to fair competition.
Law on Government Procurement	14 April 2000	Regulates matters relating to the preparation of bidding documents, advertisement, opening of tenders, evaluation of tenders, and award of contract for public procurement of goods, works and services; composition and organization of Tender Committee, and control over its activities.
Constitution of Mongolia	13 January 1992	The Constitution of Mongolia

Table II.1 (cont'd)

Legislation	Date	Description
Civil Code	10 January 2002	Regulates matters with respect to material and non-material wealth arising between legal persons.
Company Law	2 July 1999	Regulates the establishment, registration and reorganization of a company, its management and organizational structure, the rights and obligations of its shareholders, and its control and liquidation.
Law on Licensing	1 February 2001	Regulates the giving, delaying and invalidating of a licence to business activities that might negatively affect public interest, human well-being, environment, and national security and that might require specific conditions and expertise.
Tourism Law	5 May 2000	Regulates relations between the State, citizens, economic entities and organizations with regard to tourism promotion, engagement in tourism activities, and provision of tourism services on the territory of Mongolia.
Banking Law	3 September 1996	Regulates the licensing of banks, the revocation of licences, the establishment of general principles of a bank's management, organization, and activities, and enforcement measures.
Law on Central Bank	3 September 1996	Establishes the legal grounds of the powers of the Central Bank of Mongolia, its management, organization, and activities, and regulates issues concerning the implementation of state monetary policy undertaken by the Central Bank.
Law on Currency Settlements	12 May 1994	Defines the powers of the Government bodies in charge of currency settlement, regulates exchange controls for currency circulation by business entities, organizations, and citizens, and establishes mechanisms to sustain the Mongolian currency exchange rate.
Law on Deposits, Loans and Banking Transactions	31 October 1995	Regulates matters concerning the depositing of funds with banks by citizens and legal persons, the carrying out of transactions through the agency of banks and operations, and the granting and repayment of bank loans.
Law on Non-bank Financial Activities	12 December 2002	Establishes legal foundations for non-bank financial activities and regulates issues of management, organization, licensing, and suspension or revocation of licences of entities conducting non-bank financial activities.
Law on Bills	2 November 1995	Regulates relations between citizens and business entities concerning the use of bills of exchange and promissory notes as a means of payment.
Law on Insurance	5 December 1997	Defines the legal framework for conducting insurance activities in the territory of Mongolia, regulates relations between insurance companies, citizens, and legal entities, and creates principles for state auditing of insurance activities.
Accounting Law	13 December 2001	Determines the legal grounds for accounting principles, management, and institutions and regulates issues pertaining to the maintenance of accounting records and the preparation of financial statements of the business entity or organization.
Securities Law	13 October 1994	Regulates the issue of securities for the purpose of accumulating capital, the buying and selling of securities, depository arrangements, and clearing and settlement services, the regulation of issuers and other persons involved in the securities market and the protection of investors.
Law on Telecommunications	16 November 1995	Regulates relations between state organizations, service providers, business entities, and individuals engaged in telecommunications and the creation, utilization, and protection of the telecommunications network and telecommunications services in Mongolia.
Energy Law	1 February 2001	Regulates matters relating to energy generation, transmission, distribution, dispatching and supply activities, construction of energy facilities, and energy consumption that involve utilization of energy resources.
Minerals Law	5 June 997	Regulates exploration, mining and related activities within the territory of Mongolia.
Petroleum Law	18 January 1991	Regulates the operations of Mongolian and foreign entities or individuals involved in the exploration for and the protection, processing, transportation, storage, and marketing of petroleum originating in Mongolia.

Source: Information provided by the Mongolian authorities.

18. The terms of international treaties to which Mongolia is a signatory may be invoked directly in national courts (Civil Code, Article 2.2). Where the terms of its own national legislation are contrary to provisions of such a treaty, the terms of the international treaty prevail. Based on various international arbitration agreements, such as the New York and Washington Conventions, to which Mongolia is a party, the rights and obligations of parties to international contracts are regulated by the law of any country designated by the contracting parties; thus parties to trade-related contracts are free to choose legal jurisdiction for the contracts.

(4) TRADE POLICY OBJECTIVES

19. Mongolia's overall trade policy objectives, as stated in the Action Programme of the Government of Mongolia for 2004-08, are to support economic growth through an active trade policy, promote the industrial, agricultural and services sectors, and increase exports. The Action Programme also aims to change Mongolia's export structure by diversifying export products and markets, and to work towards the establishment of free-trade agreements with Russia, China, and the United States. In light of the upcoming expiry of the Agreement on Textiles and Clothing, Mongolia aims to take measures to exploit new trade opportunities for these products in order to maintain its position in international markets. Mongolia also aims to intensify negotiations with the European Union, Japan, the United States, and other countries to expand the scope of Mongolian products to be covered by their Generalized System of Preferences.

(5) TRADE AGREEMENTS AND ARRANGEMENTS

(i) Mongolia and the World Trade Organization

20. Mongolia acceded to the WTO on 29 January 1997. The WTO Agreements have been largely incorporated into Mongolia's domestic law; where parts of the Agreements are not incorporated, the WTO Agreement can be applied directly. Hence, private individuals can invoke the WTO Agreement before national courts. Mongolia is not a signatory to the Agreement on Government Procurement and the Agreement on Trade in Civil Aircraft. Since 1997, Mongolia has made a number of notifications to the WTO (Table II.2).

21. Mongolia bound all its tariffs under GATT 1994 on its accession to the WTO. The majority are bound at a ceiling rate of 20%, which is higher than applied duties (5% for most of goods). It committed to eliminating export subsidies under the Foreign Investment Law for foreign invested enterprises that export more than 50% of their output by 31 December 2002. Mongolia also committed to eliminating, within ten years of the date of its accession, an export duty at the rate of not more than 30% *ad valorem* on the export of raw cashmere.

22. Mongolia made various GATS commitments during its accession (Table IV.3). While it did not participate in the extended negotiations on financial services (Fifth Protocol, adopted 14 November 1997) and telecommunications (Fourth Protocol, adopted 30 April 1996), its accession commitments on services covered certain of these subsectors (see Chapter IV(6)). Mongolia has made no MFN exemptions.

23. Mongolia has not been a party to any disputes under the WTO dispute settlement mechanism.

Table II.2
Principal notifications under WTO Agreements, as at 20 September 2004

Agreement – Committee	Document reference and date	Requirement/Contents
Agreement on Agriculture	G/AG/N/MNG/6, 09 June 2000	Export subsidies under Article 10 and 18.2 of the Agreement
	G/AG/N/MNG/5, 09 June 2000	Domestic support under Article 18.2 of the Agreement (Table D:1 and the relevant supporting tables)
	G/AG/N/MNG/4, 06 August 1999	Domestic support under Article 18.2 of the Agreement (Table D:1 and the relevant supporting tables)
	G/AG/N/MNG/2, 10 August 1998	Domestic support under Article 18.2 of the Agreement (Table D:1 and the relevant supporting tables)
Agreement on Textiles and Clothing	G/TMB/N/351, 15 May 2000	Notification under Article 3.1 of the Agreement
	G/TMB/N/350, 15 May 2000	Notification under Article 6.1 of the Agreement
Agreement on Implementation of Article VI of the GATT 1994	G/ADP/N/1/MNG/1, 16 January 1998	Notification of Laws and Regulations under Article 18.5 of the Agreements
Agreement on Implementation of Article VI of the GATT 1994	G/ADP/N/72/Add.1/Rev.1, 12 October 2001	Semi-Annual Reports under Article 16.4 of the Agreement – Revision
GATT 1994, Understanding on the Implementation of Article XVII	G/STR/N/7/MNG, 09 July 2001	State Trading - New and Full Notification Pursuant to Article XVII:4(a) of the GATT 1994 and Paragraph 1 of the Understanding on the Interpretation of Article XVII
Agreement on Import Licensing Procedures	G/LIC/N/1/MNG/1, 27 April 2001	Notification under Article 1.4(a) and 8.2(b) of the Agreement
	G/LIC/N/3/MNG/1, 12 June 2003	Notification under Article 7.3 of the Agreement - Replies to Questionnaire on Import Licensing Procedures
Agreement on Pre-shipment Inspection	G/PSI/N/1/Add.7, 24 February 1998	Pre-shipment Inspection - Notifications under Article 5 of the Agreement – Addendum
Decisions of Contracting Parties on GATS Article III	G/MA/NTM/QR/1/Add.6, 20 September 1999	Notifications of Quantitative Restrictions - Note by the Secretariat – Addendum
	G/MA/NTM/QR/1/Add.8, 01 March 2002	Notifications of Quantitative Restrictions - Note by the Secretariat – Addendum
Agreement on Rules of Origin	G/RO/N/20/Rev.1, 27 July 1998	Notifications under Article 5 and Paragraph 4 of Annex II of the Agreement on Rules of Origin - Costa Rica, Haiti, Maldives, Mongolia – Revision
Agreement on Subsidies and Countervailing Measures	G/SCM/N/60/MNG G/SCM/N/71/MNG G/SCM/N/95/MNG, 06 September 2004	Subsidies - Updating New and Full Notifications Pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the Agreement on Subsidies and Countervailing Measures
	G/SCM/N/68/Add.1/Rev.1, 16 October 2001	Semi-Annual Reports under Article 25.11 of the Agreement – Revision
	G/SCM/N/1/MNG/2, 06 September 2004	Notification of Laws and Regulations under Article 32.6 of the Agreement
	G/SCM/N/1/MNG/1, 14 January 1998	Notification of Laws and Regulations under Article 18.5 and 32.6 of the Agreements
Agreement on Safeguards	G/SG/N/1/MNG/1, 14 January 1998	Notifications of Laws, Regulations and Administrative Procedures Relating to Safeguard Measures
Agreement on Sanitary and Phytosanitary Measures	G/SPS/N/MNG/2, 05 March 2004	Notification of Emergency Measures - Chicken and chicken products
Agreement on Technical Barriers to Trade	G/TBT/CS/N/65, 21 March 1997	Notification under Paragraph (c) of the WTO TBT Code of Good Practice (Notification of acceptance of the WTO TBT Code of Good Practice)
	G/TBT/10.7/N/17, 05 September 1997	Notification

Table II.2 (cont'd)

Agreement – Committee	Document reference and date	Requirement/Contents
	G/TBT/10.7/N/18, 05 September 1997	Notification
	G/TBT/2/Add.44, 29 January 1998	Implementation and Administration of the Agreement on Technical Barriers to Trade - Addendum - Communication from Mongolia
Agreement on Trade-Related Investment Measures	G/TRIMS/N/2/Rev.8, 19 July 2000	Notifications under Article 6.2 of the TRIMs Agreement of Publications in which TRIMs may be Found – Revision
Agreement on Trade-Related Aspects of Intellectual Property Rights	IP/N/6/MNG/1, 09 November 1998	Checklist of Issues on Enforcement – Responses from Mongolia
	IP/N/1/MNG/C/1/Rev.1, 30 October 1998	Main Dedicated Intellectual Property Laws and Regulations Notified under Article 63.2 of the Agreement – Revision
	IP/N/1/MNG/1/Add.1, 16 July 1998	Notification of Laws and Regulations under Article 63.2 of the Agreement – Addendum
	IP/N/3/Rev.2/Add.9, 11 May 1998	Notification of Contact Points under Article 69 of the Agreement - Note by the Secretariat - Addendum

Source: WTO Notifications.

(ii) Other trade arrangements

24. Mongolia has not concluded any regional trade agreements. Nor is it a member of the Asia Pacific Economic Cooperation (APEC). The authorities consider that joining the Bangkok Agreement would offer concrete advantages to Mongolia.[11]

25. Mongolia is currently a beneficiary of the Canadian, EU, Japanese and U.S. preferential schemes under the Generalized System of Preferences. The authorities are concerned that the envisaged full integration of textiles into the multilateral trading system by the end of 2004 would promote relocation abroad of joint ventures in the textiles sector.

26. Mongolia is negotiating a Transit Transport Framework Agreement with China and Russia to aid the transit of Mongolian products through its neighbouring countries to third countries. The authorities expect that this would help to make the transit of Mongolian exports in the North-East Asian region more efficient, which would improve the international competitiveness of Mongolian products destined for third countries.

27. Mongolia has concluded various bilateral trade-related arrangements (Table II.3).

28. In July 2004, Mongolia signed an Agreement Concerning the Development of Trade and Investment Relations between the Government of Mongolia and the Government of the United States (Trade and Investment Framework Agreement (TIFA)); the TIFA establishes a Mongolia-U.S. joint council on trade and investment. The Government is considering the possibility of negotiating free-trade agreements with its major trading partners, such as the European Union, Japan, the Republic of Korea, and the United States.

[11] The Bangkok Agreement involves a preferential tariff arrangement among members; current members are Bangladesh, China, India, Republic of Korea, Lao People's Democratic Republic, and Sri Lanka. The ESCAP functions as the secretariat for the Agreement.

Table II.3
Mongolia's bilateral trade arrangements

Agreement	Date	Description
Trade Agreement between the Government of Mongolia and the Government of Japan	1 March 1990	Accords MFN treatment with regard to customs duties, clearance and products of both parties in the territory of the other party, establishes a mixed commission to examine the problems arising from the implementation of the agreement.
Trade Agreement between the Government of Mongolia and the Government of Lao PDR	25 December 1990	Accords MFN to trade between the two countries and provides for dispute settlement, transportation, settlement of payments.
Trade Agreement between the Government of Mongolia and the Government of the PR of China	1991	..
Agreement concerning Trade Relations between the Government of Mongolia and the Government of the United States	23 January 1991	Accords MFN treatment and non-discriminatory conditions for products, customs duties, market access for goods and services, provides for trade expansion and promotion, promotion of intellectual property, framework for further economic cooperation.
Agreement between Mongolia and Russia/the Soviet Union on Trade and Economic Cooperation	12 February 1991	Covers the development of trade and economic cooperation, promotion of investment, cooperation in establishing economic zones, the development of transit transportation, the increase of the exchange of goods, the increase and expansion of border trade and economic relations; a joint commission was established to monitor the implementation of the agreement.
Trade Agreement between the Government of Mongolia and the Government of the Rep. of Korea	28 March 1991	Accords MFN and national treatment, non-discrimination with regard to imports from both countries, facilitates transit transportation, provides for dispute settlement.
Trade and Economic Cooperation Agreement between the Government of Mongolia and the Government of Bulgaria	1 May 1991	Accords MFN treatment to trade and economic cooperation, including customs tariffs, transportation, provides for the negotiation of bilateral agreements on investment promotion and protection, avoidance of double taxation, exchange of information with regard to economic activities, investment, taxation, banking, insurance, etc.
Agreement between the Government of Mongolia and the Government of the PR of China on the Access to Sea and Transit Transportation by Mongolia through the territory of the PRC	26 August 1991	Recognizes the rights of Mongolia to access the sea and transit goods through the territory of PRC, sets out general rules for transiting poisonous and perishable goods, restricts transit transportation of narcotic drugs, infectious micro-organisms, etc.; also sets rules for charges related to transit transportation.
Trade Agreement between the Government of Mongolia and the Government of Nepal	January 1992	Accords MFN treatment; parties undertake to facilitate transportation.
Trade and Economic Cooperation Agreement between the Government of Mongolia and the Government of the Republic of Belarus	24 January 1992	Accords MFN treatment to economic and trade cooperation, including transit transportation, customs tariffs.
Agreement between the Government of Mongolia and the Government of India on Trade and Economic Cooperation	17 April 1992	Promotes economic and technical cooperation between Mongolia and India, includes Mongolia in technical cooperation programme.
Trade, Economic and Technical Cooperation Agreement between the Government of Mongolia and the Government of Turkey	29 May 1992	Accords MFN treatment, non-discrimination, identifies sectors for cooperation such as agriculture, industry, SMEs, construction, transportation, free zones, etc.; provides for dispute settlement.
Agreement between Mongolia and the EEC on Trade and Economic Cooperation	16 June 1992	Accords MFN treatment with regard to imports, exports and re-exports of all goods exchanged between Mongolia and the Community, identifies sectors of economic cooperation, including industry, mining, agriculture, science, energy, communication, environmental protection, tourism, intellectual property, standards, and statistics.
Agreement between the Government of Mongolia and the Government of the Russian Federation on Mongolia's Access to the Sea by transiting through Russian Territory	19 October 1992	Covers the rights of Mongolia on free movement of transit transportation, utilization of sea ports, freight storage, reshipment, application of Russian domestic tariffs on transportation and compliance by both parties with tariffs imposed under international agreements to which both countries are parties.

Table II.3 (cont'd)

Agreement	Date	Description
Trade and Economic Cooperation Agreement between the Government of Mongolia and the Government of the Republic of Kazakhstan	27 October 1992	Accords MFN treatment to trade and economic cooperation, including customs, transit transportation; establishes Intergovernmental Commission.
Agreement between the Government of Mongolia and the Government of Austria Concerning Economic Cooperation	15 December 1992	Promotes economic cooperation and identifies sectors of cooperation such as energy, roads, construction, railways, etc.; establishes a Joint Commission to monitor the implementation of the agreement.
Trade and Economic Cooperation Agreement between the Government of Mongolia and the Government of Kyrgyz Republic	10 July 1993	Accords MFN treatment to trade and economic cooperation, as well as transit transportation and customs services.
Trade and Commerce Agreement between the Government of Mongolia and the Government of Canada	8 June 1994	Accords MFN treatment with regard to tariffs and other export and import charges, provides for facilitation of transit transportation, transparency of information and settlement of disputes.
Agreement between the Government of Mongolia and the EEC on Trade in Textiles	31 December 1997	Applies to trade in textile products originating from Mongolia, sets limits to its exports to the Community.
Trade Agreement between the Government of Mongolia and the Government of Viet Nam	13 December 1999	Accords MFN to trade, transportation, customs and taxation, provides for transit transportation through the territories of the parties, as well as for dispute settlement.
Trade Agreement between the Government of Mongolia and the Government of Cuba	9 November 2001	Accords MFN to exchange of goods and services, provides for the promotion of activities related to fairs, exhibitions, and other trade activities, recognizes that sanitary and phytosanitary requirements do not necessarily create barriers to trade, establishes intergovernmental Commission, sets non-discriminatory principles with regard to trade between the two countries.
Agreement between the Government of Mongolia and the Government of the United States concerning the Development of Trade and Investment Relations/TIFA	15 July 2004	Establishes Joint Trade and Investment Council and provides for further development of trade and investment relations between the two countries.

.. Not available.

Note: This list does not include bilateral agreements between Mongolia and its trading partners concerning customs cooperation, quality certification of goods, general economic and technical cooperation, investment, and double taxation.

Source: Information provided by the Mongolian authorities.

(6) FOREIGN INVESTMENT REGIME

29. The main law governing foreign investment in Mongolia is the Foreign Investment Law.[12] Under this law, wholly foreign-owned business entities are allowed; inward foreign direct investment (FDI) receives national treatment. No restriction is imposed on the size and content of FDI into Mongolia, except that the production of weapons is prohibited. Foreign nationals or companies are not allowed to own land in Mongolia; they can lease land for up to 60 years. FDI into Mongolia cannot be legally expropriated. Foreign investors can remit income, profits and payments out of Mongolia without any barriers; they are subject to a 20% withholding tax. The Foreign Investment and Foreign Trade Agency (FIFTA) is responsible for foreign investment policy formulation and implementation.

[12] The Foreign Investment Law was adopted in 1991. Subsequently, the minimum amount for foreign investment was set at US$10,000. FDI in the banking sector is covered under the Banking Law.

30. Mongolia has concluded agreements on avoidance of double taxation with 31 countries.[13] It has also signed agreements on Mutual Protection and Promotion of Investments with 34 countries.[14] Mongolia is a signatory of the Multilateral Investment Guarantee Agency.

(7) TRADE-RELATED TECHNICAL ASSISTANCE

31. Technical assistance from various sources has been instrumental in supporting Mongolia's transition to a market-based economy and open trade regime. For example, Germany has been providing technical assistance on trade policy and WTO issues through and International Trade Policy/WTO project in collaboration with the Mongolian Ministry of Industry. Various other countries and agencies, including the Asian Development Bank, United Nations Development Programme, United Nations Industrial Development Organization, Japan, United States Agency for International Development, World Bank, and the WTO have also provided trade-related technical assistance to Mongolia.

32. The WTO's technical assistance has focused on increasing government officials' understanding of WTO-related issues. Since 1997, Mongolia has participated in some 52 regional and 11 national training activities, which have covered many WTO subjects. Mongolia also took part in WTO Global Workshops on: scheduling of commitments under GATS (in 2002); training of trainers and labelling (in 2003); domestic regulation for services, and technical barriers to trade (in 2004); and cross-border supply of services (in 2005). Mongolian officials participated in the 2004 edition of the 12-week WTO trade policy course and the 10th Specialized Dispute Settlement Course held in Geneva.

33. While past assistance from these sources has been valuable, it would appear that further efforts might be required in a number of areas. As study conducted by the Asian Development Bank, at the request of the Ministry of Industry and Trade, drew up a list of technical assistance still needed. Examples of needs identified in the study include assistance concerning : trade remedy measures, rules of origin (if Mongolia is to conclude any free trade agreements), economic costs and benefits of export taxes, duty exemption facility, export development functions, competitiveness of transport sector, and further analysis of trade negotiations.[15] In addition, the authorities consider that further efforts are also required in a number of areas including: training on WTO rules and regulations as well as Mongolia's commitments for new members of Parliament, who were elected in June 2004; training on dispute settlement mechanism for lawyers; and capacity building on the multilateral trading system for academic institutions. Mongolia also wishes to participate in the Joint Integrated Technical Assistance Programme, which has been organized by the WTO, the United Nations Conference on Trade and Development, and the International Trade Centre.

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[13] These are: Belarus, Belgium, Bulgaria, Canada, China, Czech Republic, Egypt, France, Germany, Hungary, India, Indonesia, Italy, Kazakhstan, Kuwait, Kyrgyz Republic, Luxembourg, Korea, Malaysia, Netherlands, Poland, Romania, Russian Federation, Singapore, Switzerland, Turkey, Ukraine, United Arab Emirates, United Kingdom, Uzbekistan, and Viet Nam.

[14] These are: Austria, Belarus, Belgium, Bulgaria, China, Czech Republic, Cuba, Denmark, France, Germany, Hungary, India, Indonesia, Italy, Japan, Kazakhstan, Korea, Kuwait, Kyrgyz Republic, Lao People's Democratic Republic, Malaysia, Netherlands, Philippines, Poland, Romania, Russian Federation, Singapore, Switzerland, Turkey, Ukraine, United Arab Emirates, United Kingdom, United States, and Viet Nam.

[15] Asian Development Bank (2003e).

III. TRADE POLICIES AND PRACTICES BY MEASURE

(1) INTRODUCTION

1. Since acceding to the WTO in January 1997, Mongolia has substantially liberalized its trade regime. Liberalization has, *inter alia*, involved the reduction of tariff rates and elimination of a number of import licensing requirements.

2. Mongolia employs the "transaction value" method of customs valuation. It does not use preshipment inspection for customs valuation purposes. The tariff is Mongolia's main trade policy instrument. Most imports entering Mongolia are subject to an *ad valorem* duty rate of 5% (compared with a uniform rate of 15% in 1997). In 2004, the simple average applied MFN tariff was 5.0%. All tariff lines are bound; the average bound rate was 18.4% in 2004. Bound rates are higher than applied MFN rates for most lines, thereby according Mongolia considerable latitude to raise its tariffs within existing bindings. Due to a relatively uniform tariff structure, which simplifies customs procedures, reduces market distortions, and enhances transparency, there is no tariff escalation, and there are no tariff peaks. Some agricultural products (0.3% of total tariff lines) are protected by a seasonal rate of 15%. Mongolia has not used any anti-dumping, countervailing or safeguard measures.

3. Mongolia has a few non-tariff border measures, such as import prohibition and import licensing requirements. Since Mongolia's accession to the WTO, licensing requirements have been substantially reduced.

4. Certain exports from Mongolia are subject to export duties. Export prohibitions concern drugs, narcotics, and certain dangerous and poisonous chemicals. Export taxes apply to various products, including raw cashmere, with a view to increasing domestic processing. Imports of equipment for export-oriented businesses and for foreign businesses investing in "priority sectors" are free of import duties. Export-oriented companies are also exempt from VAT and excise tax; VAT on gold sales (including exports) was abolished in December 2001. The Government has adopted laws establishing free-trade and economic zones since 2002. Tax holidays are granted for export-oriented industries.

5. Preferences are granted to domestic suppliers with regard to government procurement. Mongolia is not a signatory to the WTO Agreement on Government Procurement.

6. About 30% of Mongolian industrial standards are harmonized with international standards. More than 40% of Mongolian standards are quoted as mandatory technical regulations. Mongolia has strengthened its legislation on intellectual property rights, with a view to assuring compatibility with international agreements. Different excise tax rates may apply between domestically produced and imported goods. Privatization has progressed since the early 1990s. Competition policy remains weak; there are no agencies authorized to enforce competition legislation.

(2) MEASURES DIRECTLY AFFECTING IMPORTS

(i) Customs procedures

7. The main legislation governing importation into Mongolia is the Customs Law, adopted by Parliament in 1996, and its implementing regulations.[1] The law defines the organizational structure

[1] The Customs Law was adopted in 16 May 1996 and entered into force on 1 July 1996; several amendments have been made to the Customs Law, most recently in March 2003, and to the Customs and Tariff Law in April 2003.

and legal basis of the Customs, under the Customs General Administration of Mongolia, as well as the procedures of customs control and clearance and enforcement of the customs legislation. Under the law, the importation of goods into Mongolia is subject to no restriction, except import licensing, which applies to a few products (see section (v)). Importers must register with the tax authorities; registration with the State Registry Office is also required for the purposes of customs clearance.

8. Article 12 of the Customs Law delegates authority to the Customs General Administration to set up regulations related to customs clearance procedures within the purposes of the law. The main implementing regulation regarding customs clearance is Order No. 694 of the Head of the Customs General Administration[2]; this Order regulates procedures for customs control and examination of goods and cross-border transport.

9. The principal document for customs clearance is the Customs Declaration Form (CDF), as approved by the Customs General Administration.[3] Where necessary, the Customs may require an importer to produce other documents for the purpose of customs clearance. These include: a foreign trade contract, an invoice, transport document, a packing list, certificate of origin, and a licence issued by the competent authorities. Documents for customs clearance must be provided in the Mongolian language; Customs may accept a translated copy of these documents.

10. Customs clearance documents must be submitted to the Customs at the customs frontier. If Customs agrees with the submitted customs value, then the importer must pay the import duties, VAT, and any excise tax. Subsequently, the Customs authorizes the importation of the declared goods.

11. Prior declaration of customs documents is allowed under Order No. 315 (27 October 1998), if a shipment contains a variety of goods, requires rapid processing during particular seasons (e.g. during the harvest season and New Year), or requires special storage facilities. Simplified procedures for customs declaration, which entail a reduced number of required documents, are also available where goods enter or leave customs bonded zones or customs special zones directly from or for abroad. Accelerated procedures (Order No. 187, 15. May 2000) are applicable for certain hazardous goods (e.g. nuclear goods), blood and blood products, and donors' organs to be used for treatment purposes. Accelerated procedures entail customs clearance on the basis of ex-post completion of customs declaration forms. Businesses and individuals permitted for accelerated procedures are allowed to pay customs duties and other taxes prior to the clearance. Examination must be finished within eight working hours for dangerous goods requiring special treatment (e.g. uranium and highly toxic chemical substances) or animals. Since 2002, a "gold card" system has been provided for the best performing companies that meet certain criteria; gold card holders are exempt from all but random cargo inspections.

12. With a view to easing the administrative burden on enterprises and saving time for importers, an importer may designate a customs broker who goes through all documentation and other formal procedures on behalf of the importer. Regulations on the operation of customs brokers are issued by the Customs General Administration. In addition, "one-stop" services have been provided at major customs points. One-stop services aim to complete all the necessary customs documentation and other formal procedures in one location; they include examination of documents by customs inspectors, customs valuation, payment of customs duties and other taxes, and customs examination.

[2] The Order entered into force on 6 February 2001.

[3] The CDG was approved by Order No. 336 of the Head of the Customs General Administration, 4 November 1998.

13. Mongolia has introduced a national Automated System for Customs Information Management (GAMAS) since 2001; the system aims to allow customs clearance and payment of customs duties and other taxes through an online system.[4]

14. If a person considers the decision of a State Customs Inspector unjustified, they may appeal within ten days of the decision, either to the head of the appropriate customs branch, unit or customs office, or to the chief of the customs house concerned. Appeals of decisions by heads of customs branches, units or offices or the director of a customs house may be made to an appropriate customs officer of a higher-level of authority. Decisions by the relevant higher-level official may be appealed in court.[5]

15. The Customs Law contains provisions on temporary admission into Mongolia's customs territories and re-exports. Provisions also exist for the operation of customs bonded manufacturing areas, customs bonded warehouses, customs bonded exhibition sites, customs bonded construction sites, customs special zones, and duty-free shops.

16. The main problems facing Mongolia's customs administration are administrative and operational issues, including corruption and smuggling. The authorities have taken steps to address these issues by introducing, *inter alia*, internal measures at customs (e.g. anti-corruption, anti-smuggling), computerization of customs procedures, staff training, and capacity-building programmes at agencies involved in customs administration and policy making.

(ii) Tariffs

(a) Overview

17. The Customs Tariff Law of Mongolia is the main legislation regulating matters relating to the customs tariff, the adoption/modification of duty rates, customs valuation, and collection of customs duties.[6] Tariff rates for goods crossing the border are, in principle, approved by Parliament. The Customs Tariff Council, which is established on an *ad hoc* basis, makes proposals to the Government on matters relating to the development of the tariff system, such as the adoption/modification of customs duty rates and the imposition of additional duties, such as anti-dumping and countervailing duties.

(b) Tariff structure

18. Mongolia adopted the Harmonized Commodity Description and Coding System (HS) on 1 January 1993. All subsequent changes to the HS have been introduced into the Mongolian nomenclature. Mongolia adopted HS2002 on 1 January 2002. The current tariff schedule consist of 5,541 lines at the HS 8-digit level: the first six digits refer to the common coding of the HS; the last two digits are sub-divisions at the national level.

19. According to the Customs Tariff Law, Mongolia's customs tariff consists of general, most-favoured-nation (MFN) bound and applied, and preferential rates. Under the Law, MFN applied rates apply to goods from countries that offer MFN status to Mongolia, and preferential rates to goods originating in countries that grant tariff preferences to Mongolia; goods originating in other countries are dutiable according to the general rates, which are double the MFN applied rates. In practice, none

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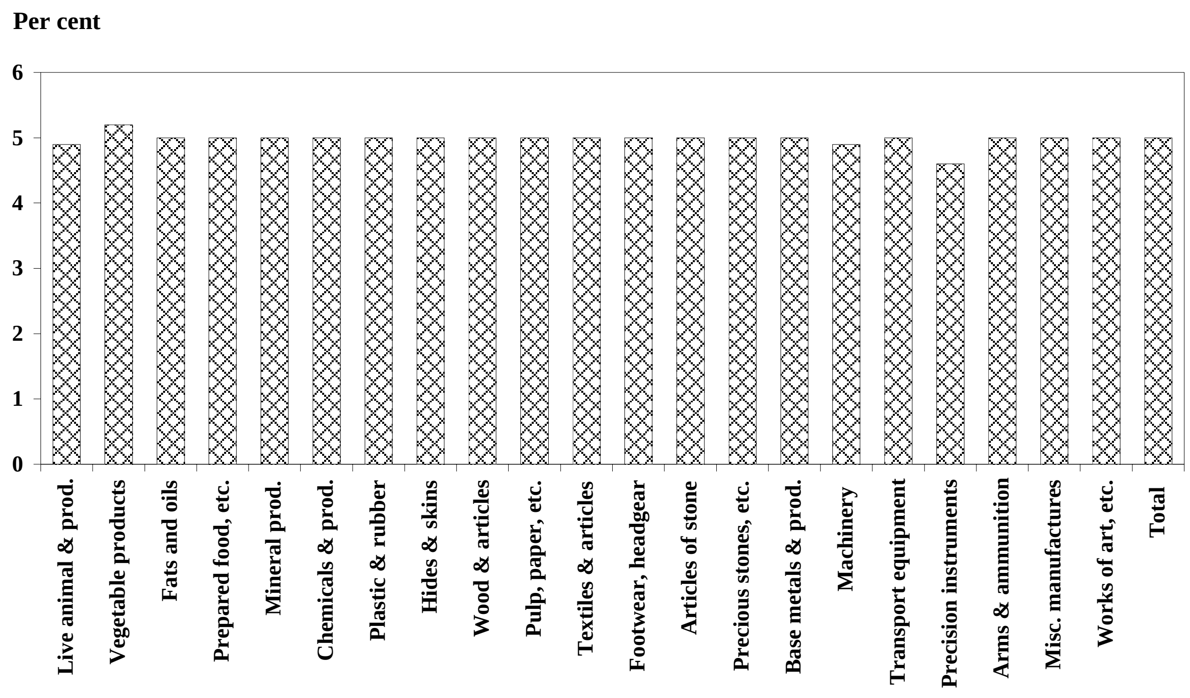
[4] About 65% of total customs clearance is currently processed through the online network.
[5] Article 89, the Customs Tariff Law of Mongolia.
[6] The Customs Tariff Law was adopted by Parliament on 20 May 1996 and entered into force on 1 July 1996.

of Mongolia's trading partners are granted preferential tariffs and nor are general tariffs applied. According to the Customs Tariff Law, customs duty rates can be *ad valorem*, specific and/or a combination of the two.

20. Currently, Mongolia applies an *ad valorem* MFN tariff rate of 5% to most of imported goods (Chart III.1).[7] Before its accession to the WTO in 1997, Mongolia applied a 15% *ad valorem* duty on the majority of imports. Since the introduction of the Customs Tariff Law, tariff rates have been changes several times. One of these major changes included the introduction of zero tariffs for all imports between May 1997 and September 1999, and the imposition of 7% rate for the majority of imports in 2001.

Chart III.1
Average applied MFN tariff rates, by HS section, 2004



***Source*: WTO Secretariat calculations, based on data provided by the Mongolian authorities.**

21. There are two other applied MFN duty rates, i.e. a zero tariff rate and a seasonal tariff rate of 15%. Zero rates apply to 49 tariff lines (0.9% of total lines), which include live animals for breeding, horses, cows, pigs, sheep, goats, information dissemination equipment and its spare parts, other machines for information development, transistor diode and any similar transistors, and various medical equipment. Since 2000, there have also been some exemptions from the customs tariffs for various purposes, such as on equipment and goods imported under international agreements and programmes for cooperation in which Mongolia is a party; on heavy equipment imported for the "Millennium Road" project; or for coal and energy projects (Table III.1).

[7] The authorities note that the objectives of applying a uniform tariff rate are to simplify customs processes, provide incentives for the efficient production of goods, refrain from protection for individual domestic industries, and to have low-priced import products available in the domestic market.

Table III.1
Legislation on tariff exemptions under certain projects

No.	Legislative Act	Product Coverage	Date
1.	On Exemptions from Tariff on Passport Printing Equipment	Equipment and materials for the printing of passports	18.10.01
2.	On Exemptions from Tariff on Millenium Road	Equipment for the building of roads	18.10.01
3.	On Exemptions from Tariff & VAT on Choibalsan Power Station Equipment	Equipment for the power station	25.05.01
4.	On Exemptions from Tariff on Communication Equipment	Communication equipment	26.07.00
5.	On Exemptions from Tariff on Coal Equipment	Equipment, materials, appliances	06.04.00
6.	On Exemptions from Laws on State Stamp Duties & Customs Tariff applied to Certain Goods & Services	Equipment and materials	08.04.99
7.	On Exemptions of Tariff on ADB Road	Machines and mechanisms for the repair of roads	10.01.02
8.	On Exemptions from Tariff on IDA Transport	Diagnostic equipment for the checking of motor vehicles, machines and mechanisms for the repair of roads	06.06.02
9.	On Exemptions from Tariff on KOIKA State Com	Communication equipment and appliances	13.06.02
10.	On Exemptions from Tariff & VAT on Buses	Buses and trolley buses	31.10.02
11.	On Exemptions from Tariff on Telecom	Communication equipment	09.10.03
12.	On Exemptions from Tariff on IDA Transport	..	26.12.03

.. Not available.

Source: Information provided by the Mongolian authorities.

22. A seasonal import duty rate of 15% is imposed on flour and vegetables (potatoes, onions, cabbage, raddish, turnips, and yellow carrots) to provide protection to domestic producers of these products. The duty is imposed during the period 1 August to 1 April, i.e. after the harvesting period of the products concerned. Outside this period, the applied duty rate is 5%.

23. The Government may, at its discretion, reduce or increase a tariff rate by up to 50% of the rate under Mongolia's tariff schedule, upon the recommendation of the Customs Tariff Council in accordance with Articles 4 and 6 of the Customs Tariff Law.

(c) Bound MFN rates

24. Mongolia bound all its tariffs upon accession to the WTO, at 20% for most tariff lines; certain lines are bound at different rates (Table III.2). The average bound MFN rate is 18.4% (compared with an average applied MFN rate of 5%) (Table III.3); the highest bound rate is 75%. In theory, this gives Mongolia considerable latitude to raise its tariffs within existing bindings.

Table III.2
Products bound at tariff rates other than 20%

HS code	Product description	Rate of duty
	Agriculture products	
2207	Undenatured ethyl alcohol	75%
2208	Rum, gin, vodka, liqueurs, tequila	35-50%
2401	Unmanufactured tobacco	40%
2402	Cigars and cigarettes	30%
2403	Smoking tobacco	40%

Table III.2 (cont'd)

HS code	Product description	Rate of duty
	Other products	
4203.10	Articles of apparel	30%
5701-02	Carpets and other textile floor coverings, knotted and woven	30%
6103-15, 6203-04	Clothing, garments (suits, shirts, etc.)	30%
93	Arms and ammunition	30%
9403	Wooden furniture	30%

Source: Mongolian authorities.

Table III.3
Structure of MFN tariffs

		2000	2002	2004	U.R.[a]
1.	Bound tariff lines (% of all tariff lines)	100.0	100.0	100.0	100.0
2.	Duty free tariff lines (% of all tariff lines)	0.9	0.9	0.9	1.6
3.	Non-*ad valorem* tariffs (% of all tariff lines)	0.0	0.0	0.0	0.0
4.	Tariff quotas (% of all tariff lines)	0.0	0.0	0.0	0.0
5.	Non-*ad valorem* tariffs with no AVEs (% of all tariff lines)	0.0	0.0	0.0	0.0
6.	**Simple average bound rate**	18.4	18.4	18.4	17.6
	Agricultural products (HS01-24)	19.0	19.0	19.0	19.0
	Industrial products (HS25-97)	18.3	18.3	18.3	17.4
	WTO agricultural products	19.0	18.9	18.9	18.9
	WTO non-agricultural products	18.3	18.4	18.4	15.2
	Textiles and clothing	21.5	21.8	21.8	21.7
7.	"Nuisance" bound rates (% of all tariff lines)[b]	0.0	0.0	0.0	0.0
8.	**Simple average applied rate**	5.0	5.0	5.0	..
	Agricultural products (HS01-24)	5.1	5.1	5.1	..
	Industrial products (HS25-97)	4.9	5.0	5.0	..
	WTO agricultural products	5.1	5.1	5.1	..
	WTO non-agricultural products	4.9	5.0	5.0	..
	Textiles and clothing	5.0	5.0	5.0	..
9.	Domestic tariff "spikes" (% of all tariff lines)[c]	0.0	0.0	0.0	..
10.	International tariff "spikes" (% of all tariff lines)[d]	0.0	0.0	0.0	..
11.	Overall standard deviation (SD) of tariff rates	0.5	0.5	0.5	..
12.	"Nuisance" applied rates (% of all tariff lines)[b]	0.0	0.0	0.0	..

.. Not available.

a Final bound calculations are based on the 2004 tariff schedule.
b "Nuisance" rates are those greater than zero, but less than or equal to 2%.
c Domestic tariff spikes are defined as those exceeding three times the overall simple applied rate (indicator 8).
d International tariff spikes are defined as those exceeding 15%.

Note: For 2000, 2002, and 2004, four, three and three tariff lines, respectively, are excluded in the tariff analysis due to prohibition. The corresponding HS codes are 22071, 22072 and 22089010 (22089001 and 22089002 for 2000). The 2000 tariff is based on HS96; the 2002 and 2004 tariffs are based on HS02.

Source: WTO Secretariat calculations, based on data provided by the Mongolian authorities.

(d) Applied MFN rates

25. Mongolia's current (2004) average applied MFN tariff rate is 5%, unchanged since 2000 (except in 2001, when the majority of tariff rates were increased to 7%; the rates were decreased to 5% in 2002). In 2004, 0.9% of tariff lines were duty free. A tariff rate of 5% applies to 98.8% of all tariff lines. The range of applied tariff rates is zero to 15%.

(e) Tariff escalation, tariff ranges, and tariff peaks

26. There is effectively no tariff escalation nor any evident tariff peaks, because of an almost uniform applied MFN rate of 5%.

(f) Tariff quotas

27. Mongolia does not maintain tariff quotas.

(iii) Other charges affecting imports

28. In addition to customs tariffs, the Mongolian authorities apply VAT and excise taxes on imported goods. These taxes apply equally to domestically produced and imported goods.

(a) Value-added tax

29. The VAT was introduced under the Value-added Tax Law, which entered into force on 1 July 1998. The current VAT rate is 15%; it applies to both goods and services. Goods sold in Mongolia, jobs performed and services rendered in Mongolia, and goods imported for sale, use or consumption in Mongolia are subject to the VAT.

30. The General Department of National Taxation and the Customs General Administration are responsible for the administration of the VAT. Any citizen or legal person engaged in the importation of goods, sale or manufacture of goods, performance of work, or rendering of services in Mongolia, with a taxable turnover of at least Tog 10 million during the preceding year, must register for VAT purposes.

31. The tax base is the price determined by Customs in conformity with the Custom Tariff Law, plus customs duty, excise tax, and other taxes. The taxable amount is defined based on the current market value of goods sold, jobs performed, and services rendered; where the price is uncertain, the taxable amount is defined by the tax and the customs administrations. Where the taxable amount is expressed in foreign currency, it is converted into togrogs using the official exchange rate announced by the Bank of Mongolia. Several imported commodities and trade-related services are exempt from the VAT, as stipulated in the VAT Law (Table III.4).

Table III.4
Imports exempted from the VAT

VAT Law Article No.	Goods and services exempted from the VAT
9.1.1	Financial services
9.1.7	Services rendered by government organizations
9.1.13	Services provided to foreign tourists by organizations engaged in tour operating activities
9.2.1	Passengers baggage for personal use
9.2.2	Goods imported for use of diplomatic missions or international organizations residing permanently in the territory of Mongolia
9.2.3	Goods, jobs, and services purchased in the territory of Mongolia for work needs of diplomatic missions and consular offices residing in Mongolia, if these purchases for the needs of diplomatic missions and consular offices of Mongolia are exempted from tax in the respective foreign countries
9.2.4	Humanitarian and grant aid goods obtained from governments and non-governmental organizations of foreign countries, international, charity organizations
9.2.7	Special purpose appliances for handicapped people

Table III.4 (cont'd)

VAT Law Article No.	Goods and services exempted from the VAT
9.2.8	Any weapons, technical appliances imported for defence needs, police, state security, and law enforcement
9.2.9	Primary raw materials produced in the territory of Mongolia from agriculture, forestry and hunting; applies to producers of primary raw material of respective types
9.2.10	Equipment and heavy machinery to be used and assembled for technological purposes in production by a business entity with foreign investment, which has made an investment in a priority industry and export-goods manufacturing. The list of priority industries is approved by the Government of Mongolia
9.2.11	Sale of an apartment and/or part of it; does not apply to an apartment or to a part thereof, newly built for purposes of sale
9.2.12	Imported machinery, equipment, materials, raw materials, spare parts, gasoline, diesel fuel, food and personal items for employee needs, in support of activities related to crude oil as provided in an agreement with the Government based on principles of products sharing in crude oil industry.
9.2.13	Personal-use passenger vehicles (not more than one) of individuals appointed to work in diplomatic missions or consular offices residing in foreign countries or in inter-governmental international organizations for more than one year, and who are returning to the country permanently
9.2.14	Blood, blood products, and organs to be used for treatment purposes
9.2.15	Sold gold
9.3	Production and service suppliers with annual taxable sale revenue of Tog 10 million or less; does not apply to importers.

Source: Value-added Tax Law of Mongolia.

(b) Excise tax

32. In accordance with the Excise Tax Law, excise taxes are levied on goods considered to be damaging to the health of the population and/or the environment, to luxury items, and to items related to gambling (Table III.5). They apply to goods produced in Mongolia and to imports; different rates may apply between goods produced in Mongolia and imports. The taxes are calculated either by quantity, or as a percentage of the value of the dutiable goods. Exports are exempt from excise taxes. Snuff tobacco, and gasoline and diesel fuel imported for oil-related business activities conducted jointly with the Government are exempt from excise taxes. Domestically produced spirits distributed to food factories for the production of hard alcoholic beverages or for medical use and veterinary medicine, as well as domestically produced beer and home-made liquor distilled from milk, are exempt from excise taxes; imports of these products are not tax-exempt. Excise tax is therefore a barrier to imports of these products.

Table III.5
Excise taxes

Goods subject to excise tax	Domestic goods		Imported goods
	Ad valorem rates	Specific rates (US$)	Specific rates (US$)
Raw spirits	85	-	7.0 per litre
Hard alcoholic beverages			
up to 40°	80		5.0 per litre
over 40°	80		6.0 per litre
Wine	30		0.75 per litre
Tobacco products		0.30/100 per sticks	0.30/100 per sticks
Pipe tobacco and other identical tobacco		0.15 per 1 kg.	0.15 per 1 kg.
Beer		0.20 per 1 litre	0.20 per 1 litre
Gasoline			Imported at: Tsagaannuur, Yarant, Handgait, Tes, Borshoo, Burgastai, Gashuun Sukhait
Octane up to 90	-	11.0 per 1 ton	11.0 per 1 ton

Table III.5 (cont'd)

Goods subject to excise tax	**Domestic goods**		**Imported goods**
	***Ad valorem* rates**	**Specific rates (US$)**	**Specific rates (US$)**
Octane over 90	-	12.0 per 1 ton	12.0 per 1 ton
Diesel fuel	-	15.0 per 1 ton	15.0 per 1 ton
Gasoline			Imported at: Hankh
Octane up to 90			17.0 per 1 ton
Octane over 90			21.0 per 1 ton
Diesel fuel			19.0 per 1 ton
Gasoline			Imported at: Sukhbaatar, Zamyn-Ud, Ereentsav
Octane up to 90			38.0 per 1 ton
Octane over 90			43.0 per 1 ton
Diesel fuel			48.0 per 1 ton
Passenger vehicles			
0-3 years			500
From 3 to 10 years			1,000
More than 10 years			2,000

Source: Excise Tax Law of Mongolia.

(iv) Customs valuation, preshipment inspection, and rules of origin

33. Customs valuation for imported goods is administered in accordance with the Customs Tariff Law. Mongolia uses the c.i.f. price of imports as the basis for customs valuation. According to Articles 10-18 of the law, the primary basis for determination is the transaction value, i.e. the price actually paid or payable for the goods when sold for export to the customs territory of Mongolia. If Customs suspects that the declared value is not correct, and if the importer cannot justify the declared import value, Customs may apply either the "deductive method", the "computed method", or the "fall-back method".

34. Mongolia does not use preshipment inspection procedures.

35. Mongolia does not appear to have any rules of origin for imported goods, partly because it does not have any preferential import schemes.

(v) Import prohibitions, restrictions, and licensing

36. Mongolia does not apply any import quotas.

37. According to the Customs Law, prohibition or restriction of imports requires the authorization of Parliament. Currently, prohibited goods include certain drugs and narcotics as well as raw materials and equipment that can produce them, and all types of pure spirits.[8] Goods that are currently restricted are classified into several different categories, such as: certain cows, horses, sheep, goats, and camels; animal-related raw materials and body parts of rare animals; natural plants; uranium and concentrates thereof; ionized and ultra-violate rays substances; low risk chemical substances; all chemical substances included in the Montreal protocol that produce harmful effects on the ozone layer; dangerous industrial waste; donor blood; any body parts that should be stored under guidance; medical products that can affect the human mind, according to the UN 1961 convention on drugs and UN 1971 convention on substances and the UN 1998 convention on illegal trading of drugs; weapons; veterinary equipment; knitted final good; and cultural artefacts (Table III.6).[9]

[8] Government Resolution No. 5, 1998.
[9] Government Resolution No. 54, 2001.

According to the authorities, the main purpose of these restrictions is to protect human, animal and plant health while safeguarding national security.

Table III.6
Goods prohibited under Government Resolution No. 54 of 2001

Goods under 4-digit HS code	Goods under 6-digit HS code	Commodity description	Export/import
12.11	1211.90.00	Plants and parts (including seeds and fruits), of a kind used primarily in perfumery, in pharmacy, or for insecticidal, fungicidal or similar purposes, fresh or dried, whether or not cut, crushed or powdered	Export and import
13.01	1301.90.00	Lac. Natural viscous gums, resins, gum-resins and greasy- gums (balsams)	Export and import
29.22	2922.19.00 2922.30.00 2922.39.00 2922.49.00 2922.50.00	Amino- compounds with oxygen-function	Export and import
29.24	2924.10.00 2924.29.00	Carboxyamide-function compounds amide-function compounds of carbonic acid	Export and import
29.26	2926.90.00	Nitrile function compounds	Export and import
29.33	2933.39.00 2933.40.00 2933.90.00	Heterocyclic compounds with nitrogen hetero-atom(s) only	Export and import
29.34	2934.90.00	Nucleic acides and thereof salts, heterocyclic compounds:	Export and import
29.39	2939.10.00 2939.90.00	Vegetable alcaloids, natural or reproduced by synthesis, and their salts, ethers, esters and other derivatives	Export and import
		All of kind spirits	Import
22.07		Undenatured ethyl alcohol of an alcoholic strength by volume of 80% vol or higher: ethyl alcohol and other spirits, denatured, of any strength	Import
		Chemicals, the production of which is prohibited by an International Convention on the Prohibition of Production, Storage and Utilization of Chemical Weapons and their Proliferation	Export and import
		Poisonous chemicals, the use of which is prohibited in Mongolia /16 types of chemicals listed in the annex to the Order by the Minister of Environment No. 75 of 1997	Import
		Poisonous chemicals used in the production of weapons, wastes thereof	Export and import
		Radioactive chemicals, wastes thereof, originating from nuclear weapons	Import
		Parts and compounds of nuclear weapons prepared for nuclear weapon purposes	Import
		Dangerous wastes	Import
		Human blood, blood fractions and organs, not proven to be non-infected with AIDS	Import
		Donor blood and organs for medical preventive purposes that are required to be under strict control	Import
30.01	3001.10 3001.20 3001.90	Glands and other organs for organotherapeutic uses, dried, whether or not powdered; extracts of glands or other organs or of their secretions for organo-therapeutic uses; heparin and its salts; other human or prophylactic uses, not elsewhere specified or included.	Import
30.02	3002.10 3002.20 3002.90	Human blood; animal blood prepared for therapeutic, prophylactic or diagnostic uses; antisera and other blood fractions and modified immunological products, whether or not obtained by means of biotechnological processes; vaccines, toxins, cultures of microorganisms (excluding yeasts) and similar products.	Import
		High-yielding animals, their semens	Export and import
01.01		Live horses, asses, mules and hinnies	Export and import
		Horses	Export and import
01.02		Live bovine animals	Export and import

Table III.6 (cont'd)

Goods under 4-digit HS code	Goods under 6-digit HS code	Commodity description	Export/import
01.04		Live sheep and goats	Export and import
01.06		Other live animals	Export and import
		Camel	Export and import
05.11	0511.10 0511.99	Animal products not elsewhere specified or included; dead animals of Chapter 1 or 3, unfit for human consumption.	Export and import
		Printed magazines, books, movies, videos, pictures, etc. that propogate pornography	Export and import

Source: Government Resolution No. 54 of 2001, Government of Mongolia.

38. According to Government Resolution No. 219 of 25 October 2002, which entered into force on 1 January 2003, several ministries are in charge of issuing import and export licences for restricted goods; these include the Ministries of Environment, Education, Culture and Science, Industry and Trade (MIT), Food and Agriculture, and Health. These ministries are required to provide information on licensing to MIT every quarter, and to provide the official name, position, and signature of the licence holder to the Customs General Administration. A licence-issuing ministry must respond to the licence request within 21 working days. If necessary, the issuing organization has the right to extend the period for a further 14 days in order to conduct a detailed analysis of the request. A licence is valid for one year. A licence can be extended for a year, when needed, to fulfil an export and import contract. Goods subject to import and export licensing requirements are listed in Table III.7.

Table III.7
Goods subject to import or export licence

HS Code, national	Description	Export/import
	I. Breeding animals	Export
01011000	Pure-bred breeding horses	
01019000	Other breeding horses	
01021000	Pure-bred breeding live bovine animals	
01029000	Other breeding live bovine animals	
01031000	Pure-bred breeding live swine	
01041000	Sheep	
01042000	Goats	
01069010	Camels	
	Other live animals, raw materials originating therefrom, samples of animals for research purposes, semen of animals, cultures of micro-organisms	
	Very rare animals (26 types of animals listed in the Animals Law)	
	Rare animals (list to be determined by the Government)	
05079011	Antlers, filled with blood, of deer	
05079021	Horns, of deer	
05079029	Horns, of wild sheep and of wild goats	
05100011	Musk	
05100012	Penis, of deer	
05111000	Bovine semen	
05119910	Animal semen (other than bovine semen)	
05119990	Semen, of other animals other than breeding animals	
26121000	Uranium ores and concentrates	

Table III.7 (cont'd)

HS Code, national	Description	Export/import
	II. Poisonous chemicals (96 types of chemicals indicated in joint order No. 83/A/160 of 1998 by the Ministers of Environment, Health and Social Welfare)	Export and import
	III. Human blood and organs for therapeutic and prophylactic purposes that require necessary control	Export and import
30011000	Glands and other organs, dried, whether or not powdered	
30012000	Extracts of glands or other organs or of their secretion	
30021000	Antisera and other blood fractions and modified immunological products, whether or not obtained by means of biotechnological processes	
30023000	Vaccines for veterinary medicine	
30029000	Other: human blood, cultures of micro-organisms	
	IV. Explosives	Export and import
36010000	Propellent powders	
36020000	Prepared explosives, other than propellent powders	
36030000	Safety fuses, detonating fuses, percussion or detonating caps, igniters, electric detonators	
3604	Fireworks, signaling flares, rain rockets, fog signals and other pyrotechnic articles	
	V. Guns, equipment and tools for military use and their spare parts	Export and import

Source: Government Resolution No. 219 of 2002, Government of Mongolia.

(vi) Contingency measures

39. According to Article 8 of the Customs Tariff Law, the Government may, in addition to customs tariffs, impose anti-dumping and countervailing duties. These may be imposed in cases where failure to do so will or may: cause damage to a domestic manufacturer; preclude production or expansion of production of comparable goods; or allow other countries to discriminate against Mongolia or infringe its interests. Before imposing such duties, the Customs Tariff Council must verify the situation to determine whether grounds to do so exist under the legislation and Mongolia's international treaties. Mongolia currently imposes neither anti-dumping not countervailing measures.

40. There are no provisions in Mongolia's current legislation covering safeguard measures. It currently applies no safeguard measures.

(vii) Government procurement

41. Government procurement is used as an instrument of economic policy in Mongolia; government procurement of goods and services since 1995 amount to Tog 328 billion (equivalent to about US$270 million). Infrastructure accounts for 65.4% of total purchases made through tender, state-owned industrial entities for 8%, local areas for 6.5%, and education, culture and science for 3.8%.

42. Mongolia is not a signatory to the WTO Agreement on Government Procurement; it is an observer in the GPA Committee. In April 2000, Mongolia adopted a Public Procurement Law to regulate matters concerning the preparation of bidding documents, advertisement, opening of tenders, evaluation of tenders, award of contracts for public procurement of goods, works and services, composition and organization of the Tender Committee and control over its activities.[10] The Law regulates the procurement practices of the Central Government and of local governments.

[10] Article 1, the Law of Mongolia on Government Procurement.

43. According to legislation, procuring entities are defined as legal persons with state participation of more than 50% that are engaged in procurement of goods, works and services. It is forbidden to exclude foreign bidders from tenders for contracts exceeding Tog 100 million. Domestic suppliers receive a 10% of margin of preference for goods and 7.5% for services. The Law specifies threshold values for the selection of procurement procedures, open and selected tendering, and comparison of quotations.

44. In June 2000, a Central Procurement Monitoring Office was established under the Budget Department, Ministry of Finance and Economy. The office was subsequently restructured and renamed the Procurement Policy and Coordination Division (PPCD); it is responsible for all matters of public procurement. In view of fiscal consolidation (Chapter I(3)(i)), the PPCD aims to establish an efficient and effective procurement policy and to monitor the implementation of a transparent national procurement system with concurrent cost savings in public procurement; it is not a central purchasing agency. Procuring entities that are users of public funds are responsible for their own procurement in accordance with the Public Procurement Law.

(viii) State trading

45. Mongolia does not maintain any state-trading enterprises.[11]

(ix) Other measures

46. The authorities maintain that there are no legal provisions covering countertrade or import/export cartels; nor does the Government or state-owned enterprises engage in them. The authorities are not aware of the existence of any import/export cartels in the private sector.

(3) MEASURES DIRECTLY AFFECTING EXPORTS

(i) Procedures

47. Tax registration and registration of economic entities with the State Registry Office are required for the purposes of customs clearance for exports; customs clearance procedures and documentation requirements for exports are regulated by the Customs Law. The principal document for customs clearance is the Customs Declaration Form (CDF) (see section (2)(i)); Customs may require the exporter to produce additional documents, such as an invoice, a packing list, and a certificate of origin. The customs value of exported goods are their value at the Mongolian border.

48. Like imports, one-stop services are available at major customs points, and a "gold card" system has been introduced since 2002 (see section (2)(i)).

49. The Mongolian National Chamber of Commerce and Industry (MCCI) issues certificates of origin for exporters, particularly to textile exporters that export to the United States and the European Union. Rules associated with the issuance of certificates of origin are stipulated in regulation "Issuing the Certificate of Origin and Determining the Origin of Textiles originated in Mongolia", which entered into force on 2 August 1999. To request a certificate of origin, an exporter must submit copies of the contract, invoice, and packing list, and an application form to the MCCI; the MCCI normally issues certificates of origin within four business hours, provided the required documents have been submitted. The MCCI may conduct an inspection of the goods to be exported at the factory.

[11] WTO document G/STR/N/7/MNG, 9 July 2001.

(ii) Export taxes, charges, and levies

50. Mongolia applies export taxes on several goods. The main legislation governing export taxes is the Law of Mongolia Determining the Amount of Export Customs Duty to be Imposed on Certain Commodities, approved on 29 March 1996. Insofar as such taxes reduce the domestic price of these products, they constitute assistance to their domestic processing (Table III.8).

51. Upon accession to the WTO, Mongolia made a commitment to eliminate export duty on raw cashmere within ten years of the date of accession. With a view to protecting domestic metal-smelting plants, due to the increasing shortage of raw metals and a large increases in the world prices of metals since 1997, export taxes on scrap metals were raised from Tog 140/kg. to Tog 350/kg. in May 2004.

Table III.8
Export taxes for certain commodities, as of January 2004

No.	Product/Commodity	HS Code	Tax
1	Camel wool, raw, thick	(5102.10.11)	Tog 100/kg.
2	Camel wool, raw, thin	(5102.10.12)	Tog 200/kg.
3	Raw cashmere	(5102.10.20)	Tog 4,000/kg.
4	Goat, baby goat raw skins	(4103.10.00; 4301.80.12)	Tog 1,500 for every piece
5	Round wood, logs	(44.01; 44.03)	Tog 150,000/m^3
6	Billets	(44.03-44.06)	Tog 150,000/m^3
7	Cut timber	(44.07-44.09)	Tog 150,000/m^3
8	Scrap metals and worn rails	(72.04; 7204.10.00; 72.04.21.00; 72.04.29.10)	Tog 350/kg.
9	Poles made of iron and steel sheets	(73.01)	Tog 140/kg.
10	Rails	(7302.10.00)	Tog 140/kg.
11	Copper, zinc alloys/brass	(7403.21.00)	Tog 128/kg.
12	Copper waste and scrap	(74.04)	Tog 1,500/kg.
13	Bars, rods and profiles of copper	(74.07)	Tog 1,500/kg.
14	Aluminium, unwrought	(76.01)	Tog 450/kg.
15	Waste and scrap aluminium	(76.02)	Tog 450/kg.
16	Bars, rods and profiles of aluminium		Tog 350/kg.

Source: The Law of Mongolia Determining the Amount of Export Customs Duty to be Imposed on Certain Commodities, 29 March 1996.

(iii) Export prohibitions, restrictions, and licensing

52. Exports of drugs and narcotics (and raw materials and equipment that can produce them) and certain dangerous and poisonous chemicals are prohibited; exports of raw hides, skins, and cashmere are prohibited with a view to protecting domestic processors.[12] Mongolia does not apply any UN-related economic sanctions.

53. There are no licensing requirements for exporters in Mongolia, except on some items including guns, explosives and certain drugs (Table III.7).[13] Mongolia has no voluntary export restraint agreements with other countries. Mongolia uses no price regulations with respect to its exports.

[12] Joint resolution No.64/125 of 2003 by the Minister for Industry and Trade and the Minister for Finance and Economy.

[13] Government Resolution No.219 of 2002.

(iv) Export-tax concessions, subsidies, free zones, and export performance requirements

(a) Tax concessions and subsidies for exporters

54. Mongolia does not provide direct subsidies to any exported goods, including agricultural products. Exports are exempt from excise duties and VAT.

55. A business entity with foreign investment that exports more than 50% of its production enjoys income tax holidays in the first three years and 50% tax relief in the following three years.[14] While Mongolia committed to eliminate these subsidies by 31 December 2002, there appears to be little political will to do this, since other countries provide similar incentives for export-oriented industries.

(b) Free-trade zones

56. The concept of free-trade zones was initially adopted in the Law of Mongolia on Free Zones, which was approved by Parliament in June 2002; to date no such zones have been established. The main objective of the law is to intensify the production of export goods, to encourage foreign investment, to create employment, and to promote development of regions near the border with neighbouring countries. Free-trade zones are formally part of Mongolia's customs territory but separated from it by special check points; business and investment in the zones are subject to separate customs duty and tax treatment from other parts of Mongolia.[15] In the zones, firms are to be accorded simplified entrance/exit procedures. Special preferential conditions, including tax and other concessions, are to be applied in free-trade zones.

(v) Export finance, insurance, and guarantees

57. Neither the Government nor its affiliated institutions provide export finance; however, it is apparently available from commercial banks in Mongolia. There is no export insurance or guarantee system in Mongolia.

(vi) Export promotion and marketing assistance

58. Existing institutions involved in trade promotion are mainly the Mongolian National Chamber of Commerce and Industry (MCCI) and to a certain extent the Foreign Investment and Foreign Trade Agency (FIFTA). The MCCI has cooperation agreements with foreign chambers of commerce and its own network of representatives abroad to allow it to provide export-market information to its members. Recently, an Export Promotion Center was set up in the FIFTA.

(4) MEASURES AFFECTING PRODUCTION AND TRADE

(i) Promotion of inward foreign direct investment

59. Since 2001, the Government has introduced a number of measures to raise production and investment. These included: determining "priority sectors"[16], reforming the legal environment with a

[14] Foreign Investments Law of Mongolia.

[15] Law of Mongolia on Free Zones, paragraph 3.1.

[16] The list of priority sectors was approved by Government Decree No. 140, 27 June 2001. It lists 21 sectors including agriculture; exploration of coal, oil and gas, uranium and thorium ore, iron ore, and other mineral resources; production of food, flour and animal fodders; knitting; fur processing; leather processing; timber production; liquid and radioactive fuel; production of chemical products; goods made of non-metal minerals; metallurgic industry; processing of a secondary raw material; production of electricity, steam and water supply; water treatment and water supply; and construction.

view to attracting foreign investment in key sectors, and revitalizing agriculture-related processing industries.

60. Furthermore, the Government grants tax incentives to business entities that involve foreign investment, including joint ventures, in accordance with the Economic Entity and Organization Income Tax Law, the Customs Tariff Law, the Value Added Tax Law, the Excise Tax Law, and the Land Law; domestic companies are not eligible for such incentives. For example, foreign businesses exporting more than 50% of production are entitled to receive corporate income tax exemption for the first three years of investment and 50% tax relief in the subsequent three years.[17]

61. FDI in certain sectors and activities receive further preferential tax treatment. For example, ten years of tax exemption and 50% tax relief for the subsequent five years are granted for FDI in power and thermal plants and their transmission networks, highways, railways, airways and engineering construction, basic telecommunications network, electricity source and network, and technology renovation; and five years of tax exemption and 50% tax relief in the subsequent five years are granted for FDI in oil and coal, metallurgy, chemical production, machinery, and electronics.

62. If a foreign investor reinvests its income in its own projects, then the taxable income of the investor will be subject to deduction amounting to such reinvestment.[18] The annual taxable income and gains of a shareholder (and transfers abroad) of a foreign company that conducts business in Mongolia in accordance with a product-sharing contract with the Government, are exempt from taxation. If an enterprise uses its own assets for road construction and repair, these assets are deductible from the total taxable income.

63. A "stability agreement" between the Government and a foreign investor investing more than US$2 million apparently provides a legal guarantee for a stable tax environment; tax provisions in accordance with stability agreements override provisions under the Tax Law.

64. In addition, with a view to promoting regional development, the Government provides income tax exemptions to business entities, domestic or foreign, that invest in new operations in *aimags*, in underdeveloped *aimags*, and in locations 100 km away from underdeveloped *aimags*. Business entities and organizations that are newly established to undertake production and services activities on the territory of an *aimag* and registered with the *aimag's* tax authority enjoy tax exemptions; the Government approves the list of *aimags* and *soums* that are eligible for such tax relief.[19]

65. The Government has also been promoting the establishment of industrial and technological parks to encourage export-oriented production, improve competitiveness, and introduce new technologies. Income tax allowances or exemption are to be available for companies in industrial and technological parks. No such parks have been established yet.

(ii) Standards and other technical requirements

66. The main standardization and metrology laws in Mongolia are the Law on Standardization and Conformity Assessment and the Law on Traceability of Measurement Uniformity. In 2003, these

[17] This provision does not apply to wool and cashmere washing and dehairing and primary processing leather industries.

[18] Article 7, the Economic Entity and Organization Income Tax Law of Mongolia.

[19] These provisions do not apply to business entities and organizations engaged in production of alcoholic beverages or in the mining industry.

laws were amended with a view to harmonizing the activities of standardization and conformity assessment with international approaches.

67. The Mongolian National Centre for Standardisation and Metrology (MNCSM) is a government-regulatory agency responsible for coordinating and managing metrology, standardization, and testing in Mongolia; it is also responsible for developing national standards and providing conformity marks to domestic and foreign products. The MNCSM acts as a WTO enquiry point and coordinates the implementation of the WTO Agreement on Technical Barriers to Trade; it is also member of the International Organization for Standardization (ISO) and the FAO/WHO Codex Alimentarius Commission (Codex), and has joined the IEC Affiliate Country Programme since 2001.

68. Mongolian standards are developed by consensus of industry, consumers, government bodies, and testing establishments. The main objectives of Mongolia's standardization policy include increasing the number of national standards that are identical to international standards. Currently, there are 4,156 Mongolian standards, of which 35% are harmonized with international standards. More than 40% of the Mongolian standards are quoted as mandatory technical regulations. The authorities have been making efforts to reduce the number of mandatory standards and increase voluntary conformity assessments by manufacturers. There are also 588 food standards[20], of which 45% are identical to international standards, and 388 agricultural standards, of which 14% are identical to international standards.[21]

69. Since 1995, the MNCSM has granted 308 conformity marks to domestic and foreign products. Since June 2003, Mongolia has accepted conformity marks issued by selected foreign certification bodies as equivalent to Mongolia's national conformity marks.

70. On 28 November 2002, Parliament approved the Law on Quarantine and Inspection for Transferring of Animals, Plants, Raw Materials and Products of their Origin through the State Border, which effectively replaced the previous laws on animal health and plant protection. The new law was drafted by the Government because the previous laws on animal and plant quarantine did not meet concerns related to the increase in international trade.

71. Mongolia has government-level cooperation agreements on standardization and certification with China "the cooperation agreement on the quality certification and mutual recognition of import and export commodities between the Government of Mongolia and the Government of the People's Republic of China", signed in 1994; and with Russia "the cooperation agreement on the quality of import and export commodities between the Trade Ministry of Mongolia and the Federal Agency of standardization, metrology and quality certification of the Russian Federation", signed in 1996.

(iii) Intellectual property rights

72. Mongolia committed to fully apply the provisions of the WTO Agreement on TRIPS by the date of its accession to the WTO in 1997. Parliament and the Government undertook certain activities to bringing national legislation on intellectual property rights into conformity with the TRIPS Agreement and other international conventions and agreements on intellectual property. In this context, the Law on Patent and Copyright of 1993 was amended in 1999 with a view to assuring compatibility with the TRIPS Agreement. Parliament has adopted the Law on Joining the World Intellectual Property Organization (WIPO) Copyright Treaty, and the WIPO Performers and

[20] These include 25 basic standards, six terminology standards, 243 testing standards, and 314 product standards.

[21] These include three basic standards, seven terminology standards, 137 testing standards, and 241 product standards.

Phonograms Treaty (in 2002).[22] The Intellectual Property Office, which is under the responsibility of the Deputy Prime Minister, is responsible for enforcing these laws. The Intellectual Property Office is also in charge of settling disputes and grievances. If the disputing parties disagree with the decision of the Intellectual Property Office, they can refer the matter to the court.

(a) Copyright and related rights

73. Under Article 3 of the Copyright Law of Mongolia of 1993, copyrighted work is protected from its creation. The Law regulates matters related to the protection of copyright and issues arising in connection with the use of works that are subject to copyright.[23] An author may register his work or contract of transfer of rights; registration is not required for the protection of copyrights. Mongolia's legislation defines the protection of performers and artists' rights (including duration and coverage of protection), and the rights of broadcasting organizations and producers of phonograms.

(b) Patents

74. Under the Patent Law of Mongolia, patent protection is provided for a period of 20 years following the filing of the application.[24] Patents are granted for methods and products, including inventions relating to micro-organisms, pharmaceuticals, chemicals, fertilizer, pesticides, herbicides, biotechnological processes, and biological and genetic materials. Patent applications are filed with the Intellectual Property Office. An application for patents must contain a request, a description of the invention, patent claims and an abstract.[25] The Intellectual Property Office must verify the presence of required documents within 20 days from the date of receipt of an application, and if all the requirements are met it accords the date of receipt of the application as the filing date. After according a filing date, the Intellectual Property Office examines whether the given invention meets the criteria specified in the Patent Law. The Intellectual Property Office must decide within nine months from the filing date whether a patent is to be granted. Successful applications are published; a patent is granted if no notice of opposition is received by the Intellectual Property Office within three months of the date of publication.

(c) Trade marks and other marks

75. The Law on Trademarks and Geographical Indications entered into force in 2003, effectively replacing the previous Law on Trade Names and Trademarks. The new law protects trade marks, service marks, collective marks and certification marks; the duties of the Intellectual Property Office under the new law are to decide on applications and register relevant marks and trade names. Trade

[22] Mongolia is also party to: Convention for the Establishing WIPO, Paris Convention for the Protection of Industrial Property, Madrid Agreement Concerning the International Registration of Marks, Patent Cooperation Treaty, Hague Agreement Concerning the International Deposit of Industrial Designs, Berne Convention for the Protection of Literary and Artistic Works, Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks, Strasbourg Agreement Concerning the International Patent Classification, Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks, Locarno Agreement Establishing an International Classification for Industrial Designs, and Nairobi Treaty on the Protection of the Olympic Symbol.

[23] These include literary works, musical works, works of fine and applied art, architecture and construction design, choreographic works, dramatic works, cinematographic works, photographic works, plans, sketches, designs, and models related to scientific and technical domain, computer programs, directories, dictionaries, encyclopaedia, literary collections, derivative works, and sound and visual recordings.

[24] Under the Patent Law, industrial designs are protected for a period of ten years and utility models seven years.

[25] An application for an industrial design patent must contain, a drawing and a description of the industrial design.

marks are registered for a period of ten years following the filing of the application; registration can be renewed. Both domestic and foreign natural persons and legal entities can apply for registration of marks. Trade mark applications are filed with the Office by the natural or a legal person wishing to register the trade mark; application documents must be submitted in the Mongolian language. If the application meets the requirements provided for in Article 6.1. of the Law, the date of receipt of the application is accorded as the filing date of the application. After according a filing date, the Office examines whether the sign could be considered as a trade mark and whether it is eligible for registration. Based on its findings, the Office decides whether to register the trade mark, within 12 months from the filing date of the application; this period may be extended for up to six months. When a trade mark is accepted, the Intellectual Property Office records it in the State Trademark Register, issues a certificate, and files the application. Registered trade marks and related bibliographic data are published.

(d) Geographical indications

76. According to the Law on Trademarks and Geographical Indications, geographical indications are defined as a geographical name of country or region where the product is produced, identifying the quality, reputation, and other specifics of this product. If a geographical name of country or region has become a generic name in Mongolia to denote certain goods, such name may not be protected as a geographical indication. A geographical indication may not be registered if it is identical with a geographical indication or a trade mark registered in Mongolia in respect to identical goods, or if it is identical with, or similar to, a geographical indication or a trade mark registered in Mongolia in respect of similar goods where its use would result in a likelihood of confusion on the part of consumers. Applications for the registration of a geographical indication are filed with the Intellectual Property Office by natural or legal persons that manufacture goods in the indicated locality where the characteristics of the goods are associated with that locality. The Office records accepted geographical indications in the State Register of Geographical Indications, issues a certificate and keeps the application on file. Registered geographical indications and related bibliographic data are published.

(e) Parallel imports

77. It would appear that parallel imports are allowed in Mongolia; however, sole distributors also appear to be allowed.

(f) Enforcement

78. Under the Patent Law, the Copyright Law and the Law on Trademarks and Geographical Indications, a violation of the intellectual property right (IPR) may attract administrative penalties. Compensation for damages caused by the infringement of the rights of an IPR owner may be awarded in accordance with the Civil Law. The State Intellectual Property Inspection, established in 2000, is responsible for enforcing IPR-related laws.

79. Amendments to the Copyright and Patent Law of Mongolia in 1999 established the current system of enforcement of IPRs, which is based, *inter alia,* on the Rule on State Intellectual Inspection, which provides the rules and details of inspection to enforce various laws for the protection of IPRs. Under the Copyright Law and the Patent Law, in the event of an infringement, a state inspector may impose on a natural person a fine of up to Tog 250,000, or imprisonment of the infringer for up to 7-14 days; the infringing goods are subject to seizure. The Trademarks and Geographical Indications Law has similar provisions. Right holders may initiate request for investigation; Customs also has the right to seize infringing goods, with or without the request of the right holder.

80. Since 2000, the State Intellectual Property Inspection has inspected 1,233 cases and determined 772 IPR infringements (Table III.9).

Table III.9
Enforcement statistics related to intellectual property, 2000-04

Items	2000	2001	2002	2003	2004[a]
Number of inspections conducted					
Planned	169	136	172	98	126
Follow-up of complaints	11	51	137	127	143
Follow-up of public media information	..	4	8	26	8
Entities inspected	168	182	254	217	70
Citizens inspected	12	9	63	51	207
Number of infringements	60	130	164	203	215
Remedies					
Confiscated goods (togrogs)	..	60,957,000	21,813,515	7,638,998	9,618,925
Penalties (togrogs)	2,500,000	..	1,000,000	2,200,000	..
Operations stopped	1	..	..	..	..
Operations renewed	..	..	..	..	..
Transferred to police action	1	3	4	1	..
Transferred to court action	..	3	4	4	..
Produced					
Inspectors report	3	12	28	16	4
Notification	6	47	97	93	24
Acts	17	35	76	50	41

.. Not available.

a Until 1 October 2004.

Source: Information provided by the Mongolian authorities.

(iv) State-owned enterprises and privatization

81. The Government reduced its involvement in mining, manufacturing, and services sectors towards the end of the 1990s; during 1997-00, the proceeds from the Government's sales of state-owned enterprises accounted for around 5% of GDP. In 2002, income from state-owned enterprises accounted for Tog 798 billion, with net profit of Tog 20.3 billion (Tog 23.8 billion in 2003).

82. As of April 2004, there were 80 state-owned enterprises; they are to be privatized in accordance with the Privatization Guidelines for 2004-08 (see below). According to the authorities, the private sector's share in GDP reached about 80% in 2000 (the latest year for which data are available); the private sector's shares in sectoral GDP in 2000 were 98% for agriculture, 90% for trade, 49% for manufacturing, 17% for transportation, 5% for communications, and zero for energy. No state-owned enterprises apparently have exclusive rights in production, sales or exports/imports of particular products.

83. Mongolia's laws and regulations concerning privatization include: the 1996 Central and Local Governments Property Law; Privatization Guidelines for 2001-2004 (Parliament Resolution No. 10, 15 January 2001); Main Guidelines for Social Sector Restructuring, Reform and Privatization (Parliament Resolution No. 56, 10 July 2002); and Government Resolutions No. 35 of 2001, No. 9 of 2002, No. 14 of 2003, No. 13 of 2004 on Privatization. On 25 January 2001, Parliament approved the Privatization Guidelines for 2001-2004, which serve as an official statement of the Government's privatization policies and define enterprise- and sector-specific objectives and priorities. The Government's strategy for 2001-04 focuses on the privatization of most valued companies (MVCs)

through tenders. The MVCs are defined as companies strategically positioned in their respective sectors of the economy with "substantial" market share and potential to attract foreign investment. With a view to increasing the participation of foreign investors in the privatization of the MVCs, the Government intends to: modernize equipment and technology to bring them up to current international standards; introduce management know-how to lead Mongolian companies into the international arena; and dismantle the market dominance of certain enterprises. In 2002, Parliament adopted the Guidelines for Social Sector Restructuring, Reform and Privatization; the social sector includes health, education, culture and arts, and science. The main purpose of the Guidelines is to increase private sector participation, support competition in the social sector, and to improve effectiveness and accessibility of social services.

84. Since 2002, the Trade and Development Bank, the Agriculture Bank, and the NIC (petroleum distribution) and Mongol Daatgal (insurance) have been privatized. The Government Action Programme announced for the period 2000-04 stipulated continued privatization for the state-owned enterprises in the energy and mining sectors. Privatization in the social sectors was to be promoted. In manufacturing, a large state-owned cashmere company, Gobi, is to be privatized. With the exception of Erdenet Mining and Ulaanbaatar Railways, all MVCs are subject to privatization by the end of 2004. MIAT, Mongolia's flag-carrying airline, introduced a management contract with an Irish firm in 2003: the privatization of MIAT is currently under consideration. The overall direction in the privatization process is to prepare the remaining state-owned enterprises for future private-sector involvement.

(v) Competition policy

85. The Law of Mongolia on Prohibiting Unfair Competition was adopted in 1993 and amended in 2000. Currently, there are no agencies authorized to enforce the law; in accordance with the Law, a provisional Unfair Competition and Regulation Authority is being established. The Authority is to be responsible for: enforcement of the legislation as well as for the prohibition, restriction and curbing of activities harmful for competition; the inspection and issue of conclusions on activities of entities conducting business activities; and determining dominant business entities.

86. Under the Law, market dominance is defined as a situation where a single business entity or a group of business entities acting together has more than one third of market share of a product. A business entity in a dominant position is prohibited from conducting activities that restrict fair competition. Such activities include: halting or restricting production or sale of goods in order to create an artificial shortage or to raise prices; using its dominant position to impose additional conditions for resale; selling goods and products at lower-than-cost prices in order to prevent other business entities from entering that market or to drive them out of the market (on the other hand, if a dominant entity sells a particular good at the "lowest minimum social cost" such entity is not deemed to abuse its dominant position); insisting on buyers not buying goods from their competitors as a condition for sale of its goods; demanding that competitors restructure or liquidate their companies through division and separation; insisting on including in a contract conditions that are not relevant to the subject of the contract or disadvantageous to the contracting party (such a behaviour is called a monopoly). Businesses that collectively hold a dominant position are also prohibited from making agreements that hinder competition. These agreements include: mutually agreeing to fix prices; limiting production or sales; dividing markets by location, production, services, sales, name, or type of goods or consumers; participating in competitive tenders or bid auctions having agreed in advance the price (bid rigging); and restricting the sale to or purchase of goods by third parties.

IV. TRADE POLICIES BY SECTOR

(1) OVERVIEW

1. The contribution to GDP of Mongolia's different sectors has changed substantially over the last decade. The services sector displaced agriculture (including hunting and forestry) to become by far the largest sector, accounting for 61.0% of GDP in 2003 (37.9% in 1995); agriculture (including hunting and forestry) declined from 38.0% to 20.1% of GDP, and manufacturing fell from 12.1% to 6.2%. The main service subsectors are wholesale and retail trade, transport, storage, and communications. The services sector is also the major employer, accounting for 46.4% of total employment in 2003 (39.8% in 1995), followed by agriculture and forestry with 41.8% (46.1% in 1995), and industry with 11.8% (14.1% in 1995). These compositional changes in GDP and employment reflect substantial structural adjustment in the economy, largely in response to the comprehensive reforms undertaken in Mongolia's transition from a centrally planned to a market economy.

2. Livestock herding is the main agricultural activity. Labour productivity in agriculture is little more than one third of the level in rest of the economy, and declining. Some 30% of exports are agriculture based. Agricultural reforms, including privatization and price de-regulation, advanced rapidly in the 1990s under Mongolia's transition to a market economy. This caused substantial adjustment, largely out of crops reliant on state support, especially wheat, into cashmere and other livestock activities. However, droughts and harsh winters reduced herds, and along with disease and malnutrition from nomadic over-grazing of state land, have reduced productivity and contributed to land degradation.

3. Agricultural policy is directed at reversing declining productivity and achieving greater self-sufficiency, especially in milk, flour, potatoes, and other vegetables, by promoting private participation and investment. Greater self-sufficiency is encouraged on grounds of food security. Meat and flour along with cereal seeds, salt, wheat, and drinking water are considered "strategic products". The Government intends to expand wheat production to meet 60-70% of domestic demand for flour. Greater domestic processing for export of livestock products, such as cashmere, meat, hides, and furs, is also a high priority. Mongolia has staunchly resisted protectionist pressures, including in agriculture, with few exceptions. Flour and certain vegetables have higher seasonal tariffs of 15% (instead of 5%) for most of the year, and limited state support for wheat growing has resumed through the State Agricultural Fund. Unprocessed cashmere exports are taxed to provide cheaper supply to promote domestic processing. However, such measures may have contributed to excess processing capacity, since up to half of Mongolia's raw cashmere is smuggled into China to avoid the tax. Such protective policies, including the dominance of and at times assistance provided to the majority state-owned firm, Gobi, have stifled cashmere processing and have not expanded value-added activity, despite benefiting processors through lower cashmere prices at the expense of herders. Exports of raw hides and skins are prohibited, also with the intent of encouraging domestic processing by lowering prices to processors, but again at the expense of herders and with little economic merit.

4. Forests are being depleted. Annual allowable cutting quotas are set as much as four-fold higher than seemingly sustainable levels, and substantial illegal logging exists (accounting for as much as 80% of the total annual harvest). Export taxes of US$150 per cubic metre ($m^3$) effectively ban exports, and were extended from unprocessed to semi-processed timber products to promote domestic processing.

5. Mining, mainly of gold, copper, coal, and fluorspar, is the economy's industrial backbone. Mineral processing accounts for two thirds of exports (gold and copper). State-owned firms dominate mineral production, including coal. The largest state-owned enterprise in this sector produces copper concentrate and is a government joint venture, 49% owned by the Russian Government and 51% by the Mongolian Government. Gold production has expanded substantially and is mined privately. The Government aims to double mining's contribution to GDP (12.7% in 2003). Most foreign investment is in mining. New minerals legislation in 1997 accorded foreigners greater security and access to mineral exploration and development.

6. The state monopoly on petroleum importation and distribution was abolished in 1990. The tender for the highly indebted state-owned Neft Oil Import Concern (NIC) was concluded in early 2004. Domestic interests acquired the State's 80% equity. Oil income is exempt from income tax. The Government aims to establish an oil refining industry. Restructuring of the highly indebted state-owned electricity sector started in 2001 with market reforms. The former Energy Authority's operations were unbundled into 18 companies separating generation, which was de-regulated, transmission, and distribution. Privatization efforts are continuing. The Energy Regulatory Authority was created in 2002.

7. The manufacturing sector, consisting mainly of food, beverages, textiles and clothing, has been substantially restructured. State equity in manufacturing (e.g. cashmere products) remains significant. The Government has prioritized as key industries copper and meat processing, leather and cashmere products, carpets, and wool. Removal of clothing quotas by the United States, Mongolia's major market, in 2005 may threaten production if foreign joint ventures leave as a result.

8. Mongolia made various GATS' commitments as part of its accession to the WTO. Several banking crises in the 1990s closed major banks and required costly government-funded rescue plans. However, the level and rising value of bank and other non-performing loans (albeit well down on 1990 levels) raises prudential concerns. The capital market remains thin. Prudential requirements and supervision, especially of banks and non-bank financial institutions, are being strengthened along with institutional capacities and corporate governance, based on international practices. There are no non-prudential restrictions on foreign banks or other financial institutions, including insurance companies. Bank privatization, including sales of assets to foreign interests, has advanced. State equity has fallen from 60% in 2001 to currently 4%, and bank assets are 31% foreign owned. Two insurance companies have been fully privatized, the largest to a consortium with overseas interests, in 2003.

9. The majority state-owned Mongolia Telecom (MT), has a statutory monopoly on domestic basic telecommunications until 2015. International calls were de-regulated in 2002. Two mobile operators exist. Prices, including mobile services, are regulated on a full-cost-recovery basis, and cross subsidies apply on basic services. New legislation in 2001 laid the foundations for further de-regulation, by creating in 2002 the Communications Regulatory Committee and introducing interconnection and other competition safeguards. However, the MT monopoly greatly limits their practical significance. Government policy is to end this as soon as possible, subject to re-negotiation of an agreement concluded in 1995 with Korea Telecom on the terms of MT's privatization. Transportation services, other than domestic air services, are heavily regulated, and restructuring, including private participation, is envisaged. The national air carrier and railways are state-owned; MIAT is to be privatized in 2005. Tourism is a priority sector.

(2) AGRICULTURE AND RELATED ACTIVITIES

10. The share of agriculture (including hunting and forestry) in Mongolia's GDP declined from 37.0% in 1999 to 20.1% in 2003 (Table IV.1); it accounted for 41.8% of total employment in 2003

(Table IV.2). Labour productivity in agriculture has declined and is less than one third of the national average. Over three quarters of agricultural output is livestock production, which has grown substantially relative to crops.[1] However, disease (foot and mouth) and especially harsh winters (dzuds) and droughts have substantially reduced livestock numbers in recent years. Agriculture accounts for about 30% of exports, mainly cashmere, hides and skins, meat, and camel wool. Most wheat, flour, fruit, and vegetables are imported.

Table IV.1
Share of GDP by sector, 1995 and 1999-03
(Per cent)

	Share of GDP[a]					
	1995	**1999**	**2000**	**2001**	**2002**	**2003**
Agriculture, hunting and forestry	38.0	37.0	29.1	24.9	20.7	20.1
Non-agriculture	62.0	63.0	70.9	75.1	79.3	79.9
Mining and quarrying	12.0	8.6	11.5	9.0	10.1	12.7
Manufacturing	12.1	5.9	6.1	8.1	6.3	6.2
Services	37.9	48.5	53.3	58.0	62.9	61.0
Construction	1.7	2.5	1.9	2.0	2.3	3.1
Electricity, gas, and water supply	1.8	3.6	2.4	3.0	3.8	3.4
Wholesale and retail trade and motor cycle and motor vehicle repairs	17.0	20.7	24.0	26.7	27.7	26.5
Transport, storage, and communications	6.4	9.2	11.0	13.0	14.7	13.9
Financial intermediation	1.2	2.2	2.5	3.1	3.2	3.8
Other services	9.9	10.2	11.4	10.3	11.1	10.4

a Nominal GDP (at current prices). Shares do not add to 100 due to rounding.

Source: Mongolian authorities.

Table IV.2
Share of employment by sector, 1995 and 1999-03
(Per cent)

	1995	**1999**	**2000**	**2001**	**2002**	**2003**
Employment (thousand persons)	767.6	813.6	809.0	832.3	870.8	926.5
Agriculture and forestry	46.1	49.5	48.6	48.3	44.9	41.8
Non-agriculture	53.9	50.5	51.2	51.7	55.1	58.5
Industry[a]	14.1	12.1	11.2	11.2	11.4	11.8
Services	39.8	38.4	40.2	40.5	43.7	46.4
Construction	3.8	3.4	2.9	2.5	2.9	3.8
Transport and communications	4.1	4.3	4.2	4.2	4.5	4.3
Education	6.3	5.3	6.7	6.6	6.8	6.0
Health	5.0	4.3	4.1	4.0	4.0	4.0
Other	20.5	21.1	22.3	23.2	25.5	28.3
Unemployed (thousand persons)	45.1	39.8	38.6	40.3	30.9	33.3
Labour force (thousand persons)[b]	812.7	853.4	847.6	872.6	901.7	959.8

a Includes those employed in manufacturing, mining, and electricity, gas, and water sectors.
b Economically active population registered at the Employment Regulation Office.

Source: Mongolian authorities.

[1] Livestock grazing, especially for cashmere, was an important safety net during the 1990s for persons displaced from other activities, and is the principal activity for Mongolia's poor.

(i) Policy framework and developments

11. Privatization of farms and agri-processing activities, such as flour milling, advanced rapidly during the 1990s. All farms and agri-processing enterprises are privately owned with a few notable exceptions. Two meat-processing enterprises, two cashmere companies, and one flour mill remain state-owned.[2] Agricultural prices were also liberalized relatively quickly. The State Reserve Fund buys grain, flour, and fodder at market prices only to maintain emergency reserves for natural disasters. Overall agricultural production expanded as market reforms, such as price deregulation and trade liberalization, induced significant farm adjustment. However, wheat and certain livestock products reliant on state intervention, including meat and dairying, declined.

12. Agricultural policy is currently aimed at reversing declining labour productivity to achieve greater self-sufficiency, especially in milk, flour, potatoes, and other vegetables, by raising private sector participation and investment to increase food security. The Government's Food and Agriculture Policy, released in 2003, emphasized investment in irrigated vegetables and production of cereals and fruit, accompanied by greater domestic processing. The policy's objective is to raise the production and export of key products and to reduce imports; in addition, it provides for a number of programmes to increase agricultural productivity, including technology improvements, irrigation, intensified farming, and improved animal and seed quality. The policy is to be implemented in two stages, 2003-08 and 2008-15. The Government has also highlighted greater domestic processing and export of livestock products, especially cashmere products, meat, hides, skins, fur, and flour.[3] Meat and flour are regarded as "strategic products" (Food Supply Law, 1995). The Government announced in 2000 that it aimed to expand wheat production to meet 60-70% of flour requirements, largely through enhanced seed production. The programmes have had little impact on Mongolia's production, however; Mongolia continues to import two thirds of its wheat consumption.

13. A high priority is to improve services provided by the Agriculture Extension Centre. A mid-term development programme for extension services is being implemented in two stages, 2004-07 and 2008-10 (Order of the Minister of Food and Agriculture No. A/141, 31 December 2003). It is aimed at extending the Centre's branches to all *aimags* and *soums* and to improve extension techniques based more on producers' priorities.

(ii) Main subsectors

(a) Livestock

14. The livestock industry, consisting mainly of sheep, goats, horses, cattle, and camels, is based on nomadic grazing of state-owned land using public water wells. However, many of these collective facilities, including veterinary services, have collapsed, and malnutrition impede production and contribute to low productivity in this sector. Agricultural extension services are weak, and nomadic herding, combined with over-stocking, has led to land degradation and other ecological problems. Crop and livestock production are not integrated, and there is little improvement in pasture development.[4] A 2001-05 national relief programme to help protect livestock producers from dzuds

[2] The remaining state-owned enterprises account for about half of total meat exports, 40% of industrial meat-processing capacity, and over half of cashmere-processing capacity. Provisions contained in inter-governmental technical assistance agreements have hampered privatization of the two meat-processing companies, Bagahangain and Darkhan-Mah. The state-owned Khar khorin flour mill has been renovated and is now being considered for privatization. The only non-privatized farm is a state-owned seed farm (Asian Development Bank, 2002).

[3] Government of Mongolia (2003), p. 32.

[4] Over 95% of fodder requirements come from natural pastures.

is being implemented (the National Program on Protecting the Livestock Sector from Dzuds and Drought, 2001). It involves increased emergency fodder reserves, including at regional level, and better management and coordination of activities between the central and regional governments. The Government provides subsidized fodder and other disaster relief through the State Reserve Agency (formed and merged with the State Emergency Fodder Fund). Fodder subsidies cost an estimated Tog 12 billion in 2001 (1.1% of GDP), when reserves rose from under 20,000 tonnes to over 300,000 tonnes. The Government also previously restocked herds free of charge. [5]

15. Limited voluntary livestock insurance is available commercially. The Ministry of Food and Agriculture drafted legislation to introduce mandatory livestock insurance against adverse weather conditions. However, responsibility for livestock insurance was transferred to the Ministry of Finance and Economy in 2000, which has been cooperating with the World Bank to implement a pilot index-based livestock insurance system. This consists of developing a risk index to assess risks from weather-related disasters.

16. Most wool is used for domestic carpet production. There are some 45 wool-processing firms (two foreign), two major carpet producers, and one blanket manufacturer (all privatized). A medium-term wool sub-programme for 2002-04 and a long-term programme for 2002-10 were adopted in 2001. A sub-programme was also adopted for hides and skins in 2001, along with an action plan to raise production and export of meat and meat products. The meat programme aimed to expand exports by raising quality to meet standards set by developed-country markets.

Cashmere

17. Mongolia produces about 25% of the world's cashmere (second behind China); annual production doubled during the 1990s to around 3,000 tonnes. It is Mongolia's third largest export (after copper and gold), the single largest employer, and the major income earner for over a third of inhabitants.[6] The industry has experienced a series of booms and busts, exacerbated by unsatisfactory public sector policies, adverse weather conditions, and external factors. The share of cashmere in Mongolia's total exports fell from 16.8% in 1996 to 8.6% in 2002.

18. Nomadic herders produce most cashmere using public land and water facilities. Cashmere quality has declined. There are over 30 cashmere-processing and de-hairing firms, many with foreign partners, for example from China, United States, Japan, and Italy. Exports involve mainly un-carded or de-haired cashmere. The industry suffers from several inadequacies, especially falling cashmere quality, inadequate marketing and distribution systems, and poor public and private institutional capacity. Mongolian production has moved marginally up the value-added chain, and processors are losing competitiveness.

19. There is substantial excess processing capacity, aggravated by a domestic shortage of raw cashmere. Exports of raw and washed cashmere are taxed at Tog 4,000 per kg. (equivalent to 13% based on 2001 prices, but can be as high as 35% when world prices are depressed).[7] The objective was to ensure sufficient cashmere at lower prices to assist processors and raise domestic value added. However, the measure appears to have backfired, exacerbating the domestic supply shortage, since it is estimated that half of the cashmere produced is smuggled into China to avoid the export tax. Mongolia's recorded exports have therefore remained stagnant, and smuggled cashmere reduced

[5] Restocking is claimed to have been at levels exceeding long-term sustainability (World Bank, 2003b, Chapter 9).
[6] This section draws on World Bank (2003a).
[7] This replaced the export ban in 1997. Export taxes also apply to camel maine and wool.

official exports by an estimated US$100 million from 1996-01.[8] The export tax has not increased value-added activity, and overall has depressed official cashmere exports. It reduced domestic raw cashmere prices below world market levels, and transferred income estimated at US$72 million over 1996-01 from herders to processing firms. The total estimated net efficiency loss to the economy of the tax was US$20 million from 1996 to 1999. Key policy reforms to be considered to improve the industry's efficiency include abolition of the export tax and privatization of the major cashmere processor (Gobi), which remains 70% state owned, despite several privatization attempts. The Government has periodically intervened to assist Gobi acquire raw cashmere, such as in 2001 when it subsidized Gobi's cashmere purchases. Gobi is scheduled for full privatization in 2005.

20. The Government adopted a cashmere programme for 2001-04 in 2000. It also initiated the Wholesale Marketing Network in 2002 to re-establish a collection system for cashmere and other livestock-based raw materials. The Mongolian Textile Institute classifies cashmere and sets quality standards.

(b) Crops

21. Before privatization, the State heavily subsidized wheat production (e.g. through credit). Despite a rise in wheat prices after liberalization, production fell sharply during the 1990s (from 687,000 tonnes in 1989 to 138,700 tonnes in 2001).[9] Mongolia's dependence on wheat and flour imports has generated food security concerns. Limited government support to maintain a minimum level of wheat production has resumed through the State Agricultural Fund (SAF), including subsidized credit to buy fuel during 2001-02 and on-going concessional loans to buy seed.

22. Wheat flour is protected by a seasonal tariff on imports of 15% (instead of 5%) applied from 1 August to 1 April, thereby providing additional protection for most of the year. There are no other restrictions on wheat imports. The seasonal tariff is intended to assist farmers, but could assist millers more, since millers can import wheat at the normal tariff rate. This is even more likely if the substantial amount of wheat aid sold annually significantly depresses domestic wheat prices, as claimed.[10] The seasonal tariff also applies to certain vegetables (potatoes, onions, cabbages, turnips, and carrots).

(iii) Forestry

23. Mongolia's forestry resources consist of the northern coniferous and southern Saxaul forests. Total intact forests are estimated to cover 12.4 million hectares, many located in inaccessible areas.[11] Forests provide a range of commercial activities, including firewood and logs, and subsistence activities. Mongolia meets its own timber requirements. Since 1995, a tax of US$150 per cubic metre ($m^3$) on round log exports has effectively banned them (illegal exports are apparently negligible). The tax was extended to semi-processed products, such as railway sleepers, sawn timber (green and dried) and balks (milled house logs).[12] The tax is intended to stop round log exports and

[8] World Bank (2003b), Chapter 9.

[9] In 2002, cereals accounted for 92% of cropped area, of which 97% was wheat.

[10] In addition to importing about 40% of wheat requirements commercially, Mongolia receives another 30% as wheat aid mainly from the United States and Japan. This is sold domestically, for Tog 175,000 per tonne in 2004. This reportedly depressed domestic wheat prices to below production costs at Tog 185,000 per tonne (*The UB Post*, "Wheat assistance could be damaging market", 14 October 2004, p. 4).

[11] This has fallen from an estimated 18.3 million hectares in the mid 1990s. This section draws on World Bank (2004c).

[12] Only secondary and finished (end-use) products are exempt from the export tax, such as peeled veneers, and finished, fully assembled furniture (ready-to-assemble furniture components are not exempt).

thereby to promote domestic processing. Timber processing comprises numerous sawmills, several particle and plywood plants, a cardboard mill, a match factory, and a tissue paper plant.

24. The Ministry of Nature and Environment is responsible for forest management, in conjunction with *aimag* and *soum* governors who license its use within limits set by the Ministry. The basic forestry legislation is the 1995 Forests Law. The policy framework guiding the protection, conservation and utilization of forests is the 2001 Forestry Programme. This replaced the 1998 National Forest Policy and placed more emphasis on conservation and protection than utilization. Forests are divided into designated "strict" and "protected" zones, and "utilization zones".[13] Commercial harvesting is restricted to forests in the utilization zone. These cover about 1.19 million hectares or 7% of forests and are inadequate to support a viable modern wood-based industry. Stumpage fees apply to harvested trees, including commercial and subsistence felling (Law on Fees for the Harvest of Timber and Fuel Wood). However, such fees are only collected on commercially cut logs.[14] In 2003, stumpage revenue was estimated at US$444,000 (US$516,000 in 2001). Such fees averaged US$1.80 per m^3 for round wood and US$0.60 per m^3 for firewood in 2001.

25. Commercial logging requires a licence (permit). According to the authorities, *Soum* governors allocate annual harvest permits (use tenure) based on requests. The Ministry approves an annual allowable cut (AAC), which is determined administratively based on a percentage of the ecological and economic assessment of the value of timber and firewood. Ministry-approved contractors must do the logging. Since 1997, long-term forest concessions (possession tenure) have been also allowed for up to 60 years (extendable by 40 years), and are allocated like annual permits. The AAC has been demand driven and exceeds sustainable levels, even thought it has fallen from about 1.8 million m^3 in the 1990s to 620,000 m^3 in 2003 (94% for firewood). This is estimated to be at least four times the sustainable AAC on forests in the utilization zone, or at least 1.75 times if 25% of forests in the protected zone were made commercial. Widespread illegal logging, thought to be between 36% and 80% of the total annual harvest (estimated at 965,000 to 3.0 million m^3) compounds the problem. Illegal logging for round wood is estimated to be costing the Government between US$540,00 and US$1.7 million annually in unpaid stumpage fees.

26. The Government provides limited resources for reafforestation programmes (US$400,000 to US$600,000 annually). These funds partially reimburse contractors for the costs of replanting as required in their permits.

(3) MINING

27. Mining (and quarrying) contributed 12.7% of GDP in 2003 (8.6% in 1999), and accounted for 3.4% of total employment. Mineral processing, mainly of gold, copper, molybdenum, coal and fluorspar, is Mongolia's single largest industry, accounting for over 60% of industrial output and two-thirds of export earnings (copper and gold). Most foreign investment is in mining. State-owned firms dominate mineral production. Erdenet Copper Mining Company, a government joint venture 49% owned by the Russian Government, is the only copper and molybdenum mining company. It accounts for about 40% of export receipts and 25% of government revenue. Four state-owned companies mine

[13] Strict zones are forest areas that are defined as sub-alpine and those that lie in special protected areas, national parks etc.; exploitation is limited to regulated gathering of local fire wood and certain subsistence activities, such as collecting pine nuts. Protected zones are broad-scale "green areas" established, for example, within certain distances from rivers, lakes, roads, and on slopes too steep to be cleared; exploitation is also regulated as for strict zones. Utilization zones are in a default category that covers all other forests. Commercial harvesting is permitted subject to permits and stumpage fees.

[14] An inventory fee of Tog 9,500 per hectare (Tog 240 per m^3), applied to finance state forest surveys, is only collected on legal logging, and rarely on firewood. Total annual revenue is estimated at US$10,000.

coal and another, Mongolrostsvetment (also a Mongolian-Russian Government joint venture), produces over 90% of fluorspar output.[15] Erdenet and Mongolrostsvetment, Mongolia's two largest companies, are not scheduled to be privatized, and instead are seeking technical alliances to improve competitiveness. Several major gold and copper mines are due to commence production shortly.

28. Gold production rose tenfold during the 1990s in line with the Government's "gold programme" adopted in 1991. In 2003, over 120 companies mined gold totalling 10.8 tonnes, almost entirely from placer (alluvial) deposits. Most gold is sold to the central bank, despite the market being deregulated in 2001 to allow producers to export directly. The gold export tax of 10% was also abolished in January 2002.[16] Copper, mainly concentrate, is exported primarily to Russia. Erdenet, faced with financial problems in 1999, has restored limited profitability by rationalizing costs, including through labour reductions.[17] Another company, Erdmin, exports pure copper (cathodes) extracted from Erdenet's tailings, but operates at about half capacity. Coal production, of 5.7 million tonnes in 2003, is used mainly for electricity generation. A licence to exploit the Ulaan Ovoo coal mine was granted to a Mongolian-Chinese joint venture in 2003.[18] Coal mining is to be increasingly privatized, including the Baganuur and Shivee-Ovoo joint-stock companies once they have been restructured.

29. The Ministry of Industry and Trade is responsible for mineral policy. The Government released the 2000-10 Geology and the Minerals Sector Programme in 2002 (Government Resolution No. 103): mining is a priority sector, and it intends to double the mining sector's contribution to GDP. The Minerals Law, adopted in 1997, provides a competitive and enabling environment for exploration and development that promotes private-sector participation and foreign investment. Policy guidelines, issued in 2002, outlined mineral development goals for 2002-10, and reinforced the Government's commitment to a favourable legal environment for private exploration and processing based on market-driven projects regulated by the Government.

30. Tax incentives apply to mining investments. These include a three-year income tax exemption and 50% reduction for the subsequent three years for mining enterprises with foreign investors. Eligible heavy machinery and mining equipment (excluding drilling equipment) are exempt from tariffs and VAT. To provide a stable tax structure for long-term projects, a licensee proposing to invest above US$2 million in a project can apply for a ten-year stability agreement (15 years if investment exceeds US$10 million) with the Finance Ministry.[19]

31. Foreigners can hold exploration licences, including for mining, provided they operate as locally incorporated companies. All licences are issued on a first-come first-served basis and there is no discrimination between private and state-owned mineral enterprises.[20] There are no annual work or expenditure requirements. Exploration licences are issued for three years, extendable twice for two years each time. Mining licences are issued for 60 years, renewable once for 40 years. Licensed

[15] Mongolia is the world's fourth largest fluorite producer.

[16] This was introduced in 1999. To compensate for the removal of the tax and maintain tax revenue, the VAT was amended to make gold exempt from VAT (instead of being simply zero-rated if exported), thereby removing eligibility for VAT credits on inputs for goods and services.

[17] Erdenet Copper Mining Company is a high cost producer averaging US$0.57 per pound of copper in 2002 (World Bank, 2004d). It is also largely responsible for maintaining the third largest city, Erdenet, and has various farming and other non-mining activities as well as an extensive social support programme, which added about 5% to costs in 2002.

[18] The Chinese partner is to construct 350 kilometres of the Millennium Road.

[19] These agreements cover income tax rates but not, it appears, the rules determining taxable income (World Bank, 2004d).

[20] Government can only participate in exploration and mining through registered business entities.

exploration holders have exclusive right to mine discovered minerals without state involvement, and to sell at market prices either domestically or abroad. Total exploration and mining licence fees from July 1997 to September 2004 amounted to US$16.2 million. Royalties are set at 7.5% for placer gold and 2.5% for other minerals (including hard rock gold).[21] Income of mining companies is taxed at the standard rates of 15% on the first Tog 100 million, and 30% (reduced from 40% in 2004) thereafter. All mining tax revenue accrues to the Central Government and there are no formal revenue-sharing arrangements with regional provinces.

32. The Mineral Resources Authority of Mongolia (MRAM) regulates mining, and is responsible for issuing licences, conducting geological surveys and compiling industry information. There were 4,692 licences, mainly for exploration, as at September 2004. Approximately 16% were held by wholly foreign-owned entities registered in Mongolia, 75% by local companies and individuals, 8% by joint ventures, and 0.7% by foreign companies (not registered in Mongolia) or individuals. Exploration budgets totalled US$35.3 million in 2003 (US$20.5 million in 2002), 95% incurred by foreign operators. In 2003, private investment in mine development fell from US$41.6 million to US$33.2 million.

33. Export taxes apply to several scrap metals, such as iron and steel and certain copper and aluminium, to promote domestic processing and value added. However, given Mongolia's limited mineral processing and production base, no mineral exports are currently subject to the tax.

(4) ENERGY

(i) Petroleum and petroleum products

34. All petroleum products are imported. In 2003, these totalled 430,000 tonnes, or US$144.9 million (US$70.2 million in 1996). Imports (mainly petrol and diesel) are primarily from the Russian Federation (over 90%) and China; one company imports diesel oil from Kazakhstan. Mongolia's proven oil reserves comprise mainly 1.5 billion barrels in the Tamtsag Basin. Since 1996, small quantities of unprocessed oil (totalling 736,000 barrels) have been exported by road and railway to China (137,000 barrels in 2003). The Petroleum Sector Policy up to 2010 was released in 2002 (Government Resolution No. 267). Petroleum is a priority sector. The Government aims to develop oil exploration and production to become self-sufficient in petroleum products, and to establish a domestic oil refinery in the eastern region with annual capacity of 100-150,000 tonnes. It is considering constructing a refinery to process crude oil from the Tamtsag Basin, possibly by 2007.

35. Following de-monopolization of petroleum importation and distribution in 1990, the 80% state-owned Neft Oil Import Concern (NIC) has continued to lose market share, from 74.4% in 1997 to 32.7% in 2000 for gasoline, and from 38.8% to 14.9% for diesel. NIC, which had accumulated large losses and government debt (equivalent to 1% of GDP in 2001) through supplying subsidized products to remote areas, was fully privatized in February 2004.[22] Eight private petroleum companies currently supply the Mongolian market. Petroleum prices are unregulated and set by the market according to import parity, adjusted for domestic taxes and transportation costs.

36. The Petroleum Authority of Mongolia (PAM) is responsible for oil and gas exploration, production, processing, transportation, and storage. It forms production-sharing contracts with foreign firms in accordance with the Petroleum Law, 1991, as amended, and related regulations.

[21] The royalty on placer gold was increased from 2.5% to 7.5% in 2003. Mineral royalties are deductible for income tax purposes.

[22] NIC's return on investment fell from 26.3% in 1998 to 3.7% in 1999 and to 2.7% in 2000 (Bank of Mongolia, 2002c, p. 34).

Exploration terms are for five years, extendable twice for two years each.[23] Development licences may be issued for up to 20 years, extendable twice for up to five years each. Oil production is subject to negotiated royalties of up to 12.5%, and to normal income taxes on domestic sales. Production shares are negotiable in the contract, net of royalties and the contractor's allowable production for cost recovery (limited to 40% of annual production).[24] Contractors' income from their share of petroleum was fully exempted from tax in 2000 as part of a fiscal incentives package introduced to attract foreign exploration and development. Other exemptions included VAT and tariffs on machinery, equipment and materials used for petroleum exploration and production, and excise tax on gasoline and diesel used in these activities. Eligible foreign investors may also enter into a stability agreement to protect against tax changes. Foreign investment in oil since 1994 totals US$131.4 million. An oil processing facility with a capacity of 50,000 tonnes annually was established in Erdenet, but has ceased operating. PAM is also participating in negotiations with Russia, China, South Korea, and Japan to construct a natural gas pipeline from the Russian Federation to Korea and Japan through Ulaanbaatar. A draft law on import, processing, trade, transportation and storage of petroleum products is currently before Parliament. Mongolia is a member of the North-East Asian Gas Pipeline Forum.

(ii) Electricity

37. High energy consumption reflects Mongolia's harsh climate. About two thirds of the population have access to electricity and central heating. Maximum generation capacity is 3,100 GWh. Four coal-fired power plants supply the Central Electrical Grid that serves the three largest cities. Two plants are in Ulaanbaatar, and the others in Erdenet and Darkhan. Electricity is imported from Russia during peak times through the Central and Western Energy Systems. It is also imported from China through three border points (Zamiid-Uud, Khavirga, and Bichigt). Imports account for about 10% of consumption, and are subject to a tariff of 5% and VAT of 15%. Two major hydro plants, one at Durgun in Hovd *aimag* and the other at Ulaanborn/Taishir are being developed.[25] Several small hydro plants complement regional power supplies. Stand-alone diesel generators mainly supply non-connected rural areas.

38. The Ministry of Fuel and Energy (established recently following the restructuring of the Ministry of Infrastructure) is responsible for energy policy. The state-owned sector, formerly run by the Energy Authority (EA), had accumulated large losses, which rose from US$4.3 million (0.5% of GDP) in 1999 to US$17.1 million (1.8% of GDP) in 2000.[26] These reflected low generation efficiency, large leakages in transmission and distribution, tariffs below costs by 25-50%, and payment arrears by major state-owned electricity users.[27] It had also accumulated large outstanding debts with state-owned enterprises, totalling Tog 35 billion (3.4% of GDP) in 2000, especially with its main coal supplier, the Bagannuur Coal Company.[28] While electricity and heating (under the centralized system of pumping steam throughout Ulaanbaatar) tariffs were raised in December 2000 for the first time in five years, by 14.2% and 100% respectively, and again by 15% in July 2002, retail

[23] In December 2003, the Petroleum Law was amended to allow exploration licences to be extended for up to five years. PAM applied such extensions on several licences in January 2004.

[24] Producers can export their oil share, but may be requested to provide it for domestic consumption.

[25] Loan agreements were signed with the Kuwait Fund for Arab Economic Development in 1999 and with the Abu Dhabi Fund for Development in 2002; Parliament approved them in April 2003.

[26] IMF (2002), p. 28.

[27] Including Erdenet copper mine, which consumes about one third of Mongolia's electricity.

[28] Many of these debts were met by government-guaranteed foreign loans, and have therefore contributed substantially (40% during the 1990s) to Mongolia's external debt (World Bank, 2004a, p. 9).

tariffs are still below supply costs.[29] Further tariff increases of 10.1% for electricity and 25.3% for heating are envisaged in 2004 to meet rising costs. Uniform prices generally apply among users. However, major business consumers, especially Erdenet Mining Corporation, receive a 7% discount.

39. The sector's restructuring commenced in 2001 under the Government Resolution on Energy Sector Restructuring and the new Energy Law, 2001, which provided the legal basis for the restructuring. The Energy Sector Restructuring Action Plan is aimed at improving the sector's competitiveness, efficiency, and long-run viability through market-based reforms. The Energy Regulatory Authority (ERA) was created in 2002. Its main functions are to issue licences to operators, set and supervise tariffs, ensure compliance with government policies and regulations, set standards for energy production and distribution, evenly protect consumers' and producers' interests, and to create a competitive electricity market. Generation was de-regulated, and the former EA's operations unbundled into 18 state-owned corporations, separating generation, transmission, and distribution.[30] The first stage of restructuring covered unbundling and separation, together with corporatization and commercialization, designed to introduce market principles into the energy sector.

40. The second stage includes the gradual privatization of power generation and distribution companies. A management contract was awarded for the heating plant at Nalaikh in 2003. Darkhan Selenge Electricity Distribution Network and Baganuur Gas Energy Station were privatized by open tender. The Mongolia Integrated Power System Programme is also being implemented to develop reliable, affordable energy and to contribute to regional development. The Energy Price Control Council, under the Ministry of Fuel and Energy, regulates prices in conjunction with the ERA.

41. A law on conservation and energy is due to be enacted in 2004. It will establish a fund for fuel conservation and efficiency and a revolving credit facility to help businesses invest in energy-efficient facilities.

(5) MANUFACTURING

42. Manufacturing's share in GDP has fluctuated over the period under review, but fell from 12.1% in 1995 to 6.2% in 2003 (5.9% in 1999). The sector has undergone considerable restructuring. Many industries, such as machinery, chemicals, metal, transport, and electrical products, which were dependent on past state intervention, have contracted. The main manufacturing industries are labour-intensive livestock-based products, such as food, beverages, leather, textiles, clothing, and footwear. Prioritized key industries are copper and meat processing, leather and cashmere products, carpets and wool. The main manufactured exports are textiles, clothing, leather, and footwear. State equity in manufacturing is still significant, for example in cashmere products (section 2(ii)(a)).

43. The clothing industry has expanded based on several Chinese and Korean joint ventures, which are located in Mongolia to export free of quota to the United States, the predominant market. However, Mongolia could have difficulty competing with Chinese and other low-cost clothing exporters in the United States without such advantages. The expected abolition of U.S. quotas in 2005 may adversely affect Mongolia's clothing industry if these foreign investors re-locate overseas.[31]

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[29] Retail electricity prices of US$0.042 per KWh are below estimated marginal costs of US$0.055-US$0.065 per KWh (IMF, 2002, p. 31).

[30] Comprising eight generating entities, four electricity distributors (plus retail), two heat distributors (plus retail), one transmission company, one dispatch company (National Dispatch Centre), and two stand-alone systems (Eastern Electricity System and Western Electricity System). Shares in these enterprises are held by the Ministry of Fuel and Energy (41%), the State Property Committee (39%), and the Ministry of Finance (20%).

[31] UNDP (2002).

(6) SERVICES (OTHER THAN ENERGY)

44. Services have expanded substantially and accounted for 61.0% of GDP in 2003, up from 48.5% in 1999 (37.9% in 1995). The largest subsector in 2003 was wholesale and retail trade (26.5%), followed by transport, storage, and communications (13.9%), financial intermediation (3.8%), and electricity, gas, and water (3.4%). Employment in services, rose to 46.4% in 2003 after falling from 39.8% of the employed work force in 1995 to 38.4% in 1999. Labour productivity in services is higher than in agriculture and manufacturing.

45. Mongolia made various GATS' commitments during its 1997 WTO accession (Table IV.3).[32] While it did not participate in the extended negotiations on financial services (Fifth Protocol, adopted 14 November 1997) and telecommunications (Fourth Protocol, adopted 30 April 1996), its accession commitments on services covered certain of these subsectors. Its commitments included no limitations on market access or national treatment for the cross-border supply (mode 1), consumption abroad (mode 2), and commercial presence (mode 3) in postal, courier and insurance services, as well as in many value-added telecommunication subsectors (e.g. electronic and voice mail and on-line information and data retrieval), most insurance services, and many banking and other financial services (e.g. acceptance of public deposits). Similar commitments were made in several business services (e.g. accounting, management consulting, services incidental to mining, and engineering services), and almost all tourism-related services (hotel and restaurants, travel agencies and tour operators, and tourist guide services). Distribution services (excluding commission agents' services) were scheduled, including commitments to have no market access or national treatment limitations on supply modes 1, 2 and 3 for wholesale trade and on mode 2 for retail trade. No commitments were made for retail services supplied by modes 1 or 3. Installation and assembly construction and related engineering services were also scheduled, and included commitments for no limitations on modes 2 and 3. No mode 4 (presence of natural persons) commitments were made for any service.[33] Mongolia made no MFN exemptions.

Table IV.3
Commitments on services under GATS

	Market access[a]				National treatment[a]			
Modes of supply:								
Cross-border supply	1				1			
Consumption abroad		2				2		
Commercial presence			3				3	
Presence of natural persons				4				4
Commitments (■ full; ◨ partial; □ no commitment)								
Horizontal limitations[b]				□[c]				□[c]
Commitments in specific sectors[d]								
1. Business services								
A. Professional services								
(b) Accounting	■	■	■	□[e]	■	■	■	□[e]
(e) Engineering services (CPC 8672)	■	■	■	□[e]	■	■	■	□[e]
F. Other business services								
(c) Management consulting services	■	■	■	□[e]	■	■	■	□[e]
(e) Technical testing and analysis services (CPC 8676)	■	■	■	□[e]	■	■	■	□[e]

Table IV.3 (cont'd)

[32] WTO document WT/ACC/MNG/9/Add.2, 27 June 1996.
[33] They were unbound, except for measures affecting the entry and temporary stay of people with managerial or technical skills in short supply, and falling in the categories of business visitors, intra-corporate transferees, and professionals under a service contract.

Modes of supply:	Market access[a]				National treatment[a]			
Cross-border supply	1				1			
Consumption abroad		2				2		
Commercial presence			3				3	
Presence of natural persons				4				4
(h) Services incidental to mining (CPC 883 and 5115)	■	■	■	□[e]	■	■	■	□[e]
(m) Scientific and technical consulting services (CPC 8675)	■	■	■	□[e]	■	■	■	□[e]
2. Communications services								
A. Postal services (CPC 7511)	■	■	■	□[e]	■	■	■	□[e]
B. Courier services (CPC 7152)	■	■	■	□[e]	■	■	■	□[e]
C. Telecommunication services								
(h) Electronic mail	■	■	■	□[e]	■	■	■	□[e]
(i) Voice mail	■	■	■	□[e]	■	■	■	□[e]
(j) On-line information and data retrieval	■	■	■	□[e]	■	■	■	□[e]
(k) Electronic data interchange	■	■	■	□[e]	■	■	■	□[e]
(l) Enhance/value added fax services, store and forward and retrieve	■	■	■	□[e]	■	■	■	□[e]
(m) Code and protocol conversion	■	■	■	□[e]	■	■	■	□[e]
(n) On-line information and/or data processing (including transaction processing)	■	■	■	□[e]	■	■	■	□[e]
3. Construction services								
C. Installation and assembly work	□[f]	■	■	□[e]	□[f]	■	■	□[e]
D. Building completion & finishing work	□[f]	■	■	□[e]	□[f]	■	■	□[e]
4. Distribution services								
B. Wholesale trade services	■	■	■	□[e]	■	■	■	□[e]
C. Retailing services	□	■	□	□[e]	□	■	□	□[e]
7. Financial services								
A. Insurance, reinsurance and transportation insurance	■	■	■	□[e]	■	■	■	□[e]
B. Banking and other financial services (excluding insurance)								
(a) Acceptance of deposits and other repayable funds from the public	■	■	■	□[e]	■	■	■	□[e]
- Negotiable loans and advances for the purpose of financing trade, commercial and fixed investment	■	■	■	□[e]	■	■	■	□[e]
(d) Payments, money collection and transmission services	■	■	■	□[e]	■	■	■	□[e]
(e) Guarantees and commitments	■	■	■	□[e]	■	■	■	□[e]
(f) Trading for own account or for the account of customers on an exchange or an over-the-counter market, the following: cheques and other bills of exchange; foreign exchange; forward exchange rate agreements; approved securities; other negotiable instruments; customers fund management; financial and investment advisory services; provision and transfer of financial information and financial data processing; advisory and other auxiliary services, excluding intermediation, relating to banking and other financial services; and participation in issues of all kinds of securities, including underwriting and provision of services related to such issues	■	■	■	□[e]	■	■	■	□[e]

Table IV.3 (cont'd)

	Market access[a]				National treatment[a]			
Modes of supply:								
Cross-border supply	**1**				**1**			
Consumption abroad		**2**				**2**		
Commercial presence			**3**				**3**	
Presence of natural persons				**4**				**4**
9. Tourism and travel services								
A. Hotels and restaurants	■	■	■	□[e]	■	■	■	□[e]
B. Travel agencies and tour operators	■	■	■	□[e]	■	■	■	□[e]
C. Tourist guide services	■	■	■	□[e]	■	■	■	□[e]

a Negotiated as part of Mongolia's WTO accession, effective 29 January 1997, and reproduced in WTO documents WT/ACC/MNG/9/Add.2, of 27 June 1996, and GATS/SC/123, of 28 August 1997.
b Applicable only to services included in Mongolia's Schedule of Commitments.
c Except for measures affecting the entry and temporary stay of natural persons with managerial and technical skills that are in short supply in Mongolia, and falling within the categories of business visitors, intra-corporate transferees, and professional under a service contract.
d Services are listed according to the services sectoral classification used by Members to schedule commitments (WTO document MTN.GNS/W/120, 10 July 1991).
e Except as indicated in horizontal limitations (see footnote c).
f Due to lack of technical feasibility.

Source: WTO Secretariat.

(i) Financial services

(a) Introduction

46. Reforms in Mongolia's financial sector are important because of the sector's key role in channelling savings into the most profitable investments across various sectors of the economy. Mongolia's financial sector consists mainly of the central bank, the Bank of Mongolia (BOM) and, at end 2003, 17 commercial banks, 88 non-bank financial institutions (NBFIs), about 570 saving and loan associations, 43 securities companies, over 41 exchange bureaus, a state pension fund, other financial corporations, and 23 insurance companies.[34] The BOM, formed in 1991, supervises and licenses banks, regulates their operations, and undertakes enforcement measures; it is required to maintain, *inter alia*, financial market and banking system stability (Central Bank Law, 1996).[35] The BOM's prudential regulation and supervision of NBFIs (other than mainly savings and credit cooperatives, professional securities market participants, and insurance companies, brokers and agents) was also strengthened in 2003 (Non-bank Financial Institutions Law, 2002).

47. Mongolia began developing a market-based financial system during its transition to a market economy by introducing a two-tiered banking structure of commercial banks overseen by a central bank. However, despite notable progress, financial sector development was slow, and the banking system, where most efforts were directed, performed badly in the 1990s, due mainly to inadequate institutional and central bank supervisory and prudential capacity, along with poor corporate governance and management of commercial banks.

48. Financial sector performance has improved since 2000, reflecting mainly greater stability and the revival of the banking sector after substantial restructuring and reforms, such as enhanced BOM prudential supervision. A relatively large number of commercial banks exist, and NBFI numbers and

[34] Bank of Mongolia (2004b).
[35] This replaced the 1991 Banking Law, which provided the legal basis for changing the banking system. Other relevant banking legislation includes the Deposits, Loans and Banking Transactions Law, 1995, the Currency Settlements Law, 1994, and the Treasury Law, 1995.

services have expanded rapidly. Financial intermediation has increased, with the ratio of broad money to GDP rising from 37.9% to 51.6% in 2003 (19.9% in 1996).[36] Total financial sector assets (mainly banks, NBFIs, and savings and loan cooperatives) rose from 25.3% of GDP at end 2000 to 65.5% at end-2003, and total loans from Tog 68.3 billion (6.5% of GDP) to Tog 465.3 billion (34.2%).[37]

49. However, despite the recent expansion and restored public confidence, the financial sector, including banking, remains under-developed, and further restructuring and deepening is required. Financial services accounted for only 3.8% of GDP in 2003. The money and capital markets are thin, and the Mongolian Stock Exchange (MSE), established in 1991, became dysfunctional in the late 1990s.[38] Reviving the capital market would deepen financial intermediation and provide competition for banks to lower interest rates. Continued bank rehabilitation is essential to boosting financial intermediation and achieving an efficient and sound financial sector.[39]

50. The ongoing growth in the amount of non-performing loans (NPLs) raises possible prudential concerns.[40] In 2003, NPLs of the financial sector, including of banks, rose by Tog 7.8 billion (14.4%) to Tog 37.7 billion. While the sector's total share of NPLs, of 8.1% at end 2003, was only slightly above the end 2002 level of 7.0% and remained well below previous levels (above 50% in 1996 and 1999 for banks alone), these recent trends understate the increase in NPLs because of the rapid rise in total financial sector loans (by 80% in 2002 and 74% in 2003).[41] Moreover, the share of bank NPLs also rose from 7.2% to 7.9% in 2003, and while lower for NBFIs (6.5% at end 2003), it was much higher for savings and loan cooperatives (11.2%). These accounted for almost one third of deposits held outside the banking system in 2003. To help counter these developments, the BOM is strengthening prudential and supervisory requirements for banks, NBFIs, and savings and loan cooperatives, as a high priority, including detection and enforcement powers. While all banks met minimum capital requirements in 2003, some NBFIs and many savings and loan cooperatives did not, thereby heightening exposure to financial risk.[42]

(b) Policy objectives and framework

51. Resolving the banking crises of the 1990s has been technically and politically difficult, and has required a comprehensive ongoing strategy to restructure banks as well as to implement institutional and legal reforms, along with significant fiscal costs, including budgetary costs and funds raised from government bonds to finance bank rescue plans.[43] Banking and other financial sector reforms accelerated in 2001-02, in line with the Government's commitment to a new adjustment programme to revitalize reforms. Its ten-year vision, approved by the BOM in 2000, is to limit

[36] Broad money (M2) is M1 plus quasi-money i.e. time and foreign currency deposits. However, this ratio may overstate the degree of intermediation because it includes substantial foreign currency deposits due to the economy's significant unofficial "dollarization". The share of foreign currency deposits to total money, an indicator of dollarization, was 33.6% at end June 2004, well up on levels in the mid 1990s (Bank of Mongolia, 2004b, and Bank of Mongolia, 2002b).

[37] Bank of Mongolia (2004b).

[38] Bank of Mongolia (2002a), p. 69.

[39] Greater financial intermediation raises efficiency by allowing the financial market to mobilize and allocate savings (both domestic and foreign) into more productive investment, thereby contributing to growth.

[40] Bank of Mongolia (2002a), p. 96.

[41] NPLs were increased during the mid 1990s by widespread government directives to the BOM to extend large loans through state commercial banks to support industry and investment, prepare power stations for the winter, and finance farm activities, such as harvesting and cultivation (Bank of Mongolia, 2002a, p. 65). Such practices have ceased.

[42] Bank of Mongolia (2004b).

[43] Enoch, et al. (2002).

intervention in the financial sector to maintaining systemic stability, based on effective prudential regulation and supervision by an autonomous central bank that allows prompt corrective action to close banks not meeting minimum capital adequacy ratios.[44] Other key objectives are to promote competition by having a relatively small number of domestic and foreign commercial banks competing with an expanded NBFI network, and eliminating state-owned banks. The Government's medium-term strategy to reform the financial sector is based on Mongolia's disappointing experience with reforms during the 1990s (Box IV.1). Key reforms are also incorporated in the BOM's annual monetary policy guidelines, and in the Government's 2000-04 Action Programme.

Box IV.1: Financial sector reforms

The Government's medium-term strategy for the development of the financial sector was approved by Parliament in 2001, and involves introducing reforms that:

- establish the foundations for a market-based financial system, including the development of modern banking skills, enhancement of auditing and accounting standards, the enforcement of financial contracts and the establishment of an exit policy process for troubled banks;
- signal the Government's commitment to uphold private property rights and financial contracts, beginning with the timely servicing of interest payments on government bonds held by banks;
- reduce the pervasive role of the State in the allocation of financial resources;
- facilitate the development of sustainable rural financial institutions to provide payment systems and banking services appropriate to conditions in sparsely populated country such as Mongolia;
- prompt consolidation of the banking system by doubling minimum capital requirements to Tog 2 billion (US$1.9 million);
- strengthen the legal framework for effective supervision and regulation by the central bank including the requirement for prompt corrective action;
- develop a resolution and liquidation framework for failed banks; and
- provide the foundations for the development of a market for government bonds.

The Government believes that: (a) reforms must be properly sequenced to ensure that the essential building blocks for a market-based financial system and a credible government commitment to honour contracts and protect property rights are first established; (b) pervasive state involvement in allocation of financial resources is incompatible with developing a market-based system; (c) re-capitalization of insolvent state banks leads to greater future losses; (d) liberal entry requirements allow too many poorly managed banks; (e) a legal and institutional framework is needed to encourage debtors to meet commitments to creditors.

The Bank of Mongolia's State Monetary Guidelines for 2004 included:

- policies to develop long-term financial markets such as mortgage, apartment, land and immoveable property;
- in order to support fair competition in the financial market, and to strengthen control by customers over banks, correct information and transparency will be provided, bank accounting standards will be improved to international requirements, and financial responsibilities of shareholders increased;
- rules and regulations on banks and non-bank financial institutions will continue to approach international standards, and the legal framework protecting interests of bank customers and depositors and information confidentiality improved;
- legislation to fight money laundering and terrorism financing; and
- directions to improve the bank's management capability and legal environment, to strengthen data, and to keep information exchange open will be followed.

Source: Bank of Mongolia, *Government's Medium-Term Strategy for the Development of the Financial Sector*, and *State Monetary Policy Guideline for 2004*.

[44] Bank of Mongolia (2000).

(c) Banking services

52. Mongolia's banking sector suffered systemic crises in 1994, 1996, and 1998. Each involved major bank insolvencies, closures, and costly government-funded rescue plans. The cost of the 1994 restructuring programme was estimated at over 2% of GDP.[45] The 1996-98 rescue plan was much larger, costing some 8% of GDP.[46] Impaired loans of closed banks, totalling Tog 47 billion between 1997 and 2001, were transferred to an established collection agency, the Mongolian Asset Realization Agency (MARA).[47] The BOM had also extended exceptional liquidity support, totalling about Tog 5 billion, to troubled banks without required safeguards.[48] Bank restructuring was funded mainly from issuing government reconstruction bonds to replace troubled loans and to compensate commercial banks for losses on government-directed credits. These bonds totalled Tog 47.9 billion (5.2% of GDP) at end 1999 (Tog 38.6 billion or 3.4% of GDP at end 2001).[49] The ongoing direct cost to Government of financing these bonds was estimated at over 0.6% of GDP in 2001.[50]

53. Several factors undermined the banking sector's performance in the 1990s. These included the legacy of directed lending and the limited consequences for loan default pre-1991, as well as excessive government borrowing and failure to honour payments. Poor accounting, banking standards, and skills also contributed to the sector's difficulties. However, it has expanded rapidly since 2000, with total bank assets rising from 22.1% of GDP to 60.6% at end 2003.

54. Domestically-owned, especially state, banks no longer dominate the banking system. The largest bank, Trade and Development Bank (TDBM), was fully privatized in May 2002, followed by the Agricultural Bank in March 2003, by sale to foreign interests.[51] Both banks have contracted international managers.[52] State equity in the banking system was reduced from 60% in 2001 to currently around 4%. There remains one fully state-owned bank (Savings Bank), which is due to be privatized in 2005, and two partially state-owned banks.[53] Foreign-owned banks, primarily TDMB and the Agricultural Bank, now represent a substantial share (30.6%) of total bank assets; one private foreign bank operates in Mongolia. However, the banking sector remains highly concentrated; the largest five banks account for over 80% of the urban market, and the Agricultural Bank provides by far most of the rural market. Bank net profitability rose by 25.5% in 2003, but return on assets fell to 3.1%.

55. The substantial spread between commercial bank lending and deposit interest rates reflects many factors, including NPLs, risk premiums on loans with inadequate collateral and high corporate risk. It also indicates bank inefficiencies, and provides a useful guide to the degree of competition in supplying banking services. Although still wide, the narrowing in the interest rate spread since 2000, as banks have reduced lending rates while maintaining deposit rates to attract funds, possibly reflects enhanced competition and bank efficiency. For example, the average commercial bank lending

[45] World Bank (2002), p. 55.

[46] World Bank (2004b), p.5. Total losses by the Reconstruction Bank, ITI Bank, and Agricultural Bank in 1998 were Tog 21.1 billion, or 2.4% of GDP (Bank of Mongolia, 2002e).

[47] MARA, formed in 1996, was not expected to recover a large share of non-performing loans. By June 1997, its recovery rate was about 17% (IMF, Working Paper WP/02/56, March, 2002).

[48] IMF, Working Paper WP/02/56, March 2002; and World Bank, Report No. 24439-MOG, June 2002.

[49] Tog 37.4 billion by end April 2002 (Bank of Mongolia, 2002e).

[50] World Bank (2002), p. 55.

[51] The divestment covered the State's 76% equity in TDBM (24% was owned by its employees and other shareholders) to joint Swiss and U.S. interests, and 100% equity in the Agricultural Bank to a consortium of mainly Japanese interests; equity of 40% was subsequently re-sold to domestic interests.

[52] Trade and Development Bank signed management cooperation contracts with ING Bank in 2003.

[53] Ulaanbaatar City Bank is 20.0% state-owned, and the Capital Bank is almost 80% foreign owned and 9.0% state-owned. Past attempts in 2002 and 2003 to divest these holdings were unsuccessful.

interest rate on short-term loans has fallen from around 30.3% in 2000 to currently around 25.6%, while the average deposit rate has remained largely unchanged at about 14.0%, thereby reducing the spread from over 16% to 11.6%.

56. While Mongolia has no deposit insurance scheme, the Government intervened from 1996 to 1999 to compensate depositors of bankrupt banks, at a total cost of Tog 70 billion, equivalent to 40% of government revenue, or 7% of GDP.[54] The Government is introducing a deposit insurance scheme, and draft legislation has been prepared; it will be administered by an independent body. Commercial bank premiums will be supplemented by government funds pooled from the BOM and the Ministry of Finance; deposits of up to Tog 5 million will be covered.

Regulatory and prudential framework

57. Four new banking licences were issued in 2001, and one each in 2002 and 2003.[55] Foreign and domestic banks are subject to the same prudential requirements. However, foreign banks wishing to operate in Mongolia must submit additional documentary licensing requirements, such as evidence of their home registration. BOM grants a licence based on, *inter alia*, prudential requirements, such as meeting minimum paid-up capital levels, and whether the new bank would have any "adverse effect on national economic security" (Banking Act, Article 20). According to authorities, this is not an economic needs test but is concerned with ensuring the integrity of the financial system. BOM licences state- and privately-owned banks. Bank licence applications are to be processed within 60 days. There is no limitation on the number of licences issued, including to foreign banks. Foreign banks may operate in Mongolia as either subsidiaries or joint ventures, with no cap on foreign equity. Foreign bank branches and representative offices must also be licensed (Banking Act, Article 19). One foreign branch (Russian) currently operates. Foreign banks can offer the same commercial bank services as Mongolian-owned banks, and no restrictions apply to location of branches or their numbers. Banks, foreign and domestic, are prohibited from performing non-banking activities, such as insurance, management of investment funds, and securities business.[56] BOM must approve opening and closure of all bank branches. This is for prudential reasons and such permission is readily given provided the bank is prudentially compliant. At least 70% of the staff of foreign banks, irrespective of business form, must be Mongolian residents. There are no restrictions on the use of automatic teller machines by foreign or Mongolian banks.

58. Minimum equity capital requirements were raised from Tog 1 billion to Tog 2 billion in 2000, and to Tog 4 billion in September 2001. Existing banks had until April 2004 to comply and did so. It is anticipated that this may also encourage bank consolidation through mergers and acquisition of smaller banks. With this main aim in mind, the minimum capital level has been further increased to Tog 8 billion for new banks; existing banks have until 2006. All banks have met the total risk-weighted minimum capital adequacy ratio of 10% since 2000; the average ratio for the banking sector was 19.1% in September 2004.[57] The sector's average liquidity ratio of 41.1% in 2003 is also well above minimum prudential requirements of 23.1%, thereby indicating banks could further expand lending, but remain reluctant to engage in longer-term commercial loans.

[54] Bank of Mongolia (2002a), p. 73.

[55] Eleven licensed banks operated before 1993. Since then, 20 new licences have been issued, and 14 revoked due to prudential non-compliance, seven of these were revoked in 1999.

[56] However, some uncertainty is created by the Banking Law defining banking activities to include the issuing, buying and selling of securities and the provision of investment, financial consultancy, and/or information services (Article 6).

[57] Minimum capital adequacy ratios were increased from 4% to 10% for total capital and from 2% to 5% for tier 1 capital in 1996. All loans are risk-weighted at 100% for capital adequacy requirements.

59. Enhancing bank regulation and supervision, including greater enforcement of compliance through prompt corrective action, is a high priority of the BOM's Policy Reform Programme. It has taken steps to upgrade and strengthen the prudential and supervisory framework in line with international standards to incorporate greater risk-based approaches to monitoring banks. In November 2002, BOM had reportedly achieved satisfactory compliance, compared with other developing countries, with the 25 core principles on banking supervision and prudential regulations issued by the Basle Committee on Bank Supervision.[58] In the non-compliance areas, namely consolidation and cross-border supervision, the authorities indicate that corrective action has since achieved compliance. To reduce bank credit risks, guidelines on asset classification and provisioning were revised to raise requirements for past due loans and to allow additional provisions as needed.[59] Revised guidelines were also issued on credit, market, and operational risk assessment in 2003. A Model Charter was prepared for banks.

60. BOM also issued guidelines on good corporate governance practices, including measures to strengthen internal control mechanisms, based on BIS recommendations. On-site and off-site banking supervision has been expanded in line with the revised Supervision Handbook, completed in 2002. Recent examination has focused on evaluating bank liquidity, asset quality, compliance with prudential ratios, and on provisioning and profitability analysis. BOM's statutory powers to regulate and supervise banks are relatively extensive, and remedial actions include appointment of a controller and signing of memoranda of understanding with the deficient bank to improve its financial position.[60] Changes to accounting standards have reflected international practices. Banks must be audited annually by external independent internationally recognized firms approved by BOM, and meet disclosure requirements.

61. The Credit Information Bureau has been enhanced, including greater links with taxation authorities and other relevant agencies, to improve financial records for assisting banks to assess the credit risks of potential borrowers.[61] Amendments to the Civil Law in 2001 strengthened arrangements for banks to seize collateral on NPLs. However, the new Civil Code of September 2002 also introduced a contradictory provision that created ambiguity and removed a strong incentive borrowers had to meet commitments. Foreclosure provisions are therefore uncertain and slow. Banks continue to be financially disadvantaged by their inability to enforce non-performing borrowers to exit the market through bankruptcy or restructuring procedures.[62]

(d) Insurance

62. Insurance services cover mainly cars and shipping. Total premiums amounted to 0.5% of GDP in 2002. Mongol Daatgal, which has about 90% of the market, was fully privatized in 2003 to a financial consortium with foreign and domestic interests. Tushing Insurance Company was also fully privatized in 2002. Since 2001, only premiums for "compulsory" insurance have been tax deductible.

[58] Bank of Mongolia (2002a), p.98. The IMF report on which this assessment was made concluded that the overall standard of banking supervision was "reasonable". Mongolia complied with four core principles, largely complied with nine, and materially complied with eight principles.

[59] Regulations strictly limit the re-scheduling of loans to hide a borrower's inability to pay. Loan loss reserve provisions were increased to a 1% reserve for performing loans and from 1% to 5% for NPLs. Loans are classified as overdue if interest is late, even if principal repayments are current (Asian Development Bank, 2003b, p. v.).

[60] These include written warnings, remedial action by a due date, limiting or stopping bank activities, administrative punishments, appointment of a controller, conservatorship (administration) for up to 12 months or a receiver, and revocation of licence (Article 31 of the Banking Law).

[61] The Bureau's database has been expanded to cover all *aimags* and information on property under bank loan collateral as well as criminal records of individuals.

[62] Bank of Mongolia (2002a), p. 69.

The Government aims to broaden insurance coverage by diversifying the types of insurance available, and improving accountability and disclosure requirements.[63]

63. Current insurance legislation entered into force in 1998 (Insurance Law 1998). The Ministry of Finance is responsible for licensing insurance companies (but not insurance intermediaries) and a non-independent agency operating under its supervision, the Insurance Supervisory Unit (ISU), administers the legislation by making recommendations on licensing to the Minister and supervising compliance by insurance companies.[64] New legislation, passed in April 2004, will be operative from January 2005 (Insurance Law, 2004). It has substantially strengthened the licensing and prudential requirements. It will also transfer supervisory, prudential, and licensing responsibilities from the ISU to a designated regulatory agency, the State Central Administrative Organization (SCAO).[65] It will conduct compliance monitoring of insurance companies to ensure enforcement of prudential regulations and requirements, using a range of powers, including inspection of premises and documents, and various sanctions for contravening licensing conditions. An insurance licence will be issued unless, *inter alia*, the SCAO believes it would be "against the public interest" (Article 16). It is envisaged to establish an agency, the Financial Regulatory Council, from January 2005 to regulate all NBFIs, including insurance companies. Relevant legislation, the Financial Sector Law, is currently before Parliament.

64. Foreign suppliers may provide insurance services as subsidiaries, joint ventures without equity limits, or as branches, subject to being licensed. Foreign representative offices must also be licensed. The licensing and prudential requirements do not discriminate against foreign suppliers or impose special conditions. There are no restrictions on the types of insurance services offered, on the number of branches or their location.

65. Insurance intermediaries i.e. insurance brokers, agents or loss adjusters are currently unregulated. However, as from 2005, they will be subject to similar prudential and licensing provisions to be applied to insurance companies (Insurance Intermediaries Law, 2004). The designated regulatory agency is also the SCAO, and responsibility is likely to be transferred to the Financial Regulatory Council following its creation.

(e) Other financial services

NBFIs

66. NBFIs started in 1999, and have grown rapidly. Total NBFI assets rose by 51.7% in 2003, equivalent to 2.3% of total banking sector assets (1% at end-2000). They cannot accept deposits from the public, but may provide a range of activities, including lending, factoring, financial leasing, issuing payment instruments, investment in short-term financial instruments, and financial and investment consultancy services.

67. New legislation, effective from February 2003, simplified licensing procedures (Non-bank Financial Institutions Law, 2002). Despite improvements, NBFI regulation and supervision remain fragmented, and below international standards.[66] To be licensed by BOM, NBFIs must meet certain

[63] Government of Mongolia (2000), p. 6.

[64] The ISU therefore has only supervisory responsibility. Development of regulatory policy, including authority to license insurance companies, resides with the Ministry of Finance. The ISU reports directly to Parliament through the Office of the Prime Minister.

[65] The State Central Administrative Organization is a generic term used in some Mongolian laws where a specific supervisory agency has not yet been designated as having regulatory or supervisory responsibility.

[66] Asian Development Bank (2003d), p. 2.

prudential requirements, such as minimum capital levels and capital adequacy ratios. The minimum equity capital was raised from Tog 30 million to Tog 100 million for NBFI's incorporated in Ulaanbaatar in 2003.[67] BOM must authorize all NBFI branches. Prudential and licensing requirements are applied equally to domestic and foreign NBFIs, and foreign suppliers are not restricted. They may provide services as subsidiaries, joint ventures without equity limits, or as branches. Three foreign-owned NBFIs were granted licences in 2003. At end 2003, the six foreign NBFIs held some 20% of total NBFI capital. The envisaged Financial Regulatory Council will be responsible for regulating NBFIs from January 2005.

68. However, NBFI legislation excludes savings and credit cooperatives. These are largely unregulated, being principally self-regulated by the Association of Co-operatives under the broad supervision of a unit within the Tax Department of the Ministry of Finance. Their regulation and supervision is being reviewed, and it is likely that such responsibility will be transferred either to the BOM or to the impending Financial Regulatory Council under a revised law on cooperatives.

Capital market

69. The capital market remains thin and under-developed. New legislation covering trade in securities replaced the 1994 Securities Law (Securities Market Law, December 2002), which became operative from 2003. The legislation was also amended in 2004. It regulates and supervises the public offering of securities, trading, protection of public shareholders' rights, and also covers supervision of operators in securities, such as brokers, underwriters, and investment funds. The Securities Exchange Committee (SEC), established in 1994, regulates the securities market. The SEC must license all professional operators in the securities market, including stock exchanges, securities dealers' trading centres, brokers, dealers, underwriters, investment managers, and advisers. The SEC may grant commercial banks or insurance companies a special licence to issue or trade in securities provided the BOM or the ISU are consulted (Securities Market Law), although it is unclear whether either of these regulatory bodies can refuse SEC's decision.

70. The poorly performing Mongolian Stock Exchange (MSE), established to facilitate voucher privatization, is being revived. The 2002 Securities Market Law covers activities of the stock exchange. Revised regulations on listing procedures have been adopted. There are 34 brokers, and by end 2002 there were 403 listed companies (up from 153 at end 2001). However, only 37 companies actively traded shares. In 2002, Tog 1.4 billion worth of shares were traded, and market capitalization was Tog 52 billion at end-2002 (5% of GDP). Over 95% of securities traded on the MSE are bonds, predominantly government paper (over 90% or Tog 41.7 billion in 2002). Company bonds were first traded in 2001, and sales occurred in the secondary market in 2002. No restrictions apply to foreigners buying shares on the MSE. The Law on Bills governs the issue of bills of exchange and promissory notes.

(ii) Telecommunications

71. Telephone density is low. Total (fixed and mobile) telephone density is about 17%. Mongolia's 135,500 fixed telephone lines at end 2003 covered some 5% of the population, about 1% in rural areas. The waiting list for a fixed telephone is around 19,000 (6 to 9 months). The network was largely digitalized by 2000. There were some 319,000 mobile subscribers at end 2003. Communications revenue increased substantially in 2003 from Tog 38.7 billion to Tog 92.4 billion (6.3% of GDP). The Master Plan for Development of the Rural Telecommunication Sector up to

[67] The increase also applied to existing NBFIs. Minimum equity capital requirements remained at Tog 10 million for Darkham and Erdenet, and Tog 1 million for other rural areas. Different minimum capital requirements were extended to rural areas to help attract NBFIs to these locations in 2002.

2021 was adopted in 2002 to improve access to communications in rural areas using mainly microwave services. A medium-term policy statement on telecommunications was also released in 2001. The Information, Communication and Technology Agency formulates telecommunications policy.[68]

72. The majority state-owned supplier, Mongolia Telecom (MT), has a monopoly in wired domestic (local and national) telephone services until 2015 under the 1995 agreement with Korea Telecom (KT).[69] MT leases the public network from the PTA (now the Information, Communication and Technology Agency).[70] The international call market was deregulated in January 2002, when the monopoly agreement with KT on these services expired. Five licensed private operators compete with MT to supply these services.[71] International call charges have fallen substantially as a result of competition, from US$4-5 per minute in 1995 to US$0.7-0.9 in 2002.[72] There are two licensed mobile carriers: Mobicom with a GSM network and 80% of the market, and Skytel.[73] These licences were auctioned in 1996 and 1999, respectively. MT does not provide mobile services. A third mobile licence has been tendered four times, but bids were rejected for being too low.

(a) Regulatory arrangements

73. The Government aims to achieve an open and competitive telecommunications sector, and has introduced regulatory reforms (Communications Law, 2001) (Box IV.2). Since 2000, the number of communications and IT companies has grown substantially to some 140. However, while these legislative reforms provide an important framework for further deregulation, their practical impact is largely blocked by MT's monopoly on non-international basic services. Government policy is to abolish this monopoly as soon as possible before 2015, but this would require re-negotiating the KT agreement. The Government plans to further privatize MT and would consider full divestment. Deregulating basic services to promote competition by ending MT's monopoly is likely, however, to provide greater economic benefit. There are no foreign investment restrictions in telecommunications, including mobile services.

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[68] This replaced the recently restructured Ministry of Infrastructure. It is under the Office of the Prime Minister, and was formed by combining the Ministry's Department of Information, Communications and Technology with the Post and Telecommunications Agency (PTA). The PTA (initially called the Mongolian Communications Assets Company) was created in December 1996 to own the public telecommunications infrastructure after MT's formation. This separated network ownership from the operator, and left the Government responsible for infrastructure maintenance and development.

[69] The fully state-owned Mongolian Telecommunications Company was partially privatized in 1995 to form MT by selling 40% to Korea Telecom. Another 5.6% was later sold to MT staff and other Mongolian interests. A second land-line company (Mongolian Railways Company) provides restricted telephone services to customers near the railway, using its fibre optic cable through MT's network, or to circuits in the Russian Federation and China. It had 11,000 customers in 2002.

[70] General revenue accrues to the Government as lease charges, taxes, and dividends from MT (US$79 million-US$49 million in lease payments from 1995 to 2002). Government is considering whether to end this separation by transferring ownership of switching equipment to MT, while retaining ownership of the trunk lines. This would require substantially more equity from MT's private partner or dilution of its ownership.

[71] The internet market was also opened. There are currently eight providers and some 46,000 subscribers. Voice-over-internet was also allowed for long-distance and international communication.

[72] Asian Development Bank (2003c), p. 12. The authorities indicate that per minute call charges to the United States have fallen from US$7 to currently well under US$1.

[73] Mobicom is 80% Japanese and 20% locally owned. Skytel is 70% Korean and 30% locally owned.

Box IV.2: Telecommunications regulatory reforms

The Communications Law, enacted in 2001, contains regulatory reforms aimed at safeguarding competition, overseen by a new independent body, the Communications Regulatory Commission (CRC).

The legislation requires the operator of a "backbone telecommunications network" to provide "connection conditions without hindrance". A "backbone network" is defined as the public network, which consists of international and domestic long-distance transmission, and international long-distance switching facilities (Article 17). The PTA, as owner of the state-owned public network, is responsible for, *inter alia*, organizing investment and concluding network operation contracts with providers (Article 10). Licences to establish and operate a telecommunications network stipulate that the holder is to provide others with interconnection. The CRC must approve the "general terms of interconnection agreements between network operators" (Article 8, Communications Law), and interconnection fees are to be "subject to the methodology set by CRC" (Section 3, Licensing Terms and Conditions). Given MT's monopoly on non-international basic services, the only interconnection arrangements to date cover access to the network negotiated by international call providers with MT, following the de-monopolizing of this service in 2002. These confidential interconnection agreements are somewhat dated, and may need to be reviewed (ADB, p. 38).

The CRC "monitors" telephone charges for services "dominating a market", and must approve the accounting methodologies used to set them (Article 9, Communications Law). Licensees have the right to determine tariffs based on CRC methodologies (Article 25), and licences are conditional on operators using CRC methodologies to set tariffs.

The CRC is authorized to "create conditions for fair competition" (Article 9). Licensees are to "keep away from acts of blocking competition in a communication's market, overusing its rights as well as discrimination" (Terms and Conditions of Licences). Any licensee is also subject to the Unfair Competition Law. The Communications Law also established a universal service obligation fund to construct and expand networks to provide "necessary services" to remote areas (Article 11). The fund, yet to operate, is to be disbursed by the PTA. Its funding is currently being reviewed, including the possibility of introducing a levy on operators. MT and the two mobile carriers are currently responsible for providing universal services.

While the new legislation lays the foundations for moving to an open and independently regulated competitive sector, should MT's monopoly be abolished, it may have several weaknesses. These include the inclusion of postal matters with telecommunications, the vagueness of funding arrangements for the universal service obligation fund, and having it controlled by the PTA (ADB, pp. 4-5).

Source: Communications Law, 2001; and ADB (2003), *Project Performance Audit Report on the Telecommunications Project (Loan 1300-MON[SF]) in Mongolia*.

74. As the first telecom regulatory body, formed in 1996, proved ineffective, the Communications Regulatory Committee (CRC) was established in June 2002 (Communications Law, 2001). Its independence is yet to be demonstrated.[74] The CRC is the licensing authority, and is mainly financed from licence fees, which are structured to provide incentives for infrastructure development in remote regions.[75] Licences are granted for up to 20 years. Type A licences are to establish and operate a basic telecommunications network and type B licences cover most other services, including international, domestic long-distance, and cellular calls.[76] There are no limitations on foreign entities holding licences, either as a subsidiary or a joint venture without equity limits, and licensing

[74] Asian Development Bank (2003c), p. 5. According to the authorities it is fully independent; having the Prime Minister appoint its members for six-year terms contributes to CRC's independence.

[75] Licensing fees depend on the type of licence and service. They are flat rate fees, except for type A licences, where *ad valorem* fees apply to operators exceeding minimum annual revenue levels. These standard fees do not apply to MT, Mobicom, and Skytel; their fees are set by government agreement. Fee discounts of 50% for three years apply to holders establishing services in remote regions (Regulatory Fees, Order of the Minister for Infrastructure of Mongolia, No. 361, 26 December 2002).

[76] Some services, such as LAN installation and internet, require only registration with the CRC.

provisions do not discriminate against them. As already indicated, however, MT is the only licensed provider of basic non-international services.

75. CRC regulates telephone charges on a cost basis. It recommends proposed tariff changes to the Information, Communication and Technology Agency. Mobile call charges are set by regulating those of the dominant provider, Mobicom. MT's tariffs for basic services contain significant cross-subsidies from profitable international calls to fund losses on local calls.[77] The cross-subsidy has declined following lower international call prices. Significant cross-subsidies also apply favouring residential over business subscribers. The Government intends to move progressively to full cost-recovery on local calls and to re-balance tariffs to remove cross-subsidies.

(b) Information technology

76. IT development is being fostered in accordance with the "Concept of Information and Communications Technology Development in Mongolia up to 2010", adopted by Parliament in February 2000. It provides for the establishment of a state fund to develop information and communications technology, and state support to construct IT infrastructure based on national satellites. The National ICT Committee, formed in April 2001 and consisting of government and private sector representatives, advises government on implementation strategies. It has proposed a medium-term strategy for IT development, and its recommendations to the Government include VAT exemption for electronic goods, products, and services that use IT, and having a third mobile phone provider. Developing IT and the internet is part of the Government's 2000-04 Action Programme. The Government adopted a Medium-term Strategy for Development of ICT and an Action Plan in 2002.

77. Regulatory arrangements for the IT industry are contained in the Information Technology Law, 2003. In addition to reaffirming relevant provisions of the Communications Law, it covers e-governance, e-signature, and e-commerce.

(iii) Transportation

(a) Air transport

78. Mongolia depends on air transport for international access and domestic communications. Some high value goods are exported by air, such as gold, cashmere products, and small quantities of horsemeat to Japan. Mongolia has 22 airports, including Buyant Ukhaa International Airport (BUIA) at Ulaanbaatar. Traffic volumes at BUIA expanded by 4.2% annually, on average, between 1993 and 2002. It currently handles about 6,000 aircraft movements and 330,000 passengers per year. Most recent growth has been in international traffic, but domestic passengers still account for the majority (60% in 2003). BUIA's airport charges and fees, last amended in 2000, follow ICAO principles; according to the authorities, the changes compare favourably with other airports in the North Asian region. Total air freight carried in 2003 was 2,200 tonnes.

79. Airport facilities are state-owned (Civil Aviation Law, 1999) and managed and operated by the Mongolian Civil Aviation Authority (CAA), which was formed in 1991 to regulate and upgrade the sector's safety, in accordance with the National Air Safety Master Plan. Its main source of revenue is fees from significantly increased over-flying international aircraft.[78] The Ministry of

[77] Local calls cost MT a minimum of Tog 13 per minute to supply while the current tariff is Tog 7 per minute. Mobile calls range from Tog 150-250 per minute (Asian Development Bank, 2003c, p. 38).

[78] Much of CAA's revenue accrues to the Government as accelerated loan repayments, taxes, dividends, and other withdrawals.

Roads, Transport and Tourism, following the recent restructuring of the Ministry of Infrastructure, is responsible for formulating air transport policies and regulating the sector. In particular, it approves procedures for licensing of air carriers, and regulates matters related to the designation of air carriers performing international flights, determination of flight routes, certification of air carriers, establishing fares and rates, and joint ownership and lease of aircraft.

80. The Mongolian Civil Aviation Air Transport Company (MIAT) operates the fully state-owned national carrier, Mongolian Airlines, under the control of the Ministry of Roads, Transport and Tourism. Operational control is delegated to the CAA. MIAT provides both domestic and international services, and eight of its fleet of 18 aircraft are in commercial service (three on international routes). MIAT's commercial viability is weak, due mainly to the current fare structure set on full-cost recovery basis, and domestic operations have been curtailed due to continual losses. It was placed under external management in May 2003, which is due to end in November 2004. Significant cost reductions have been implemented, including reducing staff from 900 to 700. Its privatization is planned for 2005. Foreign equity is limited to 49%.

81. The Government regulates domestic airfares. MIAT's fares have historically been kept below cost, but steps are being taken to raise them to profitable levels. They were raised by 25% in 2004 (10% in February and 15% in August). Several small private airlines operate scheduled commercial domestic services in competition with MIAT. The Ministry must approve private airfares. There are no restrictions on provision of domestic air services, including by locally incorporated foreign firms. However, cabotage is prohibited, and foreign carriers providing international services cannot operate domestic services. Charter flights are allowed in accordance with related legislation and procedures.

82. International air services are governed by bilateral air service agreements. The Ministry negotiates these agreements. Mongolia currently has 29 agreements, but only six are operational due to insufficient commercial interest by other foreign carriers. These cover international services between the Russian Federation, China, Japan, Korea, Germany, and Kazakhstan. Rights provided are mainly "third and fourth freedoms". No new agreements are currently being negotiated. MIAT operates limited international services, such as to Moscow, Beijing, and Berlin.

83. There are many private travel agents, mostly IATA-approved, which provide services in accordance with related agreements signed with airlines. There are no restrictions on foreigners supplying these services. Airports, including BUIA, are run by the CAA and incur losses; there are no plans to privatize them. All ground-handling, maintenance, and airport services are provided by government-owned bodies, such as CAA, MIAT, or BUIA. The authorities indicate that there are no restrictions on private, including foreign, operators providing these services. Fuel services at BUIA are provided privately.

(b) Land transport

84. A landlocked country, Mongolia relies heavily on road and rail transport. In 2003, some two thirds of freight was carried by rail (down from 86% in 2002), and 30% by road (14% in 2002).[79] It depends upon road and rail access to China and the Russian Federation for trade, and for transit to access other markets. Mongolia's main port, Tianjin in China, is reached through Zamyn-Uud and Erlian. Major exports, such as copper concentrate to Russia, textile products in containers to Tianjin, and meat products to the EU through the Russian Federation, are transported by rail. Transit goods by rail between the Russian Federation and China, especially liquid petroleum and timber from the Russian Federation, are a major source of government revenue. There are about 30 companies in

[79] Rail accounts for about 95% of passengers.

Mongolia operating multi-modal transportation services. The authorities indicate that there are no restrictions on foreigners providing these services.

85. Mongolia is negotiating a Transit Transport Framework Agreement with China and Russia. The sixth meeting is scheduled for December 2004. It is to cover all road transport, including freight and passengers. This agreement will replace Mongolia's historical bilateral agreements with China and the Russian Federation.

Road

86. Mongolia's road network covers about 11,000 kilometres. Some 12% of roads are paved; three quarters are natural earth roads. A major road project has recently been approved to complete the north-south road corridor by constructing a road from Choyr to Zamyd-Uud in China. It will link China with the Russian Federation and pass through major economic centres in Mongolia. The Government is funding the eight-year "Millennium road" project that will link together major centres from east to west. The Department of Roads is responsible for road construction and maintenance. The Ministry of Roads, Transport and Tourism is responsible for formulating road transport policy, implementation, and coordination.

87. The main legislation is the Law on Roads, 1998, as amended. A Road Fund, comprising revenue from mainly fuel taxes, road fees, transit fees, and government grants, is used to develop and maintain roads. These funds totalled Tog 46.5 billion from 1991 to 2001 (Tog 10.7 billion in 2001).

88. Road transportation is dominated by the private sector. Informal taxis and minibuses principally provide passenger services.[80] Several private companies, including with foreign interests, provide taxi services in Ulaanbaatar. Taxi services are subject to special licensing requirements aimed at ensuring safety and other minimum standards. There are no limits or restrictions on undertaking taxi services, including by foreigners. City authorities set maximum taxi fares allowing for full cost recovery. Four financially non-viable public bus companies provide passenger services in Ulaanbaatar (consisting of 250 buses and 90 trolleybuses). Efforts are under way to privatize them. Several private companies provide urban and inter-urban bus services. City authorities set maximum urban bus fares, which are set below cost. Certain passengers, such as students, travel free of charge. Government subsidies to private bus companies total about Tog 700 million annually. Inter-urban passenger services are auctioned for particular routes every three years and limited to one operator. The authorities indicate that there are no restrictions on foreigners bidding to provide such services.

89. There are about 25,000 trucks in Mongolia, and private haulers carry road freight. There are no restrictions on entry, including by foreigners, and freight rates are market determined. No government subsidies exist.

90. Transit rights are governed by historical bilateral agreements with the Russian Federation and China. Chinese and Russian buses and haulers can operate in Mongolia, subject to certain conditions.[81] Cabotage is prohibited, and operations are restricted to specified routes. However, the lack of an adequate road network connecting Mongolia with China and the Russian Federation severely limits transit road traffic.

[80] Bikales et al. (2000), p. 16.

[81] The authorities indicate that Mongolian haulers and busses cannot in practice operate in either the Russian Federation or China.

Rail

91. Mongolia's railway system consists of 1,815 kilometres of track. The main route, the Trans-Mongolian Railway, links Ulaanbaatar to Naushki in the Russian Federation and Erlian in China. Parliament is yet to approve the ten-year Master Plan for developing the railway sector. Railways are owned and operated by Mongolian Railways, an equal joint venture of Russian and Mongolian transport ministries. There are no plans to restructure or privatize it. The Ministry of Roads, Transport and Tourism is responsible for formulating rail transport policies. The Railway Authority is the implementing agency for providing freight and passenger services. Mongolian Railways operates profitably, helped by the substantial transit fees received on rail transit traffic, especially on fuel products and timber. Rail freight is equally divided between local and international activity. Transit freight represents about two thirds of international freight. Mongolian Railways incurs substantial losses on domestic transportation of coal from state-owned mines.

(iv) Tourism

92. Tourism is a government priority. It accounts for an estimated 10% of GDP (equivalent to US$130 million in 2002) and 1% of total employment. The sector has expanded due to increased numbers of foreign visitors, which grew by over 40% during 1999-02, but fell by 12% in 2003 to about 201,000. International tourism receipts also fell in 2003, from US$167.4 million to US$149.1 million (US$7.8 million in 1999). Foreign tourists are mainly from China, Russian Federation, South Korea, and Japan.

93. The Ministry of Roads, Transport and Tourism formulates tourism policy. The independent Mongolian Tourism Board (re-named in 2000 from the National Tourism Board, established in 1999) handled tourism promotion and sector regulation until its recent closure. The Ministry's Department of Tourism Policy and Coordination is currently responsible for tourism promotion. The Tourism Law, 2000 (as amended) covers tourism promotion, engagement in tourism activities, and provision of tourism services. Legislative amendments in November 2001 introduced mandatory grading of hotels and tourism resorts, and special licences for "high level" hotels (three star and above). The legislation also established the Tourism Council, under the Office of the Prime Minister, to advise on tourism-related policies. A new 15-year Master Plan has been adopted to develop the tourist sector.

94. Total annual tourist capacity is estimated at 450,000.[82] Hotels and tourism resorts catering for foreigners receive the same support and depreciation allowances as other export-related enterprises. Tourism-related services were exempted from VAT in 2001. The authorities indicate that a bed tax may be considered, but if introduced, would apply to both domestic and foreign tourists.

95. A tourism fund has been established to finance tourism infrastructure and promotion (Tourism Law, Article 19). It is financed mainly by the state budget and donations.

96. The authorities indicate that there are no restrictions on foreigners providing tourism services, other than guide-interpreters, which must be Mongolian citizens and meet certain training and grading requirements. There are currently over 500 private tourism companies. Both foreign and domestic operators require the same permission to enter national protected areas in order to safeguard the environment. Land can be leased for between 20 and 60 years.

[82] There are 116 hotels with 5,000 beds in Ulaanbaatar, 81 provincial hotels with 3,000 beds and 118 tourist camps with 5,200 beds.

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2005 MONGOLIA COUNTRY COMMERCIAL GUIDE

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Chapter 6: Investment Climate Statement

A.1 OPENNESS OF GOVERNMENT TO FOREIGN INVESTMENT

In its specific policies, laws, and general attitude, the government of Mongolia supports foreign direct investment (FDI) in all sectors and businesses—at whatever levels investors want. Its industrial and economic strategies do not discriminate actively or passively against foreign investors. Mongolia screens neither investments nor investors, except in terms of the legality of the proposed activity under Mongolian law.

While the Mongolian government writ large supports FDI, individual agencies and elements of the judiciary often use their respective powers to hinder investments into such sectors as meat production or pharmaceuticals. Both domestic and foreign investors report similar abuses of inspections, permits, and licenses by Mongolian regulatory agencies. We find no concerted, systematic, institutional abuse specifically targeted at foreign investment. In the case of the judiciary—corruption aside (see A. 11 Corruption)—most problems arise from ignorance of commercial principles rather than antipathy to foreign investment.

Privatization policies have actually favored foreign investment in key industries, including banking and cashmere production. The bidding processes for privatizations and other tenders have been transparent, and the results widely accepted by all participants. Foreign companies and investors are subject to the same legal regime imposed on Mongolian domestic firms regarding incorporation and corporate activities For example, casinos are illegal under Mongolian law; and so, neither Mongolians nor foreigners may own or operate them (except in one specifically designated free trade zone).

Generally, Mongolian private businesses want foreign participation in all sectors of the economy. They seek foreign partners and equity. That said, some Mongolian businesses use Mongolian institutions to stop competitors, if they can. These activities represent no animus against foreign investment as such; rather, they reflect individual businesses desire to keep competitors, Mongolian or foreign, at bay.

Key Investment Laws

The Foreign Investment Law of Mongolia (FILM) has transformed the anti-business environment of Soviet era into today's investor-friendly regime. Under the old system everything not provided for in law was illegal. Because such economic activities as franchising, leasing, joint venture companies were not mentioned in earlier Mongolian statutes, they were technically illegal. In 1993 the government enacted FILM to legalize all manner of foreign investment in Mongolia (amended in 2002 to allow for representative offices and franchises). This law defines broad ranges of activity that would otherwise have no validity under Mongolian law. It also defines the meaning of foreign investment under the civil code without limiting activities that foreign investors can conduct. The definition is largely for tax incentives, as only foreign investments over

10,000 USD qualify for tax breaks under the law. FILM also establishes registration procedures for foreign companies. It creates a supervisory agency, the Foreign Investment and Foreign Trade Agency (FIFTA), to run the registration process, liaise between businesses and the Mongolian government, and promote in- and out-bound investments. We have found FIFTA a reasonably fair and efficient agency.

A.2 CONVERSION AND TRANSFER POLICIES

Over the last four years, the Mongolian government has employed a limited regulatory regime for controlling foreign exchange for investment remittances. Although lacking sophisticated mechanisms for converting and transferring funds, Mongolia has exceptionally liberal policies for these transactions. Foreign and domestic businesses report no problems converting or transferring investment funds, profits and revenues, loan repayments, lease payments into whatever currency they wish and to wherever they wish. There is no difficulty in obtaining foreign exchange, whether the investor wants RMB, Euros, English Pounds, Rubles, or US Dollars.

The Mongolian government wants funds to flow easily in and out of the nation, with one exception. Foreign-held interest bearing dollar accounts are subject to a 20% withholding tax. The bank retains 20% of all such interest payments sent abroad, and remits this withholding to the Tax Authority of Mongolia. Otherwise, businesses report no delays in remitting investment returns or receiving in-bound funds. Most transfers occur within 1-2 business days or at most a single business week.

Ease of transfer aside, foreign investors criticize Mongolia's lack of sophisticated mechanisms for converting currencies and parking money. Letters of credit are difficult to get, and legal parallel markets do not exist in the form of government dollar denominated bonds or other instruments for parking funds in lieu of payment. Many Mongolian financial institutions lack experience with these arrangements. Moreover, Mongolian banking law currently provides no secure statutory grounds for the activity to take place. Banks may hesitate to use instruments that may be technically illegal under Mongolian law. The immediate impact has been to limit access to certain types of foreign capital, as international companies resist parking cash in Mongolian banks or in local debt instruments.

A.3 EXPROPRIATION AND COMPENSATION

Mongolia respects property rights as they apply to all types of asset categories. We detect no changes in policies, statutes, or regulations related to the use and ownership of private property. Foreigners face no legal bias in asset ownership (except that only citizens of Mongolian may own land) or how they structure ownership. Foreign investors need not seek local partners or share ownership of any asset or endeavor as a condition of doing business. However, in the crucial mining sector, with extensive foreign participation, we note governmental actions that might represent "creeping expropriation."

Security of Ownership

To date, the government has expropriated no property or assets; and so, we have no precedent from which to assess how the system would respond to seizure and compensation. The Mongolian government can claim land or leases in the national interest, as can most governments. Currently, this means little, as most land outside Mongolia's urban centers remains government property. The government has no plans to privatize these vast countryside holdings, but it leases parcels for such economic activities as mining, pasturage, timbering, etc. This practice remains in flux because the government must still determine how to let these rights and what fees to charge. Except for mining, foreign firms are inactive in these regions.

Since May 2003, land in the urban areas has been privatized to citizens of Mongolia or leased to both citizens and foreigners for periods ranging from 3-99 years. The legislation and implementing regulations are all new, but so far investors believe that the Mongolians have respected recently enacted property rights and leases.

Creeping Expropriation 1: Acts of the Central Government

We closely watch the key mining sector. To date we have received no report of recent expropriations of exploration tenements or mining licenses. However, over the last four years certain official factions within the Mongolian government have unsuccessfully tried to amend the mining law to make seizure of tenements by the government easier. Some amendments to the mining law seem reasonable. The government would like to see tenement holders exploit their holdings, sell their interest to those who will exploit, or return tenements to the state. It rubs some Mongol officials the wrong way that rights holders can speculate without developing a mining asset (even if the rights holders pay required fees for the land under exploration or extraction license). Calling it national interest, these officials demand higher fees, stiffer performance guarantees or even revoke existing rights.

The idea of tenement holders agreeing to performance guarantees or higher fees is nothing new and practiced in other countries. Although domestic and foreign miners grumble about the additional costs, they accept these concepts. However, the mining industry and the USG have resisted the government's effort to allow officials greater latitude to revoke tenements. Making revocation of use rights easier in mining creates a threatening precedent for other industries, lowering investor security and raising investor risk in all sectors.

Over the last four years, proponents have submitted such amendments to the excellent 1997 Minerals Law of Mongolia. Concerted lobbying activity by this Mission and the foreign and domestic mining industry has defeated it each time. Most encouraging, both the legislative and executive branches of the government have proved willing to give a fair hearing to all participants in this dispute. Currently, the amendments have been shelved, but we remain vigilant.

Creeping Expropriation II: Acts of Provincial Administrations:

With regard to permitting, we note a disturbing trend: Provincial officials blocking access to legally granted mining rights. For example, some provincial government officials abuse their authority to designate land as “special use zones” to usurp mining exploration tenements. In one case, a provincial governor reclassified a piece of property for agricultural use, although the central government had legally granted exploration rights to a miner. The miner could not gain access to the subsurface resources because the provincial government claimed that doing so would damage the potato farm that had suddenly appeared over the site. This case is working its way through the courts.

Other miners harshly criticize the misuse of the local officials’ rights to comment on permits for water use and mining licenses. Comments are advisory, and have no legal force regarding allowing activity, but the central government is loathe to reject a governor’s negative comment no matter the motives behind it. The de facto effect has been to stop progress for months, limiting access to the resource and costing rights holders’ time and money.

Whatever the motives, these provincial actions are a creeping bureaucratic expropriation. The problem is that the law provides no clear limit on these powers or guidance on to apply them. Consequently, the central government interprets the rules and regulations differently from the provincial authorities. The central government acknowledges the ambiguity but has taken no steps to clarify the situation in law or practice. Mongolian and foreign permit holders have advised the government that letting this problem fester raises perceptions of risk and scares away inbound investors.

A.4 DISPUTE SETTLEMENT

The Mongolian government consistently supports transparent and equitable dispute settlements, but executing good intentions has proven problematic. These problems come from ignorance of standard commercial practices rather than from any intent by public or private entities to target foreign investors. The framework of laws and procedures is functional, but many judges who adjudicate disputes remain ignorant of commercial principles.

Problems with Dispute Settlement in Mongolia's Courts

Court structure is straightforward and supports dispute settlement. Disputants know the procedures and the venues. Plaintiffs bring cases at the district court level before a district judge or judges depending on the complexity and importance of the case. The district court renders its verdict. Either party can appeal this decision to the Ulaanbaatar City Court, which rules on matters of fact as well as matters of law. It may uphold the verdict, send it back for reconsideration or nullify the judgment. Disputants may then take the case to the Mongolian National Supreme Court for a final review.

Problems arise for several reasons. First, commercial law in Mongolia and understanding of it are in flux. New laws on contracts, investment, corporate structures, leasing, etc. have been passed or are being considered at both the ministerial and parliamentary levels. Mongolian civil law does not work on precedents but from application of the statute as written. If a law is vague or does not cover a particular commercial activity, the judge's ability to adjudicate can be severely limited or non-existent. For example, leasing does not exist in the Mongolian civil law code as such, but would seem to be covered under various aspects of Mongolian civil law regarding contracts and other agreements. But judgments made under these laws may not apply to an arrangement not otherwise recognized under existing law. Further, because precedents are not legally relevant, decisions reached in one case have no legal force in other suits, even when the circumstances are similar.

Trained in the former Soviet Era, too many judges remain willfully ignorant of commercial principles. They dismiss such concepts as the sanctity of the contract. This is not a problem of the law, which recognizes contracts, but of faulty interpretation. In several cases courts have intentionally misinterpreted provisions regarding leases and loan contracts. Judges regularly ignore terms of a contract in their decisions. If someone defaults on a loan, the courts often order assets returned without requiring the debtor to compensate the creditor for any loss of value. Judges routinely assert that the creditor has recovered the asset, such as it is, and that is enough. Bad faith and loss of value simply do not enter into judicial calculations of what is equitable.

Replacing old-school judges is not an option. It has proved politically impossible—if not functionally impractical—for the Mongolians to dismiss this cadre of Soviet-era judges. There is a realistic hope that young justices, trained in modern commercial principles by

American and German experts, will gradually improve judicial protections for commercial activities in Mongolia. Lately, we have seen better decisions in several cases involving Americans seeking to recover on debts and contractual fees, but these results remain limited to courts where better-educated, younger judges preside.

Bankruptcy and Debt Collection

Mongolia's bankruptcy provisions and procedures for securing the rights of creditors need serious reform. Mongolia currently has no mortgage law, no way to register titles, and no clear method for recovering on any debt. There exists a patchwork of laws that may or may not apply, making lending on local security risky. Banks frequently complain that onerous foreclosure rules are barely workable and unfair to the creditor.

Once a judgment is rendered, the disputant faces a relatively hostile environment to execute the court's decision. For example, consider a bank collecting on a debt in Mongolia. Currently, debtors put forward assets for auction and set the minimum bid price for those assets. If assets do not sell, a second round of auctions occurs in which a reduced minimum bid is put forward. The State Collection Office (SCO) supervises this process but does not set the price; but it will receive 10% of the settlement. Failing to get this set price, the SCO supervises the sale of assets and takes its 10%; however, not of the actual money raised but 10% of the second auction minimum.

There is no current method by which the participants can independently evaluate the value of any collateralized asset. Because it derives income from the forced sale of assets, the SCO itself has a conflict of interest; and, anecdotally, seems to have failed as an impartial arbiter between debtors and creditors. For banks, this has meant that forcing a company into bankruptcy may be the safest way to recover rather than forcing piecemeal sales of assets. This approach automatically puts all assets into play rather than those selected by the debtor. However, it is an onerous procedure without a clear process behind it.

Purchase financing is also tricky. For example, an American car dealer financed an auto for 20,000 USD down and 60,000 USD, secured by a local bank guarantee. The buyer subsequently defaulted on the loan, the bank refused to honor its guarantee, and the dealer took the buyer to court. Under current Mongolian law, once a case is filed, interest payments are suspended for the duration of the case—from first filing to final appeal before the Supreme Court of Mongolia. Possibly months of interest-free time can pass while the asset rusts in an impound lot. In this case, the dealer simply reclaimed the car and dropped the lawsuit, swallowing the lost interest payments and loss in value on the car. Both domestic and foreign businesses have responded by requiring customers to pay in cash, limiting sales and the expansion of the economy.

Binding Arbitration: International and Domestic

The Mongolian government supports and will submit to both binding arbitration and international settlement procedures. However, glitches remain in local execution.

Mongolia ratified the Washington Convention and joined the International Centre for Settlement of Investment Disputes in 1991. It also signed and ratified the New York Convention in 1994.

To our knowledge the government of Mongolia has accepted international arbitration in two disputes where claimants have asserted the government reneged on a sovereign guarantee to indemnify them. In both cases the government has consistently declared that it would honor the arbitrators' judgments. However, this resolution has not been put to the test, as Mongolia won one case and judgment in the second has not been rendered.

More widely, Mongolian businesses partnered with foreign investors accept international arbitration, as do government agencies that contract business with foreign investors, rather than avail themselves of the Arbitration Bureau operated by the Mongolian National Chamber of Commerce and Industry. They seek redress abroad because they perceive that domestic arbitrators are too politicized and self-interested to render a fair decision.

Although arbitration is widely accepted among business people and elements of the government, support for binding international arbitration has not penetrated local Mongolian agencies responsible for executing judgments. In the two cases, the Mongolian-state-owned copper mine lost two international arbitral cases. The awards were certified and recognized as valid and enforceable by Mongolian courts. But the local bailiff's office has consistently failed to execute the collection orders.

A.5 PERFORMANCE REQUIREMENTS AND INCENTIVES

Mongolia imposes few performance requirements on, and offers few incentives to, investors. The few requirements imposed are not onerous and do not limit foreign participation in any sector of the economy. Performance requirements are applied somewhat differently to foreign investors in a limited number of sectors. Incentives in the form of tax holidays are mostly reserved for foreign investors; however, some customs tax and value added tax reductions are allowed for all businesses engaged in certain sectors identified by Parliament and the ministries.

Few Restrictions on Foreign Investment

The government applies the same geographical restrictions on both foreign and domestic investors. Existing restrictions involve border security, environmental concerns, or local use rights. There are no onerous or discriminatory visas, residence, or work permit requirements. Foreign investors need not use local goods and services, local equity, or engage in substitution of imports. Neither foreign nor domestic businesses need purchase from local sources or export a certain percentage of output, or have access to foreign exchange in relation to their exports.

Foreign investors set their own export targets without concern for government imposed targets or requirements. There is no requirement to transfer technology. As a matter of law, the government imposes no offset requirements for major procurements. Certain tenders may require bidders to agree to levels of local employment or to fund certain facilities as a condition of the tender, but as matter of course such conditions are not the normal approach of the government in its tendering and procurement policies.

All investors may finance as they see fit. Foreign investors need sell no shares to Mongolian nationals, unless they so choose. Equity stakes are at the complete discretion of investors, Mongolian or foreign. Investors, not the Mongolian government, make arrangements regarding technology, intellectual property, etc.

Regarding employment, investors can locate and hire workers without using hiring agencies—as long as hiring practices are consistent with Mongolian Labor Law. However, Mongolian law requires companies to employ Mongolian workers in certain labor categories whenever a Mongolian can perform the task as well as a foreigner. This law generally applies to unskilled labor categories and not areas where a high degree of technical expertise not existing in Mongolia is required. The law does provide an escape hatch for all employers. Should an employer seek to hire a non-Mongolian laborer and cannot obtain a waiver from the Ministry of Labor for that employee, the employer can pay a fee of around $65.00 USD per employee per month. The Ministry of Labor seems quite eager to issue work permits for cash payments.

Limited Performance Requirements

Performance requirements are sparingly imposed on investors in Mongolia. The Mineral Resources and Petroleum Authority of Mongolia (MPPAM) issues exploration blocks to firms, which then agree to conduct exploration activities. The size and scope of these activities are agreed upon between MPPAM and the business in writing and are binding. If the firm fails to fulfill exploration commitments, it must pay a penalty to MPPAM based on the amount of hectares in the exploration block, or give back the block to MPPAM. These procedures apply to all investors in the petroleum and natural gas exploration business.

All businesses holding mining exploration tenements or extraction licenses need neither explore nor mine so long as they pay fees associated with their holdings and provide annual reports of their activities to the government of Mongolia.

All foreign investors must register with, and pay a yearly fee of 700.00 USD, and provide an annual report on their activities for the coming year to the government through the Foreign Investment and Foreign Trade Agency of Mongolia (FIFTA). Businesses need not fulfill plans set out in this report, but failure to report may result in non-issuance of licenses and registrations and suspension of activities. This requirement differs from that imposed on domestic investors and businesses. Mongolians pay lower registration fees, which vary too much to say with any precision what the fees actually are; nor do locals have a yearly reporting requirement.

FIFTA explains that the higher registration costs for foreign investors arise from the need to compensate for the services it provides to foreign investors, including assistance of registrations, liaison services, trouble-shooting, etc. The different reporting requirements provide the government with a clearer picture of foreign investment in Mongolia. Foreign investors are generally aware of FIFTA's arguments and largely accept them, with two exceptions. They question the need for annual registrations. Investors recommend that FIFTA simply charge an annual fee rather than require businesses to submit a new application each year.

Regarding reports, foreign businesses are concerned about the security of their proprietary information. Several foreign investors have claimed that agents of FIFTA routinely use or sell information on business plans and financial data. We have yet to verify these claims, but FIFTA acknowledges that data security largely depends on the honesty of its staff, as there is little internal control over access to the annual reports.

Incentives

Foreign investors under the Foreign Investment Law of Mongolia and the Tax Law of Mongolia are entitled to a sliding scale of tax holidays. The exemption increases in the amount and duration as the investment increases. For larger projects seeking a more comprehensive tax treatment and more extensive package of incentives, foreign investors have two routes. They may utilize an off-the-shelf stability agreement that locks in current tax and fee structures, as they existed at the time the agreement was signed and approved by the Ministry of Finance. This relatively new arrangement has not given rise to any disputes, and we have no reason to think that the Mongolian government would not honor it.

The second approach is to negotiate a customized agreement directly with the government. Such a stability agreement locks in current tax rates and fees as well the entire range of regulations, statutes, and rules that existed when the agreement was signed and approved by the Parliament of Mongolia. The full range of labor, environmental, tax, and any other laws and rules are frozen as matter of statute by the establishment of such an accord. The parties agree between themselves on the widest array of incentives, laws, practices; Parliament approves it; and the agreement becomes a unique statute unto itself.

The government of Mongolia only undertakes such ad hoc agreements for investments of the highest magnitude and value. To our knowledge Mongolia has negotiated only one such agreement, with an American petroleum exploration firm. This firm has been satisfied with the outcome of its arrangements. Currently, we know of one other potential agreement for a multi-billion dollar investment in the mining sector under negotiation.

The Mongolian government, through an act of Parliament, also grants exemption from customs duties and the value-added-tax for all businesses and entities engaged in the following activities:

LIST OF PRIORITY SECTORS FOR FOREIGN INVESTMENT

Sector, Sub-sector	Chapter, Sub-Chapter	Sector
A.01		**Agriculture**
	0111	Cultivation of crops, fruits, sugar canes, oil and animal fodder plants
	0121	Intensive animal husbandry (diary, meat production, chicken farming)
C.10		**Coal Exploration**
	1010	Exploration of all types of coal through open-cut and underground mining methods, crushing, grading and a quality improvement. Production of briquette fuel
	1020	Exploration of brown coal and a fuel of coal type, production of briquette fuel
	1030	Exploration of shale and peat
C.11		**Exploration of Oil and Gas**
	1110	Exploration, strengthening, processing of oil, mineral resources containing oil and exploration of gas
	1120	Services for drilling and equipping oil and gas pits, erecting and maintaining towers

C.12		**Exploration of Uranium and Thorium Ore**
	1200	Exploration of uranium and thorium ores and ores containing radio-active components
C.13		**Exploration of Iron Ore**
	1310	Exploration, concentration, conditioning (heating, breaking into pieces, floatation, sorting and cleaning) of iron ore and minerals containing iron
	1320	Exploration of copper, zinc, tin, tungsten, molybdenum, gold, silver, rare metals (zircon, tantalum, nyoby etc.), rare earth and strontium
C.14		**Exploration of Other Mineral Resources**
	1421	Exploration of chemical and fertilizer minerals, minerals containing nitrogen, phosphorus and sulpher, fluor spar and other minerals which can become chemical raw materials such as soil colorants
	1429	Other exploration works Exploration of minerals such as asbestos, fossil organics, magnetite, argillite, quartz, mica, fiber-glass
		Processing Industry
D.15		**Food Production**
	1511	Production and storage of meat and meat products, processing technologies for meat storage, drying, smoking, salting and tinning
	1514	Production of vegetable and animal originated oils
D.15		Production of Flour and Animal Fodders
	1533	Production of mixed and tossed fodder
D.15		Other Food Production
	1542	Production of cane and turnip sugar
D.17		**Knitting Industry**
	1711	Spinning, knitting, dying, decorating of woolen and paper thread of animal and plant origin
	1712	Final processing of knitted cloth
	1729	Production of knitted goods for tagging, belting and hygiene purposes
D.18		**Fur Processing**
	1820	Final processing of fur and sheep skin tannery

D.19		**Leather Processing**
	1911	Leather processing
	1912	Production of leather goods
	1920	Production of all types of shoes, including male, female and children's shoes
D.20		**Timber Production**
	2021	Production of boards
D.23		**Cocking, Liquid and Radio Active Fuel**
	2310	Production of cock, tar and other by-products out of coal
	2320	Fuel production Production of liquid and gas fuel out of shale and oil
D.24		**Production of Chemical Products**
	2411	Production of industrial chemicals, such as gas, acetylene, oxide, alkali, paints and substances for processing skin
	2412	Production of nitrogen, phosphorus and potassium fertilizers and substances containing them
D.26		**Goods Made of Non-Metal Minerals**
	2692	Non-flammable ceramics Production of non –flammable bricks, transportation boards and pipes
	2694	Production of cement, lime and
D.27		**Metallurgic Industry**
	2710	Production of conditioned iron ore, primary cast-iron and steel (reinforcement steel, rails, pipes, wires etc.) using scrape metal
	2720	Refining and melting precious and non-ferrous metal, gold, silver, production of non-ferrous metal through segregation by electrical and other chemical methods, production of copper, lead, aluminum, zinc, molybdenum, tungsten, nyoby, tantalum, zircon, rare earth and strontium
D.37		**Processing of a Secondary Raw Material**
	3720	Processing of a secondary raw material except scrape metal
		Infrastructure Sector

E.40		**Production of Electricity and Steam and Water Supply**
	4010	Electricity production, transmission, distribution activities (hydropower station, transmission facilities, thermo and diesel stations)
	4030	Production of steam, hot water supply (heat distribution facilities)
E.41		**Water Treatment, Water Supply**
	4100	***Collection, treatment and distribution of a water for household and industrial use***
F.45		**Construction Industry**
	4520	***Construction of engineered buildings and structures***
	4530	***Installation, placement and maintenance of lifts and security alarm devices***
	Special	***Construction of a "Millennium Road" (equipment leasing)***
	Special	***Construction of oil and gas pipelines***

To qualify for these exemptions businesses must prove that the imports are used in the specified sectors and not diverted to non-allowed uses. There is a perception among investors that the Mongolian government unfairly targets for enforcement foreign investors who use the exemptions, while domestic businesses are not targeted. We have not been able to verify such claims.

The Mongolian government also provides credit in the form of zero interest loans and no-fee use of government buildings to businesses engaged in wholesale trade in the countryside. These arrangements are granted by tender and are not limited to domestic businesses; however, to our knowledge no foreign investor has entered this field.

Tariffs

Mongolia has one of Asia's least restrictive tariff regimes. Its export and import policies do not harm or inhibit foreign investment. Low by world standards, tariffs of 5% on most products are applied across the board to all firms. However, some non-tariff barriers, such as phytosanitary regulations, exist that limit both foreign and domestic competition in the fields of pharmaceutical imports and food imports and exports. The testing requirements for drugs are extremely unclear and onerous. When companies attempt to clarify what the rules for importing food or drugs into the country are, they receive conflicting information from multiple agencies. Our sense of the matter is that existing pharmaceutical and food import and export interests are abusing the current rules and regulations to limit all competition and investment.

WTO TRIMS Requirements

Mongolia employs no measures inconsistent with WTO TRIMs requirements, nor has anyone alleged that any such violation has occurred.

A.6 RIGHT TO PRIVATE OWNERSHIP AND ESTABLISHMENT

Mongolia has one of Asia's most liberal ownership and establishment regimes. Unless otherwise forbidden by law, foreign and domestic businesses may establish and engage in any form of remunerative activity. All businesses can startup, buy, sell, merge; in short, do whatever they wish with their assets and firms.

Diminishing Competition from the State-Owned Sector

Mongolia has passed and is implementing a competition statute that applies to all business entities active in Mongolia—foreign, domestic, and state-owned. As a practical matter, competition between state-owned and private businesses has been declining for the simple reason that most parastatels have been privatized—with the exception of the state-owned power and telecom industries, cashmere production, aviation, the national rail system, and a large copper mine. These remaining companies are set for privatization in the next 2-3 years.

Currently, only one private firm is active in the power generation and none in the railway sector. Few want to enter the power generation field until the regulatory and statutory framework for private power generation firms up. Mongolia has no plans to privatize its railroads. The state-owned cashmere producer does not seem to be impacting private producers negatively, and will be privatized in early 2005. With the exception of the domestic aviation and the telecom parastatel, the public sector is a limited and shrinking competitor with the private sector.

Issues in the Telecom and Aviation Sectors

We note that state-owned telecom has actively used its regulatory and technical clout to attack its competition. As the monopoly supplier of land-based lines through which most internet access is obtained, Mongol Telecom (MT) charges predatory rates for access to all other Internet Service Providers (ISPs) at a rate 10 times the access charges assessed to the state-owned ISP. These per-minute charges add up and are hard for competitor ISP's to absorb. In addition, the state, in an effort to make Mongol Telecom more attractive for privatization, is inclined to make MT the sole portal for all telecommunication into Mongolia. The intent here is to require licenses for both telecommunication services and technology, which only MT could satisfy. There has been significant lobbying against this policy by ISPs, voice-over IP providers, cellular rights holders, multi-lateral organizations, and diplomatic missions as contrary to Mongolia's own competition law and long-term interests. So far these efforts have delayed the passage of any damaging legislation.

The state also interferes in the domestic aviation arena. Mongolia has two domestic service providers, the state-owned MIAT and the privately owned Aero Mongolia. Government regulation sets maximum ticket prices that airlines may charge for all domestic routes. These prices are well below operating costs. MIAT is heavily subsidized, primarily through its foreign routes. Investment in domestic service, into which the US might sell aviation products and services, has been limited. Investors, both Mongolian and foreign tell us that until the state gets out of the local aviation business, they will not be able to invest.

A.7 PROTECTION OF PROPERTY RIGHTS

The right to own private movable and real property is recognized under the law of Mongolia. Regardless of citizenship (except for land which only citizens of Mongolia can own), owners can do as they wish with their property. One can collateralize real and movable property. Should a debtor default on such secured loans, the creditor does have recourse under Mongolian law to recover the debt by seizing and disposing of property offered as security.

Mongolia's Current Regime to Protect Creditors

The current protection regime is functional but needs reform. The legal system presents the greatest pitfalls. Although the courts recognize property rights in concept, they have a checkered record of protecting and facilitating acquisition and disposition in practice. Part of the problem is ignorance of, and inexperience with, standard practices regarding land, leases, buildings, and mortgages. As noted in A.4 Dispute Settlement, some Soviet-trained judges, largely out of ignorance of the concepts, have simply refused to recognize these practices. New judges are making a good faith effort to uphold property rights, and need time to learn how to adjudicate such cases.

Currently, legal uncertainties make mortgage lending in Mongolia risky. Mongolia has yet to pass a law on mortgages; a mortgage law is under review by the relevant ministries and parliament for consideration in 2005. As noted in A.1 Openness to Foreign Investment, the legal system is based on that of the former Soviet Union and is "Continental" or "civil" in nature: courts tend to recognize only that which is specified or enacted in the law. As a consequence, while possible to make secured loans, it is currently not possible to make mortgages. The judges have no statutory guidance upon which to base their rulings. This opens an avenue for appeals based on the technical illegality of a decision enforcing the rights of a creditor or protecting the rights of debtor. Judges not wanting to be called to account for making faulty rulings make vague decisions, using provisions that do not exactly fit the particular aspects of mortgages. At the end of the day, we find the courts basically making equitable judgments but in a very roundabout way.

Debt Collection Procedures

Mongolian debt collection procedures require reform. Getting a ruling is relatively easy; collecting on a judgment is hard. The problem is not the law, but enforcement and execution. Mechanisms for enforcing a judgment are simple. The judge orders the state collection office to move on the assets of the debtor. The state collection office orders district bailiffs to seize and to turn those assets over to the state, which then distributes them to creditors. However, foreign and domestic investors claim that the state collection office and the district bailiffs frequently fail in their responsibilities to both the courts and the creditors.

In some cases, bailiffs refuse to enforce the court orders (see the Erdenet case mentioned in A.4). The perception is that they do so because they have been bribed or otherwise suborned. Bailiffs are often local agents who fear local retribution against them and their interests if they collect in their localities. In some cases, bailiffs will not collect unless the creditor provides bodyguards during seizure of assets. Creditors also have reason to believe that the state collection office accepts payments from debtors to delay seizure of assets.

Protection of Intellectual Property Rights

Mongolia supports intellectual property rights in general and has protected American rights in particular. It has joined the World Intellectual Property Organization (WIPO); signed and ratified most treaties and conventions, including the WTO TRIPS agreement. The WIPO Internet treaties are un-ratified. However, even if a convention is un-ratified, the Mongolian government and its intellectual property rights enforcer, the Intellectual Property Office of Mongolia (IPOM), make a good faith effort to honor these agreements.

Under TRIPS and Mongolian law, the Mongolian Customs Authority (MCA) and the Economic Crimes Unit of the National Police (ECU) also have an obligation to protect IPR. MCA can seize shipments at the border. The ECU has the exclusive power to conduct criminal investigations and bring criminal charges against IPR pirates. The IPOM has the administrative authority to investigate and seize fakes without court order. Of these three, only the IPOM makes a good faith effort to fulfill its mandates.

Part of the problem is ignorance of the importance of intellectual property to Mongolia and of the obligations imposed by TRIPS on member states. Customs has been particularly hesitant to seize shipments, saying that their statutory mandate does not allow seizure of such goods. Technically they are correct, but they have seized fake products when it suits them. Mongolian customs law will have to change to bring it into line with TRIPS before Customs will actively fulfill its obligations. The ECU has also been lax. The ECU hesitates to investigate and prosecute IPR cases, deferring to the IPOM as the lead agency. Anecdotal evidence suggests that ECU officials fear political repercussions from going after IPR pirates, many of whom enjoy political protection.

The IPOM has an excellent record of protecting American trademarks, copyrights, and patents. However, its small budget limits the scope of its actions. In most cases, when the U.S. Embassy in Ulaanbaatar conveys a complaint from a rights holder to the IPOM, the IPOM quickly investigates the complaint. If it judges that an abuse occurred, it will (and has in every case we have brought before it) seize the pirated products or remove faked trademarks, under administrative powers granted in Mongolian law.

We note two areas where enforcement lags. Legitimate software products are rare in Mongolia. Average low per capita incomes have given rise to a thriving local market for cheap, pirated software. The IPOM estimates pirated software constitutes 95% of the market. The Office allows the abuse because the scale of the problem dwarfs its capacity to deal with it. However, the IPOM will act if we bring cases to their attention.

Pirated optical media are also readily available and subject to spotty enforcement. Mongolians produce no fake CD's, videos, and DVD's, but import such products from China. Product is sold through numerous local outlets and sometimes broadcast on private local TV stations. The IPOM hesitates to move on TV stations, most of who are connected to and protected by major government or political figures. Nor does the IPOM raid local ("street") DVD and CD outlets run by poor urban youth; IPOM argues that such action would not halt sales and only alienate the public. Again, when an American raises a specific complaint, the IPOM acts on the complaint, but IPOM rarely initiates action on its own.

A.8 TRANSPARENCY OF THE LEGISLATIVE AND REGULATORY PROCESS

Generally, Mongolia's problem is not lack of laws and regulations—Mongolia has passed over 1,500 laws since undertaking its transition to a market economy 12 years ago—but a lack of knowledge on the part of the lawmakers on what is needed and an unwillingness to consult with affected communities. Corruption aside, the fact that laws and regulations change without much consultation creates a chaotic situation for all parties. Many laws and regulations, as well as behavior, still require amendment and adjustment; but, overall, the trend is positive. We have seen definite improvement in the mining sector and in the foreign investment statutes.

Problems with the Drafting Process for Legislation and Regulations

The normal procedure for drafting laws and regulations is as follows. A Member of Parliament or the Cabinet of Ministers requests legislative action. These organizations then send this request to the relevant ministry. The minister relays the request to the proper agency, which forms a working group. The working group prepares the bill, submits it for ministerial review, makes any recommended changes, and then the bill is reviewed by the full Cabinet of Ministers. This body recommends changes or passes the bill on to Parliament. In Parliament, the bill is reviewed by the relevant standing committee, sent back for changes or sent on to the full Parliament for a vote. The President can veto bills, but his veto can be over-ruled by a two-thirds (2/3) vote of Parliament.

For regulations, the process is truncated. The relevant minister assigns the task of writing the regulations to the working group that wrote the original law. This group submits their work to the minister who approves or recommends changes.

Absent from these drafting processes is a statutory, systematic, transparent review of legislation or regulations by stakeholders and the public. Ministerial initiatives are not publicized until the draft has passed out of a given ministry to the full Cabinet. Typically, the full Cabinet discusses and passes bills on to Parliament, without public input or consultations. Parliament itself does not issue a formal calendar and does not announce or routinely open its standing committee or full chamber hearings to the public. While Parliament at the beginning of each session announces a list of bills to be considered during the session, this is very general and seldom accurate. New legislation is often introduced, discussed and passed without public announcement or consideration. It is possible for a bill or regulation to be drafted and passed without any public or stakeholder input.

The U.S. Embassy in Ulaanbaatar and members of the North America-Mongolia Business Council (NAMBC) have repeatedly urged the Mongolian government to utilize the government's *Open Government* web site to post draft and pending legislation for public consultation and review before it is finalized and sent to Parliament. Over the past year, we have noticed some improvement in the timeliness and completeness of the postings.

To supplement this effort, the U.S. Embassy and local business organizations have jointly created an informal system to identify legislation and regulations under review. Once identified, we meet with working groups, provide information on how other nations have handled such legislation, share stakeholders' points of view, and widely distribute draft bills, preferably before they reach a minister's desk. Should a piece of vital legislation pass on to the Minister, Cabinet, or Parliament, these organizations are prepared to lobby at the appropriate level. Over the last three years we have found that many agencies and Members of Parliament welcome our advice and information, particularly if given in a non-confrontational way.

Regulators also resist consultation when it comes to implementation. Soviet-trained bureaucrats are only slowly becoming comfortable with the concepts and practices of broad, public consultation and information sharing with their own citizens, let alone foreigners. Many times businesses ask for a clear copy of the current regulations, only to be met with blank stares or outright refusals. The government has acknowledged that the Soviet-era State Secrets Law requires substantial amendment. Currently, most government documents—including administrative regulations affecting investments and business activities—are technically classified and cannot be released to the public. This gives both bureaucrats and regulators a convenient excuse to deny requests for information or, more commonly, to demand extra-legal fees to provide documents. The legacy of secrecy has also resulted in cases where government officials themselves cannot get up-to-date copies of the rules.

High officials acknowledge the value of and need for a more open, transparent system. While laws are easy to fix, the behavior of individual bureaucrats, members of parliament, and the judiciary will only gradually change, with training and experience. Already a younger generation of professionals, many trained abroad, is beginning to take hold and to move into senior positions of authority. This bodes well for Mongolia's continuing transition to a private sector-led, open, market economy underpinned by good government and corporate governance.

Reforming the Tax Law

Although the process of making and executing law are key problems, we note a particularly troublesome area that all foreign and domestic investors identify as a must solve: The Tax Law of Mongolia (TLM). First, the law is not consistent with best practices in either Europe or North America. Key complaints from American and western investors center on the deductibility of legitimate expenses and depreciation. This failure to adopt best practices raises the effective tax rate on business activities in Mongolia, making Mongolia less competitive than other business venues. Second, the law, vague on concepts of income and taxation, lets the auditors determine what is and is not taxable. Nor does the law specify how precedents or practices of tax collection are to be set. Consequently, audits become opened ended: One auditor's assessments may be disallowed by another's months or even years later.

The government, consulting with the U.S. Embassy, American technical advisors, and the business community has begun to overhaul the TLM. We look for results in late 2005.

A.9 CAPITAL MARKETS AND PORTFOLIO INVESTMENT

Mongolia currently lacks experience and expertise to sustain portfolio investments. It has no regulatory apparatus for these activities, and neither the state nor private entities engage in them. However, Mongolia has active capital markets. The Mongolian government imposes few restraints on the flow of capital in any of its markets. Multilateral institutions, particularly the IMF, find the regime too loose, particularly in the crucial banking sector. Although the government has clear rules about capital reserve requirements, the Mongol Bank, Mongolia's central bank, seems loathe to restrain credit flows at many of its banks. That said, most foreign businesses approve of the ease with which they can access financial resources.

Capital and Equity Markets

Although liquidity is quite high in Mongolia, capital is scarce. Local credit for the best customers hovers near 18 % per year; for the rest, 30 % or higher. Foreign investors can easily tap into the domestic capital markets. However, they seldom do so because they can do better abroad or better locally by simply taking on an equity investor, Mongol or otherwise.

Mongolia's stock market is moribund. Investors do not use stocks to raise equity for investment but to gain control of companies listed on the exchange. As most of the firms have been bought up, the market sees little trading.

Mongolian firms do not use shareholding relationships to restrict foreign investment at this point. Part of this arises from lack of experience with such devices. It also arises from the fact that Mongolians prefer to concentrate ownership in their own hands, rather than disperse it through complicated shareholding relationships. They perceive such devices as weakening their ability to control the companies, which is more important than safeguarding the firm from foreign or domestic raiders. If a foreign company wanted to purchase a Mongolian firm, the foreign entity would have to contact the shareholders and buy them out. These could not be hostile takeovers, because few outstanding shares remain on the market to buy. Eager to take on equity partners or sell businesses entirely, the Mongolians would employ few defenses beyond sharp negotiating.

The Banking Sector

Weakness in Mongolia's banking sector concerns all players. Small by American standards, the total assets of the four top banks add up to about 600 million USD. The system has been through massive changes since the Soviet era, during which the banking system was divided into several different units. This early system failed through mismanagement and commercial naivety in the mid-90s, but over the last seven years it has become more sophisticated and better run.

Mongolia has three generally well-regarded banks owned by American/Swiss, Japanese, and Mongolian interests respectively. They follow prudent capital reserve requirements, have conservative lending policies, up-to-date banking technology, and are generally well managed. If a storm should descend on Mongolia's banking sector, these three banks should weather it.

However, concerns remain among these bankers about the effectiveness of the legal and regulatory environment. As with many issues in Mongolia, the problem is not of lack of laws or procedures but the will of the regulator, Mongol Bank, to execute mandated functions, particularly in regard to capital reserve requirements and non-performing loans.

Since 1999, no Mongolian bank has been closed for insolvency or malpractice. Industry observers think that that Mongol Bank will not shut any bank, fearing that closure sends a signal of weakness to the general public. Instead, the central bank has doubled capital reserve requirements. The first increase occurred in April 2002 from 2 to 4 billion Mongolian National Tugriks (MNT) or approximately 3.3 million USD. The second is set in 2006 from 4 to 8 billion MNT or 6.6 million USD. Mongol Bank recently told the banking industry that it has no plans to raise the reserve requirements beyond 8 billion MNT.

Industry watchers expected several banks to close or merge during the first round, but not one of the 17 banks shut its doors. The Central Bank did not examine the nature of the reserves; it only checked to see that the money designated as reserves was present during the April evaluation phase.

The non-performing loan (NPL) rate is equally troubling. No accurate figures exist. American and foreign bankers believe that central bank methods for tracking NPLs seriously understate the rate. They perceive that several banks are insolvent or nearly so.

Another concern about Mongolia's capital markets is that large credit flows lay beyond regulatory control. Although banks are technically subject to regulatory restraint, an industry of unregulated non-bank-lending institutions (NBFI) has sprung up. NBFIs cannot engage in the full range of activities banks engage in, but also are not subject to the same reporting and reserve requirements as banks. These organizations act like "financial cooperatives," taking deposits on interest from members and lending it. Bankers tell us that the NBFIs in Mongolia may be as large as the legitimate banking sector (1 billion USD in assets). To attract deposits NBFIs pay higher interest rates than banks (returns of 30% per annum are not uncommon). NBFIs also obtain funds from legitimate banks at 30% + per month and loan this money out at rates exceeding 60% + per month. Most of these loans are to finance short-term trade deals. Money that ends up with NBFIs is not secured, meaning that Mongolia's full-service banks may have an immense exposure. It remains unclear what impact a NBFI meltdown would have on the wider capital market in Mongolia.

A.10 POLITICAL VIOLENCE

Mongolia is peaceful and stable. Mongolia has an ethnically homogenous population; 97% of the population is Khalkh Mongol. The major minority –90,000 estimated – is Kazakh (Muslim), concentrated in the far western part of the country. Over the past decade, we record no incidents of anti-American sentiment or politically motivated damage to American projects or installations. Political violence is rare. Mongolia has held eight presidential and parliamentary elections in the past 12 years, during which power changed political hands peacefully. The 1998 assassination of the founder of the democratic movement (and then minister) Zorigt remains under investigation.

A. 11 CORRUPTION

Foreign investors, the international donor community and many Mongolians believe corruption is a significant and growing problem in Mongolia. The USG's first-hand experience with public sector corruption has included Cabinet-level officials directing donor funds to their personal property, refusing to account for donor funds, providing donor sub-contracts to close friends and relatives, and interfering with the court system when prosecution of such acts is initiated.

The U.S. Government has raised with the Mongolian Government its concerns about the corrosive impact of corruption on economic growth, good governance and public confidence in Mongolia’s political leadership. Together with other international donors, and with the North America-Mongolia Business Council, we have formally requested that Mongolia sign and ratify the UN Convention Against Corruption. The current Mongolian government has agreed to consider signing and ratifying this Convention in 2005 and to amend its laws to bring them into compliance with the provisions of the Convention. Draft anti-corruption legislation is under consideration by Parliament. The UNDP as well as the U.S. Departments of State and Justice are providing technical assistance and advice to this process.

In September 2004, the reputable international anti-corruption non-governmental organization, Transparency International (TI), included Mongolia (for the first time since 1999) in its annual “Perceptions of Corruption” survey. Mongolia ranked 85 out of 145 countries and its score (3 out of 10, where 10 is the “best”) is “poor.” (For more information, see: www.transparency.org.) UNDP surveys of Mongolia, conducted in 1999 and again in 2002-3, also indicate a growing and serious entrenchment of bureaucratic and political corruption in Mongolia. Transparency International opened a national chapter in Mongolia in 2004. U.S. technical advisors are working with TI to train Mongolian staff to monitor corruption and to advocate on behalf of anti-corruption legislation and enforcement.

B. BILATERAL INVESTMENT AGREEMENTS

1. Australia

- Agreement on promotion and reciprocal protection of investment
- Agreement on avoidance from double taxation

2. **Austria**

- Convention for the avoidance of double taxation with respect to taxes on income and prevention of fiscal evasion, 2003

3. **Belgium**

- Convention for the avoidance of double taxation with respect to taxes on income and prevention of fiscal evasion, 1995
- Agreement on the reciprocal promotion and protection of investments, 2003

4. **Bulgaria**

- Agreement on the reciprocal promotion and protection of investments in 2000
- Convention for the avoidance of double taxation with respect to taxes on income and prevention of fiscal evasion, 2001

5. **Canada**

- Trade and Commercial Agreement between the Governments of Mongolia and Canada, 1994
- Intergovernmental Agreement on double taxation avoidance between Mongolia and Canada, 2002

6. **China**

- The Agreement on Mutual Protection and Encouragement of Investment, 1991
- The Agreement on Avoidance of Double Taxation, 1991

7. **Cuba**

- Agreement on investment promotion and protection
- Agreement on trade

8. **Egypt**

- Agreement on the reciprocal promotion and protection of investments
- Agreement on economic and technical cooperation

9. **France**

- Agreement on the reciprocal promotion and protection of investments 1991
- Convention for the avoidance of double taxation with respect to taxes on income and the prevention of fiscal evasion, 1996

10. **Germany**

- Agreement on the reciprocal promotion and protection of investments, 1993

- Convention for the avoidance of double taxation with respect to taxes on income and prevention of fiscal evasion, 1994

11. **Italy**
- Agreement on the reciprocal promotion and protection of investments, 1993
- Convention for the avoidance of double taxation with respect to taxes on income and prevention of fiscal evasion, 2003

12. **Japan**
- Agreement on investment promotion and protection
- Agreement on trade

13. **Laos**
- Agreement on promotion and reciprocal protection of investment

14. **Philippines**
- Agreement on promotion and reciprocal protection of investment

15. **Singapore**
- Agreement on the reciprocal promotion and protection of investments
- Convention for the avoidance of double taxation with respect to taxes on income and prevention of fiscal evasion

16. **Switzerland**
- Agreement on the reciprocal promotion and protection of investments, 1997
- Convention for the avoidance of double taxation with respect to taxes on income and prevention of fiscal evasion, 1999

17. **United Kingdom**
- Agreement on the reciprocal promotion and protection of investments, 1991
- Convention for the avoidance of double taxation with respect to taxes on income and prevention of fiscal evasion, 1996

18. **United States of America**
- Agreement on the reciprocal promotion and protection of investments, 1991
- Trade and Investment Framework Agreement, 2004

19. **Vietnam**
- Agreement on trade
- Agreement on promotion and reciprocal protection of investment
- Agreement on avoidance from double taxation

Taxation issues of Concern to American Investors

Although the process of making and executing laws is a key problem, we note a particularly troublesome area that all foreign and domestic investors identify as a must solve: The Tax Law of Mongolia (TLM).   First, the law is not consistent with best practices in either Europe or North America.   American and western investors consistently site the inability to deduct legitimate expenses and depreciate assets as the key complaint against Mongolia's tax regime. This failure to adopt best practices raises the effective tax rate on business activities in Mongolia, making Mongolia less competitive than other business venues. Second, the law, vague on concepts of income and taxation, lets the auditors determine what is and is not taxable. Nor does the law specify how precedents or practices of tax collection are to be set. Consequently, audits become opened ended: an auditor's assessments may be disallowed by another's months or even years later.

C. OPIC AND OTHER INVESTMENT INSURANCE PROGRAMS

Recently OPIC has become more active in Mongolia. OPIC has issued and plans to issue direct loans to American firms providing a variety of services in Mongolia. Loans and political risk insurance to American investors involved the banking, tourism, mining, and equipment sectors are in process. Because the amounts required are relatively small, OPIC seems willing to make direct loans rather than provide loan insurance to projects.

Mongolia is a member of the Multilateral Investment Guarantee Agency (MIGA).

D. LABOR

The Mongolian labor pool is well educated, relatively young, and adaptable. Shortages exist in most professional categories requiring advanced degrees or training. Unskilled labor is available in sufficient amounts.

Shortages exist in both vocational and professional categories because any Mongolian who obtains such skills almost invariably goes abroad to find higher wages. Why stay in Mongolia if one cannot recover the outlay on the training from any Mongolian-based job. Foreign invested companies are dealing with this situation by providing in-country training to their staffs or hiring expatriate workers to perform functions not available locally. There remains a deficit of trained skilled labor, which only time and investment will remedy.

Mongolian labor law is not particularly restrictive. Investors can locate and hire workers without using hiring agencies—as long as hiring practices are consistent with Mongolian Labor Law. However, Mongolian law requires companies to employ Mongolian workers in certain labor categories whenever a Mongolian can perform the task as well as a foreigner. This law generally applies to unskilled labor categories and not areas where a high degree of technical expertise nonexistent in Mongolia is required. The law does provide an escape hatch for all employers. Should an employer seek to hire a non-Mongolian laborer and cannot obtain a waiver from the Ministry of Labor for that employee, the employer can pay a fee of around $60.00 USD per employee per month. The Ministry of Labor seems quite eager to issue work permits in lieu of cash payments, as no one has reported that the Ministry denying any request.

Although foreign and domestic investors express a number of discontents with local labor rules and laws, they consistently argue that they bear too much of the social security costs for each domestic hire. Businesses must provide a social security tax amounting to nearly 29% of the annual wage. This tax charge makes Mongolian unskilled labor more expensive than imported labor from China, even when factoring in the $60.00 USD per monthly fee. Those active in the animal products and apparel industries that absorb much of this labor capacity note that a fairer distribution of this tax would make them more competitive; and they might be inclined to hire more domestic labor.

The Mongolian government has ratified 14 ILO conventions, of which 13 remain in force:

C.87 Freedom of Association and Protection of the Right to Organise Convention, 1948 (No. 87)

C.98 Right to Organise and Collective Bargaining Convention, 1949 (No. 98)

C.100 Equal Remuneration Convention, 1951 (No. 100)

C.103 Maternity Protection Convention (Revised), 1952 (No. 103)

C.111 Discrimination (Employment and Occupation) Convention, 1958 (No. 111)

C.122 Employment Policy Convention, 1964 (No. 122)

C.123 Minimum Age (Underground Work) Convention, 1965 (No. 123) *Minimum age specified: 18 years*

C.135 Workers' Representatives Convention, 1971 (No. 135)

C.138 Minimum Age Convention, 1973 (No. 138) *Minimum age specified: 15 years*

C.144 Tripartite Consultation (International Labour Standards) Convention, 1976 (No. 144)

C.155 Occupational Safety and Health Convention, 1981 (No. 155)

C.159 Vocational Rehabilitation and Employment (Disabled Persons) Convention, 1983 (No. 159)

C.182 Worst Forms of Child Labour Convention, 1999 (No. 182)

E. FOREIGN TRADE ZONES/FREE PORTS

The Mongolian government has only recently launched its free trade zones (FTZ). Both are located along the Mongolia spur of the trans-Siberian highway: one in the north at the Russo-Mongol border town of Altanbulag and the other in the south at the Sino-Mongol border at the town of Zamyn-Uud.

Management for the Zamyn-Uud zone has been tendered to a Chinese firm. So far we have no indication that government will not keep promises to open the zone to any who satisfy the relevant legal requirements. However, we have other concerns about the Mongolian free trade zones in general and Zamyn-Uud in particular. In April 2004, the USAID sponsored Economic Policy Reform and Competitiveness Project (EPRC) made the following observations of Mongolia’s FTZ Program. Post continues to share these concerns:

1. Benchmarking of Mongolia’s FTZ Program against current successful international practices shows deficiencies in the legal and regulatory framework as well as in the process being followed to establish FTZs in the country

2. Lack of implementing regulations and procedural definitions encapsulated in transparency and predictability quotient required to implement key international best practices

3. A process of due diligence, including a cost-benefit analysis, has not been completed for the proposed Zamyn-Uud FTZ

4. Identifiable funding is not in place to meet off-site infrastructure requirements for Zamyn-Uud and Altanbulag sites

5. Deviations from international best practices in the process of launching FTZs risks repeating mistakes made in other countries and may lead to “hidden costs” or the provision of subsidies that the government of Mongolia did not foresee or which will have to granted at the expense of other high priority needs.

F. FOREIGN DIRECT INVESTMENT STATISTICS:

1. Comment on the data sources for foreign direct investment in Mongolia.

The Foreign Investment and Foreign Trade Agency (FIFTA) provides most of the data for tracking FDI in Mongolia. However, the data has severe limitations:

a. **Inaccurate reporting and data collection:** Many foreign firms provide inaccurate data to FIFTA on their annual investment amounts. FIFTA's registration regime requires companies to document business plans and total FDI for the coming year. FIFTA uses their amounts to determine FDI for the year. However, many firms fear that their plans and information are not secure at FIFTA and provide incomplete data on their actual activities. In addition, FIFTA does not update reports to account for any changes to investments during the year. (See Chapter 6, Section A.5: Performance Requirements and Incentives).

b. **Data not Available:** Because of questionable quality of our data sources and because FIFTA generally does not track anything more than the aggregate totals of investment year by year, it is not currently possible to provide:
    1. Mongolia's direct investment abroad
    2. FDI stock as a percentage of GDP

Overall, because of the paucity or inaccuracy of the data, Post will refrain from drawing any conclusions about FDI in Mongolia.

2. FDI Statistics (Source Foreign Investment and Foreign Trade Agency of Mongolia)

A. FDI from 1990 to 2001

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
FDI (in thousands) USD)	1	2.1	1.9	3.4	10.7	36.5	53.2	40.5	30	86.1	90.6	125
Number of companies	2	10	23	40	78	147	191	258	278	341	294	353

B. Focused look at FDI in 2001 (latest year for detailed statistics)

Top 27 Investors of 2001 by national origin

Country	Investment (in thousands USD)	Number of investors
China	39635.3	7
S.Korea	18771.24	10
Great Britain	16216.40	3
British Virgin Islands	15000.00	1
Bulgaria	3566.64	1
USA	1894.68	2
Hong Kong	1000	1
Russia	512.87	1
Switzerland	506.39	1

2001 FDI by Sector

Sector	Number of companies	Total investment (in thousands USD)
Geological prospecting and exploration	19	56248
Banking and financial services	4	19713
Trade and catering service	99	8213
Engineering construction and production of building materials	23	7715
Light industry	21	5846
Processing of animal originated raw materials	18	5814
Energy	3	1072
Others	166	20659

2001 FDI by Country

Country	The number of foreign invested companies			FDI	
	JVC	Wholy owned	Total amount	Millions USD	FDI per company /in thousands USD/
China	515	160	675	145	215
Russia	238	55	293	26	89
S. Korea	135	135	270	61	226
Japan	95	25	120	50	417

USA	32	30	62	33	532
Germany	49	12	61	4	66
Total amount	1064	417	1481	319	
All	1379	576	1955	489	250

3. Major Foreign Direct Investments in Mongolia:

Company	Nation of Origin	Sector	Estimated FDI USD
Ivanhoe Mines Mongolia	Canada	Mining	100,000,000 +
SOCO Tamsag	USA	Petroleum	90,000,000 +
Boroo Gold	Canada	Mining	70,000,000 +
Trade and Development Bank	USA/Switzerland	Banking and Finance	25,000,000 +
Marubeni	Japan	Cashmere Production	20,000,000 +
Wagner Asia Mongolia	USA	Equipment/CAT, Ford, Ingersoll-Rand	12,000,000 +
Dongsheng Petroleum	China	Petroleum	NA
Komatsu	Japan	Equipment	NA
MobiCom	Japan/Mongolian	Telecommunications	NA
Itochu	Japan	Equipment	NA
Siemans	Germany	ICT	NA
Sugura Mongolia	Japan	Construction	NA
Seoul Company	Korea	Construction/Hospitality	NA
United Apparel	Fiji	Apparel	NA
Coca Cola Mongolia	US/Mongolia	Bottler	8,000,000 +
MSM Co.	US/Mongol/German	Fast Moving Consumer Goods, Tools and Equipment, Daimler-Chrysler	5,000,000 +
Anglo-American Gold Mongolia	South Africa	Mining	NA
CVRD	Brazil	Mining	NA

World Bank Doing Business 2006

Featured economy

Mongolia

Region: East Asia & Pacific
Income category: Low income
Population: 2,554,000
GNI per capita (US$): 690.00
Country laws: see our Law Library

Ease of...	2006 rank	2005 rank	Change in rank
Doing Business	*45*	*41*	*-4*
Starting a Business	55	54	-1
Dealing with Licenses	34	35	+1
Employing Workers	61	57	-4
Registering Property	17	17	0
Getting Credit	65	59	-6
Protecting Investors	19	18	-1
Paying Taxes	56	53	-3
Trading Across Borders	162	161	-1
Enforcing Contracts	41	40	-1
Closing a Business	115	113	-2

Note: 2005 rankings have been recalculated to reflect changes to the 2006 methodology and the addition of 20 new countries.

Starting a Business (2006)

The challenges of launching a business are shown below. Included are: the number of steps entrepreneurs can expect to go through to launch, the time it takes on average, and the cost and minimum capital required as a percentage of gross national income (GNI) per capita.

Indicator	Mongolia	Region	OECD
Procedures (number)	8	8.2	6.2
Time (days)	20	46.3	16.6
Cost (% of income per capita)	5.1	42.8	5.3
Min. capital (% of income per capita)	115.3	60.3	36.1

Dealing with Licenses (2006)

Shown below are the procedures, time, and costs to build a warehouse, including obtaining necessary licenses and permits, completing required notifications and inspections, and obtaining utility connections.

Indicator	Mongolia	Region	OECD
Procedures (number)	18	17.6	14.0
Time (days)	96	147.4	149.5
Cost (% of income per capita)	48.4	207.2	72.0

Employing Workers (2006)

The difficulties that employers face in hiring and firing workers are shown below. Each index assigns values between 0 and 100, with higher values representing more rigid regulations. The Rigidity of Employment Index is an average of the three indices.

Indicator	Mongolia	Region	OECD
Difficulty of Hiring Index	11	23.7	27.0
Rigidity of Hours Index	80	25.2	45.2
Difficulty of Firing Index	10	19.6	27.4
Rigidity of Employment Index	34	23.0	33.3
Nonwage labor cost (% of salary)	20.0	9.4	21.4
Firing costs (weeks of wages)	8.7	41.7	31.3

Registering Property (2006)

The ease with which businesses can secure rights to property is shown below. Included are the number of steps, time, and cost involved in registering property.

Indicator	Mongolia	Region	OECD
Procedures (number)	5	4.2	4.7
Time (days)	11	85.8	31.8
Cost (% of income per capita)	2.2	4.0	4.3

Getting Credit (2006)

Measures on credit information sharing and the legal rights of borrowers and lenders are shown below. The Legal Rights Index ranges from 0-10, with higher scores indicating that those laws are better designed to expand access to credit. The Credit Information Index measures the scope, access and quality of credit information available through public registries or private bureaus. It ranges from 0-6, with higher values indicating that more credit information is available from a public registry or private bureau.

Indicator	Mongolia	Region	OECD
Legal Rights Index	5	5.0	6.3
Credit Information Index	3	1.9	5.0
Public registry coverage (% adults)	10.2	3.2	8.4
Private bureau coverage (% adults)	0.0	10.1	60.8

Protecting Investors (2006)

The indicators below describe three dimensions of investor protection: transparency of transactions (Extent of Disclosure Index), liability for self-dealing (Extent of Director Liability Index), shareholders' ability to sue officers and directors for misconduct (Ease of Shareholder Suits Index) and Strength of Investor Protection Index. The indexes vary between 0 and 10, with higher values indicating greater disclosure, greater liability of directors, greater powers of shareholders to challenge the transaction, and better investor protection.

Indicator	Mongolia	Region	OECD
Disclosure Index	5	5.2	6.3
Director Liability Index	8	4.4	5.0
Shareholder Suits Index	6	6.1	6.6
Investor Protection Index	6.3	5.2	6.0

Paying Taxes (2006)

The data below shows the tax that a medium-size company must pay or withhold in a given year, as well as measures of the administrative burden in paying taxes. These measures include the number of payments an entrepreneur must make; the number of hours spent preparing, filing, and paying; and the percentage of their profits they must pay in taxes.

Indicator	Mongolia	Region	OECD
Payments (number)	42	29.8	15.3
Time (hours)	204	290.4	202.9
Profit tax (%)	7.8	19.7	20.7
Labor tax and contributions (%)	23.2	10.9	23.7
Other taxes (%)	1.2	11.6	3.5
Total tax rate (% profit)	32.2	42.2	47.8

Trading Across Borders (2006)

The costs and procedures involved in importing and exporting a standardized shipment of goods are detailed under this topic. Every official procedure involved is recorded - starting from the final contractual agreement between the two parties, and ending with the delivery of the goods.

Indicator	Mongolia	Region	OECD
Documents for export (number)	11	6.9	4.8
Time for export (days)	66	23.9	10.5
Cost to export (US$ per container)	3,007	885	811
Documents for import (number)	10	9.3	5.9
Time for import (days)	74	25.9	12.2
Cost to import (US$ per container)	3,030	1,037	883

Enforcing Contracts (2006)

The ease or difficulty of enforcing commercial contracts in is measured below. This is determined by following the evolution of a payment dispute and tracking the time, cost, and number of procedures involved from the moment a plaintiff files the lawsuit until actual payment.

Indicator	Mongolia	Region	OECD
Procedures (number)	29	31.5	22.2
Time (days)	314	477.3	351.2
Cost (% of income per capita)	17.6	52.7	11.2

Closing a Business (2006)

The time and cost required to resolve bankruptcies is shown below. The data identifies weaknesses in existing bankruptcy law and the main procedural and administrative bottlenecks in the bankruptcy process. The recovery rate, expressed in terms of how many cents on the dollar claimants recover from the insolvent firm, is also shown.

Indicator	Mongolia	Region	OECD
Time (years)	4.0	2.4	1.4
Cost (% of estate)	8.0	23.2	7.1
Recovery rate (cents on the dollar)	18.0	27.5	74.0

Sample Call Order Statement of Work

Country: Mongolia

Background:
A part of the Mongolia Compact will likely entail partial privatization of the national railroad system. Currently all aspects of the railroad are run directly by the government. The injection of substantial MCC funds (and private sector funds from abroad) will lead to partial privatization of the rail system. However, the GOM must still maintain a degree of regulatory oversight.
Another aspect of the Compact will likely be a substantial investment in the telecoms sector – mainly in Internet backbone.
MCC is likely to be making a major investment in the field of Vocational and Technical Education (VTE).
Health services in Mongolia are currently very much the domain of the government. However, many of MCC's health-related interventions will involve the private sector (such as hospital management), and thus increase government regulatory responsibilities.
The health ministry will be required to set up a mechanism.

Needs: As part of the evolution of Mongolia's proposal it appears that MCC will need to advise on the *creation of up to four new government regulatory or supervisory bodies*.
Thus, a regulatory body will be created. The legal status of the new body must be defined, the scope of its authority, advice on legislation provided, as well as advice on its structure and management.

It is anticipated that additional regulatory oversight will be required because of this intervention as, again, it the issue of greater private sector involvement on what was formerly the sphere of government. Pricing and competition issues will be of foremost concern for this new regulatory body. As above - status, scope, authority, etc, issues will arise and MCC must provide guidance.

After our intervention VTE throughout Mongolia will look very different than it does now. The private sector will be involved in the setting of skills standards, development of curricula, etc. This is an entirely new direction, and setting up structures to facilitate the government working closely with the private sector will be a challenge.

Skills Required: Each of the four areas could require multiple areas of expertise. However, since all four areas should be handled together, so that the advice given for one area fits with what is being given in another, a firm that knows how to collect the right people and get them working in parallel is needed.