Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 23-Jun-2019 | Report No: PIDA27132

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Mongolia	P167485	Second Economic Management Support Operation (P167485)	P162402
Region	Estimated Board Date	Practice Area (Lead)	Financing Instrument
EAST ASIA AND PACIFIC	30-Jul-2019	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	Implementing Agency		
Mongolia	MINISTRY OF FINANCE		

Proposed Development Objective(s)

The Program Development Objective is to support the Government of Mongolia in restoring debt sustainability, strengthening the social protection system, and enhancing competitiveness.

Financing (in US$, Millions)

SUMMARY

Total Financing	100.00

DETAILS

Total World Bank Group Financing	100.00
World Bank Lending	100.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

This proposed DPL aims to support the Government of Mongolia in restoring debt sustainability, strengthening the social protection system, and enhancing competitiveness.

Mongolia's economy has recovered strongly from the brink of a macroeconomic crisis in 2016, but underlying vulnerabilities remain. The economy grew by 6.9 percent in 2018, compared to 1.2 percent in 2016. Growth has been driven primarily by robust private consumption, strong foreign direct investment (FDI) inflows, and a revival in mineral exports. The country's fiscal stance has improved substantially as the deficit declined from 16.4 percent of GDP in 2016 to a surplus of 2.7 percent in 2018. This improvement led to about 16 percentage-point reduction in the public-debt-to-GDP ratio in the past two years. The 2019 budget caps the fiscal deficit at around 1 percent of GDP while projecting strong revenue performance, as well as a step-up in capital expenditures, after two years of compressed spending levels. Monetary policy was loose in 2018, prompting high import growth and putting some pressure on the balance of payments. The Bank of Mongolia has, however, tightened its stance since the last quarter of 2018, and gross reserves ended the year at US$ 3.5 billion (about five months of imports) up from 4.3 months in 2017. Enhanced policy credibility and good market conditions supported new external bond issues, contributing to reserve accumulation.

Poverty increased during the economic slowdown of 2014-16 and declined only moderately during 2017-18, pointing to continued challenges in the labor market and the need for stronger social support policies. Declining growth rates during 2014-16 led to higher unemployment, sluggish household income growth, and higher poverty. The economic recovery of the past two years, coupled with sustained spending on social sectors, has led to a strong increase in real average household incomes by 8.8 percent and a moderate recovery of private consumption - by 3.9 percent in 2018. However, the poverty rate declined only moderately from 29.6 percent in 2016 to 28.4 percent (preliminary) in 2018. To ensure that growth benefits the poor more effectively, the proposed operation includes measures to promote employment creation outside the mining sector and better targeting of social policies.

Mongolia has experienced some political volatility during the implementation of the ERP, reflected in partial policy reversals, but the commitment to sound macroeconomic management has been maintained. The EMSO program was prepared and appraised under one government but is being implemented by another. The change in government has not affected the overall commitment to macroeconomic stability, fiscal adjustment and structural reforms. However, popular resistance against some of the structural fiscal measures motivated a change in reform priorities. Specifically, in February 2018, the new government took the decision to partially reverse two policies supported by EMSO 1 (restored the flat income tax structure instead of progressive taxation and slowed the pace of the increase in the retirement age).

Recently, progress on structural reforms supported by EMSO has accelerated, and this, together with strong fiscal performance and a sound 2019 budget have created an environment conducive for the World Bank's policy lending support to resume. The preparation of EMSO 2 comes at a particularly sensitive time for Mongolia. One year before the next parliamentary elections, the authorities are keen to lock in critical reform gains. However, the sixth review of IMF's External Fund Facility, which continued to disburse throughout 2018, has been delayed due to slower than expected progress in the recapitalization of the banking system. The resulting risks to Mongolia's financial sector stability have prompted the team to incorporate additional measures related to the banking sector recapitalization program, complementing reforms supported by the IMF's EFF program in this area.

Relationship to CPF

The key areas of support by this DPF are consistent with the last Country Partnership Strategy (CPS) and the most recent Progress and Learning Review (PLR). The CPS, which was launched in 2012 and will soon need to be renewed, stressed, among others, the importance of improving resource revenue management, promoting economic diversification and competitiveness, and better targeting of social welfare programs. The PLR, which was discussed by the Board in December 2016, confirms these areas as important priorities and highlights the government's request for a Development Policy Financing (DPF) to support Mongolia's economic recovery in close coalition with the IMF and other development partners. The PLR further confirms the Bank's readiness to engage in policy-based lending. In addition, the three pillars of the proposed operation are squarely aligned with the development priorities highlighted in the recent Systematic Country Diagnostic (SCD), which was published in November 2018. The DPF has been closely supported by the analytic work and technical assistance of the Bank, including: (i) the Public Expenditure Review - 2018; (ii) the Strengthening Fiscal and Financial Stability Project (SFFS); and (iii) other sectoral technical assistance (TA) activities including audits of the BoM and the DBM, restructuring of the Housing Mortgage Program, tax expenditure review and the preparation of the PIP Guideline, and pension reforms and Trade Facilitation Agreement (TFA).

C. Proposed Development Objective(s)

The Program Development Objective is to support the Government of Mongolia in restoring debt sustainability, strengthening the social protection system, and enhancing competitiveness.

Key Results

The proposed DPF aims to further stabilize Mongolia's economy and move it toward a sustainable development path. The reform program seeks to (i) restore the country's debt sustainability through fiscal adjustments, (ii) strengthen the social protection system with an emphasis on poor and vulnerable groups, and (iii) enhance competitiveness of the economy through structural reforms. More specifically, EMSO 2 will help Mongolia to consolidate the adjustment already achieved, address some of the long-standing structural weaknesses and distortions in the economy and anchor macroeconomic policies going into an election year. Moreover, it will help create fiscal space by substituting high-cost, short-term domestic borrowing with relatively more concessional and long-term external assistance.

D. Project Description

The Government is determined to implement fiscal reforms to increase fiscal space and address the daunting development challenges of the country. Phasing out quasi-fiscal spending of the DBM and the BoM, which have been the major driver of unsustainable fiscal expansion and monetary easing in 2013-15 and improving the efficiency of the tax system and public investment management, are among the most urgent actions to restore fiscal stability.

Pillar I of the DPF, therefore, is focused on three high priority reform areas critical for successful fiscal adjustment: (i) to publicly disclose the report of an external review on the operations of the Development Bank of Mongolia in 2012-17. To ensure the commercial viability of DBM's operations under the new DBM law, this audit will help verify whether DBM has been run as an independent and viable development bank in 2017; (ii) aims to restructure the Housing Mortgage Program to better serve the purpose of affordable housing and establish a time bound plan for the Bank of Mongolia (BoM) to fully exit the program; and (iii) An independent special external review on the BoM's quasi-fiscal operations—including Housing Mortgage Program, Price Stabilization Program, and financial support to companies—has been publicly disclosed on the BoM's website. This pillar also supports the design of a framework to reduce ineffective tax incentives and exemptions in future budgets, starting for the 2020 budget as well as approval of the Public Investment Rationalization Guideline aimed at reducing the cost for ongoing investment projects in the budget. Moreover, the adoption of a resolution by the government to improve the legal, operational, and monitoring frameworks of government special funds and other special programs financed from the state budget is also included under Pillar 1.

Pillar II of the DPF is focused on protecting the fiscal allocation for social protection system during periods of macroeconomic stress. Ensuring adequate protection of the poor is vital in maintaining economic and social stability during the fiscal adjustment, particularly in light the recent deterioration of poverty condition. This pillar, therefore, puts priority in increasing the budget provisions for the poverty-targeted Food Stamp Program as well as other poverty targeted programs compared to the approved 2016 budget, in line with MTFF allocations.

Pillar III, looking beyond the short-term challenges, supports the Government in pursuing structural reforms to help unlock the long-term growth potential of the economy. This pillar includes three structural reform areas that have been identified as key constraints to the competitiveness and diversification of the economy by the previous analytic work of the Bank and other development partners. The three reform areas include: (i) enhancing business environments by strengthening investor protection, streamlining permit requirements, and providing a level playing field between the public and private sectors through fair competition; (ii) strengthening animal health management—a critical element for promoting livestock production and exports as one of the major sources of export diversification; and (iii) improving the trade environment by lowering the costs and administrative burden of trade. The Government has submitted a revised Permit Law to Parliament, listing all licenses and permits granted by public administrations and reducing their number, approved a package of regulations, ordinances or guidelines to operationalize the Animal Health Law,; and adopted the institutional framework for the Trade Facilitation Agreement (TFA) implementation.

E. Implementation

Institutional and Implementation Arrangements

The Ministry of Finance will be responsible for overall monitoring and evaluation of the proposed operation and for coordinating actions among relevant ministries and agencies. Policy dialogue and monitoring and evaluation (M&E) of the reform program supported by this DPF will be shared with the BoM and the government line ministries. A working group chaired by the State Secretary of the MoF coordinates M&E activities under the EMSO. Regular discussions with the government and the donor community, including regular roundtables on implementation progress, will continue. The Bank will continue to monitor the actions and review progress on the implementation of the proposed operation, as well as the subsequent actions of the government program, by using the baseline and expected overall program outcomes outlined in the Policy Matrix. The Bank will also continue to participate in regular reviews of the IMF to jointly assess macroeconomic performance and progress toward observance of the program's structural benchmarks.

Grievance Redress. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local of national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel, which determines whether harm occurred, or could occur, because of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

F. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

The Poverty and Social Impact Analysis (PSIA) focuses on a subset of the proposed policy actions of this DPF that are likely to have short-term poverty and distributional consequences. Such measures include the restructuring of the Housing Mortgage Program, and the expansion of the Food Stamp Program and other poverty-targeted programs. Finally, the PSIA focuses on the distributional impacts of changes to the Animal Health Law, because the herders represent an important share of the population, the labor force, and the poor. Over the medium term, the measures supporting improvements in the business climate and non-mining sector job creation under pillar 3 are expected to improve the trickle down from growth to poverty reduction, which has remained limited in recent years.

The expansion of the Food Stamp Program and other poverty-targeted programs will have a pro-poor impact. By the end of the program, the combined budget allocation for both programs will have expanded by at least 300 percent compared to the baseline (2016). The implementation of these reforms is projected to have a strong progressive impact on disposable incomes.

The impact of pension system reform on the poor could be positive in the medium to long run but is uncertain in the short term. While the 2017 measures may have benefited some poor in the short run, they would—if not reversed—undermine the overall fairness, coherence, and sustainability of the pension system, thus threatening the future adequacy of pensions for all participants across the distribution.

The restructured Housing Mortgage Program could be favorable to households at the lower end of the distribution. The restructured program resulted in limited new mortgage financing in the market, but the extension of the mortgage will target some of the low-income household groups including first-time buyers and households moving from ger district to apartments in the urban areas. Although the medium- and long-term aspects of the reform in terms of targeting the mortgage program are not fully gauged, policy changes that restructure the program to bring it within the government's budget and better target the mortgage program to those in need are expected to create positive pro-poor impacts.

The proposed operation is expected to be gender neutral or positive. Most of the actions envisioned in this program are cross-cutting in nature and would not be expected to have differentiated impacts on different genders, nor would gender equality be significantly advanced or hampered by the proposed actions. On social protection, however, some of the actions could conceivably have gender dimensions. Expanding the poverty-targeted programs, notably the Food Stamps Program, will have a neutral or possibly a positive effect on female-headed households, considering that poverty rates are slightly higher among female-headed households.

Environmental Aspects

The specific country policies supported by the proposed operation are expected to have limited adverse environmental consequences. A review of specific policy reforms supported by EMSO 2 revealed that these actions are unlikely to cause significant environmental impacts, including on forests and other natural resources. Implementation of measures under EMSO 2 are largely neutral from this perspective. The EMSO 2 prior actions related to the new guideline for appraisal and selection of projects, the draft Permit Law, and the Trade Information Portal (TIP) includes environmental related provisions. Moreover, strengthening the social protection system would increase the resilience of the vulnerable populations most at risk from extreme climate events, and implementation of the Animal Health Law would contribute to increasing the resilience of herder families as well as slowing down land degradation. Moreover, there are some recent positive signs regarding the government's commitment to environmental sustainability.

G. Risks and Mitigation

This operation carries substantial risks.

Political risks are high considering the upcoming parliamentary elections in 2020, which might lead to expansionary economic policies. The government has shown unusual fiscal rectitude so far, but loose fiscal policy prior to elections has been a norm rather than an exception in Mongolia's democratic history. Mitigation measures include (i) elimination of quasi-fiscal activities by DBM and BoM and public disclosure of special external reviews of their operations; and (ii) adoption of fiduciary measures to improve the governance of Government Special Funds, which have come under pressure when improper use of the SME Fund was revealed. The Bank's mitigation measures also include policy outreach activities to improve the understanding on the importance of a prudent economic policy framework, through participation of Bank staff in the electronic media and knowledge exchange events. Moreover, there has been no sign of loose fiscal policy prior to the approaching general elections. In fact, the fiscal surplus in the first five months of 2019 was significantly higher than expected.

Macroeconomic risks are high. The major sources of external downside risks include (i) weaker-than-expected global commodity prices, as mineral revenue accounts for about 20 percent of total revenue; (ii) lower-than-planned minerals production due to weaker import demand from China; and (iii) lack of sustainable resolution of southern border bottlenecks, the main commodity export gateway for Mongolia. These external factors could undermine growth recovery, fiscal sustainability, and external balance, thereby slowing the projected improvement in fiscal and external sustainability. To mitigate against these risks, EMSO 2 includes substantial macroeconomic policy adjustment that would strengthen the policy capacity to cope with external shocks by restoring fiscal and external buffers. To address the structural vulnerability of the economy to external shocks, EMSO 2 also aims to support structural reforms to improve the competitiveness and diversification of the non-mining sector and promote a more business-friendly environment. The resolution of southern border transit exit is dependent on the agreement and mutual understanding with China.

The slow progress in recapitalizing the banks, while not an immediate threat to macro stability, poses a significant risk to Mongolia's medium-term growth outlook. The authorities have agreed to pursue the recapitalization of banks to meet required prudential norms (an EMSO 3 trigger).

Risks in sector strategies and policies are substantial. The ability of the government to build consensus and coordinate across key implementing agencies is growing but still limited. While the MoF coordinates preparation of the overall government budget, sectoral strategies are decided by line ministries, limiting the coordination role of the MoF to allocate aggregate budget envelopes to line ministries. The recently improved coordination authority of the MoF, is however, supplemented by the active support of the Prime Minister and the Cabinet Secretariat.

Risks in the technical design of the program are moderate. The design of the proposed operation reflects the key reform priorities of the government. Considering the medium-term horizon of the proposed reform measures, a programmatic approach was proposed. The proposed triggers for EMSO 3 will remain flexible and subject to further discussions with the government.

Risks in institutional capacity for implementation and sustainability are substantial. Institutional frameworks that are foundations of most of the prior actions were established in 2009–11 with the adoption of the Fiscal Stability Law, the

Integrated Budget Law, and the amendment of the Social Welfare Law. The Debt Management Law was adopted in 2015 to monitor and control public debt, with the support of the Bank. On animal health, the General Authority for Veterinary Services was created in 2018. Capacity of the authorities has also been significantly improved in recent years with technical assistance of various Bank activities and other development partner support. However, a main concern has been the weak implementation of the institutional framework under growing political pressures. Technical and analytic support of the World Bank in key reform programs—such as tax reform, public investment adjustment, social protection and pension reform, and business and investment environment—would help mitigate implementation risk and sustain reform momentum throughout the remaining years of the program.

Fiduciary risks are substantial. The overall fiduciary risks to this operation arising from Mongolia's public financial management (PFM) system, including the use of budget resources, and its foreign exchange environment controlled by the Bank of Mongolia, are substantial. This risk principally arises from opportunities to incur quasi-fiscal expenditures and contingent liabilities and insufficient controls to limit, within a reasonable range, political influence on the budget. The recent improper use of the SME Fund was evidence of growing existing fiduciary weaknesses in the PFM system. These risks would be substantially mitigated after the implementation of actions identified in the government's Economic Recovery Program through consolidating and phasing out the off-budget and quasi-fiscal expenditures of the DBM and the BoM. In addition, the new prior action (2.6) to improve the governance of special funds will also mitigate this risk.

Environment and social risks are moderate. The operation is not expected to have a significant environmental impact. Tighter fiscal and monetary policies are expected to have contractionary effects on the economy, which could affect the poor and vulnerable in the short term. The operation, therefore, supports the policy actions to expand the coverage and benefits of poverty-targeted social welfare programs to mitigate possible adverse short-term impacts on the poor. However, building on a strong growth momentum over the past two years, a positive medium-term outlook combined with fiscal adjustment reforms is expected to help support poverty reduction in 2019–20.

Stakeholders' risks are moderate. The operation is well aligned with the reform priorities of the government strategy, and the commitment of the current Cabinet remains strong. This operation will actively encourage strong participation and a consultative process with all political parties, and support policy outreach activities to the general public on the importance of policy reforms. The operation will ensure continued close coordination with various donors.

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APPROVAL

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