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THE INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A

PROPOSED DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR86.7 MILLION  
(US\$120 MILLION EQUIVALENT, INCLUDING US\$80 MILLION FROM THE CRISIS RESPONSE WINDOW)

TO MONGOLIA

FOR THE

ECONOMIC MANAGEMENT SUPPORT OPERATION

FIRST DEVELOPMENT POLICY FINANCING

October 30, 2017

Macroeconomic and Fiscal Management Global Practice  
East Asia and Pacific Region  
World Bank

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**MONGOLIA -GOVERNMENT FISCAL YEAR**  
*January 1 – December 31*

**CURRENCY EQUIVALENTS**  
(Exchange Rate Effective as of September 29, 2017)

Currency Unit	Mongolian Togrog
US\$1.00	MNT 2,464.43

**ABBREVIATIONS AND ACRONYMS**

ADB	Asian Development Bank	MOF	Ministry of Finance
AQR	Asset Quality Review	MOLSP	Ministry of Labor and Social Protection
BoM	Bank of Mongolia	MTFF	Medium-Term Fiscal Framework
CMP	Child Money Program	NPL	Non-Performing Loan
CPS	Country Partnership Strategy	OT	Oyu Tolgoi Copper and Gold Mine
DBM	Development Bank of Mongolia	PAYGO	Pay-as-You Go
DPC	Development Policy Credit	PBoC	People’s Bank of China
DSA	Debt Sustainability Analysis	PBP	Poverty Benefit Program
FDI	Foreign Direct Investment	PIM	Public Investment Management
FSL	Fiscal Stability Law	PIMA	Public Investment Management Assessment
GDP	Gross Domestic Product	PIT	Personal Income Tax
DBM	Development Bank of Mongolia	PMT	Proxy Means Test
DICOM	Mongolia Deposit Insurance Corporation	PSP	Price Stabilization Program
HMP	Housing Mortgage Program	SDR	Special Drawing Rights
M&E	Monitoring and Evaluation	SFFSP	Strengthening Fiscal and Financial Stability Project
IBRD	The International Bank for Reconstruction and Development	TA	Technical Assistance
IBL	Integrated Budget Law	TT	Tavan Tolgoi Coal Mine
IDA	International Development Association	WTO	World Trade Organization
JICA	Japan International Cooperation Agency		

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**MONGOLIA**  
**DEVELOPMENT POLICY LOAN**

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## SUMMARY OF PROPOSED CREDIT AND PROGRAM

### MONGOLIA

#### ECONOMIC MANAGEMENT SUPPORT OPERATION

#### FIRST DEVELOPMENT POLICY FINANCING

Borrower	Mongolia
Implementation Agency	Ministry of Finance
Financing Data	IDA Credit: SDR86.7 million (US\$120 million equivalent, including US\$80 million from the IDA 18 Crisis Response Window) Terms: 1.25% interest rate, 0.75% service fee, 5-year grace period, 30-year maturity
Operation Type	Programmatic Development Policy Operation, (1 <sup>st</sup> of 3), Single tranche.
Pillars of the Operation And Program 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.
Result Indicators	<p><b>Pillar I: Restoring Debt Sustainability</b></p> <p>P1. Capital expenditure financed by the DBM: MNT 252 billion (2016) → MNT 0 billion (2019). P2. BoM's net financing to the Housing Mortgage Program: MNT 404 billion (2016) → MNT 0 billion (2019). P2. BoM's outstanding loans for the Price Stabilization Program is fully withdrawn by end-2019 and the corporate bond holdings are kept at no more than the 2016 level. P3. Aggregate tax revenue from personal income tax and excise tax on alcohol and tobacco: 3.3% of GDP (2016) → 3.7% of GDP (2019). P3. Tax exemptions and incentives are reduced in 2019 by at least 10% relative to 2016. P3. General Anti-Avoidance Rule is included to tax laws and regulations. P4. Capital expenditure for clearance of promissory notes: MNT 672 billion (2016) → MNT 0 billion (2017-19). P4. Efficiency of public investment improved by restructuring for cost-saving or removing more than 10% of the total outstanding value needed to complete the on-going public investment projects in 2018-19 based on the Public Investment Rationalization Guideline.</p> <p><b>Pillar II. Strengthening the Social Protection System</b></p> <p>P5. The 2019 combined budget allocation for the Food Stamp Program and a PMT-based poverty-targeted cash benefit program is expanded by at least 340% relative to 2016. P6. Projected budget subsidy to pension fund in year 2030: 6% of GDP (2017 projection) → 2% of GDP (2019 projection with reform).</p> <p><b>Pillar III. Enhancing Competitiveness</b></p> <p>P7. Number of permits and licenses in 2019 reduced by more than 10% from 2016. P7. At least 70% of investor grievances received by the IPC are successfully resolved (2019). P8. Number of animals vaccinated for PPR (Peste des Petits Ruminants) in 5 western aimags: 10.4 million (2016) → 25 million (2019). P8. Five western aimags become free of PPR outbreaks (2019). P9. Proportion of shipments selected for physical inspection at the border customs are reduced from 90% (2016) to 70% (2019). P9. Average customs clearance time is reduced by 20% relative to 2016.</p>
Baseline: 2016	
Target: 2019	
Overall risk rating	High
Climate and disaster risks	<i>Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? No</i>
Operation ID	P162402



**IDA PROGRAM DOCUMENT FOR  
A PROPOSED DEVELOPMENT POLICY CREDIT TO MONGOLIA  
MONGOLIA ECONOMIC MANAGEMENT SUPPORT OPERATION  
FIRST DEVELOPMENT POLICY FINANCING**

**INTRODUCTION AND COUNTRY CONTEXT**

1. **This program document seeks approval of the Executive Directors of a proposed programmatic Economic Management Support Development Policy Financing Operation (EMSO1) to Mongolia.** This operation – in the amount of US\$120 million, including US\$80 million from the IDA 18 Crisis Response Window – is the first of three Development Policy Financing (DPF) operations in a programmatic series<sup>1</sup>. The Program Development Objective of the proposed DPF is to support the Government of Mongolia in restoring debt sustainability, strengthening the social protection system, and enhancing competitiveness.
  
2. **Mongolia faces severe economic challenges from major shocks compounded by expansionary policy.** The economic boom in 2011-13—fueled by strong mineral exports and foreign direct investment (FDI), and expansionary fiscal policy—left Mongolia highly vulnerable to external shocks. These risks materialized from 2014 onward. With minerals accounting for almost 90 percent of exports, a sharp drop in commodity prices and slower growth in China significantly weakened the external and fiscal positions. The economy also took a major hit from a collapse of foreign investment which had reached over 30 percent of GDP during boom years. Expansionary policies compounded these shocks. Economic policy turned expansionary during the double-digit growth period despite high inflation and a sharp widening of the current account deficit. Economic policy was loosened further from 2014 in response to the external shocks through fiscal expansion and monetary easing, driven by off-budget expenditure and quasi-fiscal lending. The economic stimulus, however, came at the cost of a significant increase in economic vulnerabilities. Government debt has increased almost fourfold since 2011, with the budget deficit reaching 17 percent of GDP in 2016. Mounting pressure on the balance of payments caused a sharp currency depreciation and a significant loss of reserves since 2013. Substantial risks to the balance of payments remain as about US\$660 million sovereign bonds mature in 2018.
  
3. **Continued economic difficulties adversely affect poverty conditions.** Mongolia made significant progress in poverty reduction, as the poverty rate dropped to 21.6 percent in 2014 from 27.4 percent in 2012. However, the poverty rate reversed back to 29.6 percent in 2016 on account of slower economic growth, higher unemployment, and sluggish income growth. Real household consumption fell by 9.5 percent in 2016 as unemployment rate rose to 10 percent. Urban households have been affected harder, particularly among wage-dependent households, as key labor-intensive sectors such as construction and services have contracted in 2015-16 while agriculture continued to grow, albeit at a slower rate. Average wage for urban dwellers declined by nearly 10 percent in 2016 while it rose by about 16 percent for rural dwellers over the same period. Consequently, real household income declined by 4.2 percent in the capital city while it increased by 1.3 percent in rural areas, indicating disproportional effects between urban and rural households.

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<sup>1</sup> On July 5, 2017, Management informed the Board of Executive Directors of its intention to allocate US\$80 million from the Crisis Response Window (CRW) to support Mongolia in response to the adverse and wide-ranging impact of commodity price shocks on the economy. See note “Mongolia: IDA Crisis Response Window Support for the Commodity Price Shock Response”.

4. **The election of a reform minded Government in 2016 suggested emerging public support for fiscal prudence and probity, though sporadic opposition to the austerity measures persists.** The Mongolia People’s Party campaigned on a platform calling for fiscal discipline and reform, and won a landslide victory in the June 2016 general election. The post-election Government adopted the Economic Recovery Program (ERP) in November 2016 and reached an agreement with the International Monetary Fund (IMF) on a three-year Extended Fund Facility program, approved by the IMF’s Executive Board in May 2017. The Government also requested parallel financial support from development partners including the World Bank Group (WBG), Asian Development Bank (ADB), Japan, China, and Korea. Following the agreement with development partners, the 2017 supplementary budget and a package of fiscal adjustment measures were approved on April 14. Other development partners—including the ADB, Japan, and Korea—are also delivering financial support in parallel with the World Bank and IMF. The post-election Government was forced to resign in September 2017 following the loss of the party’s candidate in the Presidential election. The new Prime Minister, however, has confirmed his Government’s continued commitment to the reform program supported by the development partners, including the WBG.

5. **The proposed DPF, along with operations from other development partners, supports a set of reform measures to stabilize Mongolia’s economy and move it towards a sustainable development path.** The reform programs supported by the DPF, developed in close collaboration with the IMF and ADB, seek to: (i) restore debt sustainability; (ii) strengthening the social protection system; and (iii) enhancing competitiveness. The DPF will also help Mongolia mitigate the immediate balance of payments risks by catalyzing successful market-based refinancing of maturing commercial debt, and create fiscal space by substituting high-cost, short-term domestic borrowing with relatively more concessional and long maturity external assistance.

## MACROECONOMIC POLICY FRAMEWORK

### 2.1 ECONOMIC DEVELOPMENTS

6. **Growth has dropped sharply since the economic boom in 2011-13.** Mongolia’s economy expanded by an average 14 percent in 2011-13—boosted by surging FDI inflows that accounted for almost 70 percent of gross investment, and robust commodity exports. The strong external environment, however, began to deteriorate from mid-2013. FDI inflows dried up to less than 2 percent of GDP in 2014-16 from an average 32 percent of GDP in the previous three years, as new foreign investment projects were delayed. A continued and sharp drop in commodity prices and slower growth in China, meanwhile, dampened commodity exports which accounted for almost 90 percent of total exports. The export prices of copper and coal, Mongolia’s key export commodities, dropped by about 25 percent and 32 percent respectively, between 2013 and 2015.<sup>2</sup> Coal export volume also shrank by 21 percent over the same period, reflecting slowing demand from China which absorbed most of Mongolia’s coal exports. The precipitous drop in FDI and weak commodity exports resulted in a collapse in investment and decline in net exports, reducing growth to 7.9 percent in 2014 and 2.4 percent in 2015 (see Table 1). Growth further dropped to 1.2 percent in 2016 as private consumption contracted by 9 percent, reflecting negative real household income growth and high unemployment. A strong rebound in coal exports in the last quarter and higher public expenditure, however, helped maintain positive annual growth in 2016.

7. **The balance of payments has been under mounting pressure, triggering a sharp exchange rate depreciation and a significant loss of reserves.** The current account deficit—after reaching an average 26

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<sup>2</sup> Compared to their peak in 2011, the decline of copper and coal prices was about 45 percent.

percent of GDP in 2011-13—sharply narrowed to 6.3 percent of GDP in 2016, due to continued import compression amid weak domestic demand and lower oil prices. Despite the narrowing of current account deficit, a sudden stop in FDI inflows—from US\$4.4 billion in 2012 to around US\$120 million in 2016—put severe strain on the balance of payments. The widening external imbalance and weak confidence over the economy led to a 78 percent depreciation of the *togrog* between 2013 and 2016. In response, the Bank of Mongolia (BoM) stepped up intervention in the foreign exchange market. The intervention, however, exhausted almost three quarters of gross reserves, which fell from US\$4.1 billion in 2012 to US\$1.3 billion in 2016—amounting to less than three months’ import cover.

8. **Mongolia has heavily relied on external borrowing to fill external and fiscal financing gaps.** The Government significantly increased non-concessional borrowing to finance rapid fiscal expansion. The first large non-concessional borrowing was the sovereign and sovereign-guaranteed bonds of US\$2,080 million issued in 2012, which was followed by: (i) a US\$462 million sovereign-guaranteed Development Bank of Mongolia (DBM) loan in 2014; (ii) a US\$500 million guaranteed bond issued by a commercial bank in 2015; (iii) a RMB 1 billion sovereign bond in 2015; and (iv) a US\$500 million sovereign bond and a US\$250 million syndicated loan in 2016. The Bank of Mongolia (BoM) also used approximately US\$1.7 billion in 2012-16 on the credit line of a RMB 15 billion bilateral currency swap facility with the People’s Bank of China (PBoC) to replenish declining reserves. The total external borrowing by the Government and the BoM totaled US\$6.2 billion between 2012 and 2016.

9. **Looming repayments of sovereign bonds have added substantial risks to the weak external position.** In addition to a US\$580 million sovereign-guaranteed bond that matured in March 2017, which was successfully refinanced, a large amount of non-concessional debt is scheduled to mature in 2018, including: (i) a US\$500 million sovereign bond in January 2018; and (ii) a RMB 1 billion sovereign bond in June 2018. Prior to the successful refinancing of the US\$580 million bond, large debt repayments equivalent to over 90 percent of the country’s reserves at end-2016, triggered two downgrading of the country’s sovereign rating to Caa1 (Moody’s) in 2016, following rising investor concern on Mongolia’s external debt repayment capacity.

10. **The fiscal position has sharply deteriorated in recent years, driven by off-budget spending.** The consolidated budget deficit<sup>3</sup> amounted to an average of 9 percent of GDP in 2012-15 as the Government actively used fiscal stimulus to counter the deteriorating external environment. Facing continuous revenue drop amid slower growth and lower commodity prices, fiscal expansion heavily relied on non-concessional debt and domestic bond issuances. Most of the proceeds of non-concessional borrowing were channeled through the off-budget expenditures of the DBM to bypass the budget deficit ceiling of the Fiscal Stability Law (see paragraph 11 below for more details). Attempts were made in 2015 to curb the ballooning deficit, following the World Bank’s recommendation, by bringing DBM’s off-budget investment into the budget and reducing the consolidated deficit to 8 percent of GDP from 11.3 percent of the previous year. The fiscal adjustment efforts, however, were reversed in 2016 as on-budget expenditure was ramped up, led by large pre-electoral spending and significant increase in capital expenditure to clear payment arrears. As a result, the budget deficit widened to 17 percent of GDP; Government debt surged to 88 percent of GDP; interest payments climbed to 4 percent of GDP in 2016—raising serious concern about sustainability of public debt. Mounting domestic borrowing needs, along with heightened risk perceptions, pushed up the six-month T-bill yield from 10 percent in 2013 to over 17 percent in 2016, further squeezing the fiscal space.

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<sup>3</sup> The consolidated budget deficit, used by the Bank/Fund for fiscal monitoring, includes the off-budget expenditure of the DBM in addition to the Government’s formal budget definition.

11. **The DBM has been an important driver of the loose fiscal management.** The Government used the DBM as the major off-budget financing vehicle, providing over US\$2.7 billion (or MNT 5 trillion) in 2012-15. The latter comprised of guarantees (US\$1.2 billion) and direct proceeds of sovereign bonds (US\$1.5 billion). DBM's off-budget spending, which averaged 5.5 percent of GDP in 2013-16, was channeled through two types of loans: (i) non-commercial loans to finance the Government's capital expenditure (DBM-financed capital expenditure); and (ii) commercial loans to private and state-owned companies (commercial investment). The DBM-financed capital expenditure—even though it was budgetary investment to be implemented and repaid by the Government—remained off budget until 2015. The off-budget public investment was finally brought on budget in 2015, as a result of the Bank's initial DPL dialogue. In addition, DBM's non-commercial loans, funded by the proceeds of sovereign bonds, were lent to DBM—a complex cross-liability structure created in 2012 to bypass the deficit ceiling of the Fiscal Stability Law. Concerns were also raised about the financial viability of DBM's commercial investment, as many of commercial loans were extended to Government's programs or Government-guaranteed projects that were not commercially bankable. Considering the large potential fiscal implication, the Bank and the IMF included the commercial loans into a broader definition of the “consolidated budget deficit” for fiscal monitoring. In 2016, non-commercial loans and commercial loans of the DBM declined due to difficulty in mobilizing further external borrowing, but remained substantial at 1 percent of GDP.

12. **The central bank has been also heavily engaged in quasi-fiscal lending programs.** Monetary policy was substantially loosened in 2013-14 to support fiscal stimulus through quasi-lending activities. Two large quasi-fiscal lending programs—the Price Stabilization Program (PSP) and the Housing Mortgage Program (HMP)<sup>4</sup>—were launched by the BoM in lieu of the Government, which injected liquidity amounting to almost 17 percent of GDP in 2013. The PSP provided subsidized loans of more than MNT 1 trillion to select industries, with particular focus on construction, until it began to be phased out from late 2014 based on the recommendations of the World Bank. However, the HMP—which aims to provide subsidized loans to mortgage borrowers—continued to expand with BoM's financing, due to its political popularity. Outstanding mortgage loans under HMP reached MNT 3.1 trillion at end-2016—equivalent to 13 percent of the 2016 GDP. The BoM also provided significant financial support to companies in financial distress through a corporate bond purchase program since late 2014. The outstanding corporate bond holdings of the BoM amounted to MNT 815 billion at end-2016.

13. **Credit conditions have become tight since 2015 and bank-asset quality has been deteriorating.** Bank loan growth remained weak since 2015, with subdued loan demand amid import compression and currency depreciation. The non-performing loan (NPL) ratio continued to climb since 2015 to around 9 percent at end-2016, in the aftermath of the policy-induced credit boom in 2013-14, and accompanied by weaker prudential regulations. Despite the low inflation at 1.1 percent in 2016, the weighted average lending rate is high at about 20 percent due to significant debt-financing need of the budget, high risk premium, and limited competition in the banking sector. The BoM hiked its policy rate by 450 bps to 15 percent in August 2016 to defend the togrog, followed by a reduction in the policy rate by 100 bps and 200 bps in December 2016 and June 2017, respectively, to ease credit conditions in light of low inflation

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<sup>4</sup> The HMP was technically one of the sub-programs of the Price Stabilization Program, but was implemented separately from other sub-programs.

and stable exchange rate. As of end-September 2017, NPLs and Past Due Loans<sup>5</sup> accounted for about 8.7 percent and 6.2 percent of total outstanding loans, respectively.

14. **The macroeconomic situation shows signs of improvement, along with progress to secure financial support from key development partners.** As of the first half of 2017, the economic performance has improved from the depth of the 2015-16 economic slowdown. This improvement has been largely driven by positive developments in the mineral sector (mainly coal) as well as stronger performance in private investment following substantial FDI inflows in the mineral sector. Moreover, market confidence has also improved since the signing of an IMF-led multi-billion agreement in May 2017 supported by development partners including WBG, ADB, Japan, China, and Korea. Continued implementation of the adjustment plan, supported by financing in terms that are more favorable than commercial, is critical to fiscal sustainability and to stabilize the Government's debt. Successful market-based refinancing of the debt, however, hinges on fast disbursement of donor financing and continued policy adjustment and structural reforms to restore fiscal and external sustainability.

## 2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

15. **Growth is projected to be relatively modest in 2017-18, but accelerate from 2019 onward.** In 2017, growth is projected to be modest mainly on the account of an increased demand for coal from China. Moreover, the negative impact of strong fiscal consolidation continues to affect growth, largely offsetting the stimulus effects from a nearly US\$1 billion foreign investment into the Oyu Tolgoi (OT) underground mine (OT-2). Growth will further increase in 2018, as the growth effects from increased FDI inflows into OT-2, increased gold content in copper production of OT, and new gold production from the Gatsuurt gold mine outweigh the contractionary effects of fiscal adjustment. Economic recovery is expected to gain pace in 2019, on account of the production increase schedules and new FDI plans of major mines. Stronger coal and copper production by the Tavan Tolgoi (TT) coal mine and the OT surface mine is projected to boost mining production in 2019. A three-year US\$2.2 billion foreign investment into the TT mine is also expected to start in 2019, providing over US\$700 million investment annually. In the longer term, new commercial production of the OT-2—accounting for 80 percent of OT's total mineral deposit—is projected to bolster growth from 2022. Inflation is expected to pick up towards end-2017, reflecting weather related factors including potential failure of crops due to harsh winter and the lingering pass-through effects of a sharp depreciation in 2016. Inflation is projected to remain stable afterwards with continued fiscal consolidation and relatively tighter monetary policy stance and associated moderate credit growth. The latest data release suggests that the pace of economic activity picked up during the first half of 2017, with growth recording 5.3 percent (y/y), supported by stronger coal exports as well as robust performance in the manufacturing and service sectors. The growth performance for the second half of 2017 is, however, likely to be weaker amid decelerated coal exports on account of cross-border logistical constraints.

16. **Despite the recent progress in resolving the immediate liquidity risks, balance of payments risk will stay substantial in 2017-18 on account of additional debt repayments and inadequate reserves.** With improved investor confidence by the announcement of donor support, Mongolia successfully refinanced a US\$580 million sovereign-guaranteed bond in March 2017, issuing a US\$600 million sovereign bond, of seven-year maturity, at a rate lower than the prevailing market rates. The People's

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<sup>5</sup> Past due loans refer to overdue loans for less than 90 days.

Bank of China also extended its RMB 15 billion (approximately US\$2.2 billion) bilateral currency swap facility by three years, as part of international support, on which the BoM has drawn about US\$1.8 billion since 2012. Despite the recent progress, risks to the balance of payments will likely remain substantial in the short term, with additional US\$660 million bonds maturing in 2018—US\$500 million in January and RMB 1 billion in June. Full repayment of the bonds would exhaust about 40 percent of the remaining reserves which stood at US\$1.6 billion in September 2017. To refinance these maturing bonds, the Government successfully issued a new sovereign bond of US\$800 million, of five and half year maturity, at a rate lower than the prevailing market rates. The current account deficit is expected to widen over the next three years as strong import growth, driven by higher oil import price and foreign investments, will outpace an increase in major mineral exports. Strong FDI inflows into the OT-2 and TT mines, however, will provide significant buffers to the current account deficit, with annual FDI climbing to over US\$2.2 billion in 2019.

17. **Financial support from multilateral and bilateral partners is critical in stabilizing the external account and rebuilding buffers.** Finalization of funding arrangements with donors, including the proposed DPF, may have helped catalyze successful market-based refinancing of the 2018 bonds by reducing investor concern over Mongolia’s debt repayment capacity. In addition, a total of US\$3.5 billion financial support<sup>6</sup> from donors is projected to fully finance external financing gap and help rebuild reserves to an adequate level—over 6 months’ import cover by 2019, under the baseline projections of the current account balance and capital flows (see Table 2).

18. **Monetary policy is expected to remain appropriately tight to support price stability, and the financial supervision and safety net will be strengthened.** The BoM plans to keep monetary policy tight in the short-term through effective liquidity management, in light of the declining but still high fiscal deficit, substantial external financing, and projected FDI inflows. Interventions are expected to be limited to smoothing excessive volatility, allowing more flexible exchange rate fluctuations and rebuilding international reserves. The BoM law is planned to be amended to clarify its mandate, strengthen governance, and improve independence. A set of reform actions will be taken to strengthen the monitoring and supervision of the banking sector, with the support of the IMF. An international external auditing firm was commissioned by BoM to carry out an Asset Quality Review (AQR) aimed to assess individual banks’ financial soundness and resilience, followed by a stress testing to identify any recapitalization needs. This exercise is expected to be completed before the end of this year. Regulatory and supervisory framework is also planned to be strengthened, including improving the early intervention framework, bringing the bank resolution legislation, and strengthening the rules on related party exposure and ultimate beneficial owners. Mongolia’s deposit insurance system will be strengthened with the support of the Bank to: (i) amend Mongolia Deposit Insurance Company (DICOM) law in line with IADI Core Principles of Effective Deposit Insurance System; (ii) establish a backup financing facility for the DICOM; and (iii) improve data sharing between the DICOM and the BoM.

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<sup>6</sup> The financial support package is tentatively comprised of the following: (i) up to US\$600 million from the World Bank through three years’ DPF operations and project financing, which are subject to future Board approvals; (ii) a US\$434 million IMF loan; (iii) a US\$900 million ADB loan including US\$300 million project financing; (iv) US\$850 million from Japan; (v) US\$700 million from Korea. In addition, the PBoC extended the maturity of its RMB 15 billion (US\$2.2 billion) swap line with the BoM, on which the BoM has already drawn about US\$1.8 billion since 2012.

**Table 1. Key Economic Indicators: 2013-2022**

	2013	2014	2015	2016e	2017f	2018f	2019f	2020f	2021f	2022f
<b>Real Sector</b>										
Real GDP (% change y-y)	11.7	7.9	2.4	1.2	2.8	3.3	7.3	5.0	5.7	8.1
Mineral GDP (% y-y)	18.5	18.5	14.1	0.2	-0.2	3.7	8.7	14.7	13.5	18.6
Non-Mineral GDP (% y-y)	9.8	5.2	-1.0	1.6	3.7	3.2	6.8	1.8	2.9	3.9
Consumer price index (% change y-y)	12.3	11.0	1.1	0.9	8.0	6.7	6.9	6.5	6.5	6.5
<b>Fiscal Account (in percent to GDP)</b>										
Revenue & grants	31.2	27.8	25.1	23.6	27.3	27.1	27.5	27.4	27.5	27.3
Expenditure	40.1	38.3	33.6	40.6	35.3	34.2	32.2	30.4	28.6	28.2
Overall budget balance	-8.9	-10.5	-8.5	-17.0	-8.1	-7.1	-4.7	-3.0	-1.1	-0.9
General government debt	49.0	57.9	60.1	87.4	86.3	87.4	85.3	82.3	77.1	69.2
<b>External Accounts</b>										
Current account (million US\$)	-3156	-1405	-567	-700	-584	-955	-1486	-1210	-985	-450
(% GDP)	-25.1	-11.5	-4.8	-6.3	-5.3	-8.0	-11.2	-8.6	-6.5	-2.7
Trade balance	-1321	993	1232	1336	1453	1273	960	1172	1349	1828
Exports of goods	4273	5775	4669	4809	5662	5657	6023	6292	6782	7314
Imports of goods	-5587	-4782	-3438	-3473	-4209	-4384	-5063	-5120	-5433	-5486
Capital/Financial Account (million US\$)	1438	1065	423	902	789	1783	2709	1534	1310	566
Capital Account	126	100	112	91	138	150	162	173	187	193
FDI 1/	2098	276	183	121	961	1568	2246	1902	1954	1546
Portfolio	-156	277	282	483	-94	0	0	-500	-294	-206
Trade Credits	9	-136	-389	-101	-85	-80	-89	-85	-84	-86
Currency and Deposits	-1376	-210	-248	-204	-237	-567	-665	-689	-523	-600
Loans 1/	648	711	407	846	244	862	1217	906	257	-88
International support 2/					484	987	1047	759	150	50
Errors and Omissions	-113	-128	-115	-221	0	0	0	0	0	0
Overall BoP Balance (million US\$)	-1831	-468	-259	-19	344	978	1384	497	511	309
Gross international reserves	2242	1650	1323	1296	1640	2618	4002	4499	5010	5319
(months of imports)	3.9	4.0	2.8	2.5	3.0	4.3	6.4	6.9	7.5	7.3
<b>Monetary Sector (%)</b>										
Credit growth	57.9	23.5	0.5	8.5	8.6	11.2	12.3	10.4	9.7	10.6
Reserve money growth	54.0	2.7	-28.2	24.6	14.8	13.8	13.3	17.1	14.9	16.1
<b>Memo items:</b>										
Nominal GDP (millions US\$)	12582	12196	11728	11056	10970	11938	13217	14103	15141	16829
Nominal GDP (billions MNT)	19174	22227	23150	23936	27328	29935	33840	37580	41950	47952

1/ FDI and loans for 2016 are adjusted for \$4.2 billion off-setting transactions for OT-2 project financing.

2/ The projections for loans include multilateral and bilateral financial assistance in 2017-20.

Sources: IMF, MoF, BoM, WB staff estimates

**Table 2. External Financing Requirements and Sources: 2015-2022 (in millions of US\$)**

	2015	2016e	2017f	2018f	2019f	2020f	2021f	2022f
<b>1. External Financing Requirements</b>	<b>2149</b>	<b>2092</b>	<b>2114</b>	<b>2668</b>	<b>2324</b>	<b>2831</b>	<b>2317</b>	<b>2820</b>
Current account deficit	567	700	584	955	1486	1210	985	450
Amortizations	1219	792	1293	1146	172	932	808	1769
Portfolio investment	356	20	694	661	0	500	500	1206
Loans	863	773	599	485	172	432	308	563
Other net capital outflows 1/	363	599	237	567	665	689	523	600
<b>2. Financing Sources</b>	<b>2149</b>	<b>2092</b>	<b>2114</b>	<b>2668</b>	<b>2324</b>	<b>2831</b>	<b>2361</b>	<b>2820</b>
<b>A. Capital and Financial Inflows</b>	<b>1912</b>	<b>2074</b>	<b>1974</b>	<b>2660</b>	<b>2661</b>	<b>2569</b>	<b>2722</b>	<b>3079</b>
Capital account inflow	112	91	138	150	162	173	187	193
FDI 2/	183	121	961	1568	2246	1902	1954	1546
Portfolio investment 4/	661	465	600	661	0	0	250	1000
Trade Credits	-389	-101	-85	-80	-89	-85	-84	-86
Loans 2/	1345	1498	360	361	342	579	415	426
<b>B. Multilateral and Bilateral Support 3/</b>			<b>484</b>	<b>987</b>	<b>1047</b>	<b>759</b>	<b>150</b>	<b>50</b>
IMF			114	135	142	36	0	0
WB			120	150	150	180	0	0
Other multilaterals and bilaterals			250	702	755	543	150	50
Memo: PBoC Swap Facility Extension						1725		
<b>C. Changes in reserves: (-) means increase</b>	<b>237</b>	<b>18</b>	<b>-344</b>	<b>-978</b>	<b>-1384</b>	<b>-497</b>	<b>-511</b>	<b>-309</b>
<b>3. Gross International Reserves (end-year)</b>	<b>1323</b>	<b>1296</b>	<b>1640</b>	<b>2618</b>	<b>4002</b>	<b>4499</b>	<b>5010</b>	<b>5319</b>
(months of imports)	2.8	2.5	3.0	4.3	6.4	6.9	7.5	7.3

1/ Other net capital outflows include all other net financial flows and errors and omissions.

2/ FDI and loans for 2016 are adjusted for \$4.2 billion off-setting transactions for OT-2 project financing.

3/ The amount of annual financing from multilateral and bilateral partners is indicative.

4/ The above estimates do not account for the external debt issued by the government on October 26, 2017.

Source: BoM, IMF, WB staff estimates

19. **A strong fiscal consolidation plan has been adopted to restore fiscal sustainability.** The Government adopted the Medium-Term Fiscal Framework for 2017-19 and the 2017 supplementary budget, aiming to reduce the consolidated budget deficit from 17 percent of GDP to less than 5 percent of GDP by 2019. Under the current adjustment plan, the primary deficit is projected to be reduced from 13 percent of GDP in 2016 to less than 4 percent in 2017, and below 1 percent in 2019 (see Table 3). Financial support from donors is expected to significantly contribute to the fiscal consolidation process. Concessional budget support loans of multilateral and bilateral donors would substitute more expensive domestic borrowing whose prevailing interest amounts to over 11 percent. Interest payments, reflecting the lower-cost concessional finance, are projected to gradually decline from 2018, after reaching 4.5 percent of GDP in 2017. Gross financing needs will also be significantly reduced on account of long-term concessional budget support loans, by lowering the Government's reliance on domestic securities dominated by short-term maturity bills.

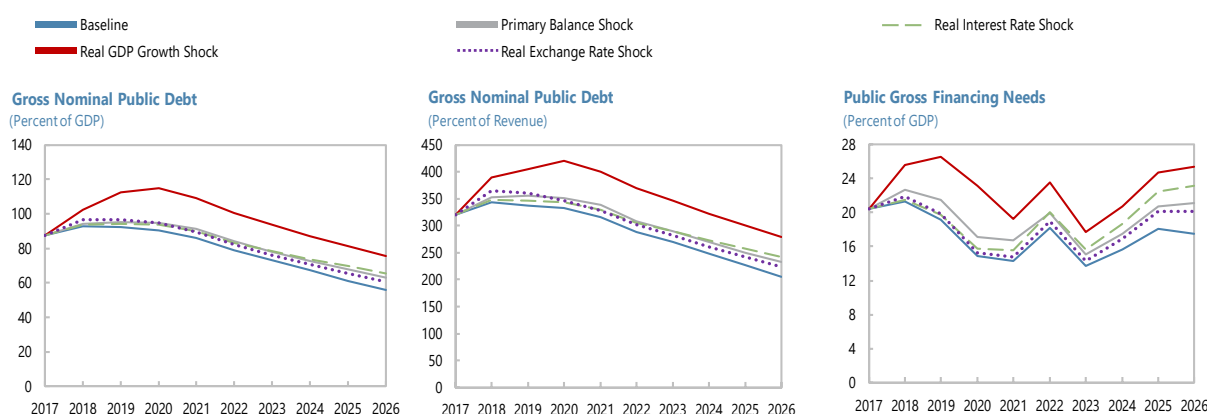
20. **Government debt is projected to peak in 2018 and then gradually decline afterwards, under the assumptions of strong fiscal adjustment and substantial donor financing.** Nominal debt-to-GDP ratio is projected to continue to rise in 2017-18 despite fiscal adjustment, reaching over 87 percent of GDP in 2018, due to the declining but still high primary deficit, growing interest payments, and sluggish growth. The debt ratio is projected to gradually decline from 2019 as the primary deficit is substantially reduced, interest payments decline, and the pace of recovery gains significantly (see Table 3).

**Table 3. Key Fiscal Indicators Outlook: 2015-2022 (% of GDP)**

	2014	2015	2016e	2017f	2018f	2019f	2020f	2021f	2022f
Total revenues and grants	27.8	25.1	23.6	27.3	27.1	27.5	27.4	27.5	27.3
Tax revenues	23.4	22.1	20.6	23.6	23.5	24.0	23.9	24.0	24.5
PIT	2.1	2.1	2.1	2.3	2.5	2.5	2.4	2.4	2.5
CIT	2.8	3.0	2.1	2.9	2.8	2.8	2.9	3.0	3.1
Social Security Contribution	4.1	4.4	4.6	5.6	5.3	5.2	5.0	4.9	4.6
VAT	6.2	4.5	4.8	5.6	5.3	5.3	5.1	5.0	4.6
Excise taxes & Special taxes	2.2	2.6	2.6	1.9	2.3	2.5	2.3	2.3	2.3
Taxes on foreign trade	1.6	1.4	1.4	1.8	1.6	1.9	1.7	1.7	1.5
Royalties	2.6	2.6	1.2	1.9	2.2	2.3	2.9	3.2	4.4
Non-tax revenues & Grants	4.5	3.2	3.1	3.7	3.6	3.5	3.5	3.5	2.8
Total expenditures	38.3	33.6	40.6	35.3	34.2	32.2	30.4	28.6	28.2
Current Primary expenditures	21.3	21.5	23.9	22.0	21.2	19.8	18.4	17.3	17.4
Wages and salaries	7.0	7.4	7.3	6.5	6.1	5.7	5.2	4.9	4.9
Goods and services	4.6	4.7	6.0	5.2	5.0	4.8	4.6	4.4	4.4
Subsidies	0.8	0.4	0.9	0.9	0.8	0.8	0.8	0.7	0.7
Transfers	8.9	9.0	9.7	9.5	9.3	8.6	7.8	7.3	7.4
Interest payment	2.5	2.9	3.9	4.5	4.4	4.0	3.5	2.8	2.4
Capital expenditures	10.9	6.0	9.6	7.1	7.1	6.8	7.0	7.1	7.0
Domestically-financed	6.8	3.1	5.8	4.7	4.4	4.0	5.0	5.0	5.0
DBM-financed	2.9	1.9	1.3	0.0	0.0	0.0	0.0	0.0	0.0
Foreign-financed		1.1	2.5	2.4	2.7	2.8	2.1	2.0	2.0
Net Lending	4.2	3.1	3.1	1.7	1.5	1.5	1.5	1.4	1.4
Net lending excl. mortgage loans	0.4	0.1	2.1	0.8	0.6	0.6	0.6	0.5	0.5
On-budget housing mortgage loans	0.0	0.0	0.0	0.4	0.4	0.4	0.4	0.4	0.3
DBM commercial loans	3.8	3.0	1.0	0.5	0.5	0.5	0.5	0.5	0.5
Overall balance	-10.5	-8.5	-17.0	-8.1	-7.1	-4.7	-3.0	-1.1	-0.9
Primary balance	-8.6	-5.6	-13.0	-3.6	-2.7	-0.7	0.5	1.6	1.5
Government debt	57.9	60.1	87.4	86.3	87.4	85.3	82.3	77.1	69.2
External debt	43.1	45.4	67.7	63.9	67.8	71.3	72.5	69.1	62.8
Domestic debt	14.8	14.7	19.7	22.4	19.6	14.0	9.8	8.0	6.5

Source: IMF. MoF. World Bank staff projections

**Figure 1. Public and Publicly Guaranteed Debt Dynamics**



Source: IMF MAC Debt Sustainability Analysis, August 2017 (First review mission)

21. **The latest IMF Debt Sustainability Analysis (DSA) of August 2017 concluded that the proposed fiscal adjustment would be able to bring Government’s debt back to a sustainable path, under the following assumptions: (i) growth will pick up substantially in 2019 and remain strong thereafter, driven by development and production from major mines; (ii) funding of donors in favorable terms will**

significantly reduce the gross financing needs and the present value (PV) of debt; (iii) external non-concessional borrowing will be successfully refinanced and domestic creditors will finance the Government with more favorable terms than those prevailing today. Under these assumptions, the PV of debt-to-GDP ratio, the major indicator for debt sustainability, is projected to reach close to 85 percent in 2018 and starts declining from 2019, down to around 75 percent in 2021. Mongolia's total external debt reached over 220 percent of GDP—155.6 percent excluding US\$7.4 billion of intercompany loans—at end-2016. The DSA projects external debt to start declining from 2018 on account of projected improvement in the balance of payments and stronger growth from 2019. The public and external debt dynamics, however, are sensitive to external shocks. The DSA suggests that public debt could increase substantially in the event of a real GDP growth shock and, to a lesser extent, exchange rate and interest rate shocks, but all stress tests indicate a declining public debt path in the medium-term, assuming the proper implementation of the fiscal adjustment plan (See Figure 1 for the DSA projections).

**22. The prospects of substantial improvement in the fiscal and external positions and growth suggest that the current macroeconomic policy framework is adequate for budget support operation.** The authorities have already taken steps to restore fiscal sustainability and build external buffers through an economic policy adjustment program, in close coordination with development partners. The current economic adjustment program is expected to significantly reduce the budget deficit, stabilize the debt path, and rebuild external buffers to an adequate level towards the end of the three-year DPF program horizon. The latest fiscal performance indicates that the fiscal consolidation in 2017 is on track, with the deficit now projected at 8.1 percent of GDP, as against a target of 10.6 percent of GDP.

**23. The economic outlook is subject to substantial macro-economic risks from external shocks.** The major sources of external downside risks include: (i) slower-than-expected FDI increase into key mining projects; (ii) disruption in the production of major copper, coal and gold mines (particularly in relation to cross border issues); and (iii) weaker-than-expected commodity prices, possibly due to a sharper slowdown in China's economy. These shocks could significantly slow growth recovery and undermine fiscal space and external buffers, thereby delaying the projected improvement in fiscal and external sustainability. The magnitude of such shocks could be particularly strong as Mongolia has been structurally vulnerable to fluctuations in the commodity market, which accounts for almost 90 percent of its exports and FDI inflows into the mining industry has been a dominant source of investment over the last decade. This DPF, reflecting the substantial macro-economic risks, adopted more conservative assumptions in the baseline outlook, including the prices of key export commodities and the projected FDI inflows. The latest economic indicators also signal possible upside risks to the baseline outlook in 2017-18, with growth registering 5.3 percent y/y in the first half of 2017. To address the structural vulnerability of the economy to external shocks, the DPF aims to support structural reform measures to improve the competitiveness of the non-mining sector and promote a more investor friendly business environment.

## 2.3 IMF RELATIONS

**24. A three-year Extended Fund Facility (EFF) program was approved on May 24 by the IMF's Executive Board for SDR 314 million or US\$434.3 million.** The EFF program sets its priority on: (i) fiscal adjustment measures to reduce the deficit and restore debt sustainability, and structural fiscal reform measures to ensure fiscal discipline; (ii) measures to maintain appropriate monetary policy and flexible exchange rate and to strengthen the governance and independence of the BoM; and (iii) measures to strengthen the resiliency of the banking system including the AQR of individual banks. The World Bank and IMF have been extensively coordinating on the reform program, including the World Bank's active participation in the first review IMF mission that reached a staff-level agreement on the EFF program, and

in the ongoing October 2017 second review mission of their program. As a result, the EFF program actively reflects the recommendations of the Bank’s analytical work—such as the recent World Bank staff analysis (2016)—and the proposed DPF operation, particularly in the specific reform measures for expenditure adjustment, revenue mobilization, discontinuation of quasi-fiscal expenditures, and protection of the poor during the fiscal adjustment.

## THE GOVERNMENT’S PROGRAM

25. **The Government of Mongolia’s economic reform program is anchored in the “Economic Recovery Program” (ERP), approved by the Parliament on November 24, 2016.** The ERP puts its primary objective in overcoming the current economic difficulties, particularly restoring fiscal sustainability, while pursuing structural reform measures to restore foreign investor sentiment and diversify the economy. Key measures to achieve fiscal sustainability are further elaborated in the 2017 supplementary budget adopted on April 14, 2017. Key reform areas of the ERP are summarized in Figure 2.

**Figure 2. Key Reform Areas of the Government’s Economic Recovery Program (ERP)**

Economic Recovery Program	
Strategic Objective I	Strategic Objective II
<p>Economic policy adjustment to overcome short-term economic difficulties</p>	<p>Structural reforms for long-term stable growth path</p>
<ul style="list-style-type: none"> <li>• Restore fiscal sustainability by: (i) reducing inefficient and unnecessary expenditures; and (ii) expanding the budget revenue base.</li> <li>• Discontinue the quasi-fiscal expenditures of the BoM and the DBM.</li> <li>• Assess the performance of, and the contingent liabilities from quasi-fiscal expenditures.</li> <li>• Prepare a plan to resolve the repayments of bonds issued by the government and the DBM.</li> <li>• Enhance monetary policy to: (i) increase international reserves; (ii) stabilize inflation; and (ii) maintain flexible exchange rate.</li> <li>• Maintain financial stability by appropriate liquidity management and proper prudential supervision of the banking system.</li> </ul>	<ul style="list-style-type: none"> <li>• Promote economic diversification by supporting non-mining sectors with large potential, e.g., livestock products such as meat, dairy, and skin/leather goods.</li> <li>• Expand bilateral trade and transit transport.</li> <li>• Attract foreign investments for sustainable and stable growth.</li> <li>• Strengthen the FDI environment, including the establishment of the Investor Protection Council.</li> <li>• Strengthen the fiscal legislation to restrict the parliament's power during the budget preparation.</li> <li>• Improve the governance, independence, and operational transparency of the BoM.</li> <li>• Improve the DBM law to ensure its transparent and efficient management.</li> </ul>

26. **The fiscal consolidation plan of the Government adopted a broad set of structural reforms and fiscal adjustments.** First, off-budget expenditures of the DBM and the BoM will be stopped and integrated into the budget. Second, safeguard measures will be introduced to ensure fiscal discipline against political influence. PAYGO system will be adopted to curb the Parliament’s ability to increase the overall spending envelope and an independent fiscal council will be established to scrutinize budget forecasts and compliances with the Fiscal Stability Law. Third, strong adjustment will be made on on-budget expenditure and revenue. The largest adjustment is expected in 2017, reducing the deficit-to-GDP ratio to 10.6 percent—a deficit reduction equivalent to 6.4 percent of GDP. Major sources of adjustment in 2017 include: (i) removing a one-off dispute settlements expense and pre-electoral policy loans; and (ii) terminating the Promissory Notes Program that resulted in a significant increase in capital expenditure in 2016. Expenditure adjustment in 2018-19 will focus on a rationalization of capital expenditure (particularly

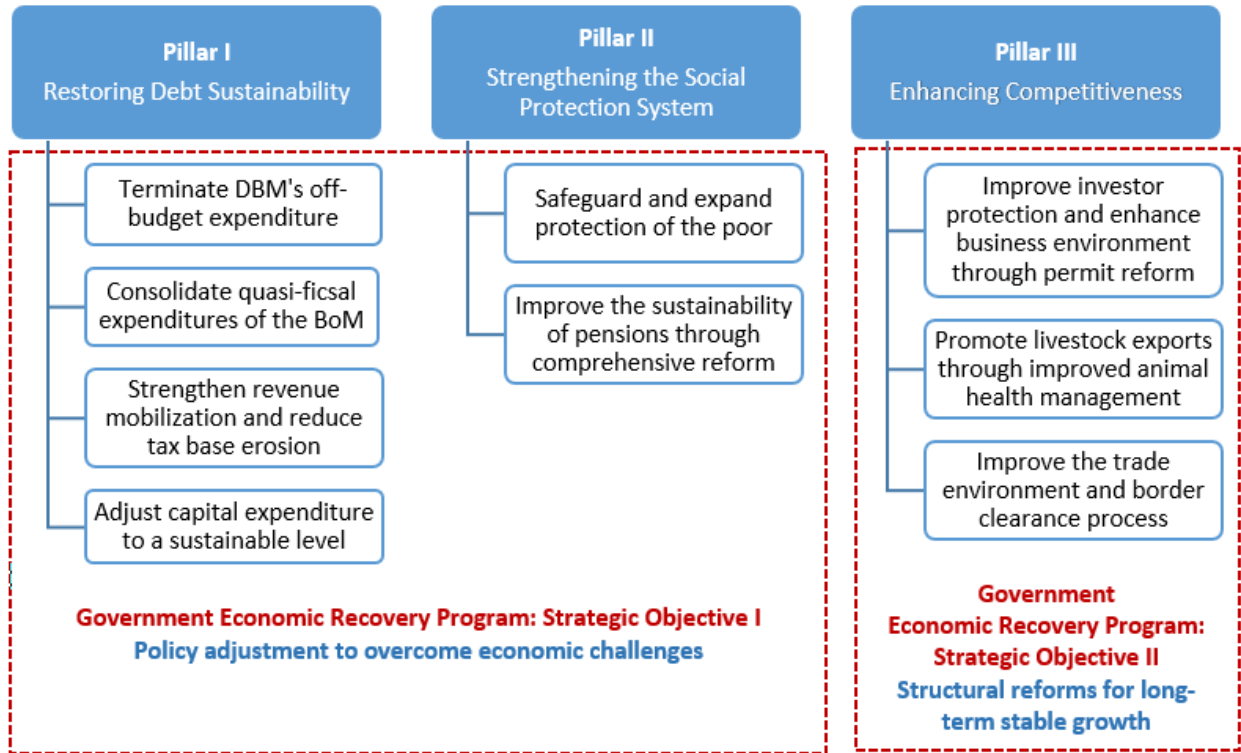
domestically-financed projects), public sector wage and hiring freeze, and reduction of unnecessary operating expenses. Revenue mobilization measures include raising taxes on higher income earners, tobacco and alcohol, petroleum and old vehicles, as well as expanding the tax base for interest tax. Fifth, budget priorities will be put on social protection and basic services—especially on education and health services. The Food Stamp Program will be expanded to scale up support to the households below the poverty line, starting from 2018. Budget for education and health will be protected, particularly the repair and maintenance budget for schools and hospitals despite a large reduction in other capital expenditures.

## THE PROPOSED OPERATION

### 4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

27. **The proposed DPF is designed to support selective reform areas critical to achieve the two strategic objectives of the Government’s ERP.** The reform programs supported by this DPF are structured into three main pillars: (i) restoring debt sustainability; (ii) strengthening the social protection system; and (iii) enhancing competitiveness. Figure 3 illustrates the alignment of the three pillars of the DPF with the two strategic objectives of the ERP. The first pillar of the DPF supports selective fiscal reform and adjustment measures to remove off-budget expenditures and reduce the extremely high budget deficit through on-budget expenditure and revenue adjustment. The proposed measures under Pillar I are expected to contribute to over one-third of the total budget deficit reduction in 2017-19, and significantly improve fiscal discipline and transparency by bringing previous off-budget expenditures on budget. The second pillar aims to mitigate adverse impacts on poor households during fiscal adjustment by strengthening poverty-targeted social welfare programs and improving the long-term sustainability of the pension system through a two-staged pension reform. The third pillar is focused on measures that are vital to strengthen the economy’s structural resilience by enhancing the investment and business climate, strengthening the animal health management—the most significant bottleneck for agricultural exports, and improving the trade environment.

**Figure 3. Proposed Structure of the DPF**



28. **This DPF identified fiscal adjustment and reforms to fiscal institutions as the immediate priority for supporting the Government in addressing Mongolia’s needs.** Pillar I of the DPF is focused on two high priority reform areas critical for successful fiscal adjustment: (i) phasing out off-budget and quasi-fiscal expenditures of the DBM and the BoM that have been the major driver of unsustainable fiscal expansion and monetary easing in 2013-15; and (ii) reducing the high on-budget deficit of 2016 through key expenditure and revenue adjustment measures. Expenditure adjustment will focus on reducing capital expenditure—the largest source of spending increase in 2016 except for one-off spending programs. Revenue adjustment comprises a series of actions that support immediate revenue mobilization in the first year of operation through introducing a more progressive PIT system and raising excises on alcohol and tobacco, followed by subsequent administration reforms to expand the tax base. A complementary measure to reduce tax burden on lower income groups will be supported by gradually raising the minimum income tax threshold that is currently far lower than the minimum wage level.

29. **Pillar II of the DPF is aimed at safeguarding and protecting the poor during the fiscal adjustment, and improving the efficiency and sustainability of the social protection system.** This pillar puts the priority on protecting and expanding poverty-targeted welfare programs—with a focus on the Food Stamp Program and a poverty cash benefit program designed using the PMT-based Integrated Household Database. Improving the financial sustainability of the pension system has been identified as one of the most urgent tasks in social protection reform, on account of the growing fiscal burden from pension liabilities. Pillar II will support a two-phased pension reform through a parametric reform of the contribution rate and retirement age in the first year, followed by a more comprehensive reform to the pension system.

30. **Pillar III, looking beyond the short-term challenges, will support the Government in pursuing structural reforms to 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 of the economy: (i) enhancing the business environment 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 non-mineral exports; and (iii) improving the trade environment by lowering the costs and administrative burden.

31. **The reform actions proposed by this DPF are underpinned by the extensive analytic work and technical assistance (TA) of the Bank.** The proposed actions of Pillar I build on the recommendations of the recently delivered World Bank staff analysis (2016), Public Financial Management Report (2015), and a series of Mongolia Economic Updates which provided comprehensive analyses on the sources of budget deficit, expenditure and revenue trend and composition, and quasi-fiscal expenditures. Pillar II incorporates recommendations of the Review on Mongolia’s Social Welfare Programs (2015), the World Bank staff analysis (2016), and technical assistance through the Multi-Sectoral TA project (2011-2017). The structural reform measures of Pillar III are underpinned by: (i) Study on Investor Protection in Mongolia (2016) and Review of Mongolia’s Competition Policy Framework (2013); (ii) Agricultural Productivity and Marketing Study (2015) and Agricultural PER (2015); and (iii) WBG Doing Business Report (2016) and a set of reports on Mongolia’s trade policy of the OECD, WTO and UN. The three main pillars of the DPF also build on the Bank’s policy recommendations that were delivered to the post-election Government in August 2016, through the World Bank staff analysis (2016).

32. **The proposed operation benefits from the lessons from the Mongolia Development Policy Credit (DPC) Operation in 2008-09.** Considering the medium-term horizon needed to secure credible and sustainable implementation of the reforms and the previous Mongolia DPC experience in 2008-09, a three-year programmatic DPO is proposed. The ICR for Mongolia DPC underscored the need for an effective combination of TA and analytical work and capacity building efforts to enhance proper reform implementation in a low capacity policy environment. The proposed DPO will actively be complemented by technical assistance and analytic support through the Mongolia Multi-Sectoral Technical Assistance II Project (MSTAP II), Public Expenditure Review (forthcoming in 2018), and targeted just-in-time TA activities—to ensure effective implementation and sustainability of the reform program.

## 4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

### PILLAR I. RESTORING DEBT SUSTAINABILITY

#### DISENGAGING THE DBM FROM OFF-BUDGET EXPENDITURES

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>•The Government has terminated DBM’s financing to capital expenditure through non-commercial loans.</li> </ul>	<ul style="list-style-type: none"> <li>•A comprehensive external special review on the DBM’s operation from 2012-2016 and an annual audit on the DBM’s operation during 2017 have been publicly disclosed on the DBM’s website.</li> </ul>	<ul style="list-style-type: none"> <li>•The Government further improves the management and operational framework of the DBM to ensure its independence, profitability, and the financial soundness, based on the 2017 audit.</li> </ul>	<ul style="list-style-type: none"> <li>•WB staff analysis (2016)</li> </ul>

33. **Rationale.** The DBM’s off-budget operations have been the major driver of high budget deficit and debt since 2012 (see paragraph 11 for explanation on DBM’s off-budget expenditure). While the DBM’s expenditure declined in 2016 compared with previous years due to funding difficulties, the DBM had been central to the unsustainable fiscal expansion in 2013-15, accounting for almost three-quarters of the consolidated budget deficit over the same period. Without stricter control over the DBM’s operation, political pressures from special interests could end up pushing DBM again in the direction of quasi-fiscal activities. Against this backdrop, the Government has adopted a set of reform actions on the DBM. In 2017, DBM’s non-commercial lending to the Government stopped through the 2017 supplementary budget, and the DBM law was amended to transform DBM into an independent and self-sustainable development bank, focused only on commercially viable projects. With the new DBM law, commercial loans will stay excluded from the Government’s official budget deficit definition, but they will be included in the consolidated budget deficit—the main fiscal deficit target to be monitored by the Government as well as the economic surveillance and analysis of the Bank and the IMF. To ensure the commercial viability of DBM’s operations under the new DBM law, a third-party audit—supported by the World Bank—will be undertaken to verify that DBM has been run as an independent and viable development bank in 2017. The DPF, in support of the Government’s reform program, will first focus on stopping DBM’s non-commercial loans in 2017, followed by the subsequent actions to monitor and improve DBM’s commercial operations through a third-party audit and necessary remedial actions.

34. **Prior Action.** This proposed action will stop DBM from issuing non-commercial loans to public investment projects of the budget, starting with the 2017 supplementary budget. This prior action completes the initial reform action taken in 2015 that included in the budget the previous off-budget investment financed by DBM’s non-commercial loans, upon the strong recommendation of the Bank and IMF. The World Bank, since then, has been urging further actions to completely stop DBM’s non-commercial loans to the budget and place all public investments under unified control and monitoring of the fiscal authorities. As a result of the prior action, the 2017 supplementary budget—adopted on April

14—removed the DBM-financed investment projects from the budget, and the DBM stopped issuing non-commercial loans to the Government. Capital expenditure in the amount of MNT 172 billion that was planned to be financed by the DBM in the original budget was immediately integrated into the state-funded investment budget, and was placed under the unified public investment management of the Government. All outstanding non-commercial portfolio of the DBM—that has been causing a complex cross-liability structure between the Government and the DBM—has been transferred to the Government. In parallel, the DBM law was amended in February to restrict the DBM’s operations to financial viable commercial projects, with strengthened independence of management.

35. **Year 2 Trigger.** This trigger will support a special external review and an annual audit of the DBM’s operation in 2012-17 to ensure that the DBM is run as an independent and profitable development bank, with its lending restricted to commercially viable projects and insulated from political influence. The comprehensive review for the 2012-16 operations will assess the decision-making processes, risk assessment, terms and conditions, and the quality of assets accumulated over the previous five years. Drawing on the findings of the past operations, the 2017 annual audit will verify that the DBM has been run differently from the past as an independent development bank, with particular focus on the DBM’s governance, loan originating and screening process, and financial soundness, in line with the newly amended DBM law. An external auditing entity will be selected through a competitive bidding process. The Bank has been providing technical assistance to the preparation of the external special review and the annual audit of the DBM, including the development of specific terms of reference of the third-party review and audit.

36. **Year 3 Trigger.** In the third year, the findings of the third-party audit will be reflected into the related laws and regulations to further improve the DBM’s management and operational structure towards an independent, profitable, and financially sound development bank.

37. **Expected Outcome.** The proposed measures are expected to contribute to fiscal adjustment, by terminating the off-budget expenditures of the DBM that has been the major driver of loose fiscal management since 2012. The outcome will be measured by the elimination of the DBM-financed capital expenditure recorded in the budget.

## PHASING OUT QUASI-FISCAL EXPENDITURES OF THE BOM

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>The BoM has discontinued net financing to the Housing Mortgage Program.</li> </ul>	<ul style="list-style-type: none"> <li>The Housing Mortgage Program is restructured through a joint decree by the BoM and the Government to better serve the purpose of supporting affordable housing in a more cost effective way, with a time bound plan for the BoM to fully exit the program.</li> <li>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.</li> </ul>	<ul style="list-style-type: none"> <li>The BoM has begun to exit Housing Mortgage Program, including properly resolving its outstanding Housing Mortgage Program assets considering the effects on its balance sheet and government debt.</li> <li>The results of the external review on quasi-fiscal operations of the BoM is included in the contingent liabilities of Fiscal Risk Report of the Government.</li> </ul>	<ul style="list-style-type: none"> <li>WB, Mongolia Economic Update (November 2015)</li> <li>IMF, Article IV Report (April 2015)</li> <li>WB staff analysis (2016)</li> </ul>

38. **Rationale.** Large quasi-fiscal operations of the BoM have been undermining fiscal discipline and the effectiveness of monetary policy since 2012 (see Paragraph 12 on page 8 for more details of BoM's quasi-fiscal activities), along with DBM's off-budget spending. Continuous engagement of the BoM in fiscal activities have created a prevailing perception that the central bank's currency issuance power is an unlimited source of resources for fiscal activities. In addition, lack of transparency in decision-making and implementation processes of key quasi-fiscal programs—particularly the PSP and financial support to companies—have created significant concern on the credit allocation mechanism and governance of the central bank. Disengaging the BoM from quasi-fiscal operations, against this backdrop, was identified by this DPF as a critical task not only for restoring fiscal discipline, but also for rebuilding the credibility and effectiveness of monetary policy. The first year of operation of the DPF will support the immediate reform action to be taken by the authorities—the discontinuation of the BoM's net financing of the HMP. The prior action will be followed by two sets of subsequent triggers: (i) restructuring of the HMP, the largest remaining quasi-fiscal lending program; and (ii) review and monitoring of the BoM's quasi-fiscal activities.

39. **Prior Action.** The proposed action aims to stop the BoM's net financing to HMP (**parallel conditionality with the IMF**). Since early 2017, the BoM has stopped printing money to finance the mortgage program and other quasi-fiscal lending programs. The BoM has stopped buying corporate bonds and no further liquidity will be injected to the purchase of corporate bonds. The outstanding corporate bonds amounted to MNT 815 billion at end-2016 which will begin to decline from 2020 according to the repayment schedule of the bonds held by the BoM. Outstanding BoM loans to the Price Stabilization Program is expected to be fully withdrawn in 2017. The Housing Mortgage program has been run as a revolving fund since early 2017, using only principal repayments and interest inflows for additional loans. With the adoption of the 2017 supplementary budget, the BoM will only recycle principal repayments to refinance the mortgage program as the agent of the Government, therefore containing its outstanding

balance-sheet exposure to the mortgage program at no more than the current level. Funding of new mortgages in excess of principal repayment inflows—defined as “net financing”—will be provided by the Government and recorded as expenditure (net lending), starting from the 2017 supplementary budget. The size of the net financing should be decided within the budget envelope affordable to contain the budget deficit within the fiscal adjustment path, competing with other spending needs. The prior action builds on continued policy dialogue between the Government and the Bank/Fund since 2012.

40. **Year 2 Triggers.**

- **Trigger #1.** This action aims to restructure the Housing Mortgage Program to better serve the purpose of affordable housing and establish a time bound plan for the BoM to fully the program. The current program design involves features that make it unsustainable, distortive, and fiscally inefficient, including the loose criteria for eligible borrowers and properties to be mortgaged, and unduly complicated mechanism using under-developed asset-backed instruments. The trigger will support the Government to restructure the mortgage program. This trigger particularly aims to improve the eligibility criteria to better meet the needs of targeted borrowers and market segments. Yearly program allocations should be planned and announced along with the annual budget preparation, based on the projected funding availability from principal and interest inflows from existing mortgage assets. The trigger will also support the BoM to develop a time-bound strategy to fully exit the mortgage program. The exit plan should involve strategies on how to resolve the outstanding assets of the mortgage program in the BoM balance sheet, including the Residential Mortgage-Backed Securities purchased since 2013. The mechanism and the pace of resolving the mortgage-related assets in the BoM’s balance sheet require a thorough assessment on the potential impacts on the BoM’s capital and Government’s debt. The Bank has begun technical assistance to the BoM and the MOF to successfully achieve the proposed trigger, including the redesigning of the HMP to a more cost effective and market-friendly mechanism as well as the exit strategy of the BoM, considering the potential impacts on fiscal space and the BoM’s balance sheet.
- **Trigger #2.** This trigger supports the BoM to improve the transparency and accountability of its operations through a special and independent financial and performance review of its previous operations. The special review will be conducted by an internationally reputable audit company and its results will be submitted to Parliament and disclosed on the BoM’s website. The special review will put particular focus on quasi-fiscal policy lending programs and BoM’s loans extended to companies, which have not been properly assessed and disclosed previously despite their significant fiscal and monetary policy implications. The terms of reference of the review will be prepared by BoM, with the World Bank’s technical assistance.

41. **Year 3 Triggers.**

- **Trigger #1.** This action will support the implementation of the BoM’s time-bound exit plan from the HMP. The BoM is expected to begin to reduce the outstanding assets of the mortgage program in its balance-sheet, building on the assessment of various exit options to be prepared by the Bank’s TA.
- **Trigger #2.** This trigger will require that the contingent liabilities emanating from the BoM’s quasi-fiscal activities be properly reflected in the Fiscal Risk Report to be published by the Government, as recommended by the World Bank staff analysis (2016).

42. **Expected Outcome.** The proposed actions are expected to strengthen fiscal discipline and the transparency and credibility of monetary policy. The outcomes will be measured by: (i) reduction of the BoM’s net financing of the HMP; and (ii) BoM’s outstanding loans to the PSP and corporate bond holdings. The PSP loans will be fully withdrawn in 2017. The outstanding corporate bonds held by the BoM will be contained at the current level (MNT 815 billion) by the target year (2019), as a result of the discontinuation of corporate bond purchases. The outstanding corporate bonds are scheduled to be repaid starting from 2020.

## STRENGTHENING REVENUE MOBILIZATION AND REDUCING TAX BASE EROSION

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>•The Government has raised the personal income tax rates on high income groups and the excise taxes on alcohol and tobacco, with a gradual increase of the minimum income tax threshold to reduce tax burden on lower income groups.</li> </ul>	<ul style="list-style-type: none"> <li>•The Government has submitted amendments to tax laws and regulations to reduce tax exemptions and incentives, based on a cost-benefit analysis of individual tax incentive and exemption programs.</li> </ul>	<ul style="list-style-type: none"> <li>•The Government has submitted amendments to tax laws and regulations to align the tax regime with agreed international tax standards such as transfer pricing regulations, interest deductibility, treaty issues and BEPS related actions, and to introduce a General Anti-Avoidance Rule.</li> </ul>	<ul style="list-style-type: none"> <li>•WB staff analysis (2016)</li> <li>•WB Mongolia Public Expenditure Review (forthcoming)</li> </ul>

43. **Rationale.** The tax reform measures supported by this DPF aim to contribute to fiscal consolidation by mobilizing additional revenues and expanding the tax base. Revenue collection has fallen steeply in recent years from 34 percent of GDP in 2011 to 23.7 percent of GDP in 2016, underscoring the importance of revenue mobilization for successful fiscal adjustment. The Government’s fiscal consolidation plan includes various revenue mobilization measures, including excises and duties on petroleum, personal income tax (PIT), withholding tax on interest income, and excise taxes on tobacco and alcohol, drawing on the recommendations of the World Bank staff analysis delivered in November 2016 at the Government’s request. This DPF will support selective revenue mobilization measures that were identified as key tax reform tasks by the World Bank staff analysis (2016) report—introducing a more progressive PIT tax system and imposing higher taxes on alcohol and tobacco in the first year of operation, which will be followed by administrative reform measures in subsequent years that focus on expanding the tax base and reducing the sources of tax erosion.

44. **Prior Action.** The prior action aims to support revenue mobilization through a more progressive PIT system and higher excise tax on alcohol and tobacco. Mongolia’s current flat 10 percent PIT rate is the lowest level in the world—compared both with the countries with a flat rate system and with a progressive rate system. The GDP share of PIT revenue (2.1 percent) is also low by international standards: 5 percent (world), 3.7 percent (EAP), and 2.7 percent (Lower Middle Income Countries) in 2014. Against this backdrop, the Government decided to introduce a progressive PIT system, by raising marginal tax rates on higher income groups. The PIT tax reform will not only raise more revenues, but also improve the

equity of the PIT system. To this end, the DPF also supports a compensatory measure to mitigate tax burden on lower income groups by gradually raising the minimum income tax threshold that is currently below the minimum wage level. This action also supports higher excise taxes on alcohol and tobacco, considering the positive externalities on citizens' health as well as its expected revenue contribution. With the support of the prior action, the Government revised the PIT Law and the Excise Tax Law in April. The new PIT scheme, starting in 2018, will raise marginal tax rates from the current flat 10 percent to: 15 percent for annual income above MNT 18 million; 20 percent for above MNT 30 million; 25 percent for above 42 million. In parallel, the new PIT scheme will increase the minimum annual income tax threshold from the current MNT 840,000 towards the minimum wage, to reduce tax burden on the poorer income group. Workers who face higher marginal tax rate account for around 30 percent of the total PIT tax base, while they account for only around 6 percent of the total number of workers. In addition, the Government eliminated the threshold on interest income tax. Currently, as only taxable deposits are those larger than MNT 100 million with a term of less than 12 months, foregone interest tax is estimated to be over 0.2 percent of GDP. The Government also switched income tax on small businesses from a very small fixed rate tax to a 10 percent ad-valorem tax. The total revenue from PIT reform measures is expected to yield an additional 0.4 percent of GDP in 2017-19. The revised Excise Tax Law will increase excise taxes on alcohol and tobacco by 10 percent in 2018, followed by a further increase in 2019-20. Excise tax was also raised on petroleum products and old and large-engine vehicles starting from May 2017. In addition, the Government will also gradually increase social security contribution in 2018-20. The total revenue contribution from entire tax reform measures is expected to reach over 2 percent of GDP by 2019.

45. **Year 2 Trigger.** In the second year, this DPF will contribute to fiscal consolidation by reducing tax expenditure that has been a significant source of tax base erosion in Mongolia, reaching about 12.4 percent of total revenues. The main driver of revenue losses are exemptions and tax holidays. According to the 2016 preliminary estimates, VAT exemptions and incentives accounted for 47.7 percent of total tax expenditure, followed by the tax expenditure on excise tax (20.5 percent), PIT (15.6 percent), Economic Entity Income Tax Law (9 percent), and Customs and duties (7.2 percent). Mongolia, however, currently lacks proper assessment on individual tax exemptions and incentives, which is critical in rationalizing tax expenditure programs based on a cost-benefit analysis. Against this backdrop, this trigger aims to reduce ineffective tax incentives and exemptions, following a proper evaluation of the existing tax expenditure system in terms of costs and benefits. The Bank will provide technical assistance in evaluating the cost and benefit of the current tax expenditure programs. In addition, the IMF plans to provide technical support to the preparation of a compliance improvement strategy and tax administration through its EFF program.

46. **Year 3 Trigger.** The third-year operation focuses on reducing tax avoidance by improving regulations on related party transactions and adopting General Anti-Avoidance Rule (GAAR), with particularly focus on transfer pricing and other tax planning instruments covered by the Base Erosion and Profit Shifting (BEPS) project.

47. **Expected Outcome.** The tax reforms supported by the DPO are expected to contribute to fiscal consolidation by mobilizing more revenue and expanding the tax base. The outcomes will be measured by: (i) an increase in aggregate revenue collection from PIT and excise taxes on alcohol and tobacco by 0.4 percent of GDP; (ii) reduction in tax revenues forgone by tax expenditure by at least 10 percent; and (iii) the introduction of GAAR into tax legislation.

## SUPPORTING CAPITAL EXPENDITURE ADJUSTMENT

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>•The Government has terminated the Promissory Note Program, to prevent using deferred payments to finance capital expenditure.</li> </ul>	<ul style="list-style-type: none"> <li>•The Public Investment Rationalization Guideline has been approved by the Cabinet to reduce the cost for on-going investment projects in the budget.</li> </ul>	<ul style="list-style-type: none"> <li>•The Integrated Budget Law is amended to better align public investment budget with strategic priorities and a hard budget constraint, through: (a) publishing in the Medium Term Fiscal Framework estimates of sustainable investment spending; (b) publishing project appraisal and selection criteria; (c) requiring an adequate funding for maintenance.</li> </ul>	<ul style="list-style-type: none"> <li>•WB staff analysis (2016)</li> <li>•IMF PIMA Report (forthcoming)</li> </ul>

48. **Rationale.** Mongolia’s public investment budget sharply rose from 6 percent of GDP in 2015 to 9.6 percent of GDP in 2016—a level almost twice as high as the average of lower middle income countries. Underscoring the importance of reducing capital expenditure to a sustainable level, the World Bank staff analysis (2016) urged the following options for capital expenditure adjustment: (i) immediately terminate the Promissory Note Program which caused a sharp increase in capital expenditure in 2016; and (ii) reduce the cost for existing domestically-financed projects by identifying and restructuring the underperforming projects based on objective rationalization criteria and procedures. The current fiscal adjustment plan of the Government, largely incorporating the recommendations of the report, aims to reduce capital expenditure to around 6 percent of GDP by 2019, which requires an adjustment equivalent to around 3.5 percent of GDP from the 2016 level—with major adjustment on the Promissory Notes Program and domestically-financed investment projects. Meanwhile, the Government plans to prioritize the projects financed by multilateral and bilateral partners—which will benefit from concessional financing, stronger project preparation process, and technical assistance. Under the hard investment budget constraint set by the Medium Term Fiscal Framework, an increase in foreign-funded investment will be offset by corresponding reduction in domestically-financed investment.

49. **Prior Action.** The proposed action will contribute to the immediate fiscal adjustment in 2017 by terminating Promissory Notes Program (PNP) which alone increased capital expenditure by 2.8 percent of GDP in 2016. The PNP has been used as a vehicle through which investment projects were implemented without proper budget appropriation, by issuing promissory notes in lieu of cash payments. Under the cash-basis accounting, this scheme allowed the Government and parliament to implement more investment projects than allowed by the budget envelope, as projects funded by promissory notes were not recorded as budget expenditure until cash payments are made. With outstanding promissory notes amounting to MNT 657 billion at the end of 2016, the new Government decided to clear all outstanding promissory notes, which resulted in a sharp increase in capital expenditure in 2016. The prior action will not only stop the Promissory Notes Program in 2017, but will also ensure that promissory notes are not used for capital expenditure again.

50. **Year 2 Trigger** will focus on reducing the cost of existing investment projects for the budget, based on objective criteria and procedures of the Public Investment Rationalization Guideline. The rationalization will be mainly focused on the investment portfolio that has been subject to poor project preparation and implementation in recent years. The draft Guideline, which was recently developed with the World Bank’s technical assistance, includes basic methodologies and criteria to identify underperforming projects and procedures for rationalizing/prioritizing the underperforming investment projects. The Guideline is expected to be applied for the preparation of the public investment budget of at least the three largest ministries that are selected based on the aggregate size and/or the number of investment projects.

51. **Year 3 Trigger** aims to improve the selection of new projects to better align public investment budget with strategic priorities and a hard budget constraint. This measure builds on the recent Public Investment Management Assessment Report jointly prepared by the IMF and the Bank. The Integrated Budget Law is expected to be amended to: (i) publish in the Medium Term Fiscal Framework estimates of sustainable medium term public investment spending; (b) require all projects, regardless of funding source, to be properly appraised prior to the budget and approved through the budget process; (c) publish project selection criteria for investment projects consistent with planning guidelines issued by the public investment authorities; and (d) require an adequate maintenance budget.

52. **Expected Outcome.** The outcome of the prior action will be measured by the removal of the capital expenditure for promissory notes in 2017-19. Another results indicator supports the improved efficiency of investment budget as a result of the second-year trigger, by restructuring or removing more than 10 percent of the outstanding value needed to complete the on-going public investment projects in 2018-19 based on the Rationalization Guideline. The proposed measures supported by the DPF are expected to adjust overall capital expenditure from 9.6 percent of GDP in 2016 to around 6 percent of GDP in 2019.

**PILLAR II. STRENGTHENING THE SOCIAL PROTECTION SYSTEM**

**SAFEGUARDING THE PROTECTION OF THE POOR**

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>•The Government has maintained budget allocation for the poverty-targeted Food Stamp Program, in the 2017 Supplementary budget, excluding administrative costs, at least at the level of the 2017 original budget.</li> </ul>	<ul style="list-style-type: none"> <li>•The Government has increased the budget provisions for the poverty-targeted Food Stamp Program, in line with MTFE allocations.</li> </ul>	<ul style="list-style-type: none"> <li>•The Government has allocated budget to a poverty-targeted cash benefit program designed using the PMT-based Integrated Household Database.</li> </ul>	<ul style="list-style-type: none"> <li>•WB, Review of program design and beneficiary profiles of social welfare programs in Mongolia (2015)</li> <li>•WB staff analysis (2016)</li> </ul>

53. **Rationale.** Ensuring adequate protection of the poor is vital in maintaining economic and social stability during periods of fiscal adjustment, particularly in light of the recent deterioration of poverty conditions. This DPF will focus on expanding expenditure on social welfare programs and targeting

benefits to poor using the proxy means test (PMT) methodology, such as the Food Stamps Program (FSP).<sup>7</sup> The FSP is currently a relatively small, but important program that provides crucial nutrition assistance to the poorest households, at a cost of 0.1 percent of GDP in 2016. The Government is committed to further strengthen protection of the households below the poverty line by improving the coverage and benefits of pro-poor programs. A World Bank report found that in 2012, average transfers received by the poorest 20 percent of households amounted to only 12 percent of household consumption for a five-member household at the poverty line. Even after a long-delayed increase in 2015, the coverage and benefit size of the FSP remains inadequate—covering less than 5 percent of households and its benefits amounting to less than 5 percent of the household poverty line for a family of five. The Government is committed to significantly expand the FSP from 2018 onwards both in terms of coverage and benefit size by reprioritizing the social welfare budget. Subsequent operations of this DPF will ensure that (i) the Food Stamp Program expands further to make the social protection system much more pro-poor, and (ii) budget is allocated to a poverty-targeted cash benefit program, designed using a PMT methodology such as the Poverty Benefit Program (PBP). The PBP was planned under the Social Welfare Law of 2012, but has not been implemented. It complements the FSP by providing a cash benefit to the poorest households identified through the PMT-based Integrated Household Database.

54. **Prior Action.** The first year of operation will focus on maintaining the budget allocation to the Food Stamp Program, in the 2017 supplementary Budget at least at the level of the 2017 original budget.

55. **Year 2 Trigger** will support the increased budget allocation for the Food Stamp Program to expand its coverage and benefit level, starting with the second supplementary budget for 2017, and submitted budget for 2018, in line with MTFE allocations. The expected growth turnaround and improved external environment will provide the resources needed to scale-up the Food Stamp Program. The planned increase in the Food Stamp Program budget will allow for both expanded coverage and increase in benefit size per household in 2018. Year 2 Trigger will support the implementation of the increase of the FSP coverage and benefit size.

56. **Year 3 Trigger** will ensure that the Government improves the targeting of the social welfare system by allocating budget to and implementing a poverty-targeted cash benefit program, designed using the PMT-based Integrated Household Database. Other donor partners are working with the Government to support rationalization of the social welfare spending to help free up resources for poverty-targeted programs. By the end of the program, the combined budget allocation for both the Food Stamp Program and poverty-targeted cash benefit programs designed using the PMT-based Integrated Household Database, will have expanded by at least 340 percent compared to baseline (2016). The Bank will continue to provide technical and analytic support to the improvement of the efficiency of social welfare system through the new Strengthening Fiscal and Financial Stability Project (SFFSP).

57. **Expected Outcome.** The proposed set of actions are expected to lead to a better protection of the poor during fiscal adjustment, and improve the allocative efficiency of the social welfare budget. While the coverage and benefit size per beneficiary of the Food Stamp Program are expected to significantly increase, the nutritional assistance of the FSP will be complemented by a poverty-targeted cash benefit

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<sup>7</sup> The largest of the social welfare transfers, the Child Money Program (CMP), has been, at times, universal and more recently targeted to the poorest 60 percent of households. Prior to the second round of voting in the presidential elections in 2017, the Government pledged to make the CMP universal, retroactive to the beginning of the year. From 2018, however, the CMP will return to a targeted program available only to the poorest 60 percent of households based on the PMT, as called for in the Government's agreements with other development partners, and as reflected in the 2018 draft budget.

program designed using a PMT methodology.

## ENHANCING THE FINANCIAL SUSTAINABILITY OF THE PENSION SYSTEM

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>•The Government has amended the Social Insurance Law and the Pensions and Benefits Paid from Social Insurance Funds Law to gradually increase the pension insurance contribution rate and the retirement age.</li> </ul>	<ul style="list-style-type: none"> <li>•A comprehensive reform package to the Pension Insurance Scheme is submitted to the Parliament, to maintain the financial sustainability of the pension system.</li> </ul>	<ul style="list-style-type: none"> <li>•The Government has adopted administrative regulations and procedures needed for the implementation of the comprehensive pension reform.</li> </ul>	<ul style="list-style-type: none"> <li>•WB, "Mongolia: Policy Options for Pension Reform", (January 2012)</li> <li>•WB, PROST Projections, (mimeo) 2017</li> </ul>

58. **Rationale.** The proposed set of actions aim to contribute to the immediate fiscal adjustment in the near term, and strengthen the adequacy and sustainability of the pension system in the medium and long term. The fiscal cost of social insurance has been increasing in recent years, reaching 2 percent of GDP in 2016. Measures adopted in 2012 substantially increased the benefit size and the number of workers qualified for benefits. Additional measures adopted in February 2017 will further increase the fiscal burden and create considerable inequity in the Pension Insurance System. These include: (i) the reduction in the retirement age for herders by 5 years; (ii) calculating each year of herders' contributory service as 1.5 years instead of one year; and (iii) introducing a second service "buyback" option for herders and the self-employed. Under the current pension scheme, the state subsidy to the pension fund is projected to increase to around 6 percent of GDP by 2030 and almost 11 percent of GDP by 2050. Against this backdrop, this DPF will support a two-phased pension reform plan of the Government through: (i) an increase in contribution rate and retirement age in the first year; and (ii) a more comprehensive reform of the pension system in subsequent years.

59. **Prior Action.** The proposed action aims to initiate pension reform with a gradual increase in the pension insurance contribution rate from 14 percent to 19 percent, and the retirement age from 60 to 65 for men and from 55 to 65 for women. This will be followed by a more comprehensive pension reform based on the Pension Reform Option Simulation Toolkit (PROST) model analysis supported by the Bank. The pace of the increase in the retirement age and the contribution rate will be sufficiently gradual to prevent labor market or retirement shocks. The Law on Social Insurance and the Law on Pensions and Benefits Paid from Social Insurance Funds will be amended to incorporate the gradual increase into the two parameters. While the primary goal of the proposed parametric reform is to improve the long-term sustainability of the pension system, the increase in the pension insurance contribution rate would also substantially contribute to the immediate fiscal adjustment, by raising social security contribution revenue by up to 0.6 percent of GDP in 2017-19. The Bank has been providing technical support to the preparation of pension reform of the Government, including the preparation of "State Policy on Pension Reform" White Paper approved by Parliament in 2015 through the Multi-Sectoral Technical Assistance Project. The Bank will continue to provide technical and analytic support to prepare the pension reform plan through the new SFFSP (Strengthening Fiscal and Financial Stability Project).

60. **Year 2 Trigger.** This proposed trigger aims to expand the scope of the parametric reforms beyond the pension insurance contribution rate and retirement age. While changes to these two parameters are the most important changes, further reforms will be needed to improve the pension scheme finances, equity and credibility, such as: (i) adopting automatic inflation-based indexation instead of the current discretionary indexation; (ii) increasing the length of the wage base used to determine benefits and indexing or “valorizing” it; and (iii) adjusting the accrual rate for benefits accrued after the reform is enacted. Long-term actuarial projections using PROST will be used to quantify the impact on the required State Subsidy and the impact on benefits as well. The authorities will weigh the tradeoffs between the adequacy and sustainability between different reform parameters to come up with a robust program of reforms to achieve the targeted fiscal objective.

61. **Year 3 Trigger.** The third-year operation seeks to ensure that the reforms adopted by the first and second operations are properly implemented through necessary regulations and measures, including the issuance of administrative regulations and guidelines by the Ministry of Labor and Social Protection and the Health and Social Insurance General Office.

62. **Expected Outcome.** The proposed pension reform will not only improve the adequacy and sustainability of the pension system by reducing the future fiscal burden and ensuring the affordability of pension promises, but also contribute to the immediate fiscal adjustment by raising social security contribution revenue by up to 0.6 percent of GDP in 2017-19. The direct outcome of the pension reform, however, will be focused on the reduction in the projected state budget’s financial support to the Pension Insurance Fund in 2030, based on the PROST model analysis supported by the Bank, from 6 percent of GDP under the current scheme to 2 percent of GDP after the proposed pension reform.

**PILLAR III. ENHANCING COMPETITIVENESS**

**ENHANCING THE INVESTMENT AND BUSINESS ENVIRONMENT**

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>•The Government has established the Investor Protection Council (IPC) , aimed at fostering the timely and systematic resolution of investor grievances.</li> </ul>	<ul style="list-style-type: none"> <li>•The Government has submitted a revised Permit Law to Parliament, listing all licenses and permits granted by public administrations and reducing their number.</li> </ul>	<ul style="list-style-type: none"> <li>•The Cabinet has approved a National Competition Policy, embedding competition principles across sectors and improving regulations to level the playing field between public and private operators.</li> </ul>	<ul style="list-style-type: none"> <li>•WB, "Investor Protection in Mongolia" (2016)</li> <li>•WB staff analysis (2016)</li> <li>•WB, "Mongolia: towards a more effective competition policy framework" (2013)</li> </ul>

63. **Rationale.** Improving the investment and business environment is paramount to revitalizing foreign and domestic investments and creating jobs, which would eventually help put Mongolia back on a stable growth path. However, lack of proper investor protection mechanism and stable and transparent regulatory environment have undermined the confidence of investors and businesses in Mongolia.

Inadequate investor protection particularly has been viewed as one of the biggest constraints to attracting foreign investors, contributing to a sharp collapse in foreign investment since 2014. In an IFC survey conducted in 2013-14 amongst 70 entities, 81 percent of the companies indicated that at least a portion of their investment was at risk of being lost due to grievances, and that a continuation of grievances and lack of resolution would put at risk the feasibility of future investment plans. Lack of proper investment protection mechanism also resulted in large dispute settlement payments. In 2016, for example, Mongolia paid MNT 143 billion for dispute settlement to a large foreign company, following the decision of the UN international arbitration tribunal. Investor confidence has also been eroded by a weak regulatory environment from: (i) uneven access to regulatory information, licenses or finance; (ii) frequent changes in laws and regulations; (iii) sectoral issues such as access to land for agricultural investments.<sup>8</sup> The effectively uneven treatment of companies affects competition and generates barriers to entry to newcomers. In addition, the lack of regulatory transparency and frequent changes increase the costs of doing business as well as overall uncertainty for both existing and new investors (and particularly those considering new sectors), negatively affecting their investment decisions. Jointly with sectoral issues, the current environment reduces the dynamics of the Mongolian economy and limits competition with additional second-round effects for companies that use high-costs inputs.

64. **Prior Action.** The first-year operation will focus on strengthening investor protection mechanism, an urgent task in the wake of a sharp deterioration of investor confidence in recent years. The prior action will support the Government to establish an Investor Protection Council (IPC) at the Cabinet Secretariat. The IPC will become operational by defining its membership and mandate through bylaws. Once the operational structure is defined, the IPC—which reports directly to the Prime Minister—will coordinate the responses to investor grievances from ministries/agencies and the different levels of Government, with an objective to resolve the grievance in an early stage and avoid escalating to full-fledged disputes. The Government will complement the high-level IPC with a support mechanism to systematically detect and resolve investor grievances—the Systematic Investor Response Mechanism (SIRM), supported by the Bank’s technical assistance. The SIRM, of which the IPC forms an integral part, is expected to address issues arising both at the individual firm level on a case-by-case basis and at a systemic level, and will permit better tracking and coordination by the public sector at the central/local level.

65. **Year 2 Trigger.** The second-year structural reform will be focused on the reform to permits and licenses to reduce the administrative burden on businesses. The Government will submit a draft permit law to Parliament—an umbrella law to clarify in a comprehensive manner all the licenses granted by public administrations (e.g. business and trade). As a result, the number of permits is expected to be reduced based on the criteria of legality, necessity and business friendliness, and will also consider the significance in environmental and social impacts.

66. **Year 3 Trigger.** In the third year, the Government will enhance the effectiveness of Competition Policy in Mongolia by developing the tools to embed competition principles across sectors and regulatory authorities in order to level the playing field between private and public operators. The AFCCP (Authority for Fair Competition and Consumer Protection) is expected to identify and remove key anticompetitive interventions of governmental bodies to level the playing field and prevent grievances. Building on the prohibition of anticompetitive actions by public bodies established by Article 13 of the Competition law, this effort could identify and suppress the rules that: (i) reinforce dominance or limit entry—e.g., absolute entry restrictions, incumbents involvement in entry decision; (ii) facilitate collusive outcomes—e.g.,

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<sup>8</sup> According to the Bank’s Worldwide Governance Indicators, regulatory quality remains low (below the mid-point) and has not improved since the early 2000s, while the indicators for the rule of law and for corruption have significantly decreased.

regulations facilitating price fixing through self/co regulation or information exchange; (iii) discriminate and protect vested interests—e.g., explicit discriminatory rules without justification, selective subsidies and incentives which distort the level playing field, explicit lack of competitive neutrality.

67. **Expected Outcome.** The proposed measures are expected to contribute to improving investor sentiment through stronger investor protection mechanism, reducing administrative burden to businesses through streamlined permit requirements, and providing a level ground for private businesses through improved competition policy. The outcomes of the actions will be measured by the share of investment grievances received by the IPC that are successfully treated, and reduction in the number of licenses and permits as a result of the Permit Law.

## IMPROVING THE COMPETITIVENESS OF LIVESTOCK PRODUCTS

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>The Government has submitted a draft legislation on animal health to the Parliament, proposing the adoption of an animal health legal framework which is consistent with international standards as these are set forth by the World Organization for Animal Health.</li> </ul>	<ul style="list-style-type: none"> <li>A package of 13 regulations, ordinances or guidelines are approved to operationalize the Animal Health Law, including the modalities of: (i) animal disease free zone establishment, (ii) international quarantine procedures, (iii) major trans-boundary animal diseases control strategic plans, and (iv) herders' obligations.</li> </ul>	<ul style="list-style-type: none"> <li>The Government has organized training in the 21 Aimags and 331 Soums, targeting 3,000 public and private veterinary professionals and 10,000 herders, to secure public awareness and knowledge about the new Animal Health Law and its regulations.</li> </ul>	<ul style="list-style-type: none"> <li>WB, Mongolia's Red Meat Value Chain (2017)</li> <li>WB, Mongolia Agriculture Productivity and Marketing Study (2015)</li> <li>WB, Agricultural Public Expenditure Review (2015)</li> </ul>

68. **Rationale.** This set of proposed actions aims to support the competitiveness of meat exports, one of the non-mineral products with significant potential, by addressing its key constraint—animal health. An important priority for the Government—as described in their Government Action Plan 2016-2020—is to diversify their export capacity to non-mining products and goods. Agriculture, accounting for 34 percent of total employment, remains the key job creation sector, of which around 85 percent is contributed by the livestock sector. Meat and milk are the primary products of agriculture, contributing 61 percent of livestock output and 7 percent of GDP. Meat is already one of the main non-mineral export products and has a significant potential to contribute to diversifying the country's export basket. A recent World Bank report highlights the emergence and rapid growth of new markets for the red meat sector. China and Vietnam, for instance, have seen their imports of red meat increase from almost zero in 2010 to over US\$3 billion and US\$1 billion in 2015 respectively. Similarly, Egypt has increased continuously its import of red meat from less than US\$500 million in 2010 to over US\$1.5 billion in 2015. It is worth noting that it is not only the "traditional" exporters (USA, Australia, Brazil) that have responded to this new demand. New middle-income countries have been able to capture the increasing demand from these new markets—for example: Uruguay absorbs about 20 percent of the Chinese demand for red meat, mainly by controlling transboundary animal diseases and ensuring full identification and traceability of its livestock. These new markets show strong interest for Mongolian livestock products as they are perceived as being produced

in an "organic" and environmentally sustainable way. However, regular occurrence of outbreaks of major contagious animal diseases have prevented Mongolia from securing access to those opportunities. The latest example was the recent outbreak of *Peste des Petits Ruminants* (PPR: small ruminants plague) in Khvod Aimag that led to China's ban on meat imports from Mongolia. Improving animal diseases surveillance and control, ensuring the compliance with the sanitary standards of trade partners are therefore urgent tasks to stabilize and expand access to export markets. Mongolia has a public and private veterinary service, both of which however are in need of significant improvement. Veterinary and Animal Breeding Units (VABUs)—with one veterinarian in each unit—were established at the *soum* level in 2011, to provide professional and technical services. However, VABU's capacity to deliver services to local communities has been undermined by lack of budget allocated by the *soum* governor's office, and the use of VABU staff for other activities. On the other hand, private veterinary services, including publicly-funded vaccination against contagious diseases, have been facing challenges from low profitability and difficulty in attracting new veterinarians in rural areas.

69. **Prior Action.** The proposed action aims to address the most critical constraint to Mongolia's livestock exports—lack of animal health management system to control disease outbreaks—by adopting the new Animal Health Law. The new law will improve the system to monitor animal health and control diseases in Mongolia, bringing it closer to international requirements of the World Organization for Animal Health (OIE). The law will also clarify the roles of the Government and the private sector in animal health management. Key features of the law will include: (i) improving the system of vaccination, surveillance, and emergency responses and isolation; (ii) strengthening veterinary services at the local *soum* level—e.g., through central funding instead of funding by local authorities; (iii) organizing the management of disease-free zones. This action builds on the recent Bank report on agricultural productivity and the report underscored: "this type of consistency with international standards and the requirements of the OIE is fundamental to achieving the internationally recognized animal health status needed to ensure access to livestock and livestock product markets".

70. **Year 2 Trigger.** The second year of operation will be focused on preparing and adopting subsequent regulations, ordinances and guidelines that are necessary to enforce the new animal health management framework, using a consultative and participatory approach. The subsequent regulations will define the modalities, terms and conditions for: (i) animal disease free zone establishment, (ii) international quarantine procedures, (iii) major trans-boundary animal diseases control strategic plans, and (iv) herders' obligations under the new Animal Health Law.

71. **Year 3 Trigger.** In the third year, the Ministry of Food, Agriculture and Light Industry (MoFALI) will enhance the public awareness and knowledge about the new legal and regulatory framework for animal health management, and ensure its full dissemination by organizing a series of training and capacity building events targeting all aimags (21) and soums (331). Guidelines will be developed in 2018, as training material to reach out a total of 13,000 beneficiaries, including 3,000 veterinary professionals (public from VABU and private) and 10,000 herding households.

72. **Expected Outcome.** The adoption and dissemination of the legal framework for animal health will contribute to strengthening the veterinary services, better controlling and reducing the number of disease outbreaks, and eventually facilitating livestock exports. The outcomes will be measured by: (i) the eradication of the PPR in the western region including Khovd, Bayanulgi, Gobi-Altai, Uvs and Zavkhan aimags; and (ii) an increase of the number of small ruminants vaccinated against PPR in the five Aimags.

## FACILITATING TRADE AND IMPROVING BORDER CLEARANCE PROCESS

Prior Action	Year 2 Trigger	Year 3 Trigger	Analytical Underpinnings
<ul style="list-style-type: none"> <li>•The Parliament has ratified the WTO Trade Facilitation Agreement (TFA).</li> </ul>	<ul style="list-style-type: none"> <li>•The Government has adopted the institutional framework for the TFA implementation, including: (i) a time-bound action plan for its full implementation; (ii) the establishment of an inter-agency coordination mechanism for the TFA; and (iii) a complete repository of all import and export regulations and procedures to increase transparency and reduce arbitrary application.</li> </ul>	<ul style="list-style-type: none"> <li>•Customs and other border agencies have improved coordination and streamlined clearance procedures, including data sharing, joint inspections and improved risk management, to be in line with the WTO TFA commitments and best practices.</li> </ul>	<ul style="list-style-type: none"> <li>•WB staff analysis (2016)</li> <li>•WB, Doing Business 2016 Report</li> <li>•OECD, Trade Facilitation Indicators – Mongolia</li> <li>•UN, Trade Facilitation in Selected Landlocked Countries in Asia (2007)</li> </ul>

73. **Rationale.** The proposed set of actions supports Mongolia in comprehensively addressing its trade facilitation challenges in line with Mongolia’s international commitments under the Trade Facilitation Agreement (TFA). Trade facilitation reform and modernization boosts trade by reducing costs and delays, improving transparency and predictability, and ensuring a greater degree of uniformity in customs and other border management procedures. The potential benefits from trade facilitation reforms for Mongolia and the trading community are significant as Mongolia’s facilitation performance remains poor with high trade costs, long delays, and a generally complex and opaque trade environment lowering trade competitiveness and the export potential. Addressing these issues will be critical and complement efforts to improve the business environment in order to attract new investment from new and existing companies. Reducing unnecessary trade-related costs and delays that increase the overall cost of intermediate inputs for all production will directly increase competitiveness, but these reforms will particularly benefit companies that are selling goods abroad and are therefore affected twice by high trade costs. Trade Facilitation reforms will also contribute to strengthening competition in the economy, which currently remains limited in key sectors. Mongolia is ranked 108th out of 160 countries in the World Bank’s 2016 Logistics Performance Indicators, 100th in the important areas of customs and border management, and only 103rd in the Trading Across Borders component of the Doing Business survey. In order to make improvements, Mongolia needs to reduce physical inspections of cargos at the borders, by implementing risk based approaches and increasing the use of ICT for information sharing, developing more competitive infrastructure at the borders, and improving its services and tracking systems. The Government now is committed to addressing trade facilitation challenges and is working towards fully implementing the WTO Trade Facilitation Agreement (TFA).<sup>9</sup> The Bank will provide technical assistance to

<sup>9</sup> The TFA was adopted by WTO members in end-2013, and entered into force in February 2017. Implementation of its provisions is mandatory for all WTO Members and it contains a set of globally agreed measures to facilitate the movement, release and clearance of goods, including goods in transit. The OECD estimates that full implementation of the TFA will result in a reduction

the Government in these areas. Against this backdrop, the first operation of the DPF supports ratification of the TFA as the prior action, which will send a strong signal to the trading community. Subsequent triggers will ensure proper implementation of the TFA, by supporting the Government to fulfill the priority commitments of the TFA and to successfully implement the complex reform program of the border clearance process and management, requiring a high degree of inter-agency cooperation and coordination.

74. **Prior Action.** This prior action will support the ratification of the WTO TFA, which will demonstrate Mongolia's commitment to deeper trade facilitation reforms, set the frame for their reform agenda, and allow the Government to access the technical assistance needed to implement the provisions of the Agreement. The WTO TFA was ratified by Parliament in November, 2016.

75. **Year 2 Trigger.** The Government, with the support of the Bank's TA, will adopt an appropriate institutional framework for TFA implementation to prompt effective coordination across Government's agencies and start implementing priority commitments—including the establishment of a complete on-line repository (a national Trade Information Portal) of all import and export regulations and procedures to increase transparency and reduce their arbitrary application, in line with Article 1 of the TFA. The establishment of the National Trade Facilitation Committee as a coordination mechanism will respond to commitments under Article 13.2. Approving a time-bound action plan for TFA implementation will enable the Committee to closely monitor implementation progress.

76. **Year 3 Trigger.** In the third year of operation, this DPF aims to implement more complex trade facilitation reforms to border management. These reforms will include: (i) improving coordination and eliminating duplication of activities among customs and other border agencies; (ii) improving border inspection processes by implementing a fully integrated risk management approach to better target high risk consignments for physical inspection of cargos; and (iii) reducing the time needed for physical inspections and testing of low risk cargo.

77. **Expected Outcome.** Implementation of the TFA is expected to contribute to export facilitation and private sector expansion by reducing trade transaction costs, improving transparency and predictability, and lowering processing and clearance time for imports, exports and transit goods. As trade performance is determined by a number of external factors beyond the control of the Government, the outcomes of the proposed actions will be measured by quantitative indicators associated with the priority commitments of the TFA, including: (i) reduction in the average customs clearance time; and (ii) reduction in the proportion of shipments undergoing physical inspection and testing at customs.

### 4.3 IMPLEMENTATION STATUS OF PRIOR ACTIONS

78. **All of the nine proposed prior actions of this DPF have been completed (Table 4).**

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in trade costs of between 13 – 15% for developing and middle income countries, and that for every one-percent reduction in global trade costs, global incomes will increase by up to US\$40 billion.

**Table 4. Implementation Status of Prior Actions**

Proposed Prior Actions	Status	Expected Outcome
<b>PILLAR I: RESTORING DEBT SUSTAINABILITY</b>		
#1. The Government has terminated DBM’s financing to capital expenditure through non-commercial loans.	Completed	DBM disengaged from off-budget spending.
#2. The BoM has discontinued net financing to the Housing Mortgage Program.	Completed	BoM’s quasi-fiscal lending is phased out.
#3. The Government has raised the personal income tax rates on high income groups and the excise taxes on alcohol and tobacco, with a gradual increase of the minimum income tax threshold to reduce tax burden on lower income groups.	Completed	Revenue mobilization is strengthened.
#4. The Government has terminated the Promissory Note Program, to prevent using deferred payments to finance capital expenditure.	Completed	Capital expenditure is reduced.
<b>PILLAR II: STRENGTHENING THE SOCIAL PROTECTION SYSTEM</b>		
#5. The Government has maintained budget allocation for the poverty-targeted Food Stamp Program in the 2017 Supplementary budget, excluding administrative costs, at least at the level of the 2017 original budget.	Completed	Protection of the poor is maintained.
#6. The Government has amended the Social Insurance Law and the Pensions and Benefits Paid from Social Insurance Funds Law to gradually increase the pension insurance contribution rate and the retirement age.	Completed	Financial sustainability of pension is improved.
<b>PILLAR III: ENHANCING COMPETITIVENESS</b>		
#7. The Government has established the Investor Protection Council (IPC), aimed at fostering the timely and systematic resolution of investor grievances.	Completed	Investor protection is improved.
#8. The Government has submitted a draft legislation on animal health to the Parliament, proposing the adoption of an animal health legal framework which is consistent with international standards as these are set forth by the World Organization for Animal Health.	Completed	Competitiveness of livestock exports enhanced.
#9. The Parliament has ratified the WTO Trade Facilitation Agreement (TFA).	Completed	Trade environment is improved.

#### 4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

79. **The national consultation processes took place with a wide range of stakeholders, led by the Government.** A consultation meeting with external partners was held on December 2, 2016, with “Partnership for Sustainable Development” as the key theme, attended by the prime minister, cabinet ministers, parliamentarians, including multilateral and bilateral development partners including the World Bank, IMF, ADB. The economic reform program of the Government was introduced, with particular focus on the Economic Recovery Program, and close cooperation and support from donors. The Government has been also carrying out extensive public outreach activities, through numerous participation in media panel discussions, roundtables with academia and business associations, consultation meetings with labor union and civil society organizations.

80. **This operation has been developed in close consultation with key Development Partners.** Close collaboration has been maintained particularly with the IMF, ADB and JICA from the scoping stage of this

operation. Assessments on the macro-economic framework and policy recommendations have been exchanged between the World Bank and the IMF, through the World Bank's regular Mongolia Economic Updates and the IMF's Article IV missions. The Bank and ADB joined a staff-level mission of the IMF and closely coordinated on key reform areas supported by each institution. The proposed policy matrix of the DPF has been regularly shared with the IMF, ADB, and JICA and extensive collaboration has been made between the task team of each institution (See Table 5 for the summary of coordination of reform measures of the Bank, IMF and ADB). The Bank contributed to the design of the IMF's EFF program, especially on the macro-framework, fiscal reform and adjustment measures, social welfare reform, and structural economic reform. The social welfare reform measures of the DPF also build on a close collaboration with the ADB to safeguard the protection of the poor in the fiscal adjustment context by strengthening the PMT-based poverty-targeted social welfare programs.

**Table 5. Summary of Reform Measures Supported by the World Bank, IMF, and ADB**

Objectives	WB EMSO1 (Prior actions and triggers)	IMF EFF (Prior actions and structural benchmarks)	ADB Social/Banking PBLs (Policy actions for disbursement)
<b>Structural fiscal reforms</b>	<ul style="list-style-type: none"> <li>• Stop DBM’s financing to budgetary investment.</li> <li>• External review on DBM commercial loans to ensure its independence and financial viability.</li> </ul>	<ul style="list-style-type: none"> <li>• Revision of relevant laws to adopt Fiscal Council and PAYGO system by November 2017.</li> <li>• Tax administration improved by: (i) adopting compliance strategies for businesses; and (ii) a simplified tax regime for micro/small businesses.</li> <li>• An independent working group submits a report to improve efficiency and equity of taxation.</li> <li>• Revise the General Taxation Law.</li> </ul>	<ul style="list-style-type: none"> <li>• Amend the DBM law to make it a commercially-oriented entity.</li> </ul>
<b>Fiscal adjustment</b>	<ul style="list-style-type: none"> <li>• Adjust capital expenditure by terminating the Promissory Notes Program and rationalizing projects with objective criteria.</li> <li>• Revenue adjustment with a progressive PIT and sin taxes.</li> <li>• Rationalize tax expenditures and reduce tax avoidance through international taxation.</li> </ul>	<ul style="list-style-type: none"> <li>• Approve the 2017 supplementary budget and fiscal adjustment measures needed to achieve program targets.</li> <li>• Passage of a 2018 budget in line with the program’s fiscal path.</li> </ul>	<ul style="list-style-type: none"> <li>• Approval of the Economic Recovery Program.</li> <li>• Approve the 2017 budget and the Fiscal Stability Law.</li> <li>• Eliminate the fiscally unsustainable “Good” Policy Lending Programs.</li> <li>• Establish the Future Heritage Fund and eliminate Human Development Fund.</li> </ul>
<b>Monetary policy and Financial sector reform</b>	<ul style="list-style-type: none"> <li>• Discontinue BoM’s net financing to the Housing Mortgage Program.</li> <li>• Restructure the Housing Mortgage Program and prepare a time-bound exit plan of the BoM.</li> <li>• External review on BoM’s quasi-fiscal activities.</li> <li>• Reflect quasi-fiscal activities of the BoM in the Fiscal Risk Report of the Government.</li> </ul>	<ul style="list-style-type: none"> <li>• Discontinue BoM’s net financing to the Housing Mortgage Program.</li> <li>• Asset Quality Reviews on banks.</li> <li>• Revise the BoM law to strengthen autonomy/governance/operations.</li> <li>• Amend the Banking Law to improve banking supervision and resolution framework.</li> <li>• Amend DICOM law for effective deposit Insurance system.</li> <li>• Adopt an NPL resolution strategy.</li> <li>• BOM reviews related party exposures and improve asset classification and provisioning.</li> </ul>	<ul style="list-style-type: none"> <li>• Prepare a draft law for an Asset Management Company.</li> <li>• A decree issued to outline the steps to rehabilitate the banking sector.</li> <li>• A working group to create a corporate debt restructuring committee.</li> <li>• The Financial Stability Council is further strengthened.</li> <li>• MOU between the MoF and DICOM to support the financing needs of the DICOM.</li> <li>• An MOU with the BoM and DICOM to plan State Bank’s privatization.</li> </ul>
<b>Strengthen the social protection system through better-targeting</b>	<ul style="list-style-type: none"> <li>• Protect the poverty-targeted Food Stamp Program in the 2017 supplementary budget.</li> <li>• Expand through increased budget provisions the coverage and the benefit size of the Food Stamp Program and a poverty-targeted cash benefit program designed using the PMT methodology, in line with MTF allocations.</li> <li>• Comprehensive pension reform adopted and implemented, starting with parametric reforms in 2017.</li> </ul>	<ul style="list-style-type: none"> <li>• The Child Money Program is targeted to the poorest 60% of children from 2018 and the savings gradually redirected toward the better-targeted food stamps program.</li> </ul>	<ul style="list-style-type: none"> <li>• Target the Child Money Program to 60% of children from 2017.</li> <li>• Strengthen needs-based eligibility criteria to: (i) caregiver allowance; (ii) social welfare allowances; (iii) at least one universal welfare program.</li> <li>• Improve the mechanism for social welfare benefits for the elderly and allowance with state merits.</li> <li>• Update Integrated Household Information Database and an action plan developed to consolidate social welfare benefits.</li> </ul>
<b>Structural economic reforms</b>	<ul style="list-style-type: none"> <li>• Improve business environment with Investor Protection Council and streamlining permits/licenses.</li> <li>• Promote the competitiveness of livestock exports.</li> <li>• Facilitate trade by implementing WTO TFA and improving border clearance.</li> </ul>	<ul style="list-style-type: none"> <li>• WB program reflected in the program document.</li> </ul>	<ul style="list-style-type: none"> <li>• WB program reflected in the program document.</li> </ul>

## 4.5 LINK TO CPS AND OTHER BANK OPERATIONS

81. **The key areas of support by the DPF are consistent with key pillars of the current Country Partnership Strategy (CPS) FY13-FY17 for Mongolia, discussed by the Board of Executive Directors on May 17, 2012.** Pillar I of the DPF will support the first pillar of the CPS by supporting fiscal adjustment and restoring fiscal sustainability. The second pillar of the CPS is supported by DPF Pillar III, aiming to promote the competitiveness of the economy. This operation supports the third pillar of the CPS by reforming the social welfare system towards a better poverty-targeted one and improving the sustainability of the pension system expenditure, through Pillar II of the DPF. The proposed reform actions supported by the DPF also draw on the lessons from the Performance and Learning Review for the Country Partnership Strategy 2013-17 which stressed the importance of improving resource revenue management, promoting the non-mining sector's growth potential with a particular focus on agriculture and livestock, and better targeting of social welfare programs. The reform measures supported by this DPF also build on the key policy recommendations provided by the Bank to the incoming Government in August 2016, through *Policy Recommendations on Economic and Social Priorities for Sustainable and Inclusive Growth*. The DPF will be closely supported by the analytic work and technical assistance of the Bank, including: (i) the ongoing Public Expenditure Review; (ii) the Multi-Sectoral TA II project; and (iii) other sectoral 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 TFA implementation.

## OTHER DESIGN AND APPRAISAL ISSUES

### 5.1 POVERTY AND SOCIAL IMPACT

82. **This 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, a more progressive structure for personal income tax, increases in excise taxes, and the restructuring of the Housing Mortgage Program of Pillar I. On Pillar II, the expansion of the food stamp program, changes in social security contributions have potential impacts on poverty. Finally, the PSIA focuses on the distributional impacts of changes to the Animal Health Law in Pillar III because rural areas, and herders in particular, represent a large share of the population, the labor force and the poor.

83. **The combination of a more progressive tariff structure for personal income tax, increases in the excise taxes on alcohol and tobacco, and the expansion of the food stamp program and changes in social security contributions have a pro-poor impact.** The simultaneous implementation of all these reforms is projected to have a progressive impact upon disposable incomes. Changes in disposable income range from around a 10 percent increase for those at the bottom two deciles of the per-capita consumption distribution to a decline of more than 7 percent for those at the top two deciles of the distribution. This simulation exercise only looks at the short-term tax-and-cash-transfer side of the policy reforms.<sup>10</sup>

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<sup>10</sup> The simulations of tax and cash transfers are done following the principles outlined in recent World Bank studies. These studies follow methods developed by N. Lustig (2016) "Commitment to Equity Handbook. A guide to estimating the impact of fiscal policy on Inequality and Poverty" Tulane University, and also from Abramovski, L., and D. Phillips (2012) "A tax micro-simulator for Mexico (MEXTAX) and its application to the 2010 tax reforms", IFS working paper, W15/23). In general, the following procedures were adopted: (i) gross-up disposable income as reported in household survey by deducting the current personal income tax and removing public transfers; (ii) apply new personal income tax, (iii) add new public transfers, and (iv) derive changes in prices of consumption goods due to changes in excise taxes and equal them to changes in disposable income.

Medium and long term aspects of the pension reform, however, are not gauged yet and will depend on the reforms adopted in following years as part of this programmatic operation. In any case, keeping the sustainability of the pension system -one of the main objective of the pension reform- will prevent a reduction of pension claims in the near future which will likely prevent increases in poverty. The progressive, pro-poor short term effects of this PSIA exercise hinge crucially on the changes in the Personal Income tax and the expansion of the Food Stamps program. See Annex 4 for more information on the PSIA assessment on individual policy actions.

84. **The Housing Mortgage Program currently has little impact among the poor.** The largest volume of low interest rate mortgages is concentrated in the areas with a lower share of people living in *gers* and with a lower proportion of the population in poverty. Consequently, policy changes that restructure the program to bring it within the Government's budget but keep the previous mechanisms for allocation of loans would mostly have impacts only on the middle and the top deciles of the distribution, but not among the poor. Going forward, better targeting the mortgage program to those in need (e.g., first time married couples who tend to have lower income, or other means-tested lower-income families) is expected to create positive pro-poor impacts.

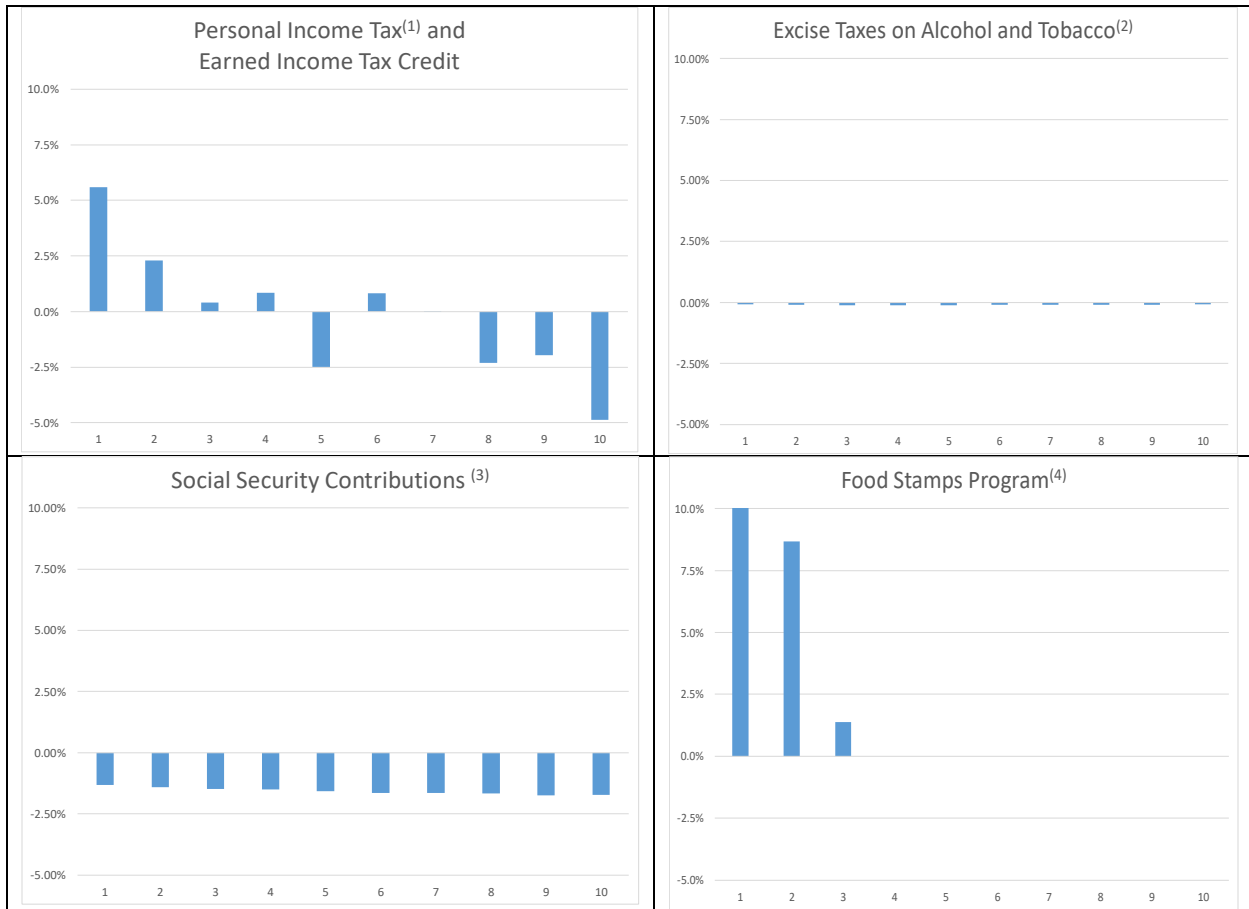
85. **The distributional impact of changes to the Animal Health Law is neutral or positive, depending on its implementation and the characteristics of livestock production.** Assuming a fully subsidized veterinary service to all producers for key public-good animal health services (say, for instance, meat inspection or key strategic vaccination campaigns), and assuming that these public-good services represent a fixed proportion of total cost, then the policy should have a neutral impact. If the economies of scale in the provision of the services by the size of producers are assumed, the subsidized provision would be progressive. Vaccination services represent a larger share of total costs for smaller producers and hence full subsidization would benefit them proportionately more. On the other hand, a fully private provision of animal health-services, would have neutral (or possibly regressive) in the constant-costs (declining-costs) to scale alternatives. A combination of public/private funding of these would have a pro-poor effect, as much as public provision of these services is targeted to the small/poor producers.

86. **The simulation exercises developed in this PSIA project a rise in overall poverty and inequality in 2017 due to sluggish growth, which however will subsequently decline by 2019 on account of growth recovery.** These underlying trends are further compensated by the estimated reform impacts in the tax and transfer system which will protect the incomes for those at the bottom of the distribution, therefore moderately reducing poverty by 2019.<sup>11</sup> Analysis of changes in housing mortgages and veterinary services for agricultural units of production are not included in the projection of overall poverty rates. But the distributional analysis of the previous paragraphs suggests that the impact of these policies would be favorable to families in the lower end of the distribution or, at least, will not affect the welfare of the poor.

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<sup>11</sup> Out Poverty and distributional simulations postulate the following: (i) GDP growth estimates of 2.4 and 1.0 percent for years 2015 and 2016, as well as projected GDP growth rates of -0.2, 1.6 and 8.0 percent for years 2017, 2018 and 2019, respectively (ii) employment growth estimates of 3.6 and -2.3 percent for years 2015 and 2016 (from Mongolia NSO) and projections of employment growth of -1.0, 1.0 and 4.9 percent for years 2017-2019, based on sector-specific employment-growth elasticities derived by authors of this PSIA (iii) unemployment rates of 9.9, 9.6 and 8.1 for the years 2017, 2018 and 2019; (iv) labor earnings growth rates equivalent to labor productivity growth projections implicit in GDP and employment projections, and (v) growth of public transfers of 3 percent a year. We adopt the official poverty line, and assume no changes in its real value over the period of study. These simulations are modelled using the World Bank ADePT macro-simulation module. For a detailed description of the simulation model see Olivieri, Sergio, Sergiy Radyakin, Stanislav Kolenikov, Michael Lokshin, Ambar Narayan, and Carolina Sanchez-Paramo. 2014. Simulating Distributional Impacts of Macro-dynamics: Theory and Practical Applications. Washington DC, World Bank.

**Figure 4. Impact on disposable income from changes in tax and transfer policies (2019 projected)**



Source: Staff calculations using HSES 2014.

Notes: The horizontal axis denotes deciles of family consumption expenditures per capita in the base year (2016 projected). The vertical denotes changes in forecasts of disposable income for the period 2016-2019. No changes in Value Added Taxes are included as prior actions in this DPL.

87. **The proposed operation of the DPF 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. In the area of social protection and tax reform, 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 households in the poorer quintiles were slightly more likely to be female-headed households than in the richer quintiles (23 percent versus 21 percent, respectively)<sup>12</sup> and poverty rates are slightly higher among female-headed households (24.5 versus 21.5 percent for 2014, respectively)<sup>13</sup>. The pension reform actions will gradually unify the minimum retirement age for men and women at age 65, including removing the early retirement option for women with four children. This will partially correct the imbalance that had existed as the retirement age had been earlier for women than men. Notably, the life expectancy of women at age 65 is higher than that of men. However, as the pace of the increase is gradual enough (over 20 years), no significant gender adverse effect is expected in the near future. On the other hand, there is a good chance that many of these women workers will enjoy salaries to age 65

<sup>12</sup> World Bank: Review of Program Design and Beneficiary Profiles of Social Welfare Programs in Mongolia. 2015

<sup>13</sup> World Bank: Mongolia Progress in Reducing Poverty and Boosting Shared Prosperity. June 2016.

and thus have a welfare improvement. Men are several times more likely than women to use both tobacco<sup>14</sup> and alcohol<sup>15</sup>, implying that men would face a higher incidence of the increases in taxes on those substances, and therefore benefit from reduced health risks. To the extent that second-hand smoke and alcohol-related problems (e.g., domestic violence) are reduced due to the increase in these excise taxes, women would also be beneficiaries of these policies.

## 5.2 ENVIRONMENTAL ASPECTS

88. **Overall, environmental policies and institutions in Mongolia provide some, but limited support to the protection and sustainable use of natural resources and management of pollution.** National Green Development Strategy was endorsed by Parliament in 2016, setting an ambitious goal to become among the top 30 countries in green development indicators. Environmental regulations, policies and standards are mostly in place, but implementation and enforcement need to be further improved. Air quality standards are in place, with 35 air quality monitoring stations operating nationwide. The capital city has a special agency that monitors air quality using international Air Quality Index, as air pollution remains the major source of environmental pollution. Regulations and policies on solid waste management are generally in place, but efficiency of garbage collection needs to be further improved. The National Action Plan on Climate Change was approved in 2011 by the Cabinet, followed by the preparation of the draft Strategy on National Climate Change Adaptation and the Public Health Sector Adaptation Strategy. Country Safeguards System Assessment (CSSA) conducted in Mongolia reviews the existing safeguards laws and regulations, agencies and institutions, and their implementation capacity. Mongolia's environmental legal framework is fully consistent with seven (28 percent) of the 25 World Bank Environmental and Social Safeguard objectives, partially consistent with two (8 percent), and not consistent with sixteen (64 percent). Key issues to be addressed include: (i) the need for improved monitoring and authorizing capacity of the environment ministry; (ii) development of a national stakeholder engagement framework; (iii) agreement and approval of laws related to involuntary resettlement; and (iv) identifying benchmarks for energy and the extractives industries.

89. **The specific country policies supported by the proposed operation are not expected to have any significant adverse impact on the country's environment, and other natural resources.** All the actions supported throughout the operation do not support direct investment in environmentally impactful investment or involve policy actions with significant adverse environmental consequences. The implementation of measures to support fiscal adjustment and strengthen fiscal transparency, strengthen the social protection system, and support the competitiveness of the economy pose no risk to the environment. Prior actions 3 and 4 promote better collection of taxes, improve the public budget, financial management and more efficient allocation of public expenditures may have positive environmental impacts through more reliable and predictable financing for the ministries and line agencies in charge of managing natural resources and the environment in the long run. The 2017 budget increased the budget for the Ministry of Environment to MNT 74 billion from MNT 54 billion in 2016, despite reduction in the budget allocation for many other ministries amid pressing fiscal adjustment needs. While the Medium-term Fiscal Framework for 2017-19 does not include sectoral budget projections, it proposed to moderately increase the budget for programs to address air pollution (MNT 11 billion), despite the ongoing fiscal adjustment. Prior action 8 will frame and guide the implementation of the new animal health law, organize training and public awareness activities country-wide to help disseminate the new Law and increase its understanding by veterinary professional and herders. The planned policy adjustments, which

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<sup>14</sup> BCM Public Health: Tobacco smoking in Mongolia: findings of a national knowledge, attitudes and practices study, 2013

<sup>15</sup> WHO: Global status report on alcohol and health, 2014

are aimed at a gradual improvement of Mongolian regulatory systems with international good practice in animal health management, will lead to an increased coverage of vaccination, notably against the disease called PPR (Small Ruminants Plague). The better legislative and policy framework, by making public investments in the livestock and animal health sector more efficient, will have beneficial impacts on the environment and the health of people. Other policy actions supported by the operation have been found to be environmentally neutral.

### 5.3 PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS

90. **Recent PFM and macroeconomic analytical work and nearly 15 years of Bank PFM implementation support to the Government underlie this operation.** A PEFA PFM Performance Report was issued in 2015, followed by a World Bank staff analysis (2016), preparation of this DPF and MSTAP 2, and implementation of MSTAP 1, among others.

91. **A key strength in Mongolia is the modern and comprehensive PFM legal framework.** This includes the General Law on Taxation 2008, Fiscal Stability Law 2010, the Budget Law 2010, the Public Procurement Law 2011, the Law on State Audit 2003 and its key amendments of 2013, the Budget Transparency Law or “Law on Glass Accounts” 2014, the new Law on Debt Management 2015, the Law on Accounting 2016, and the Law on Auditing 2016. Mongolia has gradually developed a PFM system that has many strong features. The first phase of reforms beginning in 2003 strengthened cash management, budget execution, and internal controls. A second phase of reforms starting in 2008 included improvements in fiscal policy, budget planning, and decentralization of roles and resources to sub-national governments. The PEFA PFM Performance Reports (2015) and other analytics note strong tax administration and transparency in taxpayer obligations; a timely and orderly annual budget process supported by a new budget preparation system; a fully functional Treasury Single Account; a partially integrated Government’s Financial Management Information System (GFMIS); uniform chart of accounts supporting most reporting; an accounting standards board; a Treasury debt management office; financial statements prepared on a modified accrual basis with the Government’s audit completed within four months after year-end; and internal audit in all Government’s ministries.

92. **The PEFA PFM Performance Report and other analytics note opportunities for improvement.** Priority needs include: more realistic revenue projections, better predictability in budget execution and visibility in cash flows to line ministries; integration of budget entity financial reporting and government-wide consolidation in GFMIS, modernization of the GFMIS technological platform; completion of the IPSAS implementation; stronger PIM processes and controls, particularly in relation to PPPs; strengthening of civil service management and payroll controls; more competitive procurement processes in certain situations; among others. Most of these needs are planned to be addressed through MSTAP 2.

93. **The underlying PFM system, including procurement, is considered adequate for this operation.** Actions already taken by the new Government demonstrate significant Government’s ownership and commitment for the future PFM actions, as laid out in the Government’s economic reform program. Both the substantial PFM analytical work and Bank’s implementation support experience with the Government provide a sound basis for the Government’s PFM reforms to be implemented successfully, provided risks are mitigated.

94. **The Bank has reasonable assurance that the control environment for foreign exchange at the Bank of Mongolia is satisfactory for the purposes of this operation.** The IMF completed Safeguards Assessments of the BoM in March 2002 and November 2003. The IMF conducted an updated safeguards

assessment of the BoM in connection with the Stand-By Arrangement approved in April 2009. The Bank reviewed this Assessment Report and noted that the BoM control environment has improved, is generally satisfactory, and remedial actions are monitored by the IMF. New safeguards assessment of the IMF is expected to be completed soon. The new IMF three-year Extended Fund Facility (EFF) program is an evidence that the BoM control environment continues to be considered sound. The Ernest & Young Mongolia Audit LLP's audit opinions on the 2013–2015 annual financial statements were unqualified. In addition, PwC was recently selected to carry out by November 2017 the Asset Quality Review of the commercial banks in the context of the IMF EFF program.

95. **The proposed credit will follow the Bank's disbursement procedures for development policy credits.** The credit proceeds will be disbursed against satisfactory implementation of the DPF and will not be tied to specific expenditures. The credit proceeds will be deposited in a US dollar account at the BoM designated by the Borrower and acceptable to the Bank. The Borrower shall ensure that an equivalent amount of local currency is credited to a Treasury account that finances budget expenditures. Within 30 days, the Borrower will confirm in writing to the Bank that the proceeds have been received into a foreign currency deposit account, that forms part of the country's foreign exchange reserve, and the equivalent amount (including the amount of local currency transferred, the exchange rate used for converting USD into local currency) have been credited and accounted for in the Treasury account.

#### 5.4 MONITORING AND EVALUATION

96. **The Ministry of Finance will be responsible for overall monitoring and evaluation of the proposed operation and for coordinating actions among other concerned 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 line ministries of the Government. The Government will form a steering coordination committee, as the counterpart of the Bank in the policy dialogue and the M&E process. Regular discussions will also take place with the Government and the donor community, including regular round tables on implementation progress. The Bank will monitor the actions and review progress of the implementation of the proposed operation, as well as the subsequent actions of the Government's program by using the baseline and expected overall program outcomes outlined in the Policy Matrix. The Bank will also participate in the quarterly reviews of the IMF to jointly assess macroeconomic performance and progress toward observance of the program's structural benchmarks. The IMF reached Staff-Level Agreement on the first review of its program on August 2, 2017.

97. **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/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order 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, as a result 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 Grievance Redress Service (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](http://www.inspectionpanel.org).

## SUMMARY OF RISKS AND MITIGATION

98. **This operation carries high risks.**

- (i) Political risks are high, considering the political influence underlying the previous loose economic policies. There is also a possibility of backsliding of reforms due to increasing complacency if the commodity market condition improves and growth recovers towards 2020 when the next general election is scheduled. The overwhelming victory of the majority party in the 2016 general election—which campaigned on a platform of strong fiscal reform and the need for fiscal discipline—signaled a stronger consensus for most economic reforms, confirmed by continued commitment of the current Government to fiscal adjustment and the recent fiscal indicators that are on track. At the same time, the presidential elections of 2017 showed that pressure for populist policies remains a fact of Mongolia’s system. The DPF, in collaboration with other partners, also aims to address the underlying causes of the previous loose fiscal management and build mechanisms to mitigate risk of backsliding on fiscal adjustment due to political influence. Such mitigation measures include: (i) disengaging the DBM and BoM from fiscal activities and strengthening their accountability by undertaking and publicly disclosing special external reviews of their operations—supported by the DPF; and (ii) adopting additional safeguard measures to shield fiscal discipline against political pressure, including the Pay-as-You-Go (PAYGO) system and the independent Fiscal Council by the end of 2017—supported by the IMF’s EFF program. Bank’s mitigation measures also include active policy outreach activities to improve the understanding of the importance of a prudent economic policy framework, through policy forums and knowledge exchange events in close collaboration with Bank’s TA projects such as the Strengthening Fiscal and Financial Stability Project (IDA 6084/5-MN).
- (ii) Macroeconomic risks are substantial. The major sources of external downside risks include: (i) slower-than-expected FDI increase into key mining development projects; (ii) disruption in the production increase plans of major copper, coal and gold mines; (iii) weaker-than-expected commodity prices, possibly due to a sharper slowdown in China’s economy. These shocks could slow growth recovery and undermine fiscal space and external buffers, thereby delaying the projected improvement in fiscal and external sustainability. The magnitude of such shocks could be particularly strong as Mongolia has been structurally vulnerable to fluctuations in the commodity market which accounts for almost 90 percent of exports, and FDI inflows into the mining industry which has been a dominant source of investment over the last decade. This DPF, reflecting the substantial macro-economic risks, adopted more conservative assumptions in the baseline outlook, including the prices of key export commodities and the projected FDI inflows. The latest economic indicators also suggest possible upside risks to the baseline outlook in 2017-18, with growth registering 5.3 percent y/y in the first half of 2017. The proposed measures of the DPF also include 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, the DPF also aims to support structural reform measures to improve the competitiveness of the non-mining sector and promote a more business and investment friendly environment.
- (iii) 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 has the authority to prepare the overall Government’s budget, sectoral strategies are

decided by line ministries and the coordination function of the MoF is limited to allocating aggregate budget envelopes to line ministries. The weak coordination authority of the MoF, however, is supplemented by the active support of the Prime Minister and the Cabinet Secretariat. A steering committee will be formed to facilitate close dialogue across different authorities including the MoF, the BoM, and the line ministries.

- (iv) Risks in the technical design of 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 will remain flexible and subject to further discussions with the Government reflecting the progress of the reform program, and changing priorities of the Government in dynamic and volatile economic environments.
- (v) Risks in institutional capacity for implementation and sustainability are substantial. Institutional frameworks that are foundations of the majority of the prior actions were established in 2009-11 with the adoption of the Fiscal Stability Law, 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. Capacity of the authorities has also been significantly improved in the past years with technical assistance of various Bank activities and other development partners' support. Key challenges, however, have been the weak implementation of the institutional framework under growing political pressures. Against this backdrop, additional institutional safeguard measures are planned to be adopted in order to reduce political influence on economic policy making, including the establishment of independent Fiscal Council and PAYGO system by the end of 2017 which would require any proposals for spending increases to be matched by off-setting measures. Technical and analytic support of the Bank in key reform programs—such as tax reform, public investment adjustment, social protection and pension reform, business and investment environment—would help mitigate implementation risk and sustain reform momentum throughout the three-year program horizon.
- (vi) Fiduciary risks are substantial. The overall fiduciary risk 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 is 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. 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.
- (vii) Environment and social risks are moderate. The operation is not expected to have 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 benefit of poverty-targeted social welfare programs to mitigate possible adverse short-term impacts on the poor. However, the prospects of growth recovery and the stabilization of the economy on account of reforms would support strong growth recovery from 2018, hence improving the overall poverty condition towards the end of the DPF horizon.

(viii) Stakeholders' risks are moderate. The operation is well aligned with the reform priorities of the Government's strategy and the commitment of the current Cabinet is strong. This operation will actively encourage strong participation and 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.

**Table 6. Risk Categories**

<b>Risk Categories</b>	<b>Rating (H, S, M or L)</b>
1. Political and governance	High
2. Macroeconomic	Substantial
3. Sector strategies and policies	Substantial
4. Technical design of project or program	Moderate
5. Institutional capacity for implementation and sustainability	Substantial
6. Fiduciary	Substantial
7. Environment and social	Moderate
8. Stakeholders	Moderate
9. Other	
<b>Overall</b>	High

## ANNEX 1. POLICY AND RESULTS MATRIX

Prior Actions DPL 1	Triggers DPL 2	Triggers DPL 3	Results Indicators
<b>PILLAR I: RESTORING DEBT SUSTAINABILITY</b>			
<p><b>Prior Action 1.</b> The Government has terminated DBM’s financing to capital expenditure through non-commercial loans.</p>	<p><b>Trigger 2.1.</b> A comprehensive external special review on the DBM’s operation from 2012-2016 and an annual audit on the DBM’s operation during 2017 have been publicly disclosed on the DBM’s website.</p>	<p><b>Trigger 3.1.</b> The Government further improves the management and operational framework of the DBM to ensure its independence, profitability, and the financial soundness, based on the 2017 audit.</p>	<p>Capital expenditure financed by the DBM through non-commercial loans</p> <p>Baseline: MNT 252 billion in 2016 Target: MNT 0 billion in 2019</p>
<p><b>Prior Action 2.</b> The BoM has discontinued net financing to the Housing Mortgage Program.</p>	<p><b>Trigger 2.2.</b> The Housing Mortgage Program is restructured through a joint decree by the BoM and the Government to better serve the purpose of supporting affordable housing in a more cost-effective way, with a time bound plan for the BoM to fully exit the program.</p> <p><b>Trigger 2.3.</b> 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.</p>	<p><b>Trigger 3.2</b> The BoM has begun to exit the Housing Mortgage Program, including properly resolving its outstanding Housing Mortgage Program assets considering the effects on its balance sheet and government debt.</p> <p><b>Trigger 3.3.</b> The results of the external review on quasi-fiscal operations of the BoM is included in the contingent liabilities of Fiscal Risk Report of the Government.</p>	<p>Net financing from the BoM to the Housing Mortgage Program</p> <p>Baseline: MNT 404 billion in 2016 Target: MNT 0 billion in 2019</p> <p>BoM’s outstanding assets for the Price Stabilization Program (PSP) and companies in the balance sheet</p> <p>Baseline (end-2016): Outstanding loans to the PSP (MNT 32.9 billion) and outstanding corporate bond holdings (MNT 815 billion)</p> <p>Target (end-2019): Outstanding loans to the PSP is fully withdrawn and outstanding corporate bond holdings are no more than MNT 815 billion.</p> <p>Memo: Corporate bonds held by the BoM is scheduled to be repaid from 2020.</p>
<p><b>Prior Action 3.</b> The Government has</p>	<p><b>Trigger 2.4:</b> The Government has</p>	<p><b>Trigger 3.4.</b> The Government has</p>	<p>Aggregate tax revenues from PIT and excise tax</p>

<p>raised the personal income tax rates on high income groups and the excise taxes on alcohol and tobacco, with a gradual increase of the minimum income tax threshold to reduce tax burden on lower income groups.</p>	<p>submitted amendments to tax laws and regulations to reduce tax exemptions and incentives, based on a cost-benefit analysis of individual tax incentive and exemption programs.</p>	<p>submitted amendments to tax laws and regulations to align the tax regime with agreed international tax standards such as transfer pricing regulations, interest deductibility, treaty issues and BEPS related actions, and to introduce a General Anti-Avoidance Rule (GAAR).</p>	<p>on alcohol and tobacco</p> <p>Baseline (2016): MNT 790 billion (3.3% of GDP) Target (2019): 3.7% of GDP, under the current projections on GDP growth and inflation</p> <p>Tax exemptions and incentives are reduced</p> <p>Baseline: MNT 729 billion in 2016 Target: At least 10 % reduction in 2019, compared with the baseline</p> <p>Legal inclusion of General Anti-Avoidance Rule</p> <p>Baseline: Not included Target: GAAR established in tax laws and regulations</p>
<p><b>Prior Action 4.</b> The Government has terminated the Promissory Note Program, to prevent using deferred payments to finance capital expenditure.</p>	<p><b>Trigger 2.5.</b> The Public Investment Rationalization Guideline has been approved by the Cabinet to reduce the cost for on-going investment projects in the budget.</p>	<p><b>Trigger 3.5:</b> The Integrated Budget Law is amended to better align public investment budget with strategic priorities and a hard budget constraint, through: (a) publishing in the Medium Term Fiscal Framework estimates of sustainable investment spending; (b) publishing project appraisal and selection criteria; (c) requiring an adequate funding for maintenance.</p>	<p>Capital expenditure for the clearance of promissory notes is removed by:</p> <p>Baseline: MNT 672 billion in 2016 Target: MNT 0 billion in 2017-19</p> <p>Efficiency of public investment portfolio is improved by:</p> <p>restructuring for cost-saving or removing more than 10% of the total outstanding value needed to complete the on-going public investment projects in 2018-19 based on the Public Investment Rationalization Guideline, evidenced by the project performance evaluation document of the Guideline.</p>
<p><b>PILLAR II: STRENGTHENING THE SOCIAL PROTECTION SYSTEM</b></p>			

<p><b>Prior Action 5.</b> The Government has maintained budget allocation for the poverty-targeted Food Stamp Program, in the 2017 Supplementary budget, excluding administrative costs, at least at the level of the 2017 original budget.</p>	<p><b>Trigger 2.6.</b> The Government has increased the budget provisions for the poverty-targeted Food Stamp Program, in line with MTFF allocations.</p>	<p><b>Trigger 3.6.</b> The Government has allocated budget to a poverty-targeted cash benefit program designed using the PMT-based Integrated Household Database.</p>	<p>The coverage and benefit size of the Food Stamp Program and a poverty-targeted cash benefit program designed using the PMT-based Integrated Household Database:</p> <p>Baseline (2016): 26,000 households, monthly benefit is MNT 45,500 per household of 5 (2 adults and 3 children). The budget for the Food Stamp Program is MNT 18.1 billion. The budget for cash benefit program was 0.</p> <p>Target (2019): The combined budget for both the Food Stamp Program and a poverty-targeted cash benefit program designed using the PMT-based Integrated Household Database is expanded by at least 340%, allowing for a large expansion in both the coverage and monthly benefit.</p>
<p><b>Prior Action 6:</b> The Government has amended the Social Insurance Law and the Pensions and Benefits Paid from Social Insurance Funds Law to gradually increase the pension insurance contribution rate and the retirement age.</p>	<p><b>Trigger 2.7.</b> A comprehensive reform package to the Pension Insurance Scheme is submitted to the Parliament, to maintain the financial sustainability of the pension system.</p>	<p><b>Trigger 3.7.</b> The Government has adopted administrative regulations and procedures needed for the implementation of the comprehensive pension reform.</p>	<p>PROST model projections of the state subsidy to the pension fund.</p> <p>Baseline (2017 projection): State subsidy is projected to reach 6% of GDP in 2030 under the current growth assumptions.</p> <p>Target (2019 projection with reform): State subsidy is projected to reach less than 2% of GDP in 2030 under the current growth assumptions.</p>
<b>PILLAR III: ENHANCING COMPETITIVENESS</b>			
<p><b>Prior Action 7:</b> The Government has established the Investor Protection Council (IPC) , aimed at fostering the timely and systematic resolution of investor grievances.</p>	<p><b>Trigger 2.8:</b> The Government has submitted a revised Permit Law to Parliament, listing all licenses and permits granted by public administrations and reducing their number.</p>	<p><b>Trigger 3.8:</b> The Cabinet has approved a National Competition Policy, embedding competition principles across sectors and improving regulations to level the playing field between public and</p>	<p>Number of permits and licenses</p> <p>Baseline (2016): 890 (2013) Target (2019): the number of permit and licenses are reduced by more than 10% from the baseline</p>

		private operators.	<p>Share of investor grievances successfully treated by the IPC to the total number of investor grievances received by the IPC.</p> <p>Baseline (2016): 0% Target (2019): at least 70%</p>
<p><b>Prior Action 8:</b> The Government has submitted a draft legislation on animal health to the Parliament, proposing the adoption of an animal health legal framework which is consistent with international standards as these are set forth by the World Organization for Animal Health.</p>	<p><b>Trigger 2.9.</b> A package of 13 regulations, ordinances or guidelines are approved to operationalize the Animal Health Law, including the modalities of: (i) animal disease free zone establishment, (ii) international quarantine procedures, (iii) major trans-boundary animal diseases control strategic plans, and (iv) herders' obligations.</p>	<p><b>Trigger 3.9.</b> The Government has organized training in the 21 Aimags and 331 Soums, targeting 3,000 public and private veterinary professionals and 10,000 herders, to secure public awareness and knowledge about the new Animal Health Law and its regulations.</p>	<p>Number of outbreaks of, and small ruminants vaccinated against PPR (Peste des Petits Ruminants—small ruminants Plague) in western region</p> <p>Baseline (2016)</p> <ul style="list-style-type: none"> <li>• 126 outbreaks of PPR were reported in western region (Khovd aimag).</li> <li>• 10.4 million small ruminants vaccinated against PPR in the western region.</li> </ul> <p>Target (2019)</p> <ul style="list-style-type: none"> <li>• The western region (aimags of Khovd, Bayanulgi, Gobi-Altai, Uvs and Zavkhan) is maintained free of PPR.</li> <li>• A cumulative number of 25 million small ruminants are vaccinated against PPR in the western region by 2019.</li> </ul>
<p><b>Prior Action 9.</b> The Parliament has ratified the WTO Trade Facilitation Agreement (TFA).</p>	<p><b>Trigger 2.10.</b> The Government has adopted the institutional framework for the TFA implementation, including: (i) a time-bound action plan for its full implementation; (ii) the establishment of an inter-agency coordination mechanism for the TFA; and (iii) a complete</p>	<p><b>Trigger 3.10.</b> Customs and other border agencies have improved coordination and streamlined clearance procedures, including data sharing, joint inspections and improved risk management, to be in line with the WTO TFA commitments and best practices.</p>	<p>Proportion of shipments selected for physical inspection at border customs:</p> <p>Baseline (2016): 90% Target (2019): 70%</p> <p>Average customs clearance time:</p> <p>Baseline (2016): 12 hours and 35 minutes</p>

	repository of all import and export regulations and procedures to increase transparency and reduce arbitrary application.		Target (2019): 20% reduction
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## ANNEX 2: LETTER OF DEVELOPMENT POLICY



### MINISTER OF FINANCE OF MONGOLIA

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Date 23.10.2017  
Ref. 10-1/6052

H.E. Dr. Jim Yong Kim  
President  
The World Bank  
Washington DC, 20433  
USA

### Subject: Mongolia: Letter of Development Policy

Dear Mr. President,

On behalf of the Government of Mongolia, I would like to express my sincere gratitude to the World Bank for its strong partnership to support Mongolia. The World Bank has been the most valuable development partner to Mongolia over the past two and half decades, providing critical financial resources as well as global knowledge and development experience. I believe that the new Economic Management Support Operation First Development Policy Financing (EMSO-1), which helps Mongolia overcome current economic difficulties and pursue critical economic reforms, offers another great opportunity to further solidify our close partnership.

Mongolia's future is promising, given vast mineral resource endowments, great diversification potential in agriculture and tourism, and a well-educated population. In recent years, however, our economy has been facing challenges from a sudden deterioration in the external environment. The sharp declines in commodity prices and foreign direct investment have significantly reduced growth and budget revenue over the last years. The major shocks have also put growing pressure on our balance of payments, causing a sharp depreciation of the local currency and a significant loss in international reserves. Previous policy errors have compounded these shocks. Expansionary economic policy to buffer the external shocks increased public debt and exacerbated external imbalances. Elevated economic vulnerabilities have raised concern about the sustainability of our fiscal and external accounts, triggering a series of downgrades in sovereign credit ratings in 2016.

A new Government was formed, at this critical juncture, with a mandate to successfully overcome these immediate economic challenges and bring our economy back to a stable and sustainable growth path. Recognizing the seriousness of the current difficulties, we are continuing the implementation of corrective actions that started under the previous Government, including "Economic Recovery Program" which was adopted in close consultation with the World Bank and other key development partners and termination of the one off spending programs that contributed to the large budget deficit in 2016. We are also continuing discussions on major foreign investment projects that could help unlock our significant growth potential.

Despite the efforts, difficult fiscal and external challenges lie ahead in the coming years. The most pressing challenge is to significantly reduce the high budget deficit that reached 17 percent of GDP last year, while ensuring that the poor and vulnerable population are properly protected. Approaching repayments of large non-concessional debt in 2018 is also

posing a significant risk, considering our insufficient reserves and still fragile investor confidence.

We are committed to policies and economic reforms to overcome both immediate and medium term challenges, and hope that multilateral and bilateral partners will support our efforts through concessional financing to ease pressure on the fiscal and external accounts. Against this backdrop, the Government of Mongolia reached an agreement on a three-year Extended Fund Facility with the IMF, and has adopted the first supplementary budget for 2017 on April 14, 2017 and preparing the second supplementary budget for 2017 in correspondence with the fiscal adjustment measures.

Mr. President, financial and technical support under the Economic Management Support Operation (EMSO) of the World Bank will be vital for bolstering our reform momentum and overcoming the current economic challenges. Concessional budget support loan from the World Bank, together with other donors' support, will not only help us ease pressure on our fiscal account by reducing the cost of budget financing, but catalyze successful refinancing of the next large debt repayment due in January 2018. The reform programs supported by the EMSO are an integral part of our reform agenda, especially for (i) implementing a strong fiscal adjustment through key expenditure and revenue measures; (ii) protecting the poor and improving the sustainability and efficiency of the social protection system; and (iii) strengthening the structural resiliency of the economy by improving the business and trade environment, the competitiveness of livestock exports, and the strength of the financial safety net. I am pleased to inform you that we have recently made good progress in the reform areas supported by the EMSO-1.

First, beginning with the 2017 budget, following the recommendation of the World Bank, we have terminated the Development Bank of Mongolia's (DBM) financing of capital expenditure through DBM's non-commercial loans. The existing non-commercial loan portfolio of the DBM was also transferred to the Government at the end of 2016. These measures will disengage the DBM from fiscal activities, thereby strengthening fiscal transparency and effectiveness. We will undertake an external special review on the DBM's operations in 2012-16 and an annual audit for the 2017 operations to ensure that the DBM stays accountable and disengaged from fiscal activities under the newly revised DBM law.

Second, the Bank of Mongolia has discontinued net financing of the Housing Mortgage Program. Starting with the 2017 first supplementary budget, the Government will transparently reflect the interest-financed expansion of the mortgage program as government net lending. We will restructure the Housing Mortgage Program to better serve the purpose of affordable housing in a more cost efficient way and prepare a time bound plan for the Bank of Mongolia to fully exit the program, with the World Bank's technical assistance. Furthermore, the Bank of Mongolia will also conduct an independent external review on the quasi-fiscal operations and plans and publicly disclose the results.

Third, we have revised the Personal Income Tax Law and the Excise Tax Law to strengthen revenue mobilization by imposing higher taxes on richer income groups, and on tobacco and alcohol. The revised Personal Income Tax Law also includes a gradual increase of the annual minimum income tax threshold to reduce tax burden on lower income groups. Going forward, with the World Bank's technical support, we will further deepen reform efforts in tax expenditure and international taxation to expand the tax base and reduce tax erosion.

Fourth, with the goal of reducing capital expenditures to a sustainable level, we discontinued the Promissory Notes Program, a major cause of increased of expenditures in 2016. Termination of the program will allow us to avoid using deferred payments as a means of financing investment projects in the future. We will also reprioritize existing

investment projects by applying the Public Investment Rationalization Guideline that will be prepared with World Bank assistance.

Fifth, we have maintained the budget allocation to poverty-targeted social welfare programs, including the Food Stamp Program, from the 2017 first supplementary budget. Furthermore, we will scale up the coverage and the benefit size of the Food Stamp Program in 2018 budget, which will strengthen protection of the poor population during the economic adjustment.

Sixth, we have begun to take actions to improve the financial sustainability of the pension system. As a first step, we have adopted legal amendments that, starting from 2018, gradually increase the pension contribution rate and retirement age. We will implement more comprehensive reforms to the pension system with the World Bank's technical support.

Seventh, we have strengthened investor protection by establishing and making operational an Investor Protection Council (IPC) with a well-defined membership and mandate. The IPC will allow us to prevent investor grievances from escalating to fully-fledged disputes through coordinating responses to grievances across different ministries, agencies, and levels of the government. To further improve the business environment, we are also planning to revise the Permit Law in 2018 to list all existing licenses and permits, while reducing their numbers.

Eighth, we have submitted the new Animal Health Law to the Parliament. Livestock is one of our key non-mineral exports, and holds significant potential for export diversification. But the competitiveness of our livestock products have been challenged by hygiene and animal health issues. The new Animal Health Law will allow us to more systematically control animal disease through improved vaccination, surveillance, and emergency responses, eventually improving the competitiveness of livestock exports.

Ninth, our Parliament approved the World Trade Organization Trade Facilitation Agreement (TFA) in November, 2016. Lowering costs and administrative inefficiency in trade is one of the most important tasks for achieving export diversification. Full implementation of the TFA will enable us to promote trade by reducing costs and delays, improving transparency and predictability, and using more efficient border management procedures. With the World Bank's technical support, we will adopt the institutional framework for proper implementation of the TFA's key requirements in the coming months.

Dear Mr. President, based on the reform progress that has been made, we request the World Bank's assistance through the Economic Management Support Operation. We believe that, with continued support from the World Bank through this operation, Mongolia will successfully overcome the immediate financing challenges, and will solidify its economic reform momentum. We look forward to a continued close partnership with the World Bank as the leading development partner in Mongolia's journey toward poverty reduction and shared prosperity.

Sincerely,



KHURELBAATAR Chimed

## ANNEX 3. FUND RELATIONS NOTE

### Mongolia – Assessment Letter for the World Bank

November 21, 2017

#### *Macroeconomic Conditions, Policies and Prospects*

**After years of rising vulnerabilities, Mongolia experienced a near-financial crisis in 2016.** For several years, Mongolia had maintained low foreign exchange reserves, on the order of 2–3 months of imports. During this period, prices of key commodity exports had continued to fall, contributing to a sharp slowdown in growth. Then, in 2016, the fragile situation began to unravel: in April, the authorities borrowed externally at double-digit interest rates and in August the recently elected government announced that the fiscal deficit was going to reach 17 percent of GDP. Over the following 6 months, the exchange rate depreciated by 20 percent.

**The government responded by launching its Economic Recovery Plan later that year.** To address macroeconomic imbalances and avoid default, the authorities committed to a policy mix which would reduce the fiscal deficit, strengthen the banking system, stabilize the exchange rate, and build foreign exchange reserves. Then, in early 2017, the authorities received a commitment for \$5.5 billion in official sector resources to help catalyze additional private sector financing, reduce borrowing costs and smooth the pace of adjustment. From the outset, it was recognized that the program faced large risks, in part because public debt was projected to peak at roughly 100 percent of GDP before gradually decelerating.

**Since program approval, strong policy implementation and a better external environment have yielded better economic developments than expected.** Growth was 5.8 percent in January through September, up from 1.2 percent in 2016 and well above the zero-growth projected for 2017 back in April. The primary driver was the coal sector in which prices doubled and export volumes rose by 90 percent in the January-July period over the year before. The service sector has also recovered strongly, both due to linkages with coal (higher use of transportation services) and a broader improvement in household credit, employment, and confidence. Growth is now expected to reach 3.3 percent in 2017 and rise to 4.2 percent next year as mining and mining-related construction recover. Amid this stronger demand as well as some supply-side factors, inflation has risen from near zero at end-2016 to over 8 percent in October and is expected to stabilize around 8 percent going forward.

**With stronger export growth and renewed investor confidence, the balance of payments outturn has also been better than expected.** The rolling four-quarter current account deficit as of 3Q-2017 was 4 percent of GDP, down from 8 percent a year earlier. There will nonetheless be some widening by year-end because of bottlenecks in coal exports and a rise in profit repatriation in the mining sector. Meanwhile, net capital flows reached nearly \$400 million in Q3 (up from roughly zero in the first quarter) even though donor flows were delayed. The strong capital flows continued in October when the authorities issued a sovereign bond in the amount of \$800 million (with bids over \$5.5 billion U.S. dollars) at a 5.625 percent coupon rate, well below the 10.875 percent at which they issued in 2016. This covers the government's external financing needs through end-2020.

### **Policy implementation has been strong.**

- Fiscal policy is on track to achieve a primary deficit of 3.4 percent of GDP in 2017, vs the 5.5 percent of GDP targeted at the time of program approval and 13 percent of GDP last year. For 2018, the authorities have passed a budget consistent with a primary deficit of 2.7 percent of GDP (versus 3.1 percent of GDP in the original program) as well as several key program goals including the targeting of the Child Money program at 60 percent. The authorities have again committed to save half of any revenue over-performance.
- The authorities have used the better balance of payments to accumulate foreign exchange reserves (up \$400 million since program approval to \$1.6 billion), while the exchange rate has weakened marginally (nominal effective rate has depreciated by almost 5 percent since end-2016). The external sector remains broadly in line with fundamentals.
- On monetary policy, the authorities left interest rates unchanged in September at 12 percent to allow more time to monitor recent increases in inflation and assess the impact of previous easing. Going forward, the authorities have agreed that further changes to policy rates will be data dependent.

**Concerns about debt sustainability have moderated since program approval.** With better projected near-term growth, lower fiscal deficits, and lower borrowing costs, public debt is now projected to peak at 88 percent of GDP in 2018 before reaching 73 percent of GDP in 2022 (versus 100 percent and 84 percent respectively at program approval). This path assumes continued strong program implementation and concessional donor support.

**Despite these improvements, significant risks remain.** The Mongolian economy remains highly vulnerable to changes in global commodity demand, further domestic political instability, a failure to sufficiently address any shortfalls that may emerge from the forthcoming Asset Quality Review, and insufficient progress on the mining projects necessary for raising medium term growth. With reserves still low and public debt high, the materialization of any combination of these risks could quickly reverse recent progress. For this reason, it remains critical that Mongolia experience several sustained years of sound policies and donor support.

### *Fund Relations*

**In May 2017, the IMF's Executive Board approved Mongolia's request for a three-year arrangement under the Extended Fund Facility (EFF).** The arrangement is in an amount equivalent to SDR 314.5054 million (435 percent of quota, or about \$425 million). Together with the authorities' adjustment program and large, concessional support from other development partners (totaling about \$5.5 billion), the resources were designed to help catalyze additional private sector financing, reduce borrowing costs and smooth the pace of adjustment.

**Political developments temporarily delayed the program reviews.** A July mission reached staff-level agreement on the program review; however, before the review could be brought to the Executive Board, the government was dismissed as part of the fallout to the surprise loss of the majority Mongolian People's Party (MPP) in the Presidential election. However, in early October, the MPP elevated the previous Deputy Prime Minister U. Khurelsukh, to be the new Prime Minister and he then reaffirmed the authorities' commitment to the Fund-supported program in a letter to the

Managing Director. A mission returned to Mongolia in mid-October to review performance and policies under the program.

**Performance in the program remains strong.** The October mission confirmed that all end-September QPCs were met by comfortable margins. Performance on structural benchmarks was more mixed with some reforms met on time while others are expected to be met with some delay due to the interruption of the policy making process with the dismissal of the government. Given the favorable policy implementation and the authorities' renewed commitment to policies in line with the program going forward, staff-level agreement on the first and second reviews of the program was reached on October 30.

**Executive Board discussion of the first and second reviews under the program is scheduled for mid-December.** Upon completion of the reviews, two disbursements under the EFF will become available (a total of SDR55 million, or about \$75 million).

## ANNEX 4. ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects
<b>PILLAR I: RESTORING DEBT SUSTAINABILITY</b>		
<b>Prior Action 1.</b> The Government has terminated DBM's financing to capital expenditure through non-commercial loans.	<b>Neutral.</b> Neutral environment effects.	<b>No.</b> No distributional effects are envisaged.
<b>Prior Action 2.</b> The BoM has discontinued any net financing to the Housing Mortgage Program.	<b>Neutral.</b> Neutral environment effects.	<b>No.</b> Currently the HMP, has little impact among the poor. The proportion of the poor using loans for acquiring a dwelling is below 10 percent. Consequently, policy changes that restructure the program to bring it within the Government budget but keep the previous mechanisms for allocation of loans would mostly have no impacts among the poor.
<b>Prior Action 3.</b> The Government has raised the personal income tax rates on high income groups and the excise taxes on alcohol and tobacco, with a gradual increase of the minimum income tax threshold to reduce tax burden on lower income groups.	<b>Positive</b> Promoting better tax collection may have positive environmental impacts through more reliable and predictable financing for the ministries and line agencies in charge of managing natural resources and the environment in the long run.	<b>Neutral to Positive.</b> Our estimates show progressive incidence of PIT reform, with its effect ranging from a 2 to 6 percent increase in the disposable incomes of the poor (bottom 2 deciles of the distribution) to a decline of 2 to 5 percent for the three top deciles of the distribution. The increase in excise taxes for alcohol and tobacco is neutral but its effect is very small: between 0.08 percent, for the two bottom and two top deciles, and 0.10 percent for those between the third and seventh decile. <sup>16</sup>
<b>Prior Action 4.</b> The Government has terminated the Promissory Note Program, to prevent using deferred payments to finance capital expenditure.	<b>Positive.</b> improve the public budget, financial management and more efficient allocation of public expenditures may have positive environmental impacts through more reliable and predictable financing for the ministries and line agencies in charge of managing natural resources and the environment in the long run.	<b>No.</b> No distributional effects are envisaged.
<b>PILLAR II: STRENGTHENING THE SOCIAL PROTECTION SYSTEM</b>		
<b>Prior Action 5.</b> The Government has maintained budget allocation for the poverty-targeted Food Stamp Program, in the 2017 Supplementary	<b>Neutral.</b> Neutral environment effects.	<b>Positive.</b> We simulate the impact of increasing the coverage of the food stamp program (trigger 2.7 which accompanies this prior action 6). <sup>17</sup> This simulation renders a very

<sup>16</sup> Simulations based on a reform consisting of: proposed changes in Personal Income (i) keeping the 10 percent rate for incomes below 1.5 million MNT; (ii) raising the rate to 15 percent for additional incomes until 2.5 million MNT, 20 percent for additional incomes until 3.5 million MNT and 25 percent for incomes above 3.5 million MNT. Moreover, the earning income tax credit goes from 94,000 MNT in 2016 to 120,000 MNT in 2018, with subsequent yearly increases of 40,000 MNT until 2021 when it reaches 240,000 MNT.

<sup>17</sup> Simulation based on a doubling of the number of beneficiaries (from around 147,000 in 2016 to 294,000 in 2019) and benefits growing 20 percent (that is, from 13,000 and 6,500 MNT monthly per adult and child, to 16,500 and 7,800 MNT, respectively).

budget, excluding administrative costs, at least at the level of the 2017 original budget.		pro-poor result: changes in disposable income hover ranges 9 to 11 percent of disposable income for the two bottom deciles, and zero percent for those above the 4 <sup>th</sup> decile.
<b>Prior Action 6:</b> The Government has amended the Social Insurance Law and the Pensions and Benefits Paid from Social Insurance Funds Law to gradually increase the pension insurance contribution rate and the retirement age.	<b>Neutral.</b> Neutral environment effects.	<b>Positive.</b> As part of the Pension reform, the program includes an increase in Social Security contributions which is only slightly progressive. <sup>18</sup> The impact of this increase of contributions goes from a decline in disposable income of 1.3 percent among the poor (bottom two deciles of the distribution), to a decline of nearly 1.7 percent for the two top deciles.
<b>PILLAR III: ENHANCING COMPETITIVENESS</b>		
<b>Prior Action 7:</b> The Government has established the Investor Protection Council (IPC), aimed at fostering the timely and systematic resolution of investor grievances.	<b>Neutral.</b> Neutral environment effects.	<b>No.</b> No distributional effects are envisaged.
<b>Prior Action 8:</b> The Government has submitted a draft legislation on animal health to the Parliament, proposing the adoption of an animal health legal framework which is consistent with international standards as these are set forth by the World Organization for Animal Health.	<b>Positive.</b> It will frame and guide the implementation of the new animal health law, organize training and public awareness activities country-wide to help disseminating the new Law and increase its understanding by veterinary professional and herders, the planned policy adjustments are aimed at a gradual approximation of Mongolian regulatory systems with international good practice in animal health management, it will lead to an increased coverage of vaccination, notably against the disease called PPR (Small Ruminants Plague) as an outcome of the better legislative and policy framework by making public investments in the livestock and animal health sector more efficient, which is beneficial to the environment and the health of the people.	<b>Neutral to Positive.</b> Assuming fully subsidized veterinary services to all producers for key public-good animal health services (say, for instance, meat inspection or key strategic vaccination campaigns), and assuming that this public-good service represents a fixed proportion of total cost, no matter the level of production, then the policy should have a neutral impact. If assuming economies of scale in the provision of the services by size of the producer, then the subsidized provision would be progressive (i.e., vaccination services represent a larger share of total costs for smaller producers and hence full subsidization benefits them proportionately more). A combination of public/private funding of these would have a pro-poor effect in as much as public funding of these services is targeted to small/poor producers. <sup>19</sup>
<b>Prior Action 9.</b> The Parliament has ratified the WTO Trade Facilitation Agreement (TFA).	<b>Neutral.</b> Neutral environment effects.	<b>No.</b> No distributional effects are envisaged.

<sup>18</sup> Currently, pension contributions amount to 14 percent of the total salary of an employee, half of which accrues to the employer and the other half to the employee. Under our simulations, the employee rates are planned to be raised to 8 percent in 2018, 8.5 percent in 2019 and 9.5 percent by 2020. This change affects salaried workers only. We do not estimate the inter-generational, post-pension impact of this additional contributions. As indicated at the beginning, our simulations are intended to evaluate short term impacts upon disposable income and are, hence, partial equilibrium and non-behavioral, assuming economic incidence equals “de jure” accrual.

<sup>19</sup> This is a purely deductive argument about the distributional impact of fully-subsidized private provision of veterinaries for key public-good animal health services. A more empirically-based analysis would require granular farm level data that was not available during the production of this PSIA.