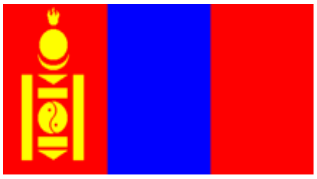


Mongolia Monthly Economic Update
World Bank

March 2010

The World Bank's *Mongolia Monthly Economic Update* provides an update on recent economic and social developments and policies in Mongolia. It also presents findings of ongoing World Bank work in Mongolia. The *Mongolia Monthly* is produced by a team from the World Bank's Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Region Vice-Presidency, with key inputs from other members of the Mongolia country team. Questions and feedback can be addressed to Altantsetseg Shiilegmaa (ashiilegmaa@worldbank.org). Copies can be downloaded from http://www.worldbank.org.mn.

Contents

Figures

Tables

Boxes

Abbreviations and acronyms

bn	Billion
BoM	Bank of Mongolia
CPI	Consumer Price Index
FX	Foreign currency
GDP	Gross Domestic Product
LC	Local currency
LHS	Left hand side
MFA	Mongolian Financial Association
mn	Million
MNT	Mongolian togrog
MoF	Ministry of Finance
mom	month-on-month
mt	metric ton
NPL	Non-performing loan
NSO	National Statistics Office
RHS	Right hand side
USD	United States Dollar
WPT	Windfall Profit Tax
yoy	year-on-year
ytd	year-to-date

Executive Summary[1]

In the first quarter of 2010, the trend improvement in the fiscal deficit stalled as the positive impact of improving revenues was offset by expanding expenditures. If expenditures were to continue to rise in step with mining-related revenues, Mongolia risks returning to the boom-and-bust cycle of the pre-crisis years. However, fiscal consolidation is necessary, given the difficult financing conditions projected for the next few years. In particular, 2011 will be a difficult year for the budget as the Windfall Profits Tax will have been abolished.

A related challenge is how to manage public investment expenditures within the current fiscal space while helping to meet Mongolia's infrastructure challenge. The current public investment planning and execution process suffers from a number of weaknesses which are examined in Box 1 through the lens of investment in the road sector. Wages and salaries are another major expenditure item within the budget and face upward pressures. Box 2 presents preliminary details of the latest survey in determining the level of public sector wage increases. At senior levels, the total cash compensation in the civil service is approximately 60 to 70 percent relative to bench-marked private sector jobs. However, pay and benefit levels are not unattractive when benefits and job security are factored in. And low level civil service jobs had similar or higher levels of total cash compensation compared to private jobs.

Mongolia's trade deficit has stabilized in recent months on a 12-month rolling basis. The sustained recovery of Mongolia's exports has been supported by upward momentum in metal prices and increasing imports from Mongolia to China, its largest trading partner. The exchange rate against the US dollar has been stable, while foreign exchange reserves are close to record levels.

The economic recovery and the prospects of strong growth in 2010 have contributed to recent consumer prices rises. While rising price pressures may be expected during recovery, the challenge going forward is to ensure that this does not develop into the overheating seen during previous booms.

In the banking sector, total lending growth remains muted as nominal lending and deposit rates remain high. On an aggregate level the commercial banks realized a profit of MNT 2.8 billion in March after reaching a loss of MNT 143.4 billion through 2009. The ratio of non-performing loans to total loans stabilized in March but is still at 22 percent while principal in arrears is increasing. A bank restructuring strategy was recently drafted by the Bank of Mongolia, reflecting lessons from international experience (including those of the Turkish banking crisis of 2000/2001, as detailed in Box 3). Timely endorsement of the plan by Parliament is crucial so as to align Mongolia with international best practices that limit the potential economic and fiscal cost associated with any government support and restructuring.

In the real sector, the severe impact from the dzud, which marked a record disaster affecting over 80 percent of Mongolia's territory, will be felt across major sectors, including the banking sector. Up until now, herder loans have been relatively well performing (Box 4) but, with the number of livestock losses increasing to over 7 million (16 percent of total herd), upward pressure on non-performing loans is likely to increase.

Currently, the Mongolian Parliament is discussing the enactment of a number of important reforms including the Fiscal Stability Law and an Integrated Budget Law which will put in place a fiscal framework for managing mining revenues as well as a commitment to prudent fiscal policy. Such important moves to improve the policy framework in key areas will help Mongolia to avoid boom-and-bust cycles and promote sustainable growth into the future.

[1] The analysis is based on the most recent data (February 2009) from the Bank of Mongolia (monthly bulletin and monthly consolidated banking system balance sheet), the National Statistical Office, National Tax Authority and the Ministry of Finance.

Fiscal developments

In the first quarter of 2010, the trend improvement in the fiscal deficit stalled somewhat as the positive impact on the deficit of improving revenues has been offset by expanding expenditures

The overall fiscal balance of recent months has been stable, after the strong improvement in the fourth quarter of 2009. Despite improved revenue performance there has been an offsetting rise in expenditures. There is a worry that rather than seeing the accumulation of fiscal savings in a process of sustained consolidation, expenditures will continue to rise in step with revenues, risking a return to the boom-and-bust cycle of the pre-crisis years.

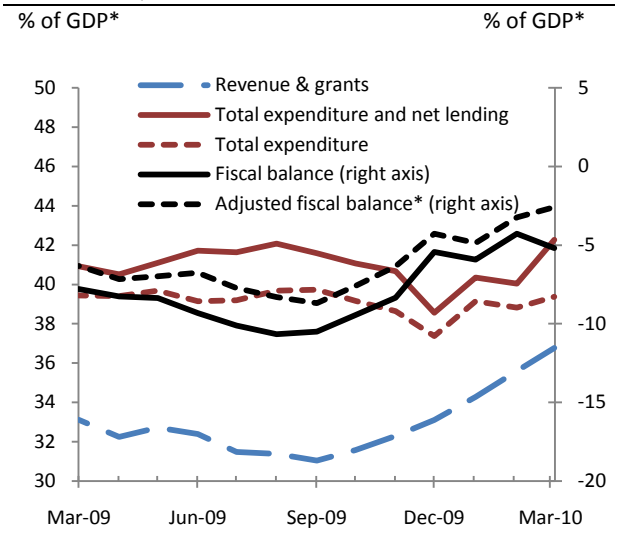
Most recently, in March, the 12-month rolling deficit deteriorated slightly to 5.2 percent of GDP, despite improved revenue generation. On the 12-month rolling basis, total revenue was equivalent to 34.7 percent of GDP while total expenditure and net lending amounted to 39.9 percent of GDP (Figure 1).

Revenue performance has improved markedly since September 2009. For example, in March, 2010, the annual growth in total revenue and grants was 66 percent in nominal terms and 61 percent in real terms. Reflecting the recovery in real economic activities, imports and favorable commodity prices, strong annual growth in March was seen in corporate income tax (up 92% in real terms yoy), the Windfall Profit Tax (12 times higher), VAT (up 63 percent), customs duties (up 39 percent) and royalties (more than double).

However, expenditures have also risen in recent months, up around 50 percent year-on-year in March 2009. Some of the rise clearly reflects the low base of early 2009 due to the expenditure restraint shown during the crisis. Nevertheless there is a concern that the trend might continue, jeopardizing progress on fiscal consolidation. One of the main expenditure drivers was current transfers - 87.6 billion MNT was allocated out of the HDF for cash distribution while subsidies to energy and public transportation sectors were more than tripled compared with March, 2009. Interest payments were also up, reflecting the impact of the rise in indebtedness to finance the deficit of 2009. Although domestic investment is also on the rise, the implementation of the first quarter domestic investment funding remains only at 30 percent against the plan. This suggests the need to improve the regulatory framework towards increasing the efficiency and timeliness of the overall bid awarding and decision making processes.

Of particular note is the sharp rise in net lending, mainly related to the cost of addressing banking sector problems. In the first quarter net lending reached MNT 110 billion, already above the outturn in 2009 of MNT 72 billion and the full-year 2010 plan of MNT 99 billion. The vast majority of lending, around MNT 100 billion, is in the form of government treasury bills lent to the central bank as a government equity guarantee to be deposited at the State Bank. A further MNT 6 billion of lending was to the Housing Finance Corporation (HFC) in order to finance the "4000 apartment houses" program aimed at providing civil servants with houses.

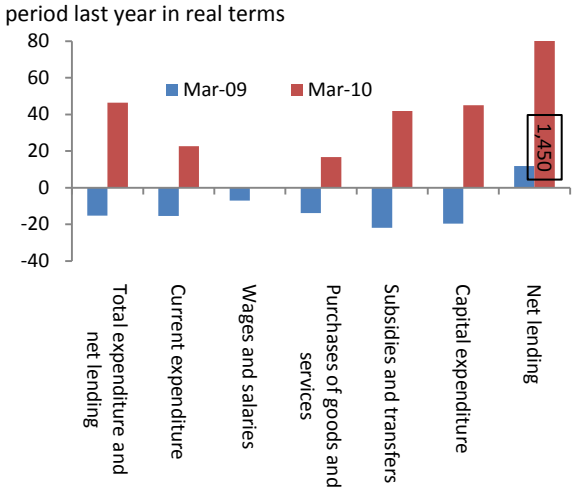
Figure 1 The trend improvement in the fiscal deficit stalled in Q1 2010



Note: *GDP interpolated using actual 2008 and 2009 GDP data and projections for 2010 data. ** Adjusted fiscal balance excludes net lending from expenditure, leaving current and capital expenditure only.

Source: Ministry of Finance, World Bank staff estimates.

Figure 2 Expenditures are up sharply in Q1 2010, particularly net lending and subsidies and transfers



Note: The number in the box indicates the increase that the scale of the chart does not reflect.

Source: Ministry of Finance, World Bank

Continued expenditure restraint is necessary given the difficult financing conditions projected for the next few years. In particular, 2011 will be a difficult year for the budget as the Windfall Profits Tax will have been abolished and donor funding for budget support will have dwindled. A related challenge is how to manage public investment expenditures within the current fiscal space while helping to meet Mongolia's infrastructure challenge. This is an important issue since the favorable growth outlook depends heavily on a small number of major investment projects, in particular OT, and it is imperative that there are no delays in the development of the OT mine and the associated infrastructure. However, the current public investment planning and execution process suffers from a number of weaknesses which are examined in Box 1 through the lens of investment in the road sector.

Box 1 Road sector case study findings

The World Bank recently conducted a case study to investigate the current state of the national road network and to determine the weakest links in the life-cycle of roads projects by analyzing a sample of 10 ongoing and recently finished projects. The findings revealed that Mongolia's road sector faces a large backlog of maintenance with around 60 percent of paved roads in poor condition. In addition the planning framework for new investment projects in the sector is weak with an average time overrun of 2.3 years (or 180 percent).

Table 1: Condition of the national paved road network

Condition	Km	Share of total classified roads (%)
Good	864.4	17
Fair	1,209.6	24
Poor	2,925.9	59
Total	4,999.9	100

Source: Department of Roads.

The sample of 10 budget-funded roads projects was drawn from the total portfolio of 50 projects

implemented since 2005. Of the surveyed projects none included cost benefit analysis during any stage of the planning process. The main reason for this absence is a lack of capacity to conduct economic analysis among both government officials and project implementers. According to officials there is not enough traffic volume on national roads to justify a usage survey due to the low population density in the rural regions. Rather than economic analysis, the social and environmental impact of a project is considered more relevant for Mongolia. With insufficient traffic the construction cost of a new road may not be economical but the new paved road reduces green pasture destruction (through off-road driving) and increases the overall development of infrastructure in that region. Still, a prioritization based on 'national importance' indicates that only 54 percent of the portfolio is rated as high priority, 38 percent medium and 8 percent low.

In addition to the lack of feasibility studies, projects were awarded through direct contracting, often with no accompanying technical documentation. Of the total sample of ten, four projects were executed through direct contracting while the remainder went through the normal tendering process. The former lacked proper screening of contractors prior to awarding contracts. They also lacked proper field investigations which resulted in costly engineering interventions and increased work scope. While seven of the ten projects had time overruns, with an average completion time of 3.1 years compared to the original plan time of 1.8 years (an overrun of 70 percent), the directly contracted projects were completed with an average time overrun of 2.3 years (or 180 percent).

The significant delays across the whole portfolio of roads, more than doubling the original completion time in some cases, reflect three factors: poor planning and inaccurate cost estimation, procurement problems, and weaknesses in the construction sector. Procurement delays are particularly severe for the projects that are added by the parliament as they usually have no accompanying engineering designs. This problem has been compounded by the decision in the 2010 budget to fund a significant portfolio of new projects by the construction companies on a reimbursement basis.

Notes: The findings of this survey provided the background analysis for Policy Note on 'Mongolia: Public Investment Planning Public Investment Planning', March 2010, Poverty Reduction and Economic Management Sector Unit, East Asia and Pacific Region, World Bank. Data provided by the Ministry of Road, Transport and Construction (MRTC) and the Department of Roads.

Wages and salaries are another major expenditure item within the budget and also increased sharply during the boom years, rising from around 20 percent of total current expenditures in 2007 to 30 percent in 2008 and 2009. Most recently, recent tripartite negotiations agreed a rise in pensions and civil servants' salaries of 30 percent from 1 October 2010. One issue in determining the level of public sector wage increases is the comparison with the private sector wage (indeed the Civil Service Council is mandated by law to conduct such survey comparisons annually). Box 2 provides preliminary details of the latest survey.

Box 2 Towards a High Performing Civil Service

The Civil Service Law mandates the Civil Service Council to conduct, with the support of the Ministry of Social Welfare and Labor and the National Statistical Office, annual research benchmarking civil service pay with marker comparators. The first such survey was completed recently with World Bank technical assistance, the preliminary results of which are reported below.

The survey methodology consisted of the following steps:

Step 1: Identifying representative jobs in the civil service to be benchmarked with comparable jobs in the private sector. 50 jobs in civil service were identified for the purposes of comparison. These benchmark jobs were selected to represent the main sub-sectors of the civil service and consisted of senior level administrative positions in the ministries; technical positions in the ministries, the National Statistical Office, the universities, and government institutes; and key service delivery staff, such as teachers and medical professionals. In order to enable comparisons of equivalent jobs, a job evaluation survey was conducted to measure each job on relevant factors such as competency, problem-solving, decision-making, and management of resources. This enabled each

job to be measured through a point system, and to enable salary comparisons between the public and private sector for jobs with similar points.

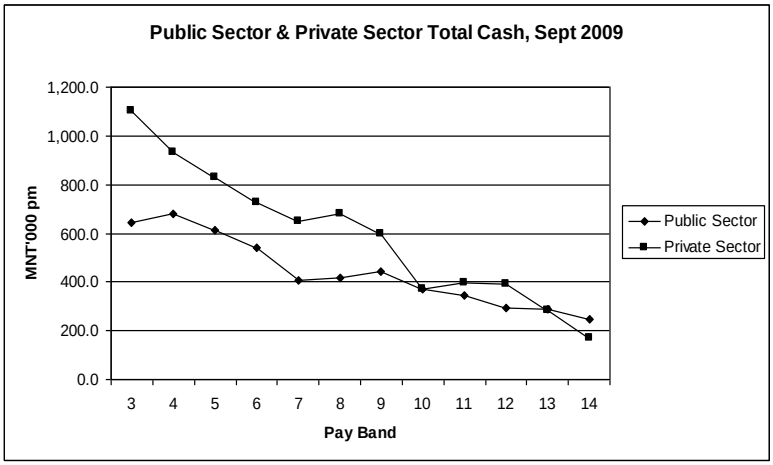
Step 2: Selecting the firms to be surveyed. The survey was limited to Ulaanbaatar and consisted of 9 manufacturing or service enterprises, 7 schools or higher education institutes, 3 financial institutions, and 3 hospitals or large clinics.

Step 3: The pay survey. A remuneration questionnaire was administered which gathered information on the total cash compensation (basic pay plus allowances) of the sampled public and private sector jobs. For ease of comparison, the civil service jobs were grouped into 14 pay bands, with each band consisting of jobs with similar pay across the civil service, and the pay in these jobs was then compared to the pay in similar jobs in the private sector.

The survey results are summarized in Figure 3, which gives the average monthly total cash compensation (thousands of MNT) for the jobs in each pay band. The results reveal:

- At senior levels, the total cash compensation in the civil service is approximately 60 to 70 percent relative to bench-marked private sector jobs. So while there is a significant pay gap, pay and benefit levels are not unattractive when benefits and job security are factored in. In many other countries these differentials are 100 percent or even 200 percent.
- Low level civil service jobs had similar or higher levels of total cash compensation compared to private jobs.
- Pay compression is higher in the public sector than in the private sector (i.e relatively lower increase in compensation as one progresses from lower level to higher level positions), which impacts the attractiveness of a career in the civil service.

Figure 3: Average monthly total cash compensation in public and private sector by pay band



Note: Lower pay band indicates higher-level position. Pm is per month.
Source: Civil Service Council.

Policy implications

The survey suggests that across-the-board salary increases are not justifiable as the lower level positions, which are the bulk of the civil service, are not underpaid. At higher levels, modest salary increases to bring public sector pay to within 80 percent of private sector pay (normally sufficient to attract and retain staff given the greater security of public sector employment) are justified, and can be sequenced over a period of a few years.

Source: World Bank based on Civil Service Council survey results.

External sector

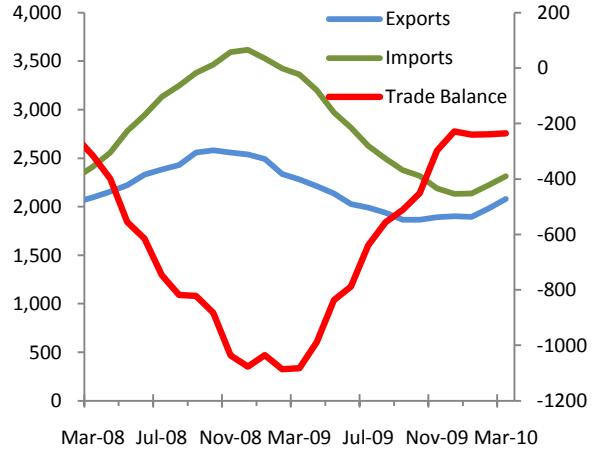
Mongolia's export sector continues to recover, supported by buoyant commodity prices

The 12-month rolling trade deficit has stabilized in recent months. At US$235 million in March it has improved considerably from US$1082 million in March 2009 (Figure 4). The sustained recovery of Mongolia's exports has been supported by upward momentum in metal prices (Figure 5) and increasing imports by China, Mongolia's largest trading partner (Figure 6). Accordingly, Mongolia's trade numbers show exports to China remains high buoyed by growing coal and copper shipments to China (Figure 7). Indeed after further increases in March, copper prices recorded their highest average price ($7463/tones) since the commodity price collapse of mid-2008. However, experts view copper price as overinflated relative to fundamentals, suggesting that it is fund buying and speculation may be propping up the price.

In terms of the commodity composition of exports, an important recent trend has been the rising contribution from coal exports, reaching around one-third of annual growth in March. This reflects increased production by many small and medium scale companies that export coal to China. Demand from Chinese buyers has risen due to the low price for raw coal. The annual growth contribution of copper to total exports decreased slightly. Developments in China are clearly crucial going forward since exports to China generates 65 percent of Mongolia's export revenues, half of which is copper.

Figure 4 The trade deficit has stabilized and is much improved on 2009[2]

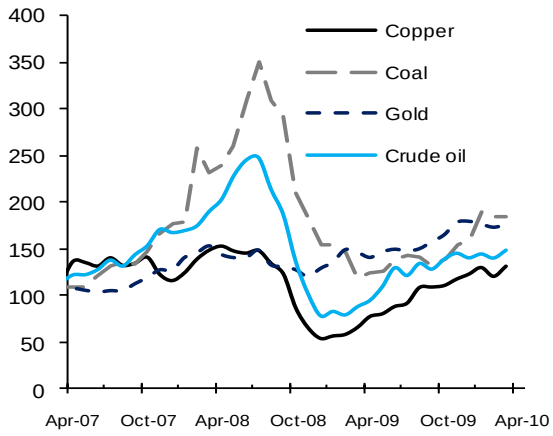
$ million, 12-month rolling sum



Source: National Statistical Office, Bank of Mongolia World Bank

Figure 5 Commodity prices rises continue…

Index=100 in January 2007

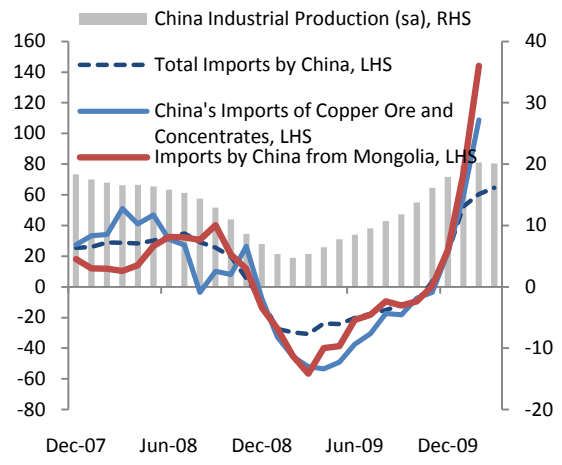


Source: World Bank

[2] Monthly trade data is strongly affected by the seasons in Mongolia, and has strong month-to-month fluctuations. For this reason, 12-month rolling sums are illustrated.

Figure 6 with Chinese import growth rising, albeit with strong base effects

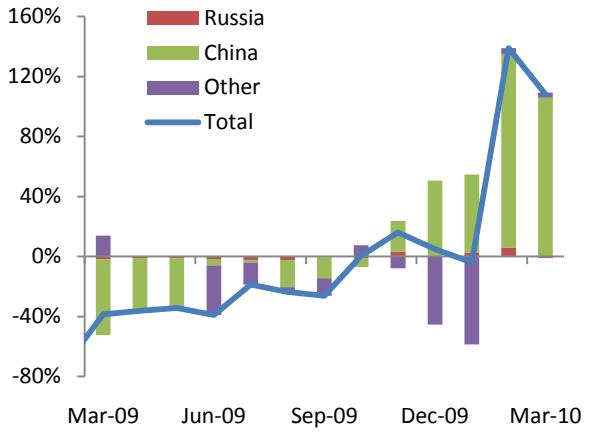
% year-on-year change of 3-month moving average



Source: Haver Analytics, World Bank

Figure 7 …supporting Mongolia's exports

% yoy contributions to export growth by destination

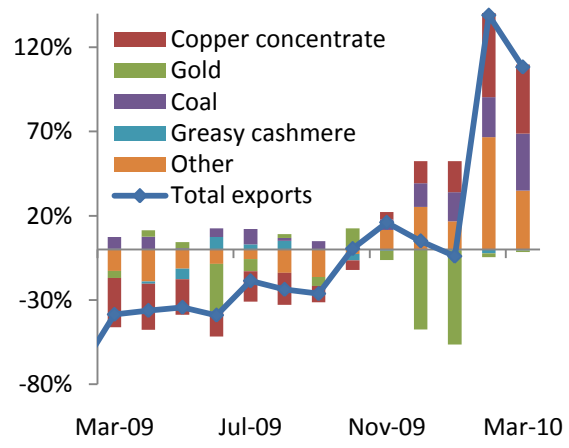


Source: Bank of Mongolia, monthly bulletin, World Bank

Mongolia's gold exports are still depressed compared to previous years. Gold prices were stable at around US$1100/toz in March, but the volume of exports in the first two months of 2010 is almost 80 percent below that in the comparable period in 2009, in spite of the provision of government-financed credit directed to support gold producers last year. As mentioned in previous updates, a number of factors may have influenced the reduction in volume of gold exports, including decreased gold production by a major gold exporting company and the existence of the Windfall Profit Tax (WPT). Anecdotal reports suggest that the actual volume of exports may be higher, as the WPT has led to gold being smuggled out of the country. Similarly, producers could be holding on to their gold stock rather than exporting it, until this tax is abolished in 2011.

Figure 8 Coal and copper exports have performed strongly

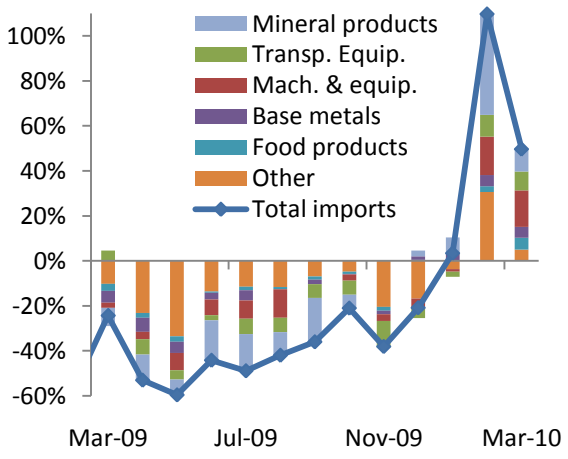
Percentage point contributions to year-on-year growth



Source: National Statistical Office, World Bank

Figure 9 With import growth also picking up into 2010

Percentage point contributions to year-on-year growth



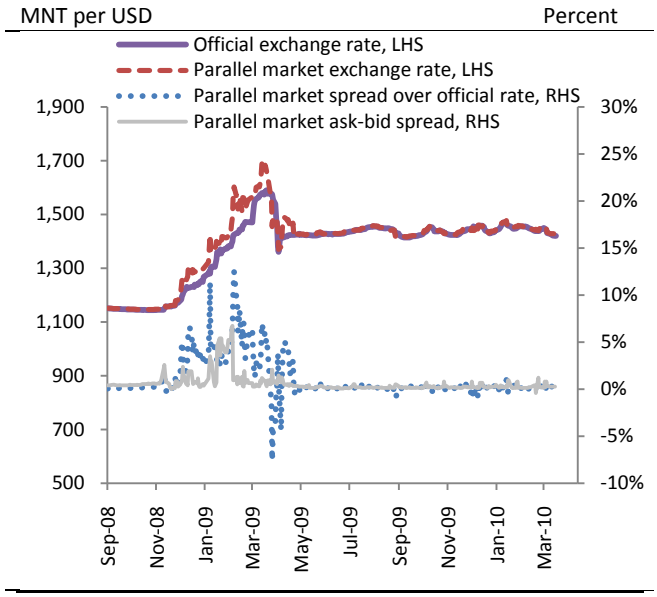
Source: National Statistical Office, World Bank

In March the dollar value of goods imports was up by 47 percent year-on-year, compared with contractions of over 50 percent in the first half of 2009. The latest numbers show sharp decreases in imports of minerals products (Figure 9). These are mostly diesel and petroleum that suggest increased economic activity as the operating season starts for key sectors such as mining, construction and agriculture.

The exchange rate against the USD remains broadly stable

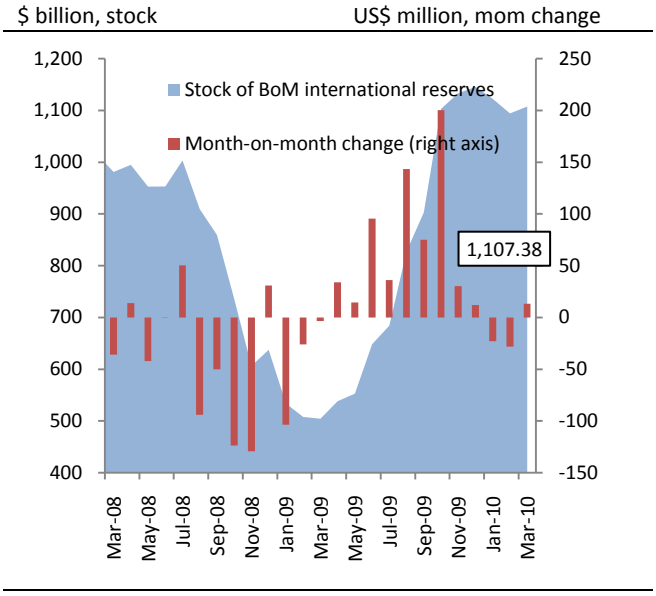
The exchange rate against the US dollar has been stable since April 2009 (Figure 10), when the Bank of Mongolia (BoM) raised its policy rate substantially and introduced an auction system for foreign exchange. In March, the average monthly exchange rate against the USD appreciated by 2.3 percent, compared with February.

Figure 10 The exchange rate remains stable



Note: Parallel market rate is mid-point of bid and ask rates. Positive spread over official rate indicates relative depreciation. Ask-bid spread measured as percentage of mid-point of the two.
Last observation: April 12, 2010.
Source: Mongolian Financial Association, World Bank.

Figure 11 BoM international reserves remain close to record levels



Note: Number in box is end-March stock of BoM international reserves in US$ million.
Source: Bank of Mongolia, World Bank.

The stabilization of the exchange rate has been accompanied by a rise in international reserves of the Bank of Mongolia to a record high level of US$1,145 million as of the end of 2009. Since November the BoM had not made any foreign exchange purchases until it purchased $25.9 million from commercial banks in March. Reserves had been boosted by an increase in monetary gold, project funding from international institutions and deposits from commercial banks. After falling slightly in January and February, international reserves increased slightly in March and remain close to record levels (Figure 11).

Inflation

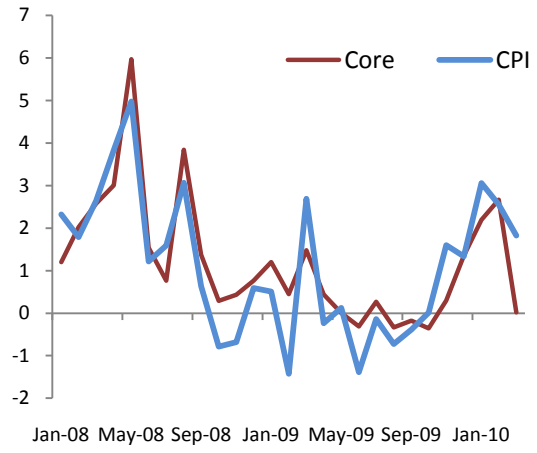
As the economy recovers inflationary pressures have risen

The economic recovery and the prospects of continued strong growth in 2010 have contributed to recent rises in consumer prices. In the fourth quarter of 2009 and early 2010 the seasonally-adjusted core and overall UB consumer price indices showed monthly growth in the range of 2 to 3 percent (Figure 12). The challenge going forward is to ensure that this does not develop into the overheating seen during the previous boom periods.

In March, the monthly rise in the CPI declined and annual UB CPI inflation fell slightly driven by decreasing energy and fuels prices (Figure 13). With temperatures finally rising above zero, energy and fuels declined by 1.6 percent yoy leading the overall UB headline inflation rate to decrease to 7.8 percent yoy in March from 8.7 percent in February. The national annual CPI inflation increased to 8.5 percent yoy. Core prices for the UB index were broadly flat on the month, seasonally adjusted, with the annual inflation rate declining to 6.2 percent yoy in March, mainly driven by discounts on clothes and furniture sales.

Figure 12 Inflation pressures have risen in recent months

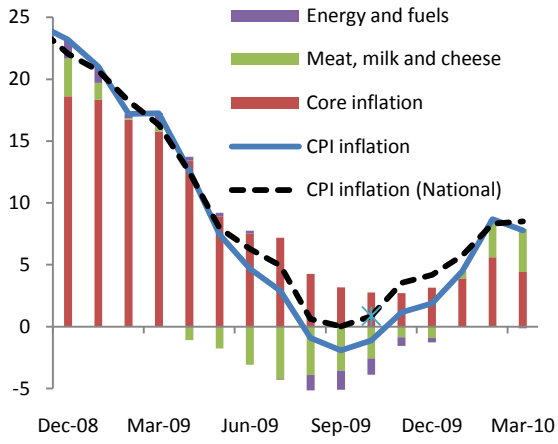
Month-on-month inflation (seasonally adjusted), percent



Note: This is the UB city CPI. Seasonal adjustment using x-12 package.
Source: National Statistical Office, World Bank

Figure 13 And annual inflation has risen

Percentage point contribution to CPI inflation



Note: This is the UB city CPI except for the dashed line which is the National CPI.
Source: National Statistical Office, World Bank

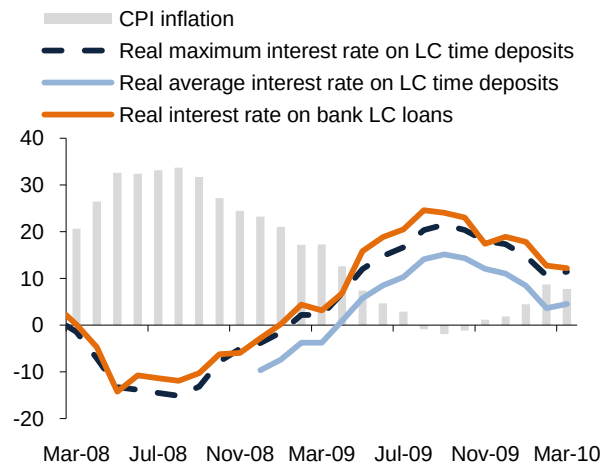
Banking sector

Commercial bank lending rates remain high

Nominal lending and deposit rates remain high. Deposit rates in both local and foreign currencies were broadly stable in March. Average lending rates decreased slightly but remain around 20 percent. Ex post real interest rates have edged up slightly reflecting the fall in inflation (Figure 14). However, ex ante real rates are likely to be falling as inflation expectations rise with the rebound in growth. But, with annual CPI inflation at end-2010 forecast at around 7.5 percent the ex ante rate is likely to remain above 10 percent.

Figure 14 Nominal lending rates have stabilized somewhat

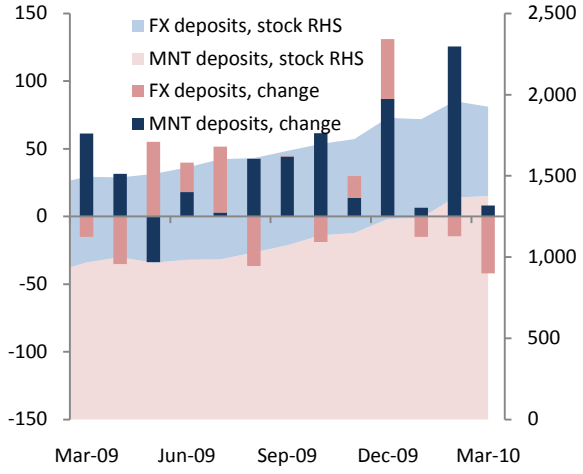
Percent (annual rate)



Source: Bank of Mongolia, National Statistical Office, World Bank.

Figure 15 MNT deposit rises ease while FX deposits decrease further

MNT billion, month-on-month change MNT billion, stock



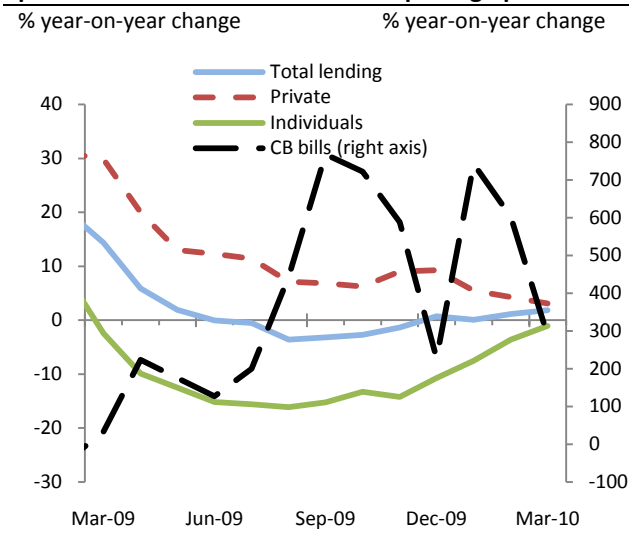
Source: Bank of Mongolia, World Bank

Lending growth remains stalled

Lending growth on an annual basis remained muted in March (Figure 16). Total outstanding loans were broadly flat for the fourth consecutive month. Lending growth to the private sector however remains in positive territory, although at 3.1 percent yoy in March, it is roughly half the rate of growth seen at the end of last year. The March data also show that banks are continuing to purchase less risky central bank bills, but at a slower pace than that seen in recent months.

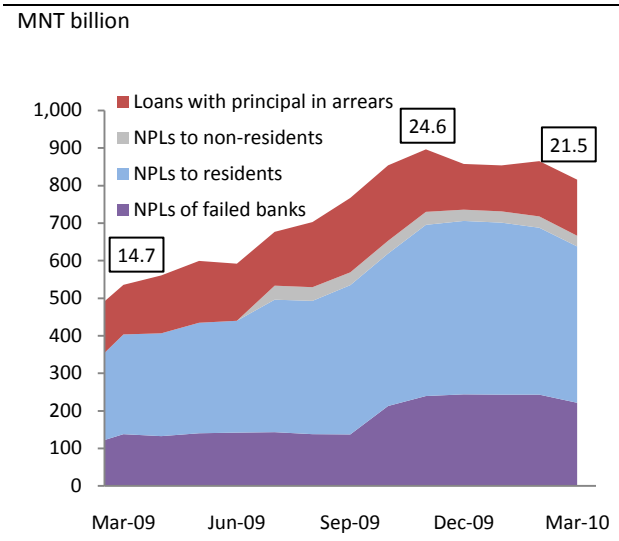
Meanwhile, high real interest rates and expectations of currency appreciation continue to drive the increase in MNT deposits (Figure 15). Indeed, local currency deposits rose to a new peak in March of MNT 1,374 billion, up slightly from February. By contrast, although the stock of foreign currency deposits remains quite high, at about a third of total deposits, it fell for the third consecutive month in March to MNT 551 billion after peaking at MNT 622 billion at end-December.

Figure 16 Total lending growth remains flat while purchases of Central Bank bills are picking up



Source: Bank of Mongolia, World Bank.

Figure 17 NPL ratios remain above 20 percent



Note: The numbers in boxes are the sums of NPLs to residents and non-residents and loans with principal in arrears as a percent of total loans outstanding.

Source: Bank of Mongolia

Banking sector reform remains a priority

Last year, the weaknesses in banking sector were exposed by the failure of two major banks which had to be taken into receivership. Loan quality, in particular to the private sector, deteriorated markedly over this period. Non-performing loans and loans with their principal in arrears currently stand at 21.5 percent of total outstanding loans. Excluding the two failed banks, the NPLs and loans with principal in arrears as a percent of total loans outstanding are 14.5 percent as of end-March, 2010 (Figure 17). However, the steady increase in NPLs seen last year appears to have come to an end with total NPLs amounting to roughly 416 MNT billion in March, down from MNT 462 billion in December. But, loans with principals in arrears[3] continue to mount, reaching MNT 149 billion in March, up 23 percent since December. In March of this year, however, the commercial banks made a profit of MNT 2.8 billion compared with a loss of MNT 143.4 billion for 2009 as a whole[4].

A bank restructuring strategy was recently drafted by the Bank of Mongolia, reflecting lessons from international experience (including those of Sweden, Thailand, and Turkey—as detailed in Box 3). The draft was discussed with various stakeholders, including the banks and members of parliament. Timely endorsement of the plan by Parliament is now crucial. The proposed strategy is founded on three principles. First, there should be well-capitalized, strong and effective banks with fit and proper private owners and managers who can enforce banking laws and regulations. The banking sector is only as strong as its weakest link. Second, if owners cannot inject the additional necessary capital to comply with the existing prudential regulations, public funds to support banks could be used, as a last resort and

[3] These are loans of which the principal is 1 to 90 days in arrears. After 90 days, they are categorized non-performing loans.

[4] Consolidated Loan Report, March, 2010, Bank of Mongolia

under stringent conditions. Lastly, the recapitalization process should be fully transparent in terms of objectives and rules to pursue, and all banks should be treated fairly and equally.

Box 3 Turkey: Banking sector reform following the 2000/2001 crisis

The origins and impact of the banking crisis

In December 1999, Turkey's banking sector began showing signs of difficulty as settlement and clearing issues were revealed. The banking system was rife with weak banking practices, poor regulation and a lack of corporate governance. Most private banks were not publicly traded and many were run as de facto treasuries of their corporate groups. Public banks were allocated to political parties; these banks were used to provide subsidized credit to political constituencies, and bank losses were covered by the government. Accumulated losses made these banks highly vulnerable to liquidity and interest rate shocks. By December 1999, five of Turkey's banks had been bailed out by the government.

Government and Central Bank action was slow and ineffective. By December 2000, another three banks had to be bailed out. Threats of activating cross default and force–majeure clauses in loan agreements were surfacing. Following further ineffective government efforts, another even larger crisis hit in January/February, 2001. The currency devalued and banks faced huge liquidity problems. By this time, banks owed USD16 billion to foreign creditors (excluding off balance sheet positions). The government was forced to intervene in the operations of another two banks.

The sector was now in a full-fledged crisis, resulting in an erosion of base capital, a drying up of bank liquidity, a run on banks' deposits due to a loss of public confidence and further bank failures. The crisis was becoming systemic and increasingly more expensive to address. However, government action was tardy, due to the fragility of the political platform—a coalition government consisting of three parties.

Restructuring strategy

Faced with the spectre of a meltdown, the government and central bank finally decided that a comprehensive Bank Restructuring Program (BRP) was required. The four main pillars of the BRP were: i) restructuring the state owned banks; ii) taking over problem banks by the Savings Deposit Insurance Fund and restructuring them; and iii) strengthening the regulatory and supervisory framework, together with a recapitalzation program.

Accumulated losses of the state-owned were equal to USD 26 billion. Overnight borrowings to stay liquid equalled a stunning USD 14 billion. Banks were encouraged to reorganize themselves towards distribution channels, marketing, sales, internal control and risk management. Advisors and experts were appointed by the government for operational re-engineering and public relations. A privatization plan was also adopted.

The Savings Deposit Insurance Fund (SDIF) took over the problem private banks. The SDIF needed USD14 billion cash for the restructuring process. Private banks were either sold quickly or subject to purchase and assumptions and merged into optimum sizes in order to start cost cutting immediately. Overall, USD 27.7 billion of bank costs were transferred to the SDIF, out of which USD 11.8 billion or 42 per cent were collected from shareholders.

A new bank restructuring law was introduced and the bankruptcy law was amended to increase its efficacy. The regulatory and supervisory framework was also improved and new and revised regulations were developed. These included regulations relating to: capital adequacy, risk management, lending limits and loan loss provisioning, related party exposure, accounting standards and independent auditing.

A debt swap operation ($7.5 billion against local currency government bonds) was conducted and a recapitalization program was implemented. In retrospect, the restructuring effort resulted in a consolidation of the banking sector, a decline in the relative share of state and SDIF banks, a reduction of financial risks, improved transparency, improved profitability, strengthened capital structure, and increased credit extension and foreign funding. Fourteen banks, including one systemic bank, were merged to three banks. In 1999, there had been 81 banks operating in Turkey. As of 2010, there are 45 banks in Turkey. Turkish banking capital now equals USD 73.4 billion up from a mere USD 1.4 billion in 2001.

Lessons Learnt

- Cost could have been lower had the restructuring strategy been in place earlier. A firm policy for dealing with intervened banks will keep the costs of bank restructuring to a minimum.
- Legal risks could have been addressed earlier. For instance, there should be no legal difficulties associated with selling assets. A predictable, enforceable and reliable legal system will keep costs down. It will also keep interference from government and other interest groups to a minimum.
- A strong supervisory structure is crucial. Close cooperation is needed between onsite and offsite supervision. It is important that outside experts are brought in to detect possible fraud and misreporting.
- Timely public information was critical. Keeping the public informed is essential is maintaining confidence in the financial system.

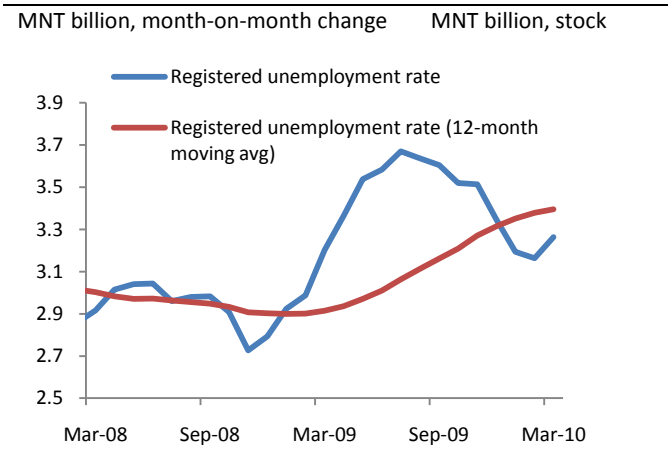
Source: World Bank based on BRSA and SDIF reports and Engine Akcakoca presentation at UB banking workshop.

Labor Markets and Poverty

Unemployment, as measured, by the labor force survey has reached almost 13 percent

The official unemployment rate, which includes only those who are registered with the Labor and Social Welfare Service Center, has been trending downward since July 2009, falling to 3.3 percent in March (Figure 18). This is only slightly up on 3.2 percent in March 2009. However, the overall number of registered unemployed has continued to increase, up almost one-third compared with December 2008.

Figure 18 Registered unemployment* has decreased in recent months



Note: * Defined as working-age population currently not working in a paid job and not self-employed, actively looking for job and registered at the Employment Office.
Source: National Statistical Office, World Bank

Nevertheless, as explained in previous Updates, these numbers likely grossly underestimate the impact of the economic downturn on both the level of unemployment and real wages. According to the Fourth Quarter Labor Force Survey, which also takes into account those who are not officially registered as unemployed with the Labor and Social Welfare Service Centers, the unemployment rate stood at 12.8 percent, up from 10.5 percent in September 2009, with some 142,000 people unemployed from the total labor force of 1120 thousand.

The rural poor and effects of dzud

The recent dzud marked a record disaster affecting over 80 percent of Mongolia's territory, 175 soums and 98 thousand herders. According to the latest information by the Ministry of Food and Agriculture, the total official livestock loss due to the dzud is around 6.9 million or 15.6 percent of the total herd. Based on average livestock prices, herders lost MNT 360.3 billion just over the winter. In order to help relief efforts related to the Dzud, the international community, including the World Bank committed USD 11.9 million, which enabled the government to distribute MNT 26.2 billion to date.

Box 4 A Herder loan is a performing loan

With herder livelihoods adversely impact by the recent severe dzud what is the potential impact on the banking sector? This Box examines this question, and the characteristics of loans to herders, using data from KHAAN bank, a major lender to herder households.

Of the total 171,000 herder households in Mongolia around 66,000 (39 percent) have outstanding loans from the KHAAN bank amounting to around MNT 60 billion. Herder loans account for 9.7 percent of total loan portfolio of the bank. In contrast with other types of loans that are paid on monthly basis, the herder loan is a specific loan product because it helps herders to meet their consumption and commercial needs with repayments twice a year: i) in May-June out of herders' income due to the cashmere season and ii) in October-November when income arises during the meat slaughtering period. The average maturity is 9-12 months with an average size of MNT 917,000 per herder. Herders who have more than 200 livestock are eligible for this type of loan product. The herder loans are used for a mix of consumer and investment goods along with education costs - around 77 percent of the borrowers disburse their credit to purchase a solar panel, an automobile, an electric appliance, hay and fodder or pay the tuition fees of their children.

Despite their specific repayment arrangements, the herder loan is found to be a reliable loan for the bank. Around 95.3 percent of herder loans are performing with herders managing to repay their loans on time (as of March 31, 2010, past due herder loans were 4.3 percent of the total loans outstanding). The majority of the herder loans were issued when the cashmere price was fluctuating in between of 23-28 thousand MNT/kg in 2009. However, the price is now at 54 thousand MNT/kg, aiding the repayment rate.

Three main reasons account for a herder loan becoming overdue. First around 23.6 percent were overdue because of logistical problems of being unable to visit or contact the soum center where the bank is located. Second, a further 28 percent of past due loans were due to a lack of cash income which was supposed to be generated out of sales of livestock or raw materials such as hide, skin etc. Third, 15.6 percent were overdue due to livestock losses.

What has been the likely impact of the dzud? KHAAN bank foresees that loan quality might deteriorate due to the impact of the dzud and therefore has been taking the following measures to ensure smooth repayment of the credits:

- A 100 percent waiver of fees and an extension of maturity. Roughly 21,700 herders are covered under this measure with 96 percent repaying on time and over MNT 300 mn of fees waived.
- A second round of maturity extension has occurred, helping herders with longer term loan maturities and providing flexibility to repay the loan out of their future income. 1.4 percent of total herder borrowers (951 herders) were covered under this measure.
- For those herders who lost their entire stock of animals, concessional terms such as waiving penalty interest and applying payment to principal first were offered.

In addition to these measures, the bank has also increased loan provisioning by 10 percent until June 30th, 2010.

Note: Data sourced from KHAAN Bank.

Reform agenda currently at the spring session of Parliament

Currently, the Mongolian Parliament is discussing a number of important reform laws. These include comprehensive social welfare reform legislation to consolidate and improve the targeting of existing social transfers in a fiscally sustainable manner. Parliament is also expected to adopt a Fiscal Stability Law and an Integrated Budget Law which will put in place a fiscal framework for managing

mining revenues (both in terms of volatility as well as a long-term increase due to the OT project) as well as a commitment to prudent fiscal policy.

With regard to the banking sector, a restructuring strategy has been submitted to improve the functioning of the banking sector and set in place a transparent mechanism for timely and cost-efficient bank resolution techniques. Existing banking legislation was amended in January to improve the governance of the banking sector by strengthening the central bank's intervention powers and sanctions.

These reforms will play a crucial role in protecting the economy from future mining boom-and-busts in a fiscally affordable manner. Similarly, addressing the current problems of the financial sector in a decisive and transparent manner will prepare the sector for the coming upturn in economic activity, investment and capital flows in the years ahead.

Finally, there is also likely to be an amendment to the 2010 budget in the spring parliamentary session. The annual budget law for 2010 was approved by Parliament in November 2009 despite a presidential veto on its public investment program (PIP) that included MNT 76 billion of investment projects allocated for each election constituency, with the majority of PIP projects lacking feasibility studies. This was also confirmed later in an audit carried out by the Mongolian National Audit Office, resulting in growing pressure for an amendment to the Budget to exclude these projects at the current session. Most importantly, the amended budget should reflect that the lessons of the past boom-and-bust cycle have been taken to heart, and that better-than-expected revenues should not immediately be translated into higher spending. As the previous experience showed, this is likely to quickly lead to higher inflation and will make the bridging needed to OT even more difficult.

Table 2 Mongolia: Key Indicators

	2003	2004	2005	2006	2007	2008	2009
Output, Employment and Prices							
Real GDP (% yoy change)	7	10.6	7.3	8.6	10.2	8.9	-1.6
Industrial production index	..	..	..	100	110.4	113.4	109.6
(% yoy change)	..	..	..	..	10.4	2.8	-3.3
Unemployment (%)	3.4	3.6	3.3	3.2	2.8	2.8	3.3
Consumer price index (% yoy change)	4.6	10.9	9.6	5.9	14.1	23.2	1.9
Public Sector							
Government balance (% of GDP)	-3.7	-1.8	2.6	3.3	2.8	-5	-5.4
Non-mining balance (% of GDP)(1)	-5.9	-5.8	-1.3	-7.3	-13.4	-15.1	-12.9
Domestic public sector debt (% of GDP)	3.1	1.4	0.1	1	0.5	0	6.3
Foreign Trade, BOP and External Debt(2)							
Trade balance ($ mn)	-199.6	-99.2	-99.5	136.2	-52.4	-612.6	-157.9
Exports of goods ($ mn)	627.3	872.1	1066.1	1542.8	1889	2539.3	1902.6
(% yoy change)	19.7	39	22.2	44.8	22.4	34.4	-25.1
Copper exports (% yoy change)	..	..	14.7	94.8	27.7	12.1	39.9
Imports of goods ($ mn)	826.9	971.3	1021.1	1485.6	2117.3	3615.8	2131.3
(% yoy change)	21.6	17.5	16	25.4	42.5	70.8	-41.1
Current account balance ($ mn)	-102.4	24.1	29.7	221.6	264.8	-721.9	-235.1
(% of GDP)	-7.1	1.3	1.3	7	6.7	-13.9	-5.6
Foreign direct investment ($ mn)	131.5	128.9	257.6	289.6	360	836	426
External debt (% of GDP)	92.6	76	61.2	45.1	40.1	34.6	50
of which public & publicly guaranteed (% of GDP)	87.3	73.7	59.7	44.3	38.9	33.7	47.1
of which private (% of GDP)	5.4	2.4	1.5	0.7	1.2	0.8	2.9
Debt service ratio (% of exports of g&s)(3)	35.1	7.5	2.7	2.3	2	2	3.7
Foreign exchange reserves, gross ($ mn)	203.5	207.8	333.1	718	1000.6	656.9	1327
(month of imports of g&s)	2.4	2	2.6	4.3	3.8	3	4.9
Financial Markets							
Domestic credit (% yoy change)	157.3	25.8	18.8	-3.1	78.4	52.5	-7.5
Short-term interest rate (% per annum)(4)	..	15.8	3.7	5.1	8.4	9.8	..
Exchange rate (MNT/USD, eop)	1168	1209	1221	1165	1170	1267.5	1442.8
Real effective exchange rate (2006=100)(5)	94.2	93.9	99.6	102.8	104.8	127.4	102.9
(% yoy change)	-4.8	-0.4	6.1	3.2	1.9	21.5	-19.2
Stock market index (2000=100)(6)	151.5	120.8	203.6	382	2048	1181.6	..
Memo:							
Nominal GDP (MNT bn)	1660	2152	2780	3715	4600	6020	6055
Nominal GDP ($ mn)	1448	1814	2307	3156	3930	5258	4.203
GDP per capita ($)	583	722	900	1214	1491	1980	1600

(1) Non-mining balance excludes revenues from corporate income tax and dividends from mining companies, the Windfall Profits Tax and royalties. (2) The 2008 data for the balance of payments are based on the final revision. (3) On public and publicly guaranteed debt. (4) Yield of 14-day bills until 2006 and of 7-day bills for 2007. (5) Increase is appreciation. (6) Top-20 index, end of year, index=100 in Dec-2000.

Source: Bank of Mongolia, National Statistical Office, Ministry of Finance, IMF and World Bank staff estimates