



MONGOLIA QUARTERLY

WORLD BANK

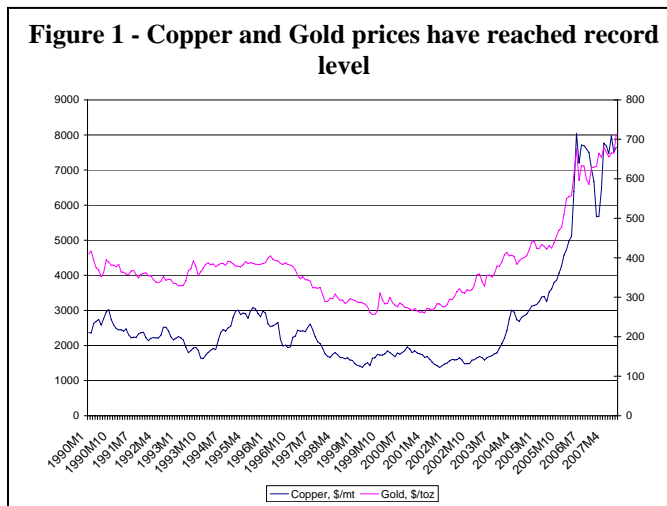
November 2007



The World Bank's *Mongolia Quarterly* 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 Quarterly* is produced by a team from the World Bank's Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Regional Vice-Presidency, with key inputs from other members of the Mongolia Country Team. Questions and feedback can be addressed to Sunjidmaa Jamba (SJAMBA@WORLDBANK.ORG)

RECENT ECONOMIC DEVELOPMENTS

1. *Mongolia continues its rapid growth but inflationary pressures have emerged.* Real GDP growth rate was 8.6 percent in 2006 and is projected to be around 8.5 percent this year. As of August 2007 gross industrial output increased by 13.6 percent in real terms compared to the corresponding period last year, led by manufacturing (33.7 percent), grain mill and fodder products, dairy products, and basic metals. While most of the foreign direct investment (FDI) coming into Mongolia continues to go to mining, its output grew by only 3.9 percent this year (mainly came from coal extraction). Mining is also the main source of government revenues. The revenues from the mining windfall tax accounted for 18.5 percent of total central government budget revenue in August 2007. Inflation (CPI) picked up from a low 4.2 percent in January 2007 to 11.3 percent in August, due to rapid monetary growth, public sector wage increases and increases in the price of some main imports (c.f. next section). As of August 2007, broad money increased by 45 percent and credit to the private sector by 53 percent.



2. *High international prices for copper and gold have sustained Mongolia's export earnings in 2007.* Total exports increased by 27 percent and total imports by 40 percent in August 2007 compared to the same time a year ago. Mineral products exports rose by 36.7 percent during this period with copper concentrate contributing to 44.3 percent and gold exports to 16 percent of total export volume, respectively. Meanwhile the togrog depreciated somewhat vis-à-vis the U.S. dollar and reached an exchange rate of Tg 1,187.3/USD at end-August 2007.

3. *The government's fiscal surplus has continued, mainly due to revenues from trade and income taxes.* As of end-August 2007, the government budget recorded a surplus of 172

billion togrog. Government revenues reported an increase of 50 percent compared to the same time last year, while government expenditure had increased by 54 percent during this period (y-o-y). The main factors contributing to this surplus were the prevailing high levels of copper and gold prices which led to an increase in foreign trade and income taxes, and dividend earnings from the Erdenet Copper plant that were transferred to the Government, its owner (Tg 59 billion). Meanwhile, government revenues from the other main taxes, such as Personal Income taxes (PIT), navigation, royalty and land fees were below budget targets. VAT refunds are on the rise as well.

Table 1: 2007 Amended Budget

Percentage of GDP	GB	DF	CB
Revenue	40.2	7.1	40.2
o.w. Windfall Tax	7.1	7.1	7.1
Expenditures	41.3	6.9	41.1
Current	31.9	2.7	27.5
Capital and net lending	7.0	4.2	11.2
Balance	-1.0	0.2	-0.8

*GB: General Budget; DF: Development Fund;
CB: Consolidated Budget.*

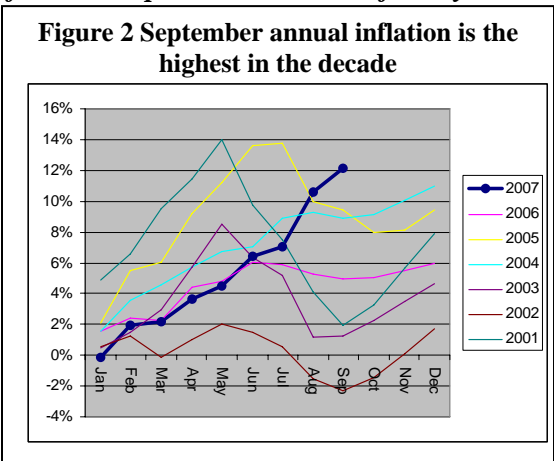
4. *Fiscal policy, as outlined in the amended 2007 budget, is significantly expansionary.* Government expenditure is budgeted to increase by 80 percent due to another public sector wage increase, and renewed spending on social welfare programs and public investment programs. This

raises concerns about the efficiency, sustainability and quality of these expenditures, partly since any analyses of the trade-offs involved in the government's spending plans are not readily available to the public to facilitate debate. Questions also have been raised by businesses about the nature of implementation of the Windfall Tax for gold and the instability it has caused in the investment climate in the mining sector. Many have called for a review of the mining tax legislation. Meanwhile, Parliament has started discussions on draft investment and shareholder agreements for the two large mining deposits Oyu Tolgoi and Tavan Tolgoi. A joint Parliamentary and Government Working Group has been set up to re-visit these agreements.

5. ***So far, Mongolia is at moderate risk of debt distress over the medium term.*** The debt burden looks sustainable assuming no major negative terms of trade shock and only concessional borrowing. The total public debt was equivalent to 42.3 percent of GDP as of end-2006, and 31 percent in Net Present Value terms (NPV).

6. ***There seem to be some symptoms of overheating in the Mongolian economy today.*** In the economics literature, a situation of "Overheating" is defined as one where the physical capacity of an economy is unable to keep pace with the demand for goods and services. A look at the aggregate demand and supply factors and structural characteristics of the Mongolian economy today, suggests that the prevailing inflationary pressures are the combined result of three factors: (i) increase in prices of key imports (i.e. "imported inflation" that has been further accentuated by the recent depreciation of the Togrog vis-à-vis the Chinese Yuan); (ii) recent upward adjustments in administrative fees and tariffs for basic utilities, transportation, education and health services; and (iii) a general price increase caused by the rapid growth in net aggregated demand components. All these factors have together contributed to increasing the available liquidity in the economy and pushed domestic prices upwards. Exchange rate movements (with a mild depreciation of the Togrog of late) have been unable to provide the necessary buffer for this price movement. The public sector has directly contributed to these inflationary pressures via recent increases in civil service wages and social entitlements even though the announced overall government spending increases have not yet fully taken effect. Inflationary pressures therefore have been generated by expectations and credit expansion on the basis of income increases of borrowers. The Government is also limiting its future fiscal space by increasing its recurrent spending and social entitlement commitments.

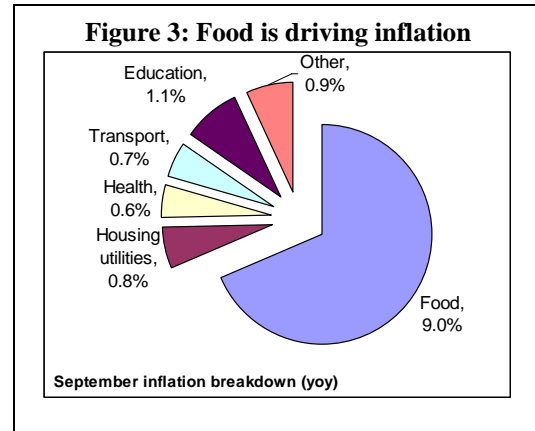
7. ***The inflation rate has increased over three-fold in the past nine-months of this year.*** At end-September 2007, the inflation rate measured in terms of the Consumer Price Index (CPI) stood at 13.1 percent year-on-year (yoy), and 12.2 percent since the beginning of 2007—the highest September-level inflation rate one has observed in Mongolia since the beginning of this decade. In January 2007, the inflation rate was 4.2 percent (yoy). Typically, inflation is highly seasonal in Mongolia. Food prices tend to go up starting in April and go down again from August. This year, however, such a seasonal pattern was not observed and the increase in prices of consumption goods (including food) has continued into September. Meat prices have started to decline recently though (by 4 percent) since September. Figure 2 shows that the typical cyclical pattern that one saw in previous years which is notably absent this year. In an effort to keep meat prices in check, the Ministry of Food and Agriculture (MOFA) organized a meeting with meat suppliers and other stakeholders and have agreed to reserve 8000 tons of meat in the



coming year and keep the price of meat from exceeding Tg 2100 per Kg. Subsequently a cabinet resolution has been issued to this effect.

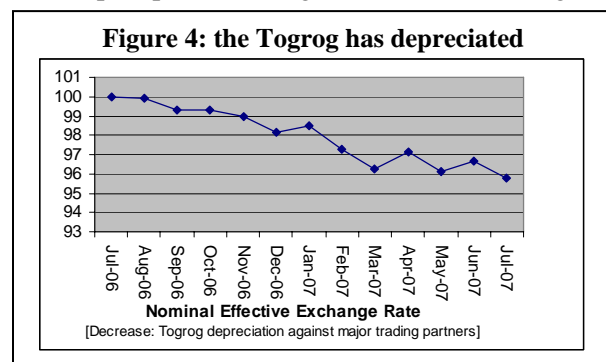
8. **The observed inflation has been driven by food items** which have a 41 percent weight in the CPI consumption basket. A decomposition of the year-on-year inflation rate as of September 2007 shows that 70 percent of the weighted average price increase (i.e. 9 out of 13.2 percentage points) is explained by the increase in food prices.

In particular, the price increase of domestically-produced meat accounted for more than 3 percentage points of the observed September 2007 inflation rate (Meat prices have gone up by 21 percent in September (yoy)). Given the absence of any adverse supply shock that one saw in Mongolia in previous years (such as a *dzud*) that may have caused a decrease in Meat supply, the increase in meat prices now is likely to be due to increased demand. There is a demand effect from the increasing wealth in the Ulaanbaatar area and prices of beef (that is primarily consumed by the higher income households) and mutton has been on the increase. Rising fuel and transportation costs are also contributing to the upward pressure on general price levels. Bread and cereals, mostly imported from Russia, contributed to 3.3 percentage points of the year-on-year September inflation rate. It should be noted that wheat crop domestic production declined in fall 2007 due to drought in the agricultural provinces such as Khentii, Selenge, and Tuv aimags, thereby contributing to reducing aggregate supply and putting further upward pressure in prices.



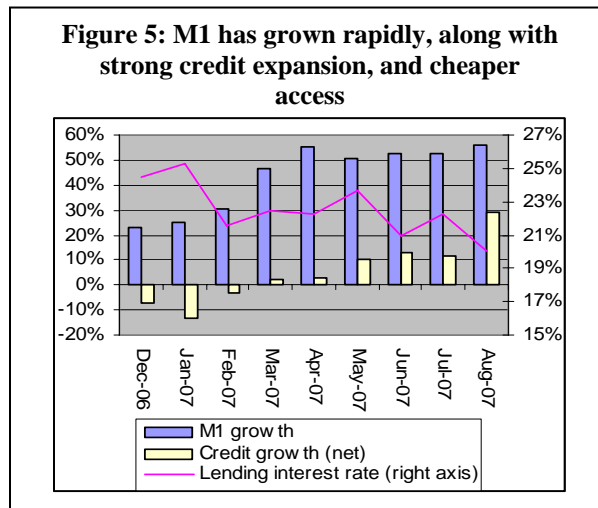
9. **But upward administrative adjustments in the tariffs of key utilities and basic services have contributed to the CPI increase as well.** In the education sector, public and private university tuition fees have increased by more than 20 percent yoy as of end of September. Hospital services (room charges) were also increased by 76 percent during this same period. In April 2007, water tariffs were adjusted upward by 74 percent, on average. (Figure 3)

10. **Imported global inflation also explains part of the food price increase one sees in Mongolia today, coupled with depreciation of the togrog** vis-à-vis the currencies of its major trading partners. Mongolia imports most of its food products, with the significant exception of locally-produced meat (mutton and beef). For example, prices of vegetables, which Mongolia mostly imports from China, were up 22.5 percent compared to a year ago and contributed to 1.8 percent of the general price increase in Mongolia. Similarly, the price of flour, which is imported from Russia, has increased by 40 percent compared to a year ago and has contributed to 2 percent of general CPI increase in Mongolia. This inflation has been transmitted through the increase in the price of Russian flour products as part of a worldwide increase in wheat prices. Meanwhile, the direct contribution of petroleum products to inflation (also mostly imported from Russia) has been fairly limited (only 0.2 percentage point of the total). On the exchange rate front, the nominal effective exchange rate (where the average



nominal exchange rates are weighted by trading importance of each of the partner countries) has depreciated by 4 percent in July compared to a year ago (yoy).

11. **Monetary growth is fueling this inflation as well.** Easy access to liquidity, due in part to foreign direct investment inflows and workers' remittances from abroad, has been instrumental in this regard. Since April 2007, the CPI growth rate on a year-on-year basis has exceeded 50 percent each month. There has also been a marked expansion in net credit from the banking sector to private sector entities as well as the Government. This combined with cheaper access to liquidity, through lower interest rates compared to past years, have added to inflationary pressures. Financial deepening has remained strong in the recent years, with M2 now accounting for 41 percent of GDP (end 2006), up from 26 percent of GDP in 2001. Some monetization of the economy is still at work. Compared with other similar developing countries, the level of monetization in Mongolia is low. In 2006 for instance, low income countries have on average a ratio of M2 to GDP of 52 percent.



ANALYSIS OF AGGREGATE DEMAND AND SUPPLY

12. **On the supply side, there is evidence of increasing cost pressures.** On the domestic front, although within year wage and income data are not available, the following evidence suggests an increasing labor cost in the economy: Rising wages in the public sector, which act as a benchmark for private sector wages, will therefore tend to push up overall wages in the economy. In addition, available indicators suggest an increase in the demand for labor: the number of registered unemployed has decreased by 3.5 percent, while employment in manufacturing has grown by 7 percent in August 2007 (yoy). Production costs for construction have also been pushed up by a short term shortage of cement, which led to a price increase of more than 70 percent since June. This sharp increase was the result of 3 combined factors: (i) China's recent decision to impose an export tariff to the exported cement and steel joist combined; (ii) a short term domestic production shortage (due to renovation of the domestic cement factory) combined with, (iii) a blockage of cement imports at the Chinese border due to a transit issue.¹ On the international front, the recent nominal exchange rate depreciation against major trading partner currencies has also played a role in increasing cost of imported goods (see above). A continued appreciation of the Chinese Yuan will push Mongolian prices further up².

13. **Aggregate demand growth is and should remain rapid.** Looking at investment, evidence suggests that investment is growing rapidly: (i) Industrial output growth is robust, expanding at 13.6 percent constant prices, with manufacturing growing by almost 34 percent (August, yoy); (ii) FDI inflows are sustained; (iii) there is a downward trend in lending interest rates (see Figure 5 above), which contributes to stimulating domestic private investment; (iv) Effective from January 1, 2007, a five percentage point cut in each of the two corporate income tax rates (along with a

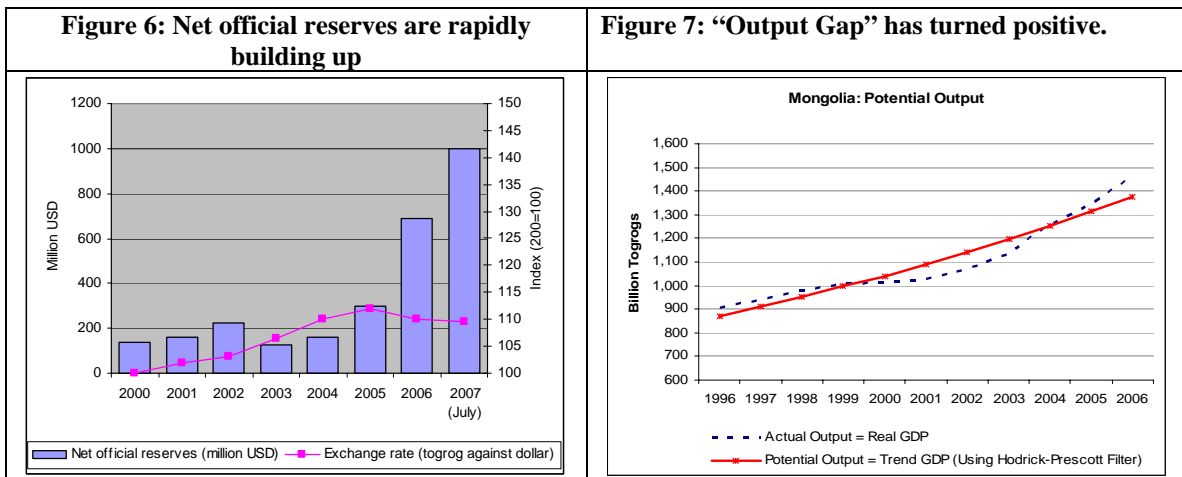
¹ This is one of the policy measures embedded in the new tax law coming into effect in January 2007. Other measures such as the elimination of tax holidays for foreign investors and the introduction of loss-carry forward provisions also contribute to stimulating aggregate supply.

² The Togrog had depreciated by 7 percent against the Chinese Yuan as of July 2007.

thirty fold increase in the higher rate's threshold) should stimulate private investment by increasing private return to capital; and (v) finally, the public investment program (PIP) was ambitiously planned to be increased from 7 percent in 2006 to 13 percent of GDP in 2007. The net Public Investment Program (PIP) impact on private investment and overall economic activity will depend on the extent to which (i) absorptive capacity develops along with the increase in investment spending; and (ii) public investment is complementing private investment by providing public goods. The crowding-out of private investment should remain limited, given the continuous downwards trend in the interest rates and the government limited domestic borrowing.

14. *It is likely that consumption growth will be sustained*, boosted by (i) expanding government consumption under the form of large past and upcoming increases in public wages and increased universal public social transfers; (ii) sustained remittances from Mongolian working abroad; (iii) a 5 percent VAT cut, effective at the beginning of 2007 combined with unification of the personal income tax at the lowest level of the previous rates (10 percent)³. However, higher consumer price inflation will tend to reduce purchasing power and real consumption.

15. *While Government spending has contributed to inflationary pressures by increasing public wages, the net public sector contribution to aggregate demand so far remains limited.* The government budget is reporting a surplus in 2006, while in 2007 the net public aggregate spending is likely to remain limited. The government deficit is projected to be around 2 percent. Nevertheless, by increasing recurrent spending at a time of high tax revenue through high commodity prices, Mongolia is taking the risk of greatly limiting its fiscal space if metal prices were to go down a declining path.



16. *Foreign saving is flowing in Mongolia, which contributes to boost aggregate demand and to accentuate inflationary pressures.* The current account is back into deficit (2nd trimester), with higher imports suggesting a stronger demand for investment and consumption. The trade balance records lower exports mainly coming from a drop in gold official exports in tonnage (- 21 percent yoy) and value (-17 percent yoy)⁴. Higher imports are accompanied by higher FDI (reaching USD128 million in the 2nd trimester, +30 percent yoy). Higher imports may heighten existing infrastructure bottlenecks, in particular in the railway transportation. For example, there

³ A good proxy for private consumption would be intra-annual income statistics, but there are not available.

⁴ The drop in official gold exports is not necessarily equivalent to a drop of total gold exports, as part of gold exports are likely to be smuggled to avoid paying the “Windfall tax” and benefit from the full untaxed gold price on international markets.

has been a marked increase in carried freight turnover at entry (by 19 percent in August yoy). Net international reserves have more than doubled (+132 percent) in August yoy, increasing further liquidities in the economy (Figure 6).

17. Calculations suggest that the “output-gap” (which is a measure of the deviation of the actual output of an economy from its potential) has turned positive in the past three years (Figure 7) thereby supporting the signs of domestic overheating that one is seeing in Mongolia today.⁵ The output gap is frequently used to gauge inflationary pressures in an economy, to indicate the economy's cyclical position, and to assess economic growth.

SPECIAL FOCUS: KEY FEATURES OF THE PROPOSED 2008 BUDGET

This section of the Quarterly examines the main features of the proposed 2008 Executive Budget as discussed by Parliament. Two important developments in the proposed 2008 Budget are: (i) the decompression of the civil service wage bill and (ii) introduction of program budgeting.

18. ***The planned 2008 overall budget is almost in balance, with a deficit limited to 0.6 percent of GDP, consistent with ensuring macro-economic stability.*** The proposed budget for FY2008 aims to achieve revenue to GDP target of 44 percent, with a corresponding programmed expenditure ceiling at 44.5 percent of GDP. The corresponding consolidated budget deficit is set at 0.6 percent of GDP. This level of budget deficit is underpinned by a real GDP growth rate of 8.7 percent and an inflation target of 5.0 percent.

19. ***The Development Fund (DF) financed out of the Windfall tax, continues to be reported outside the General Budget Account.*** While the DF operations are agreed in Parliament together with the general budget, the documentation, accounting, execution and financial management are separate. The 2008 fiscal position of the general budget does not reflect the consolidated fiscal plan of the Government finances, as it includes all revenues, but does not account for DF planned expenditures, only the windfall tax transfers. Hence, domestic investment

Table 2: 2008 Budget proposal

Percentage of GDP	GB	DF	CB
Revenue	44.0	6.6	44.0
o.w. Windfall Tax	6.6	6.6	6.6
Expenditures	47.0	4.1	44.5
Current	36.0	2.3	31.7
o.w. Child money program		2.1	2.1
o.w. School lunch		0.2	0.2
o.w. Windfall tax transfer	6.6		
Capital and net lending	8.8	1.8	10.6
o.w. Investment (dom. financed)	6.9	1.8	8.7
Balance	-3.0	2.5	-0.6

spending as well as social transfers are only partially reflected in the general budget. When the sources of spending from this DF are included in the general government budget, these expenditures are higher (See Table 2). According to international best practices, the DF operations should be consolidated with the general budget at all stages of the budget cycle—planning, execution, monitoring, reporting, and especially auditing.

20. ***The Development fund projects a total of 6.6 percent of GDP in FY2008⁶.*** According to the DF law, two-thirds of the resources in this development fund will finance social programs and

⁵ The output gap is measured as actual real GDP minus potential GDP, divided by potential GDP, where potential output is measured by any of a number of different methodologies, including in this case, by the application of the Hodrick-Prescott filter to the real GDP series to obtain its long-term trend component.

⁶ This DF, into which revenues from the windfall tax and as previous fiscal surpluses are to be channeled, was created in 2006.

capital spending while the remaining would be saved for the future. By expanding untargeted social entitlements program and increasing civil service salaries, Mongolia is jeopardizing its ability of executing a counter cyclical fiscal policy. In case of a downturn in commodity prices and corresponding slowdown in economic activity, the State Budget will need to cut back on social transfers in order to maintain macroeconomic stability, at the time when social protection expenditures would be needed most. This could lead to significant socio-economic instability.

Box 1: Civil Service Structure and Changes and Wage Bill Increases – Introducing Differentiation

In the approved 2007 budget, the Government had provided for an increase in the wages by 30 percent. In the beginning of the fiscal year, wages were increased by 20 percent. The remaining 10 percent was retained. In July 2007, the government moved to increase the salary by the remaining 10 percent, however, the Parliament did not allow this additional increase, but mandated the Government to increase the average civil service wage up to tgs. 250,000 from October 1, 2007. Following this decision, the Government issued two resolutions (No.236 and No.237) to revise the civil service grades and classification, and revise the minimum wages for each grades. According to these new regulations, bonuses for support staff, especially for primary and secondary school teachers are incorporated into the basic salary.

Prior to this revision, the civil service was classified into four categories: (i) political, (ii) administrative, (iii) special and, (iv) support staff. Resolution No.236, increased the categories to: (i) administrative, (ii) political, (iii) special staff, (iv) support staff in science sector, (v) support staff in tertiary and vocational education, (vi) support staff in primary and secondary education institutions, (vii) health sector support staff, (viii) support staff of cultural and art institutions, and (ix) support staff in other entities. The government also approved minimum and maximum salary for administrative, political and special civil servants but defined only the minimum salary for all types of support staff.

In FY2008 the government has decided to increase the wage bill by between 20 – 30 percent, by providing *differentiated* increases to different positions. This is the first time the Government has decided to provide differentiated wage increases to different positions. Previously, the Government had provided across the board increases. The FY2008 proposal calls for decompression of the wage structure between public management and operational posts by double wages of state high-ranking and equivalent positions, and staff at the court and prosecutor's office, as compared with other posts. The compression rates of public administration posts would increase from 2.0 to 2.5, while for technical posts from 2.4 to 3.1.

As part of the Budget process the Government is proposing to eliminate extra duty allowances and to consolidate the provision into the basic pay package. At the same time the proposal is to increase the additional pay for political posts for special work to 30 percent, taking into account specifics of the work and functions. However, various additional allowances of special civil servants for service term and rank have been retained.

21. ***A corresponding increase in expenditures is projected, from 41.1 percent in FY2007 to 44.6 percent of GDP.*** The increase in expenditure is largely on account of an 81 percent increase in wages and salaries, an increase of 3.5 percent of GDP (from 6.9 to 10.4 percent of GDP). This increase is attributed to an increase of 20 percent in salaries, monetization of certain benefits, and new hiring. Box 1 above presents the changes to the wage structure as per Government Resolution No 237 of September 2007.

Box 2: How are public investment projects selected?

The 2008 Budget reports the following principles which should guide public investment decisions in Mongolia:

- The Government Action Plan,
- The completion of on-going projects
- The concept of regional development
- Income generation by encouraging economic growth
- Youth recreational and entertaining activities

In addition, the proposed Budget includes an assessment of investment efficiency by looking to two main indicators, namely, the share of investment in total gross domestic product (GDP) and the incremental capital-output ratio (ICOR). The latter is used to estimate the capacity of the economy to absorb planned public investment.

The Public Investment Program (PIP) focuses on domestically-financed projects. The PIP consists of a list of projects for each ministry. Although the Development Fund is kept separate from the General Budget account, the 2008 Budget proposal as well as the public investment program discusses public investment projects from all domestic sources (i.e. the General Budget, Development Fund, and Road Fund). Although, the linkages with the overarching planning strategy are explicitly presented in the 2008 Budget document, the rationale (e.g. social and economic) for the selection of each of these projects needs further elaboration. It would also be useful to discuss in the project appraisal, the trade-offs that were involved in deciding on these public investment programs, and their associated cost-benefit analyses. More importantly, an estimate of the yearly recurrent costs generated by new public investments should be discussed as it would impact on the future fiscal space of the Government and its medium term expenditure framework (MTEF).

Foreign funded projects are presented separately. The proposed 2008 Government Budget document discusses progress in each of the projects, without though discussing their rationale, their consistency with the domestic PIP and overall prioritization.

22. ***FY2008 projects an increase in revenue collection, from 40.2 percent of GDP in FY2007 to 44 percent in FY2008.*** The increase in revenue is primarily projected to be due to an increase in VAT collection (+4 percent of GDP), as well as to a lesser extent corporate income tax (+0.5 percent) and customs duties (+0.9 percent). Increase in VAT and corporate tax may be attributed to an increase in compliance and tax base following the enforcement of the 2006 tax reform package including a lowering of the rates. It is also due to an overall increase in economic activity due to an ongoing mining boom due to high copper and gold prices and investors’ anticipation of new world class mines coming on stream. The authorities are projecting a copper price of US\$6,800 per ton and a gold price of US\$690 per ounce, on the basis of major international projections. By contrast, the windfall tax declines as a share of GDP from 7.1 to 6.6 percent of GDP, illustrating the ongoing growing tax evasion of gold producers.

Table 3: Expenditure by sectors

	2007	2008
Education	17%	19%
Health	9%	10%
Social Welfare	33%	30%
Defense	2%	3%
Justice	7%	4%
Administration	16%	17%
Infrastructure	16%	17%
Total	100%	100%

23. ***The budget for FY2008 shows that there are significant resources being devoted for social expenditures.*** Table 3 shows the sectoral composition of the budget as share of the total budget. Education and health as a share of total expenditures has increased, while social welfare and expenditures on justice have contracted relatively. Mongolia public finance management system is robust enough to also ensure that resources are delivered to their intended needs. It is not possible to determine the quality of services delivered from this analysis.

24. *The level of capital spending remains sustained at 10.7 percent of GDP*, after a three-fold increase between 2006 and 2007. The maintenance budget has continued to lag. The Budget for FY2008 proposes to increase capital spending from Tgs. 293 billion in FY2007 to Tgs. 455 billion. While at the same time capital maintenance expenditures are only increasing by Tgs. 8 billion, from Tgs 18 billion in FY2007 to Tgs 26 billion. Over the last 5 years, maintenance allocations have lagged significantly behind capital expenditures. It would be highly recommended that the maintenance cost of investment is explicitly part of the decision making process of whether to incur an investment or not, and then to provide appropriate allocations in the recurrent budget to meet the maintenance costs for projects. This will help prolong asset lifespan and in the long run cost less.

Box 3: Different types of Public Budgeting Methodologies

➤ **Line item Budgeting** (or input-based budgeting consists of the classification of expenditures on the basis of categories or “objects of expenditures” (personnel services, contractual services, capital outlays, etc.) and within each category more detailed line-items (salaries, travel, telephone, etc.). Even when a more complex budgeting technique is used, the "line item" budget usually exists. It stresses adherence to the Government Chart of Accounts and is primarily used as an expenditure control device. For instance, a fast increase in salaries, or travel costs, will be easily detected. On the other hand, it provides little information about the objectives and outcomes of programs and services being provided to citizens. In addition, individual departmental reductions in line items may have a significant impact on programs outcomes. Finally, this approach to budgeting is more rigid, as restrictions apply to transfers of funds between the lines after the adoption of the annual budget.

➤ **Incremental Budgeting** often works hand in hand with line item budgeting. With this approach, each line item is increased or decreased across the board, often based upon an arbitrary factor (e.g. rate of inflation). In such process, the recipient is usually guaranteed its prior year’s base allocation and negotiations are limited to the amount of the increment to be applied for the upcoming year.

➤ **Program Budgeting** (or output-based budgeting) consists of classifying and analyzing the proposed expenditures ("lines") by the functions (programs, problems, or policy issues) in which they are used. A program budget sets for the proposed expenditures as they relate to each function. The advantage of this kind of budget is that one can see what the money is being used for. It focuses on the issues to resolve and objectives to attain as well as the resources needed. This approach emphasizes the policy implication of budgeting. It also permits policymakers and the general public to comment on and compare programs. A significant disadvantage is that this approach requires more capacity and staff time.

➤ **Performance (or Output/outcome-Based) Budgeting** usually goes hand in hand with program budgeting. It focuses on the classification of expenditures relative to activities, the output and costs, and more broadly to the overall quality of programs and their benefits to stakeholders. Among the advantages of performance budgeting, the outcomes and benchmarks should be agreed by all ex-ante and should be consistent with the overarching sector stated strategy and objectives. Successful programs can build stakeholder support because the outcomes can be documented with measurable impact indicators and shared with the public. One significant disadvantage is the same as program budgeting: it requires significant capacity and staff time.

Source: World Bank.

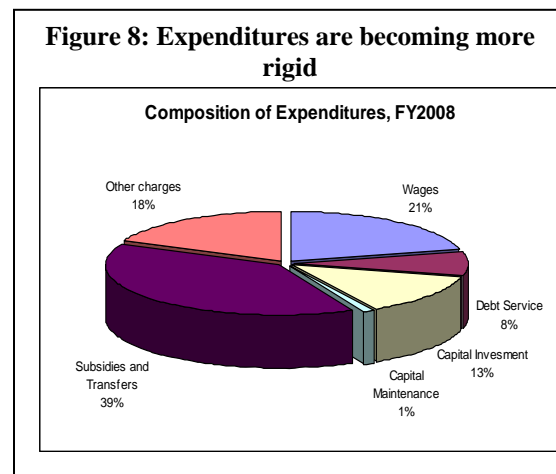
25. *Public investment focuses on infrastructure and social services*. Almost half of the investment budget goes to infrastructure, while 20 percent is devoted to education and health. In the energy sector, the main focus is on (i) power transmission lines to soums; (ii) transmission line to OT/TT; (ii) investment in a facility of production of new briquettes reducing air-pollution in UB. In the road and transportation sector, the millennium road project accounts for one third of total allocation to the sector, while 18 percent is dedicated to civil aviation, and 11 percent to road

maintenance. In the social sectors, investment is going to new education and culture buildings and facilities and to new hospitals and equipment. There is no discussion on the tradeoff for financing hospital and schools vis-à-vis other locations or options. In particular, how domestic investment program coordinate action in the social sectors with foreign-funded interventions is not discussed and would be useful.

26. **About 68 percent of the budget is spent on fixed or difficult to adjust downwards category of expenditures, while only 18 percent of expenditures are provided for operating charges.** The structure of budget seems rather rigid, as most of the expenditures are on fixed or difficult to adjust expenditures especially cyclically. In addition, there is real need to provide a higher level of capital maintenance expenditures, as 1 percent would not be adequate for the upkeep of investments. Generally, the rule of thumb is to provide between 7 to 10 percent of capital costs for maintenance.

27. **For the second consecutive year, increased resources are being allocated directly to local governments.** Local budgets will increase 2.1 times, and local investment by 2.6 times since 2006. As the expenditure assignments have not been changed, the enhanced budget allocations provide a real increase in resources for local governments.

28. **The first attempt to develop a program-based budget plan was developed in 3 pilot ministries (Education, Social Welfare, Food and Agriculture) and submitted to Parliament with the General Budget.** The objective is to enhance the consistency between approved policies and their implementation plans including their funding; to be able to better plan for future funding based on projected desired outcomes; to increase accountability for implementing activities and achieving results; and to evaluate performance in lights of achievements of stated projected outcomes. These program-based budget plans were submitted to the Parliament along with the budget law. Upon the Parliament’s deliberation and view on these pilots, program-based budget plans could be applied to all government agencies and entities in the following years.



29. For instance, the 2008 budget proposal of the Minister of Education, Culture and Science describes the main programs to be implemented in order to achieve the objectives laid out in the sector’s long and midterm master plans, MCA goals, and in the coalition government action plan. 5 major programs are presented: (i) pre-school education; (ii) General Education; (iii) Vocational and higher education; (iv) Culture and Art Program; (v) Science and Technology. For each of these programs, outcomes and their associated budget to achieve them are presented. Key issues (or obstacles) are also laid out followed by planned policy measures to resolve (overcome) them.

RECENT STRUCTURAL REFORMS

30. Since its establishment in 1992, the Parliament of Mongolia has been the single legislative body of the country. As per its mandate, each year Parliament discusses and enacts the *Annual Budget Law*, *Socio-economic Guidelines (SEG)* and *Monetary Policy Guidelines*, along with other laws and policy documents. This year, the following draft legislations were presented by the Executive branch of Government to Parliament: the *Procurement law*; an amendment to

the 2007 Budget Law; the *Medium-term Budget Framework (MTBF) for 2008-2010*; amendments to the *Criminal Code and Criminal Investigation code*; a draft *National Development Strategy (NDS)* document; and draft Investment and Shareholder Agreements for the two major mineral deposits—*Oyu Tolgoi (OT) and Tavan Tolgoi (TT)*. It also accepted for discussion various draft resolutions on subjects ranging from Air Pollution to a Millennium Development Goals (MDG) Progress Report.

31. ***The banking sector has shown rapid credit growth in the last year and consequently the non-performing loan ratio for the banking system declined to 3.7 percent as of September 2007.*** This rapid growth presents challenges so as to ensure that the growth is sound and sustained. Experience in other countries has shown that portfolio growth can some times mask weak credit underwriting practices. This is particularly important for Mongolia as a few large banks appear to be responsible for the fast credit growth and the smaller banks may have to resort to higher risk lending to increase lending and improve profitability. Furthermore, in the past few months the mortgage lending has also grown rapidly and passage of the draft mortgage and securitization laws is essential for further development of this segment. Finally, the Government of Mongolia has also recently developed a draft *Law on Development Banking* which was discussed and supported by the Cabinet and submitted to the National Security Council. In this regard, it should be noted that any government programs that are intended to promote financial sector development (for example, the proposed creation of a development bank) should be carefully structured so as to rely on market mechanisms as much as possible and avoid creating unfair competition or other distortions in the financial sector.

32. ***On the non-bank side,*** Parliament recently approved a Law that partly covers the losses of the victims of the failed Savings and Credit Cooperatives (SCC). Efforts are also underway by the authorities to develop the domestic capital markets. The capacity of the Financial Regulatory Commission should continue to be strengthened so that it can regulate the non-bank institutions effectively and preempt the need for such financial intervention from the Government. Improved governance and implementation of international accounting and auditing standards in the corporate sector would be essential for the successful development of this market.

33. ***Governance reforms are underway.*** Asset and Income Declarations of high level government officials had been collected by the Anti-Corruption agency and made publicly available according to the Anti-Corruption Law that was adopted by Parliament last Fall. Also, Parliament recently amended the *Procurement Law* and authorized the relevant line- ministries to award direct contracting on investment projects in order to speed up the implementation. Meanwhile, Parliament has returned the drafts of the NDS, OT and TT agreements to the Government and has requested the respective working groups to consider further improvements. Parliament shall continue discussions on the above mentioned strategic mining agreements, NDS, annual budget law, monetary policy guidelines and SEG during the Fall session. In addition to these, the Parliament is expected to discuss a draft *law on Right and Freedom of Information*; amendments into the *Civil Service Law and Social Insurance Package Law* during the Fall Parliamentary session.

RECENTLY RELEASED WORLD BANK STUDIES ON MONGOLIA

Country Economic Memorandum - Mongolia Sources of Growth

July 2007

This Economic Report aims to inform the ongoing debate on the Government's long term development priorities in Mongolia. It discusses the key facts and potential implications the Government would need to consider when determining its public spending, public investment program, fiscal space, and borrowing strategy going forward.

<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/MONGOLIAEXTN/0,,contentMDK:21487082~pagePK:141137~piPK:141127~theSitePK:327708,00.html>

Rethinking the Delivery of Infrastructure Services in Mongolia

June 2007

The report focuses on improving the capacity of the country's institutions to manage, finance and extend quality infrastructure. The findings are intended to be an input into the process of formulation of a National Development Strategy.

<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/MONGOLIAEXTN/0,,contentMDK:21394791~pagePK:141137~piPK:141127~theSitePK:327708,00.html>

The Enabling Environment for Social Accountability in Mongolia

June 2007

The unique feature of this study is its focus on social accountability and the conditions influencing its success and failure. It presents a number of important findings and offers recommendations for policy, institutional, legal and regulatory reforms, and capacity enhancement.

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Building the skills for the new economy

June 2007

This report examines the challenges in the labor market in Mongolia as the economy has undergone a transformation into a market economy. It identifies three major interrelated challenges—joblessness, informality and skills mismatch. The inability to find productive employment has important poverty implications, as labor is the main asset of the poor. But along with the skills mismatch, they also affect efficiency, and thus economic growth, by preventing the economy from using the available human capital to its fullest potential.

<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/MONGOLIAEXTN/0,,contentMDK:21522838~pagePK:141137~piPK:141127~theSitePK:327708,00.html>

Mongolian Health System at a Crossroads: An Incomplete Transition to a Post-Semashkom Model

January 2007

This report presents the state of health of the Mongolian population and of the challenges facing the government as it reforms the health system. This chapter examines the recent deterioration in certain key health outcomes.

http://web.worldbank.org/external/default/main?pagePK=51187349&piPK=51189435&theSitePK=327708&menuPK=64187510&searchMenuPK=327736&theSitePK=327708&entityID=000020439_20070314133155&searchMenuPK=327736&theSitePK=327708