



MONGOLIA QUARTERLY

WORLD BANK

June 2008



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 Region 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)

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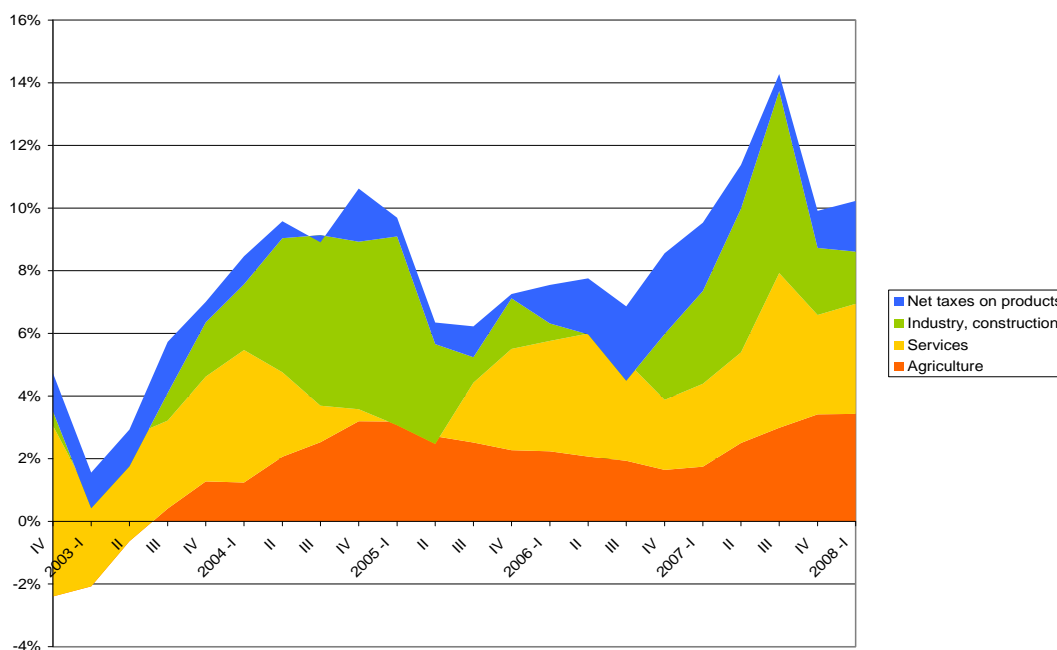
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RECENT ECONOMIC DEVELOPMENTS

1. **GDP growth accelerated in the first quarter of 2008.** For the first time, quarterly GDP series were released by the National Statistical Office (NSO) in its April Monthly Statistical Bulletin, allowing more meaningful infra-annual analysis of economic growth pattern. GDP growth was 10.2 percent in the first quarter (yoy), up from 9.9 percent in the last quarter of 2007. Much of this acceleration is due to strong growth in the service sector and a surge in net taxes on products, explained by the introduction of the Windfall tax on gold and copper sales (Figure 1).

Figure 1 – In the first quarter of 2008, (annualized) economic growth remains high



2. The availability of quarterly GDP series also provides a better understanding of the seasonal patterns of productive activities. Table 1 shows the 2007 quarterly shares of annual GDP by sector. Agriculture is the most seasonal, with only 5 percent of agricultural value-added being produced during the first quarter. Turnoff patterns are seasonal with most animals being sold once they have recovered their full body weights after grazing on green pasture - usually between October and December (Q4) adding to the difficulties of processors who aim to spread their overheads over a longer period of operation. Slaughtering takes place outside this period for immediate consumption. Wool is traditionally harvested in May and June (Q2) while cashmere is combed from goats in April-May (Q2). This seasonality in the livestock sector translates into a similar pattern in industry and services, with a smaller magnitude.

Table 1: 2007 quarterly GDP shares

| | GDP | Agriculture | Industry | Services | Net taxes/ products |
|---------|-----|-------------|----------|----------|------------------------|
| 2007-Q1 | 17% | 5% | 20% | 21% | 19% |
| 2007-Q2 | 26% | 39% | 23% | 23% | 22% |
| 2007-Q3 | 27% | 29% | 25% | 26% | 28% |
| 2007-Q4 | 30% | 27% | 32% | 30% | 31% |

3. **Inflation has picked up to reach 27.2 percent (yoy) in April 2008, and food inflation was 48.5 percent in April (yoy), the highest in East-Asia.** The Bank of Mongolia has tightened its monetary policy raising its policy rate by 1.35 percentage points to 9.75 percent recently in response to the

rising inflation and to reduce the growth of credit and monetary aggregates. The Mongolian banking system continues to expand at a fast pace. At the end of April 2008, broad money (M2) growth was 30.9 percent (yoy), a marked slowdown compared to the 2007 increase of 56.3%. By the same token, currency issued in circulation grew by 10.1 percent, a marked slowdown compared to the 2007 48.5% increase. Lending has been growing at over 60 percent on year to year basis for past several months. In the first 5 months of 2008, outstanding loans of banking system grew by 21 percent. Deposits growth was high (around 40-50 percent on year to year basis) during 2nd half of 2006 through to mid 2007 and had supported the fast growth in lending. However, based on data from Bank of Mongolia, growth in deposit mobilization appears to have slowed down during the past few months and was reported to be 27 percent on year to year basis in May 2008. This is probably a response to the rising inflation and delay/lag in adjustments in deposit and lending rates. However, if inflation persists, banks will be under more pressure to increase deposit and lending rates which may affect credit growth and put additional pressure on the banks financial performance.

4. **Key financial soundness indicators of the financial system appear to be stable, but close supervision may be required given the fast growth of credit and rising inflation.** Capital adequacy is reported to be stable. Non-performing loans have not increased in absolute amount and with the continued fast growth in credit the NPL ratio has fallen to below 3 percent in 2008. However, growth and performance varies among banks. For example the 3 largest banks account for 2/3rd of this loan yoy growth ending May 2008. Portfolio quality and financial performance also vary among banks and close supervision of the banking system will be important given an environment of rapid increase in credit and rising inflation to identify early any emerging problems, especially among the relatively weaker performing banks.

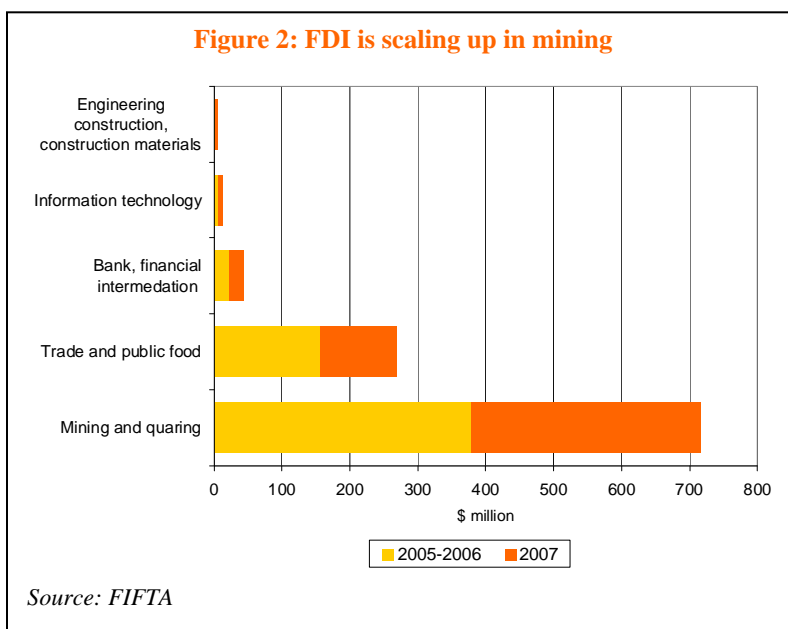
5. **Import growth outpaced export growth during the first 4 months of 2008.** Exports increases by 53 percent (yoy) in April 2008, while imports increased by 86 percent (yoy). While export growth has become heavily concentrated in metal and minerals, imports growth is driven by petroleum and related products imports, which have increased both in volume (+30 percent) and import unit prices (+40 percent). Transport vehicles contributed 18 percentage points to import growth, and cellulose and paper related products 13 percent.

6. **Food products contributed a limited 7 percentage points to import growth** (Figure 3).

Breaking down imports into specific commodities, it is interesting to note that substitution effects seem to be at work. More expensive imports such as potatoes, fruits are decreasing in volume, while rice import quantities are increasing. Despite higher prices (+81 percent yoy), flour imports have increased in volume by 57.6 percent, reflecting flour imports from Russia at subsidized prices as the result of an agreement between Russia and Mongolia.

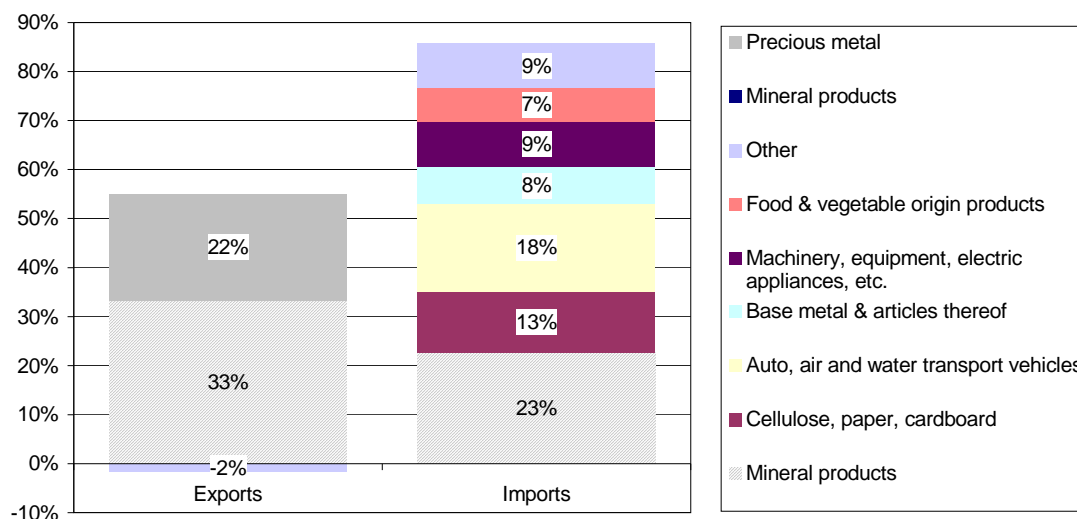
7. **Foreign investment is scaling up, with total FDI received in the last 3 years (2005-2007) amounting \$ 1.2 billion, which is as much as total FDI received over 14 years**

between 1990 and 2004. FDI reached \$500 million in 2007, of which 67 percent went to mining while trade and food was the second largest receiver of FDI (22 percent) (Figure 2).



8. *The Togrog depreciation against the Chinese Renminbi and Russian Rubble adds to inflationary pressures.* Russia and China are the main exporting countries to Mongolia, contributing respectively 34% and 31% of total imports (2007, Table 2). Because the Mongolian Togrog is *de facto* pegged to the US dollar which has been depreciating to a great extent against these currencies, so has the Togrog.¹ Import prices in domestic currency have been increasing as a result of the de facto peg to the US dollar.

Figure 3: Contribution to export and import growth – April 2008 (yoy)



Source: NSO Monthly Bulletin of Statistics

Table 2: The Togrog is depreciating against major countries of exports

| | USD | Euro | JPY | RUB | CNY | Total |
|-----------------|------|------|------|-------|-------|-------|
| ER Depreciation | 0% | 14% | 15% | 9% | 10% | 8.6% |
| Import share | 2.6% | 10% | 6.4% | 34.3% | 31.1% | 84.4% |

9. *Copper prices rose in world markets to near \$9,000/mt in early 2006, and have remained near this level in first part of 2008.* Labor disputes, particularly in Chile and Mexico, have affected production as workers try to obtain part of the significant increase in industry revenue. The industry has failed to deliver planned mine production growth the last three years, preventing rebalancing of the market. A substantial increase in refined output from scrap in 2007—the largest ever and half of which was in China—kept supplies from being even tighter. Prices have dipped temporarily as the market appeared to be tending toward surplus, but chronic supply problems kept prices high. Exchange stocks are at very low levels, and strong demand could squeeze the exceptionally tight market (Box 1). Among the list of issues impinging on supply are declining ore grades; lack of equipment and skilled labor; power and water constraints; sulphuric acid shortages, project delays; technical problems; accidents; weather-related disruptions; rising costs; and political risks—mainly in central Africa. Further delays to production could keep prices elevated in 2008.

10. *Copper prices are expected to decline over the forecast period from very high levels, as supplies increase and the market moves into surplus.* In the coming years, copper supply is expected to outstrip moderate growth demand with more than two-thirds of new mine supply coming from the

¹ The stability of the Mongolian Togrog against the dollar has led the IMF to re-classify Mongolia's exchange rate arrangement to a conventional peg, which acknowledges the *de facto* peg of the Mongolian Togrog within margins of ± 1 percent or less vis-à-vis the US dollar. There is no commitment to keep the parity irrevocably.

Americas and Africa's revived copper belt. Labor tensions are expected to dissipate as prices and operating margins fall.²

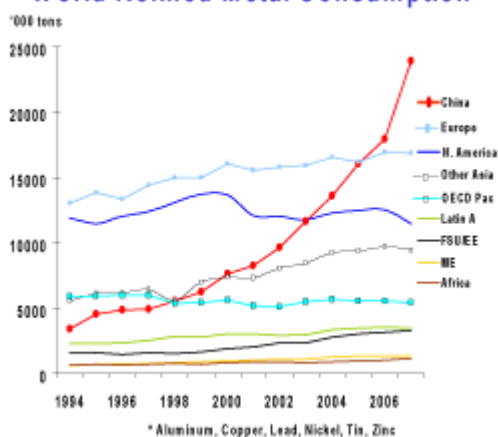
Box 1: Copper Prices remained high, while China's demand for metals soars

Copper prices rebound on falling stocks and tight supplies



Copper prices up on falling stocks and supply disruptions. Copper prices are up more than 40% from their lows of December, briefly exceeding 2006 highs due to falling stocks and a series of supply disruptions and project delays. Copper has the tightest fundamentals among all main metals despite concerns about slowing global demand. Power problems in China and South Africa have affected mining operations more broadly this year, but severe drought in Chile—which produces more than one-third of the world's copper—could result in power shortages and impact future copper output. Other metals gains have been in aluminum (power shortages in China and South Africa) and tin (supply problems in Indonesia and China).

World Refined Metal Consumption*



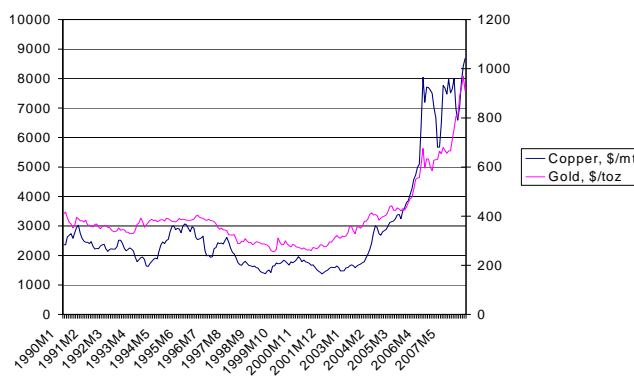
China's metal consumption soars. Global metal consumption (the six main metals traded on the LME) grew 6.3% or 4.5 million tons in 2007. Much of the growth was in China, which jumped by nearly one-third or 5.8 million tons, accelerating from average growth of 16% in the previous seven years. Growth last year was led by a 43% surge in aluminum consumption and 35% gain in copper. China is by far the largest consumer of all main metals, as well as steel, coal and other commodities. Metals consumption in the world outside China dropped 2.4%, with declines in across all OECD centers, Asia and Latin America. One of the more striking features is that copper consumption in North America declined by nearly one-third since 2000.

Source: World Bank Global Economic Monitor

11. ***In 2008, revenue policy is planned to be by-and-large unchanged,*** with most of the focus to be directed towards improving tax administration. Total revenue collection is projected at 44 percent of GDP. High commodity prices and continued economic growth are expected to result in 48 percent increase in corporation income tax and value added tax.

12. ***On the spending side of the 2008 Budget, expenditures are budgeted at 47 percent of GDP,*** an increase of about 8 percent of GDP, year-on-year. Domestic investment expenditures were increased by

Figure 4: Copper prices remain high, while gold prices are increasing fast



Source: World Bank Global Economic Monitor (\$/MT)

² Prospects for the Global Economy (World Bank).

53 percent, from 449 billion togros in 2007 to 689 billion in 2008 – reaching 13 percent of GDP, the highest level ever. Expenditures on wages and salaries will be raised by 90 percent—to 10 percent of GDP; Subsidies and transfers have been increased by 30 percent from their 2007 levels, reflecting mostly the increase in pensions and to a lesser extent social welfare. Although capital maintenance expenditures have been increased by 75 percent they still represent only 4.7 percent of total capital investment budget—low by international standards of 10 percent.

13. Fiscal policy in 2008 is estimated to be significantly pro-cyclical.

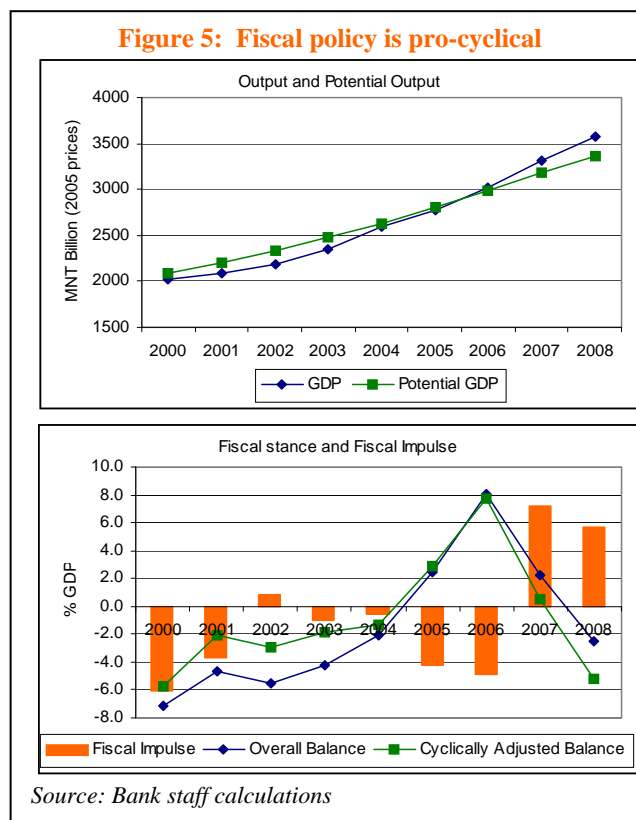
A cyclical decomposition of fiscal balance is used to measure the true fiscal stance. Since 2006-7, fiscal policy has turned significantly procyclical, with a fiscal impulse as large as 7.2 percent of GDP in 2007, and more than 5 percent of GDP planned in 2008 (Figure 5).

14. Procyclicality of fiscal policy may have important implications for macroeconomic stability and fiscal sustainability.

A recent IMF study concludes that procyclical fiscal policy exacerbates economic fluctuations, with adverse consequences for savings, investment, economic growth, and welfare. It also suggests that a stronger procyclical bias in the upturn may result in a deteriorating fiscal position over time, since deficits and debt built up during bad times are in general not offset during good times. Finally, procyclicality adds to inflationary pressure as limits in absorptive capacity might be reached more rapidly.

15. Mongolia is now at low risk of debt distress over the medium term. A Debt Sustainability Analysis was jointly conducted by the Government, the IMF, the World Bank and the ADB in early 2008. Debt indicators are prudent as of end-2007. Specifically, Mongolia’s public external debt as a percentage of GDP has decreased significantly over the last seven years, from 76 percent in 2000 to 39.4 percent in 2007 (US\$1.5 billion). The NPV debt to GDP ratio is now below the 40 percent debt sustainability threshold that is applied to countries, at equivalent levels of policy performance. The joint DSA concluded that after four years of strong economic performance, Mongolia is now at a low risk of debt distress and the public debt burden is projected to continue to decline. Debt burden indicators under the baseline and the standard stress tests are generally well below their indicative thresholds, even in the event of a decline in the terms of trade or further delays in developing a large new copper and gold mine. However, a large issuance of nonconcessional external sovereign debt, which is being considered, could raise concerns over Mongolia’s debt sustainability. In addition, the historical scenario leads to a prolonged and sustained breach of the threshold for the NPV of debt-to-GDP. This result should be interpreted cautiously however given the extensive structural changes that have taken place in the economy, which implies that a scenario based on historical averages does not appropriately capture the risks to the economy.

16. The medium term debt management strategy, approved by the Minister of finance in May 2007, provides a sound basis for public debt management in Mongolia, and outlines the preferred direction for the structure and risk exposure of the debt. The debt management strategy, providing a medium-term vision, should be revisited and updated on an annual basis, as part of the budget process. In addition, the strategy should be available to public.



17. ***There are signs of a slowdown of job creation and employment growth.*** First, while official unemployment is still decreasing, it is decreasing at a lower pace. As of April, 2008, the number of registered unemployed was 31.9 thousand people, which was 5.1 percent lower than a year ago, compared to an annualized decrease of 9 percent in 2007. Second, employment in the industry is reporting a decrease of 6 percentage points as of April 2008 (yoy), with most of this decrease is coming from manufacturing. Given that only industrial employment statistics are available, it is difficult to identify the specific sectors which are creating jobs in the economy. It is however likely that services are the most dynamic sector in terms of job creation, given its dynamic expansion and that it is typically a labor-intensive sector in the economy.

18. ***Wages and salaries are building up everywhere in the economy, adding to inflationary pressure.*** Wages and salaries show a rapid increase of 61.6 percent in the first quarter of 2008 (yoy). The highest increase is the real estate and renting businesses, followed by public administration, as a result of successive large wage increase in the public sector.

19. ***Real estate prices are on the rise.*** Mongolia does not produce real estate price index. But there is evidence that the sector is developing very fast: (i) as already noted, wages in the real estate and rental businesses are increasing fast; (ii) prices for housing rentals and maintenance/repairs have increased by 30 percent yoy at the end of May; (iii) finally, construction price are also going up.

20. ***In the run-up for elections, how to share the wealth from mining has become a major issue for in the political debate.*** Major political parties have included in their platforms measures to distribute cash transfers to every citizens, while increasing other cash transfers. Given the strong inflationary pressures in Mongolia today and the already expansionary stance of current fiscal policy, further cash injections in the economy should be guarded from as it would lead to even higher inflation.

21. ***It is recommended that Mongolia creates a fully fledged saving and stabilization fund.*** All revenues from mining will be transferred to the fund and only part of these revenues will be transferred back to the annual general budget following ex-ante agreed rules (see Box 2).

Box 2: What fiscal rules for Mongolia?

The government needs to choose the kind of fiscal rules which best suits the new Mongolian context, where (i) exploitation of the new mineral wealth as not started yet, (ii) there is an existing Development Fund where the windfall tax is transferred; (iii) Future trend in international copper prices is uncertain; (iv) Pressure to spend is high as a result of large needs and competing requests, in particular in infrastructure; (v) absorptive capacity is limited as highlighted by the recent overheating of the economy.

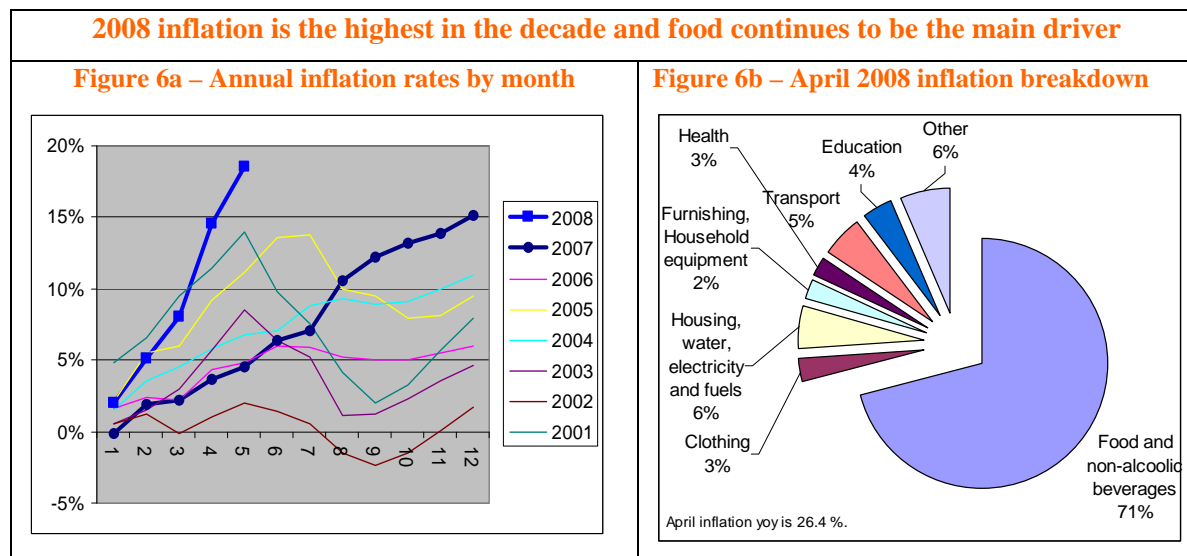
- ***The first priority is to delink public spending decisions each year from the revenues from the mining sector that year.*** This can be done by transferring all public revenues from the mining sector (windfall tax, corporate tax, royalties, and dividends) to a stabilization and saving fund. The creation of such a fund will also insulate the economy from the adverse effects of large and volatile mining revenues. This fund should replace the existing Development Fund, and it should be accompanied by governance rules which follow good international practice.
- ***Secondly, the government needs to define how much of the fund should be transferred each year to the General Budget for spending purposes.*** There might be more than one rule that fits Mongolia (e.g. price-based such as in Chile, or total wealth/Permanent income approach such as in Azerbaijan). It is recommended that the rule is defined (i) so that it smoothes available resources over time for sustainable spending and intergenerational equity; (ii) it isolates public spending and the economy from copper price volatility; (iii) in line with the absorptive capacity of the economy and a moderate real exchange appreciation to maintain long-term competitiveness of tradables.
- ***Thirdly, Mongolia should adopt fiscal rules to keep the non-mineral deficit under control.*** A variety of fiscal rules exist, and there is more than one rule which can be applied to the Mongolian context. But some good principles apply for the fiscal rules to successfully achieve fiscal discipline in a sustainable manner.

Source: World Bank Staff

FOOD AND OIL PRICES: TRENDS AND POLICIES

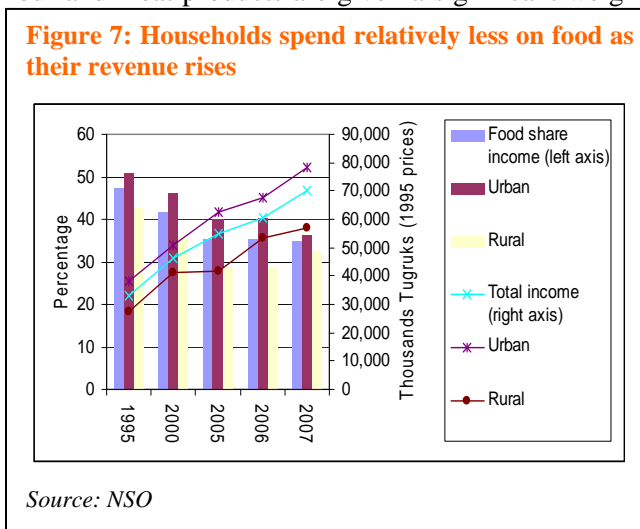
Trends

22. *The 18.5 percent of inflation rate which Mongolia experienced in May 2008 since the beginning of the year is the highest in the decade and the highest in East-Asia.* Inflation year over year reached 32.6 percent at the end of May.



23. *More than two-third of the 2008 May inflation in Mongolia can be explained by food items, while oil prices contributed a small but increasing portion (0.9 percentage point of inflation).* Food items and oil have a 41 and 1.6 percent weight respectively in the CPI consumption basket. Among food items, flour and meat prices are contributing to inflation the most (7.7 and 5.6 percentage point respectively). The reason for this is that (i) flour and meat products are given a significant weight in the CPI index (11% and 14% percent respectively) and (ii) their prices have increased the most over the last 12 months (68 and 39 percent yoy), with no sign of slowdown in the recent months: Prices for flour and meat products have increased by 25 and 45 percent since the beginning of the year.

24. *Turning to food consumption patterns, the share of food spending in incomes is decreasing.* Figure 7 shows the share of food in total monetary income (excluding non-monetary such as in kind income and consumption).³ As per capita income rises, the share of income devoted to food decreases. In 1995, households would use almost 50 percent of their monetary income to buy food, whereas in 2007, this share was down to 35 percent. This does not imply that food price increases have no impact on household

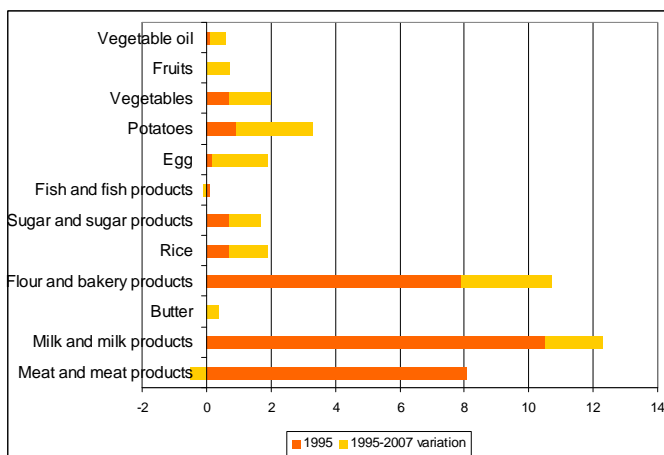


³ The 2003 LSMS data show that Mongolian households typically devote half of their total (monetary and non-monetary) consumption basket to food.

welfare, as food price increases are still hard on poor consumers, and among them, the urban poor bear most of the shock. But it does mean that the impact is more mitigated than what it would have been a decade ago, as Mongolia hadn't reached that level of income per capita.

25. *Consumption patterns are becoming more diversified and turn away from traditional consumption products.* Meat consumption is declining and consumers turn increasingly to more flour-related products, potatoes and vegetables, while fruit consumption which was negligible in 1995 has emerged. These changes in consumption patterns are important to understand if one wants to be able to anticipate future food supply needs to be met by either domestic production or imports.

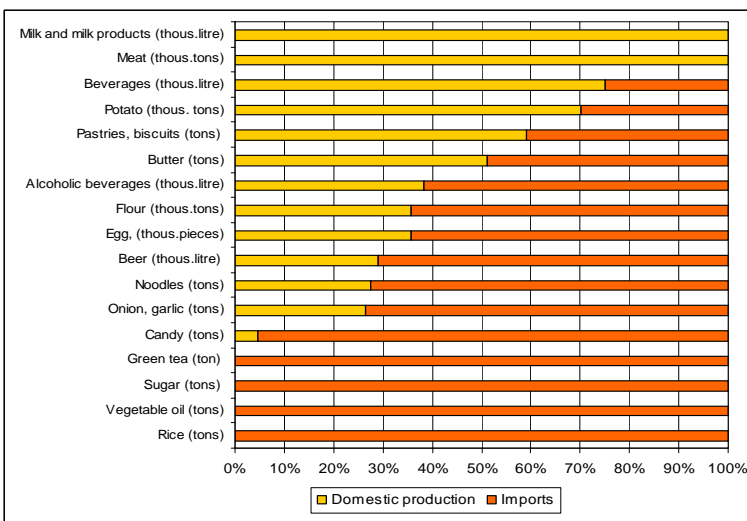
Figure 8 - Individual consumption pattern (per adult equivalent kg)



Source: NSO

26. *On the one hand, within food consumption, domestically produced meat accounts for a significant share.* Meat products account for 36 percent of food consumption and are domestically produced. Meat prices in Mongolia are thus more dependent on domestic rather than external factors. These include: number of livestock, weather conditions, the overall consumer demand that is driven by income levels, domestic meat procurement practices, and supply chain bottlenecks.

Figure 9: Share of domestic production versus imports in consumption of major products



Source: NSO

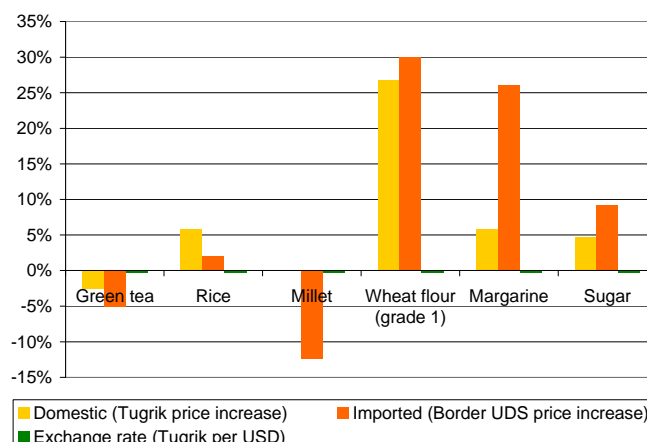
27. *On the other hand, Mongolia imports a significant share of the non-meat food products* (among which bread and cereals come from Russia and fruits and vegetables from China). Although Mongolia's domestic production of potatoes, flour, butter is significant, it depends on imports for a significant share too (Figure 9). Mongolia relies fully on imports for fruits and rice.

28. *There is some evidence that domestic prices are increasing faster than border prices,* which supports the idea that domestic policies are fueling domestic price increase. Figure 10 shows the price increases of a selection of products at the border and domestically.: The decrease in the prices of imported green tea and millet has not translated into a similar domestic price movement. Similarly, the domestic price increase of rice has been higher than the border price. For some other products,

the conclusion is less clear, with domestic prices actually increasing by less than border prices. Therefore, the comparison is not fully conclusive, and further analysis needs to be conducted to ascertain the differences between domestic and border price movements.

29. *Until mid-March 2008, the observed price of oil in the pumps in Mongolia had been kept stable, as a result of the government policy to subsidize oil distribution companies.* Mid-March, the Government announced its decision to stop the subsidies due to fiscal sustainability concerns. The oil price increased by 10.5 percent in average since then by the end of May.

Figure 10: Comparing border and domestic price increases in 2008

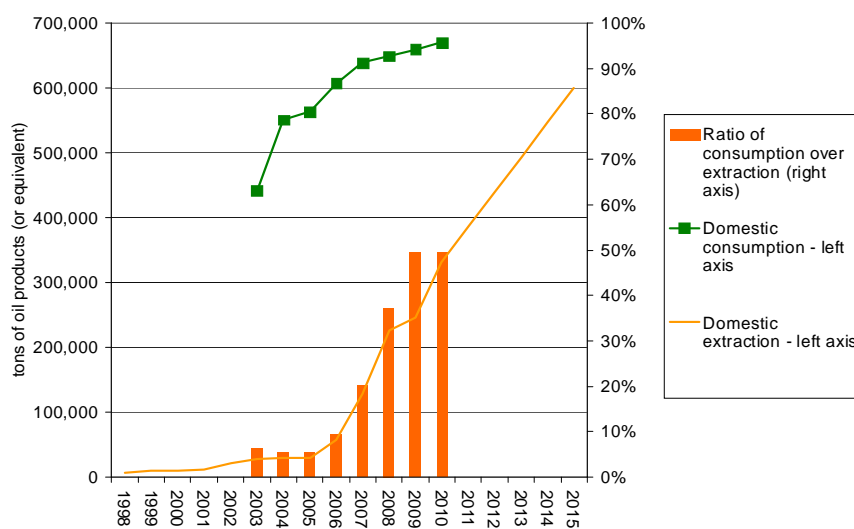


Source: Customs and NSO

30. *The total impact of oil price increase on the Mongolian economy is and will be limited, because coal is the main source for energy.* Mongolia relies on coal for 81 percent of its energy needs, and petroleum accounts for most of the remaining 19 percent of total energy consumption.⁴

The direct impact of oil price increase is somewhat limited as it accounts for less than 1 percent of the total CPI inflation in Mongolia. The total impact is larger once the indirect impact through higher production costs is added. Producer price indexes are not available in Mongolia, but a recent study by NSO has interesting findings: it shows that the impact of higher oil prices is the greatest on transportation costs, where fuel accounts for half of total production costs. It is negligible for wheat and bread production, where it accounts for only 0.6 to 1 percent of total production cost respectively.

Figure 11: Oil extraction is increasing rapidly



Source: MRPAM. Starting from 2008, forecasted figures.

31. *Mongolia was officially declared oil producer country in June 2008.* Mongolia is still at early stage of oil extraction, and due to the lack of infrastructure, such as railways, pipelines and other, crude oil is exported at small volumes. Mongolia started to extract and export natural oil starting from 1998. Two private companies are operating on this market: Petro China Tamsag and Donshen Natural Oil. Chinese invested Petro China Tamsag Company is conducting pilot extraction of natural oil out of 44 bore-holes in the Tamsag base, transports the oil by trucks and export to China. The Donshen

⁴ World Bank Mongolia Infrastructure Report, annex 1: energy (2007)

Oil Company is conducting pilot extraction out of 46 bore-holes in the Dornogobi base, transports the oil by wagoncistern and exports to China. These two companies plan to extract and export 21.8mln barrel crude oil during 2008-2015. Other smaller local companies operate under a product sharing agreement and plan extract and export 87.6 thousands barrels of oil during 2008-2015.

32. ***Total crude oil domestic extraction represents the equivalent of 20.2% of Mongolia's 2007 consumption of petroleum products and is projected to reach 50 percent by 2010.*** In 2007, Mongolia imported 639,032 tons of petroleum products and extracted the same year 850,211 barrels of crude oil for exportation. It is estimated that by 2010 the demand of petroleum products will reach 670,000 tons per year and that extraction will increase faster, to reach 220 thousands barrels of crude oil or the equivalent of 332 thousands tons of petroleum products.

33. ***Feasibility studies are underway for building a refinery facility*** with a capacity of 1-2 million tons of petroleum products. The policy agenda is to domestically produce liquid fuels from crude oil or coal by 2012-2015. The cost-worthiness of building a refinery should be carefully assessed, as refineries need to be flexible enough for different crudes and multiple uses for by-products, and sufficiently large to allow economies of scale. Experience shows that isolated refineries only making some gasoline, diesel and fuel oils are often worth less than just selling the crude oil.

Policy response to oil and food price increase

34. ***The Government Policy response has been to create a price stabilization program and set up a Council in charge of overseeing the program.***⁵ A new Action Plan was approved by Cabinet in May to strengthen the government policy response. Proposed interventions can be classified as follows:

- (i) *interventions to ensure household food security by strengthening targeted safety nets, which comprise: Introducing targeted subsidies for transportation; designing a safety net program for the vulnerable with food stamps and cards; and encouraging self production and consumption.*
- (ii) *interventions to lower domestic food prices through short-run trade policy measures, tax and subsidy policies or administrative action, which comprise: Amending tax laws to exempt of tax oil and food products; limiting food exports, introducing ceiling on prices and subsidizing the imported petrol price (the subsidies started in January and were discontinued in March, due to fiscal sustainability concerns); subsidizing public transportation; subsidizing domestic wheat producing farms by providing farmers with seeds at discounted price.*
- (iii) *interventions to enhance the medium-term food supply, which comprise: Securing oil and flour reserves (by proposing in particular to use the Development Fund contingency saving component); introducing regulations for streamlining the supply chain by reducing intermediation; strengthening public oversight; diversifying sources of energy supply abroad by finding new countries to import from and domestically by developing new sources of fuel; negotiating with main trading partners to secure adequate supplies at low prices, increasing storage and reserve capacity; increasing domestic self-sufficiency of oil and flour; improving meat provision, hygienic standards and storage.*

35. ***Targeted cash transfers to vulnerable groups are a first best way to address food insecurity.*** Nevertheless, the feasibility of such a program needs to be carefully assessed with respect to Mongolia's administrative capacity and the political economy surrounding the implementation of the programs. For instance, the initially conditional and targeted Child Money Program (CMP) was eventually universalized and unconditional in 2007, due in part to implementation issues related to

⁵ The Council is chaired by the Finance Minister and composed of the Tax office, various line Ministries, Customs Authority, Bank of Mongolia, the Unfair Competition Agency, Consumer associations, Minerals and Petroleum Authority, Employer's federation, Federation of Trade unions, General Police Department.

administrative capacity. One option would be to implement a “subprogram” of the CMP that would distribute extra benefits (food stamps for example) in a targeted manner only to the poorest households.

Table 3. East Asia: Near term policy responses to rising food prices

| Country | Economy wide policies | | | | | Existing social protection programs | | | |
|--------------|-----------------------|--------------------------------|-------------------------|-----------------------------------|------------------------------|-------------------------------------|---------------|-------------------|----------------|
| | Reduce import tariffs | Export restrictions/export tax | Reduce food grain taxes | Price controls/consumer subsidies | Increase supply using stocks | Cash transfer | Food for work | Food ration/stamp | School feeding |
| Cambodia | | X | X | | X | | X | | X |
| China | X | X | X | X | X | X | | | X |
| Fiji | X | | X | X | | | | | |
| Indonesia | X | X | X | X | X | | | X | |
| Lao PDR | | | | | | | | | |
| Malaysia | | | | X | X | | | | |
| Mongolia | | | X | X | X | * | | * | |
| Papua NG | | | | | | | | | |
| Philippines | | | | X | X | | | | X |
| Solomon Isl. | X | | | X | | | | | |
| Thailand | | | | X | | | | | |
| Timor Leste | | | | X | X | | X | | X |
| Vietnam | | X | | | | | | | |

Source: “Rising Food Prices in East Asia: Challenges and Policy Options”, World Bank policy note. * Proposed

36. **Other successful measures for Mongolia to consider include food for work programs**, which are thought to be effective in reaching the most affected households by the food crisis, since these type of programs will only attract the most in need. The government could consider this as a complement to the other programs being planned

37. **Reducing tariffs and other taxes on food and oil products is an easy to implement and efficient way to lower domestic prices.** By contrast, restricting food exports to increase supply and lower price in the domestic market reduces export and trade opportunities, contributes to a global chain reaction of protectionism at the expense of efficiency and domestic farmers earnings. Price controls as proposed in the Action Plan may be used in a short term basis to stabilize prices, but have significant longer term costs, discourage production by domestic farmers, and are often associated with the resurgence of black markets.

38. **High prices do present an opportunity to stimulate food grain production and enhance the contribution of agriculture to medium-run growth.** Higher grain prices can help reverse a generally declining trend in government, private sector and donor investment in the agricultural sector.

39. **However, some of the short-run trade policy options discussed above may limit the scope for longer-term solutions.** For example, policy responses that seek to control markets through mandated grain prices, export restrictions, forcible procurement, or direct government involvement in marketing activities are likely to lower the food supply response over the medium term. In contrast, investment in public goods such as demand led extension and agricultural research and development to foster better agronomics and better incentives and regulations to stimulate more efficient water use can go a long way in helping farmers take full advantage of higher food prices.

40. **In Mongolia, options to improve market functioning include to introduce a market information systems, grading and classification systems, to support the rural finance market and feed and fodder markets.** The Government could contribute to:

- i) A market *information system* which inform on prices in different regions and make price forecasts. Less uncertainty about prices would make production for the market less risky. Herders would be more likely to move from subsistence agriculture to marketable production. Moreover, herders would be able to take expected prices into account in their decision to sell immediately or wait.
- ii) A *grading and classification system* for selected agricultural and food products. Without collective action it is difficult to set-up a grading and classification system. And without such a system the market tends to concentrate on low quality products which are associated with lower production costs. A buyer will pay higher prices only if he can check that the quality is superior. Under these circumstances, a market for high quality products can be facilitated if an impartial grading and classification system is put in place and if regular inspections take place.
- iii) Facilitating improvements in *access to financial services* in rural areas. Access to finance is important for diversifying the agricultural sector and for the development of value chains. Herders continue to have limited access to credit even though they can use animals for collateral. Furthermore, lending rates in Mongolia are relatively high compared to other similar economies and there is limited availability of long term funds. In the past, Government has undertaken measures to inject liquidity into rural areas through the banking and non-banking sectors (for instance under its Micro-finance Development Fund). However, more could be done to facilitate the development of new lending products targeted toward rural areas, expand the availability of data on rural credit with enhancements to the credit bureau, improve the capacity of loan officers in reviewing credit proposals and provide assistance to herders and other rural areas residents in developing sound business plans and credit applications.
- iv) Lowering the risk of producing livestock by developing *feed and fodder markets*. At present, herders are more than necessary hit by *dzuds* as they have little access to fodder, despite the state reserves. Moreover, the emergence of a fodder market has been suppressed, partly due to the lack of transparency of the activities of the National Emergency Management Agency and the reserve activities of the aimags and soums.

Priorities looking forward

41. ***Looking forward, the following priorities can be considered to mitigate the global food and oil price increases:*** (i) focus on introducing *targeted policies* to help alleviate the effect of price increases on the poorest households. Cash transfers could be accompanied by food for work programs which have proven effective to target the poor while limiting administrative costs; (ii) closely monitor the impact on fiscal sustainability and economic incentives of introduced subsidies to avoid medium-term distortions in economic signals for consumption and production; (iii) Remove food supply chain constraints, in particular in the meat sector; (iv) Diversify fuel sources, by looking at alternative energy sources and diversifying oil imports. Developing Mongolia's own oil and natural gas refinery capacity must be carefully assessed as refineries require a number of pre-conditions to be economically viable; (v) at a policy level, a more freely floating exchange rate would help curb monetary growth. Combined with a counter-cyclical fiscal policy would curb in turn associated inflationary pressures.

SPECIAL FOCUS – PENSION CHALLENGES AND REFORM OPTIONS

42. *Mongolia inherited a pay-as-you go public pension and social security system providing universal coverage and relatively high levels of benefits for full-career workers* when compared to pre-retirement income, consistent with the state provision of all forms of social insurance. The system was reformed in 1995, including the introduction of contributions for pensions and other social insurance, but remained dependent upon Government transfers. The reforms improved the existing scheme but failed to achieve financial sustainability or address a number of weaknesses in the scheme's design which created weak incentives for contributing to the system and benefit inequities between different groups of workers and cohorts.

43. *In 1999 a Notional Defined Contribution (NDC) scheme was established for workers born beginning in 1960*, with the intention of gradually moving from notional accounts to partial funding. Introduction of the NDC scheme did not alter the parameters of the defined-benefit scheme for those born prior to 1960 and left an abrupt benefit reduction for those born in 1960. Also, the NDC system did not adjust key qualifying conditions such as the retirement age so that the scheme will continue to require substantial fiscal subsidies over the long run.

44. *Between 2002 and 2007 Mongolia received the advice of international experts* on modifying the design of the NDC scheme and measures to strengthen social insurance administration, as well as development assistance to support reform measures. In 2002 the Asian Development Bank (ADB) supported the development and implementation of a Social Security Master Plan (SSMP), which included substantial policy analysis and actuarial projections. But the social insurance reforms included in the SSMP were never quite implemented. More recently, the Government and the Parliament have become increasingly aware of the need to work together on a comprehensive reform of the old and newer pension schemes, and solicited advice from the World Bank in an effort to strengthen coverage, sustainability and overall equity of the schemes.

45. *The World Bank prepared a policy note in response to this request.*⁶ The note is part of an broader ongoing collaboration with the Government and the ADB on pension reform that includes: (i) supporting the development of the policy framework for pension reform; (ii) improving the pension policy making capacity; and (iii) assisting in the identification of the institutional development needs to support the social insurance system. A number of challenges in the design and implementation of the current social insurance system have been identified that would need to be addressed to strengthen the system's ability to provide consumption smoothing and old-age income security for Mongolia's population. These core challenges include:⁷

- (i) Minimum pension provisions under both the defined-benefit and NDC schemes create weak incentives for wage reporting and compliance, and contribute to the long run projected deficit of about 3 percent of GDP.
- (ii) Early retirement provisions for special professions and mothers result in low retirement ages, which adversely effect costs of the defined-benefit scheme and adversely effect benefits under the NDC scheme.
- (iii) Five-year income averaging (without inflation adjustments) to determine pension benefits creates both uncertainty for workers and has substantially reduced replacement rates during periods of high wage growth.
- (iv) Ad-hoc indexation has created substantial unpredictability of benefits, weakened credibility and therefore compliance and ultimately compromised basic old age income security.
- (v) An abrupt benefit reduction for post-1960 cohorts will shortly create substantial concern by affected parties.

⁶ "Mongolia: Pension Challenges and Reform Options", Draft, Mimeo, World Bank (2008).

⁷ Table 4 provides a more detailed summary of reform needs and proposed policy options.

- (vi) Some parameters of the voluntary pension savings scheme for herders and the informal sector do not have early withdrawal provisions in the case of severe hardship and therefore provide relatively weak incentives for participation.
- (vii) Weaknesses in the institutional framework and governance structure can also weaken the provision of promised benefits to the population and therefore the incentives for participation.

46. ***To address these challenges, it is recommended first that the Government reviews more broadly the societal objectives of the combined public and private pension and social security system.*** One option to consider is that such system should provide: (i) a minimum living subsistence to the elderly, permanently disabled and survivor/dependents so as to ensure basic poverty protection; and (ii) mandatory consumption smoothing for most formal sector workers and voluntary contractual savings for informal sector workers. Second, consistent with these two broad objectives, a possible architecture for a public pension system could include the following reforms:

- (i) Gradual reduction of the minimum pension, linkage with the Minimum Living Standard and eventual substitution by a means-tested social pension.
- (ii) Gradual elimination of early retirement provisions and unification of retirement ages between men and women.
- (iii) Extension of the periods of income averaging and application of indexation for wages during the income averaging period.
- (iv) Automatic benefit indexation linked to wages or prices or some combination thereof.
- (v) Reductions in new benefit accruals for some pre-1960 cohorts in order to smooth the reduction in benefits between pre-1960 and post-1960 cohorts in the NDC scheme.
- (vi) Introduction of provisions for partial withdrawal of voluntary pension savings for herders and the informal sector according to specified criteria in the case of severe need such as for subsistence in the face of loss of income or health difficulties.
- (vii) Establishment of a targeted and means-tested social pension as a means of extending basic old age income support for the elderly poor.

47. ***Finally, measures to improve the institutional support system for public pensions could include:*** (i) a thorough review of the institutional framework for the SSIGO, aimags and local offices; (ii) a similar review of the central and local information systems supporting SSIGO functions of financial and account management; (iii) development of improved disclosure methods and recourse for dispute resolution in order to improve accountability and public credibility; (iv) establishment of an investment management infrastructure and governance framework; (v) compilation and projections of more accurate data on mortality and life expectancy to support annuitized benefits; and (vi) improved coordination between the social insurance and tax authorities and, possibly in the medium-term unification of functions between the two agencies.

Table 4: Summary of reform needs and proposed policy options

| Issue | Proposed Design | | Effect on Fiscal Costs | Effect on Retiree Benefits |
|--|---|--|------------------------|--|
| | Defined Benefit Scheme | NDC Scheme | | |
| <i>Minimum Pension</i> | <ul style="list-style-type: none"> The minimum pension should be determined based on a prescribed percentage of the Minimum Living Standard, not the minimum wage. Assuming that a social pension has been approved and the implementation framework in place, such a social pension could replace the minimum pension. | <p>Minimum pension should be determined based on a prescribed percentage of the MLS not the average wage.</p> <p>Social pension could replace the minimum pension.</p> | Reduction ⁸ | Reduction for most of those receiving the minimum pension as currently calculated. |
| <i>Retirement Age (normal retirement age, women's retirement age and retirement age for special occupations (hazardous professions) too low to ensure a financial balance.</i> | <ul style="list-style-type: none"> Gradually eliminate early retirement for workers in hazardous occupations + women with 4 or more children. Phase in by increasing the applicable retirement age possibly by 6 months every year until all workers have the same retirement age of 60. Gradually unify the regular age for women with that of men. In the medium term, the overall retirement age also needs to be increased, possibly initially to age 65 in accordance with a careful assessment of life expectancy at retirement. | | Reduction | Reduction in present value of benefits for retirees of the DB scheme; Increase in annual benefits for retirees in the NDC scheme but no change to the present value of all benefits. |
| <i>Indexation and retroactive adjustments - indexation discretionary creating uncertainty for workers and retirees</i> | <ul style="list-style-type: none"> Modify the legal framework so that benefits are automatically adjusted in line with the growth in the CPI in four regions and Ulaanbataar on a weighted average basis. Undertake a detailed assessment of benefit erosion of earlier cohorts retiring since 1990 to determine a one-time retroactive adjustment to the extent that it is fiscally affordable. | | Increase | <ul style="list-style-type: none"> Improved predictability and old-age income protection; Increase in benefits for DB scheme; No change in benefits for NDC scheme. |
| <i>Income Averaging Period for Benefit Determination</i> | <ul style="list-style-type: none"> Increase the income averaging period from 5 years to the maximum number of years possible with existing historical wage and contribution data. | Not applicable | Small reduction | Effect depends upon wage trajectory while working. |

⁸ Wiese and Cohen in 2003 calculated the long-term annual cost reduction for eliminating the minimum pension as about 2.3 percent of GDP. See Patrick Wiese and Michael Cohen, *An Evaluation of Pension Reform Options for Mongolia*, p. 5.

| | | | | |
|---|---|--|--|--|
| | <ul style="list-style-type: none"> ▪ Gradually increase the income averaging period prospectively. ▪ Index the wages used in the calculation of benefits to the average covered wage growth. | | | |
| | Proposed Design | | | |
| Issue | Defined Benefit Scheme | NDC Scheme | Effect on Fiscal Costs | Effect on Retiree Benefits |
| <i>Inclusion of allowances in the wage base</i> | In the medium-term, develop a framework for including non-wage compensation in reported income both for the purposes of determining pension contributions and benefits. | | Increased for Govt. for contributions on behalf of public servants unless wages decreased to offset increase | <ul style="list-style-type: none"> ▪ Worker take-home pay reduced; ▪ Retirement benefits increased. |
| <i>Disability pensions</i> | <p>Two options might be considered:</p> <ul style="list-style-type: none"> ▪ Redesign benefit calculation to provide a lump-sum benefit which can be supported by an earmarked contribution for workers with short contribution histories; ▪ Provide annuitized benefits based on an actuarially-reduced benefit as a function of years of contributory service for workers with longer contribution histories. | | Reduction | Reduction |
| <i>Survivorship pensions</i> | Current framework could be improved based on the principle that the accrued retirement benefit (with actuarial reductions prior to retirement age) is divided between eligible survivors. | Current scheme links benefits to the workers' wages and not benefit accruals. For workers with short contribution histories, lump-sum benefit calculated based on contribution/premium rate and for workers with longer contribution histories, accrued benefit based on the notional account accumulation divided between eligible survivors. | Cannot be precisely determined | Increases and reductions in benefits depending upon the number of survivors and the age of death of the worker. |
| <i>Abrupt reduction in benefits for those born beginning in 1960.</i> | <ul style="list-style-type: none"> ▪ Reduce the accrual rate for service rendered after enactment of the reform. ▪ Reduce some accrued rights for cohorts born after 1950. | None | Costs depend upon design. Likely some cost reduction. | Reduction for certain cohorts. Many options including reducing benefit accruals from those under the old scheme and reducing accrued rights. |
| <i>Social Pensions</i> | Establish a social pension so that pre-1960 cohorts who meet means-testing criteria could also in principle receive the social pension either in the absence of qualifying for the standard defined-benefit pension or receive a top-up to ensure that their pension | Establish a social pension so that post 1959 cohorts registered with the SSIGO could, in principle, qualify. The impact on compliance behavior will depend upon the amount and certainty of the benefit. If the benefit is sufficiently | Costs depend upon means-testing, efficiency of administration, and benefit levels. | <ul style="list-style-type: none"> ▪ Substantial increase in benefits for those previously uncovered by formal pension provision such as herders and the informal sector. |

| | | | | |
|---------------------------|---|--|--|---|
| | benefit is no less than the MLS. | high, it likely will impact the incentives for workers to fully report wages subject to contributions. | | <ul style="list-style-type: none"> ▪ Potential reduction in pension benefits for retirees who would have otherwise been entitled to a minimum pension guarantee as currently calculated. |
| <i>Voluntary Pensions</i> | Modify voluntary pension provisions in order to enable withdrawals prior to old-age retirement according to prescribed conditions such as for hardship. | | | |