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MULTILATERAL INVESTMENT GUARANTEE CORPORATION

INTERIM STRATEGY NOTE

FOR

MONGOLIA

CY 2009-10

Mongolia Country Management Unit
East Asia and Pacific Region

International Finance Corporation

Multilateral Investment Guarantee Agency

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CURRENCY EQUIVALENTS

(as of January 26, 2009)

Currency unit = Tugrik

US\$1= MNT 1,440

FISCAL YEAR

January 1 – December 31

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	M&E	Monitoring and Evaluation
ADB	Asian Development Bank	MDG	Millennium Development Goals
ASEAN	Association of Southeast Asian Nations	MPRP	Mongolia People's Revolutionary Party
CAE	Country Assistance Evaluation	MTEF	Medium-Term Expenditure Framework
CAS	Country Assistance Strategy	NDIC	National Development & Innovation Committee
CG	Consultative Group		
CPIA	Country Policy and Institutional Assessment	NGO	Nongovernmental Organization
CPPR	Country Portfolio Performance Review	NPV	Net Present Value
CPS	Country Partnership Strategy	ODA	Official Development Assistance
DPC	Development Policy Credit	PETS	Public Expenditure Tracking Survey
DSA	Debt Sustainability Analysis]	PHRD	Policy and Human Resources Development
ECTAC	Economic Capacity Technical Assistance Credit	PIU	Project Implementation Unit
EGSPRS	Economic Growth Support and Poverty Reduction Strategy	PRGF	Poverty Reduction and Growth Facility
EU	European Union	PRSC	Poverty Reduction Support Credit
FIAS	Foreign Investment Advisory Service	PRSP	Poverty Reduction Strategy Paper
FSAC	Financial Sector Adjustment Credit	PSD	Private Sector Development
GDP	Gross Domestic Product	PSDC	Private Sector Development Credit
GEF	Global Environment Facility	PSMFL	Public Sector Management and Finance Law
GFMIS	Government Financial Management and Information System	ROSC	Report on Observance of Standards & Codes
GPF	Governance Partnership Facility	QPPR	Quarterly Portfolio Performance Review
GTZ	Gesellschaft für Technische Zusammenarbeit	SDR	Special Drawing Rights
HIES	Household Income and Expenditure Survey	SLP	Sustainable Livelihoods Project
ICT	Information and Communication Technology	SME	Small and Medium Enterprise
IDA	International Development Association	SWAp	Sector-Wide Approach
IDF	Institutional Development Fund	TA	Technical Assistance
IFC	International Finance Corporation	TF	Trust Fund
IMF	International Monetary Fund	UN	United Nations
JBIC	Japan Bank for International Cooperation	UNDP	United Nations Development Programme
JICA	Japan International Cooperation Agency	USAID	United States Agency for International Development
JSA	Joint Staff Assessment	WBI	World Bank Institute
LSMS	Living Standards Measurement Study	WTO	World Trade Organization

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**MONGOLIA
INTERIM STRATEGY NOTE**

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I. INTRODUCTION

1. *Mongolia is justifiably proud of its progress since the 1990 transition.* In the past 18 years, Mongolia has seen considerable success in moving from a system in which the economy and the politics were centrally planned, to a young, market-based democracy. Strong macroeconomic performance in recent years has increased incomes and rapidly expanded government revenues. Poverty incidence has shown decline, though nearly a third of the population remains poor, and there are significant disparities between and within urban and rural populations. Major mineral deposits, including prospects in the Gobi region, have been identified that, when developed, have the potential to significantly increase incomes and government revenues.
2. *A sustained period of rapid economic growth, propelled by high mineral prices and strong global demand, gave way to an abrupt and steep downturn in Mongolia's economy and macroeconomic situation starting in the second half of 2008.* Sharp drops in the price of Mongolia's export commodities in late 2008, particularly of copper (down by 65 percent since July 2008), have led to major declines in government revenues (copper accounted for 43 percent of revenues in 2008).
3. *Mongolia has emerged as one of the East Asian countries hardest hit by the global economic crisis.* Growth is projected to slow from around 9 percent in 2008 to 2-3 percent in 2009 and the external current account swung from a surplus 4.4 percent of GDP in 2007 to a 9.6 percent deficit in 2008. Bank of Mongolia's (BoM) net international reserves declined from US\$1,003 million in July 2008 to US\$534 million in January 2009 as the Government attempted to defend its defacto peg.
4. *The developments over the last years have highlighted both the unprecedented opportunities that the country's mining sector brings, as well as the risks of Mongolia's increasing dependence on mining exports.* They have also underscored deficiencies in Mongolia's management of the recent boom – with some domestic policies further exacerbating the impact of the global downturn. But they also present the opportunity to take some tough decisions in order to avoid similar situations in the future.
5. *The severity of the downturn will require a major fiscal adjustment, with very limited Government resources available to mitigate the impact.* The size of the adjustments is such that multilateral and bilateral support is urgently needed. Even with such support, the adjustment will need to take place over the medium-term, and will only be successful if underpinned by the appropriate domestic policies. These include fiscal adjustments that protect the poor, foster a good investment climate, maintain infrastructure, resolve key obstacles for mining and infrastructure development, and re-prioritize investment decisions. These adjustments can reduce the negative impacts of the current downturn; they can also set the stage for future economic growth and poverty reduction.
6. *The Government has introduced an ambitious macroeconomic program and taken initial steps to implement it.* An amended budget, taking into account more realistic, lower revenue projections, has been submitted to Parliament. A long-stalled investment agreement for development of a major copper-gold deposit has been negotiated and submitted for ratification to Parliament. And legislation is being prepared to strengthen the country's economic and fiscal policy framework, with potential for Mongolia to emerge from the crisis

with a stronger economic and fiscal policy framework. But as the extent of the downturn and fiscal shortfall has become apparent, the Government has called on external partners for support.

7. *In response, external partners are shifting their strategies and programs to address the situation.* The IMF has reached agreement on an 18-month Stand By Arrangement of US\$224 million in balance of payments support. Current projections suggest that even with the IMF program and necessary fiscal adjustments, a fiscal financing gap will remain, projected to be \$204 million over two years (\$140 mn for FY09 and \$64 mn for FY10). Substantial external financing will be needed to plug the gap and to help the government absorb the initial fiscal shock and smooth out the adjustment, while protecting the poor and keeping public debt at a sustainable level.

8. *Multilateral and bilateral donors have pledged at least \$160 million for budget support.* At a donor conference, hosted by the Government and the World Bank on March 14, 2009, the Asian Development Bank, Japan and the World Bank pledged a total of US\$160 million for budget support. Other donors are considering the provision of such support. Based on this outcome, the IMF has decided to present its SBA to its Board on April 1.

9. *The unexpected severity of Mongolia's economic downturn has led the Bank Group to shift its strategic focus and programming to help the Government address immediate and urgent priorities.* Given the emerging severity of crisis impacts, and uncertainties about the length and depth of the downturn, Bank management, in consultation with the Government, has prepared this Interim Strategy Note (ISN), for the coming 12-18 months, rather than proceeding with the four year Country Partnership Strategy that has been under preparation for more than a year.

II. COUNTRY CONTEXT

A. Physical context: Mongolia's extreme climate and geography

10. *Mongolia's culture, history, and contemporary development challenges are rooted in the country's geography and extreme climate.* Landlocked, and located in the heart of central Eurasia, Mongolia's climate is sunny, arid, and cold. The natural environment is characterized by thin, fragile soils supporting grassland steppes and forests, and extensive areas of mountainous and desert landscapes. Wintertime temperatures regularly dip below -30° C, making Ulaanbaatar the coldest capital city in the world. Growing seasons are short, natural productivity is low, and arable land constitutes only 1% of the total area. This physical environment defines Mongolia's unique set of demographic and development characteristics. Historically, this environment supported widely dispersed families dependent on herding sheep, cattle, horses, goats, and camels across the steppe. Today, it is the least densely populated independent country in the world,¹ with a population of 2.6 million spread over a surface area of nearly 1.6 million km² (second largest landlocked country in the world). This population has increasingly concentrated in the capital city Ulaanbaatar, which

¹ Mongolia is the 19th largest country in the world and the second largest landlocked nation. In 2006 it ranked 137th in population size out of 207 countries (source: World Bank).

now accounts for nearly 40% of the population. Dispersed across the rest of the country, more than a third of the population relies on semi-nomadic livestock herding as their primary source of livelihood.

B. Economic and political developments

11. *Mongolia has made good progress since 1990 in navigating a simultaneous political and economic transition.* Since the beginning of transition in 1990, five parliamentary elections have been peaceful and deemed free and fair by international observers. A framework of market and democratic laws and institutions has been put in place, an active media has developed, and a small, but vocal civil society increasingly engages on the political front. Fundamental economic reforms have been undertaken by the Government in the areas of price liberalization and privatization. Mongolia has one of the least restrictive trade regimes in Asia, and a relatively liberal foreign investment regime. While Mongolia has suffered bouts of inaction on reforms since transition, there has been no significant reversal of the overall reform path towards a market-oriented economy.

12. *A spatial transition has accelerated as well in recent years, as population and economic growth have become increasingly concentrated in the capital city of Ulaanbaatar.* Reversing rapid out-migration following Mongolia's 1990 transition,² Ulaanbaatar's official population has swollen to 1 million of the country's 2.6 million inhabitants, increasing more than 50 percent from 1995 to 2005 largely as a result of in-migration. Among other Asian countries, Mongolia today has one of the highest shares of its population (39.2% as of end 2008) living in its capital city. This has contributed to serious air pollution, transportation problems, and social stresses.

13. *Propelled by high global prices for minerals and good weather, Mongolia enjoyed a prolonged period of strong economic growth through the third quarter of 2008.* In 2008 Mongolia recorded a sixth straight year of economic growth, as high metal prices on the world markets (the copper price averaged around \$8000/tonne for the first seven months of 2008 versus \$2,200/tonne at the end of 2003) led to increases in the dollar value of exports from mining production, with some real effect on gold production. Gross national income (GNI) per capita rose from 1995 (\$390) to 2007 (\$1290). The livestock sector has also grown at a rapid pace (an average of 12 percent from 2005-07), recovering from severe winters in 1999-2001, with livestock numbers reaching a historic high of 44 million in 2008. Expanding revenues due in part to high mineral prices led to three consecutive years of budget surpluses from 2005-07. The current account recorded a fourth year of surplus in 2007, and net international reserves (NIR) expanded, reaching over \$1 billion in mid-2008.

14. *However, Mongolia's macroeconomic situation dramatically worsened in the second half of 2008, and the country is now emerging as one of the East Asian economies hardest hit by the global economic downturn.* Growth is expected to fall to 2-3 percent in 2009 according to IMF and Bank staff estimates, and could fall even lower if FDI contracts further. Inflation rose sharply in 2008, reaching 34 percent year-on-year in August 2008 – the highest rate in East Asia and the highest in Mongolia in a decade – due to a combination of higher prices for imports (especially petroleum products and food), expansionary fiscal policy and

² The number of semi-nomadic herders more than doubled from 1990 to 1995 as laborers displaced by the abrupt closure of state-owned enterprises and collectives took up livestock herding as a survival strategy.

an inflexible exchange rate. Plummeting global copper prices (from over \$8,000/tonne between March and July 2008 to nearly \$3,400/tonne at the end of 2008) have abruptly turned Mongolia's fiscal balance from surplus to deficit. Prices of cashmere, the primary source of income for the majority of herding households, have fallen two-thirds from their peak. The construction sector is contracting. Although Mongolian banks had limited direct exposure to foreign financial markets, the financial sector is also experiencing strains from the global downturn (see paragraph 18). Mongolia's current account has also seen a rapid deterioration.

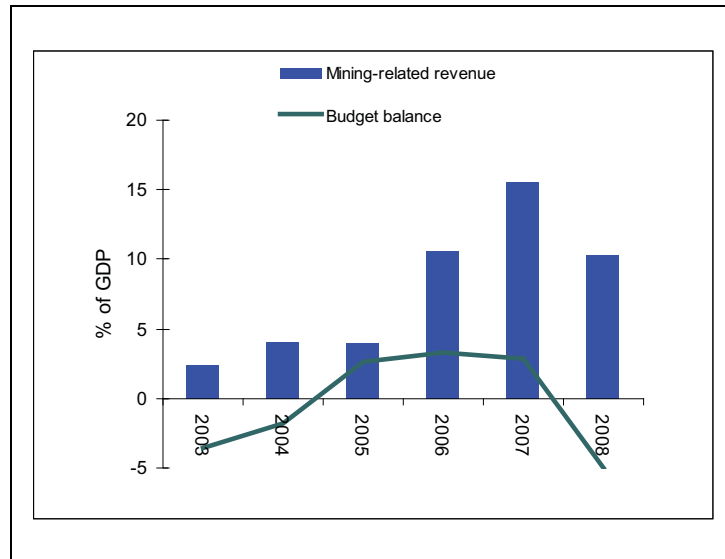
15. *The Government now faces major budget shortfalls, as a dramatic run-up in government revenues between 2005 and 2007 has come to an abrupt end, while expenditures continued to grow in 2008.* The combination of near-record high prices for copper and gold, and the imposition of a windfall profits tax in 2006, led to large, rapid increases in revenues and expenditures. With expenditures increasing to 39 percent of GDP in 2007 from 27 percent in 2005 and revenues increasing to 40 percent of GDP in 2007 from 30 percent in 2005, Mongolia recorded three consecutive years of fiscal surplus in 2005-07, but with a non-mineral deficit³ which was sharply widening at the same time to 13 percent of GDP in 2007, from 1 percent in 2005. Then, in 2008, the fiscal balance turned into a 5 percent of GDP deficit as copper and other commodity prices fell.

16. *Although the government did save significant amounts during the boom years, these were not enough to withstand a shock of this magnitude.* The Government now faces a sudden and major budget shortfall. The 2008 budget outturn has recorded a budget deficit of Tg 306 billion, about 5 percent of GDP. The original 2009 budget deficit was expected to widen even further, with potential to reach more than 12 percent absent aggressive remedial measures (see Figure 1). A subsequent budget amendment, approved in March, projects a 5.4 percent of GDP deficit in 2009. Domestic financing of the deficit is complicated by limited liquidity in the financial sector (see paragraph 18).

Figure 1: After three years of budget surplus based on revenues from high mineral prices, mining revenues declined sharply in the second half of 2008, with further declines in revenues expected in 2009.

³ The non-mining balance is defined as the non-mining revenues (which excludes all dividend and income payments from mining companies, royalties, Windfall Profit Tax) minus total expenditure.

17. *In parallel, Mongolia's external position also reversed by mid 2008, due to the fall in exports and continued high imports, both for consumption as well as to purchase mining equipment. Mongolia's current account swung from a 4.4 percent of GDP surplus in 2007 to an estimated 9.6 percent of GDP deficit in 2008, and is expected to deteriorate further in 2009 (initial staff estimates). The Bank of Mongolia's (BOM) net international reserves declined from over \$1 billion in July to*



\$637 million in December 2008 and the tugrik has depreciated by about 37 percent between the end of October and mid-March.⁴ However, even at this level, the Bank of Mongolia has resorted to rationing of its foreign exchange sales to essential imports (food, fuel and drugs). Worse-than-expected declines in global growth, including in Mongolia's main trading partners (China and Russia), could have further downward impacts on growth in 2009. China, which has emerged as Mongolia's dominant trading partner and source of FDI since 2000 (46 percent of total external trade in 2008), recently reported that growth fell to 6.8 percent in the fourth quarter of 2008 (y-o-y).

18. *After years of rapid growth, Mongolia's financial sector is also showing signs of strain.* The Mongolian banking system has been growing rapidly for a number of years in line with the economy as a whole and supported by a range of financial sector reforms. However, the non-banking financial sector, including capital markets, insurance and leasing have not developed significantly. Other elements of the financial markets infrastructure, such as credit information and the secondary mortgage market, have also failed to develop. Rapid growth of credit frequently leads to portfolio quality issues in the banks, particularly in the event of a downturn in the economy, and the recent macroeconomic events are beginning to reveal bank vulnerabilities. Negative real interest rates and exchange rate depreciation led to a contraction in tugrik deposits in late 2008, and the emergence of liquidity constraints.

19. *Despite improvements in recent years, important risks remain:* limited financial system oversight capacity, inadequate risk management capacity, weak corporate governance and internal control mechanisms at most financial institutions, and solvency problems at a number of savings and credit cooperatives. Weak liquidity management and the absence of depositor insurance also limit the ability of the system to absorb shocks without Government support. The Authorities have responded with a series of actions including the introduction of a 4-year deposit guarantee⁵ and taking the fourth largest bank under conservatorship. The banking system is likely to see further restructuring as non-performing loans increased

⁴ The tugrik has depreciated by more than 45 percent on the black market during the same period.

⁵ The government has subsequently clarified the deposit guarantee to cover current accounts, savings accounts, time deposits and interbank deposits. However, in order to prevent abuse and unnecessary fiscal costs, deposits of related persons—as defined in the banking law—and deposits of holders of subordinated debts will be excluded from this guarantee.

sharply in December 2008 (especially to the private sector). The banking system may also be strengthened by increased capital adequacy ratios and other measures that stimulate consolidation.

20. *These economic developments have unfolded as a new coalition government took office following June 2008 parliamentary elections.* The elections returned a solid majority for the Mongolian People's Revolutionary Party (MPRP), but were followed by post-election riots that left five people dead and a temporary state of emergency. Calm was quickly restored, but formation of a new government was delayed nearly three months while the two major parties hammered out an agreed agenda of legislative reforms. In late September, the MPRP formed a coalition government with the Democratic Party in a 60:40 power sharing agreement. The bi-partisan Cabinet took office to face a dramatically changed economic landscape.

21. *The new government follows a succession of coalition governments from 2004 to 2008 – a period during which rising mineral revenues, and the prospect of major new mining developments, coincided with an increasingly populist political agenda.* With slim majorities and uncertain tenure, three coalition governments during this period had difficulties in arriving at and implementing a coherent policy agenda. Despite these challenges, they promoted some important reforms, including strengthening the public financial management system, and adoption of tax reforms, anti-corruption legislation, and the Extractive Industries Transparency Initiative (EITI). Spurred by high global prices, exploration of Mongolia's rich mineral endowment intensified during this period,⁶ yielding a pipeline of new mining projects with potential to double or even triple recent output levels. But negotiations with mining investors repeatedly stalled amidst controversy over the division of mining revenues and the level of state equity ownership. When Parliament adopted a windfall profits tax and a new Mining Law in 2006, Mongolia's effective tax rate on copper extraction became one of the highest in the world. Pressures also affected the distribution of mining windfalls. Although a portion of the windfall was saved, most was directed toward large, untargeted increases in social transfers, civil service salaries, and capital expenditures.

22. *Mongolia has begun to exhibit some characteristics common to countries suffering from the "natural resource curse."* Mongolia experienced some appreciation of its real effective exchange rate during the recent boom (22 percent from the end of 2005 to its peak in October 2008) and a contraction in FDI into many non-mineral sectors. The structure of the economy remains narrow (mining and agriculture sectors together accounted for around 50 percent of GDP in 2006 and 2007 and for over 90 percent of exports in 2007 and 2008). With political attention in recent years focused on the distribution of mineral windfalls, there has been limited progress on economic reforms to further improve Mongolia's competitiveness. Governance indicators remain relatively high compared to other low income countries, but they have declined in recent years on several global surveys. The public and private sector view corruption as a major development impediment (see paragraphs 34 - 36).

⁶ Between 2000 and 2005, mining exploration increased more than in any other country in the world, accounting for 4% of the global exploration budget.

Medium-Term Prospects

23. *An IMF Stand-By Arrangement and budget support will give the Government breathing space to make the needed macroeconomic adjustment and implement both short and medium-term reforms.* The Government and the IMF have agreed on a Stand-By Arrangement with \$224 million in balance of payments support in response to the extraordinary external shock coming from the collapse of copper prices. The SBA is non-concessional, but gives Mongolia exceptional access to IMF resources and will help restore confidence in the Mongolia tugrik. The Government is also mobilizing donor budget support to cover the projected fiscal gap for 2009 and 2010, with commitments obtained from the World Bank, ADB, and Japan at the time of this writing.

24. *Although the sharp drop in the global economy and in the economies of Mongolia's trading partners has led to a deterioration of the medium-term outlook, the country can return to a new commodity-based growth path soon if Mongolia manages the crisis well.* Under the baseline case, real GDP growth is forecast to drop to 2-3 percent in 2009, down from an average of over 9 percent from 2004-08, as global export demand (in particular from China), private consumption and FDI inflows are projected to fall. Growth will start to recover in 2010 to 4-5 percent and tick up as the development of the Oyu Tolgoi (OT) copper mine intensifies. The current account deficit is projected to narrow gradually to around 6-7 percent until 2009 and 2010, from 9.6 percent of GDP deficit in 2008. The fiscal deficit is projected to be 6 percent of GDP in deficit in 2009 and 4 percent in 2010. Assuming the OT development is well-managed and will come on stream in 2013, both the current account and the fiscal balance are expected to receive a boost and jump into a prolonged surplus.

25. *Mongolia could emerge out of the crisis with a stronger economic and fiscal policy framework than the one with which it entered the crisis.* The IMF Stand-By Arrangement agreed in March 2009 and budget support from other donors will give the Government breathing space to make the needed macroeconomic adjustment and implement both short and medium-term reforms. Fiscal policies could become more sustainable with the adoption of fiscal rules to limit expenditures (in its medium-term framework presented at the donor meeting on March 14, the Government stated its aim to keep the 2009 deficit at 6 percent of GDP and narrow the 2010 deficit at 4 percent of GDP) and public debt, while enforcing savings during boom years; social transfers could become considerably more efficient in reducing poverty; the banking sector could benefit from consolidation and better supervision; and the mining sector could benefit from a more pragmatic approach to negotiations with investors and more clarity with respect to the legal framework.

26. *Mongolia remains at low risk of debt distress.* The joint Bank-Fund staff's debt sustainability analysis, updated in March 2009 as part of the IMF's Stand-By Arrangement negotiations, indicate that Mongolia is at low risk of external debt distress. Although the debt ratios will rise significantly over the next two years as the government is expected to receive front-loaded IMF, IDA and ADB support, the debt outlook is expected to recover and improve over the medium-term as the Oyu Tolgoi mine comes on stream.

27. *There are considerable downside risks.* An increasingly deep and prolonged global recession or a significant delay in the development of OT, will lead to reduced mineral revenues and negatively impact growth, the current account and the fiscal balance, which would increase Mongolia's debt stock indicators significantly, although the debt service

burden would remain manageable. Populist pressures could derail the fiscal, monetary and exchange-rate policy reforms needed to contain the crisis, leading to a further worsening of the economic situation. And pressures to spend its way out of the crisis could lead Mongolia to agree to sub-optimal mineral export contracts or non-concessional financing that negatively impacts debt sustainability. Another key medium-term risk involves large debt service in 2012-15 associated with the repayments to the International Monetary Fund (under the proposed SBA).

C. Impacts on poor and vulnerable

28. *The current economic downturn poses particular risks to Mongolia's poor and vulnerable people.* Although poverty has declined in recent years, it still affects a significant part of the population. The proportion of Mongolians living in poverty declined from 40 percent in 1998, to an estimated 32 percent in 2005. A poverty assessment currently underway will examine more recent developments, following several years of strong growth.⁷

29. *Mongolia's semi-nomadic livestock herders remain particularly vulnerable to shocks.* Livestock herding today accounts for around 35 percent of employment, but generates only around 20 percent of GDP, with herding households reliant on low value primary products and highly vulnerable to severe weather, which can cause significant livestock mortality. This vulnerability is heightened by a rapid expansion in livestock numbers since 2001,⁸ and by an increasing portion of goats in the national herd (goats are the source of cashmere, which is a main source of cash income to herders), which both contribute to continuing degradation of grasslands. A repeat of the widespread livestock losses in 1999-2001 and resulting loss of livelihood for poorer herding households is a distinct possibility. Herders' risk mitigation actions are improving and livestock insurance is being piloted (under the IDA financed Index-based Livestock Insurance Project), however, many households remain vulnerable in the short term.

30. *Ulaanbaatar's large and growing peri-urban "ger" areas (a ger is the traditional round felt tent used by Mongolia's nomads) house another major vulnerable group.* An influx of migrants in recent years has resulted in the rapid expansion of ger areas, which cover hillsides around the city and now account for about 60 percent of the city's population (around 600,000 people). Ger area residents lack access to central heat, water, sewer systems, have higher rates of unemployment, lower incomes, rely more heavily on the informal sector, score lower on human development indicators, and pay higher prices for utility services than do more affluent apartment dwellers.

31. *While Mongolia has largely managed to protect the high levels of human capital inherited from the socialist period, progress had been limited in reducing unemployment and addressing a skills mismatch.* Mongolia has maintained high literacy rates, and has met or is likely to meet MDG targets for primary school enrollment and gender equity in general education. However, even before the crisis, Mongolia's policy makers expressed concern about the quantity and quality of employment that the economy is generating, and the weak

⁷ Definitive discussions of poverty are complicated by a lack of reliable, comparable statistics needed to track trends over time. The Bank is currently working with the National Statistical Office (NSO) to conduct a new poverty assessment (initial results due in mid 2009) and to integrate improved survey designs into its annual household income and expenditure surveys.

⁸ Livestock numbers, at 42 million, reached a historical high in 2008 (NSO, December 2008).

match between available skills and emerging employment opportunities. Official unemployment figures remain at low levels, but they do not reflect the current high levels of hidden unemployment and idleness, particularly among workers with no education or vocational education graduates. In 2007, a Bank study estimated that about 21 percent of the working age population was not working, not looking for a job and not in school.

32. *The current economic downturn is likely to increase these vulnerabilities.*

Unemployment is likely to increase in the current downturn. High inflation has eroded real wages as well as the value of social transfers and private remittances upon which many of the poor depend. Low income families may struggle to keep children in school, and financing for health care is likely to decline on a per capita basis. A rapid needs assessment conducted in fall 2008 identified the poor living in cities and rural towns as being particularly vulnerable to the rapid food price inflation experienced in 2008, given the high percentage of their consumption devoted to food and fuel,⁹ and high levels of unemployment and underemployment. Herders have also been hit in recent months by falling prices of cashmere (a major source of cash income in rural Mongolia) and other livestock-originated raw material (meat, hides, skin, wool, hairs, etc.). This in turn has put pressure on loans to the livestock sector, pushing herders to default and banks to substantially cut back on new lending to the sector.

33. *Vulnerability is further exacerbated by unsustainable use of natural resources, environmental degradation, and climate change.* Two-thirds of Mongolia's population is involved in activities linked with the environment and natural resources management. Yet a growing body of research, including a series of World Bank studies financed by the Netherlands Government, has documented rapid and unsustainable exploitation of forests and biodiversity, and encroachment on unique natural and cultural sites. As noted, grasslands are increasingly under stress due to overgrazing. Rapid depletion of key natural resources heightens vulnerability and can reduce options for diversification. A report on the potential impacts of climate change on the livestock sector found that Mongolia has already experienced significant warming, and that the adaptive capacity of traditional rural networks and land use systems is weakening, while the frequency and magnitude of climate variability and land use intensity are rising. Climate change models predict significant future warming, and an increase in climatic conditions that prevent animal grazing in both summer and winter.¹⁰

D. Governance and corruption

34. *Surveys indicate that corruption and governance deterioration are growing concerns.* Perception-based governance indicators have deteriorated in recent years. Mongolian firms single out corruption as the single most severe investment climate obstacle¹¹, and report that corruption pervades every sphere of business activity. Regular surveys of the public's actual experience of corruption indicate that bribery is commonly required to obtain public health, education, and administrative services, with around 25% of the population reporting that they

⁹ the IMF estimated that in 2006, before rapid food inflation, the bottom quintile of the population spent 80 percent of total consumption on food.

¹⁰ Source: Assessments of Impacts and Adaptations to Climate Change (AIACC), Project No. AS 06: *Potential Impacts of Climate Change and Vulnerability and Adaptation Assessment for Livestock Sector in Mongolia*

¹¹ Several studies, including a report by FIAS, have identified business inspections as a major obstacle to businesses in Mongolia.

paid a bribe over a three-month period. Corruption has also been highlighted as a primary cause of weak enforcement of environmental laws.

35. *Still, Mongolia scores above many other developing countries on a range of governance indicators and continues to progress on some important governance reforms. The Government has improved public financial management, adopted new anti-corruption legislation, is collecting and publishing asset and income disclosures for top officials and made important progress in implementing the Extractive Industries Transparency Initiative (EITI), to which Mongolia is a signatory.*

36. *To inform the Bank's strategy, the country team in 2008 conducted a governance assessment under the Bank's new Governance and Anti-Corruption framework. The assessment focused on understanding key governance impediments in the mining value chain, including: (i) sudden and rapidly expanding revenues and pressure to spend; (ii) lack of accountability and transparency in policy making and use of mining revenues, and to keep patronage networks in check; and (iii) political uncertainty; and (iv) limited awareness among policy makers and the general public of global good practices in managing mineral resources and revenues.*

37. *To address these impediments, the assessment recommended that Bank engagement should: (i) support more flexibility and pragmatism in its own program and in its policymaking advice, (ii) strengthen vertical accountability by broadening engagement (e.g., parliamentarians) and by encouraging more transparent policy analysis and monitoring by civil society across the extractive industry value chain; while (iii) continuing to build on core public sector reforms to strengthen institutional accountability. [See description of three-year grant for Mongolia under the Bank-administered Governance Partnership Facility in paragraph 68.] Follow up will also continue on World Bank supported reviews of corporate governance and accounting and auditing standards.*

III. COUNTRY DEVELOPMENT PROGRAM AND ISSUES

A. Country Priorities

38. *The coalition government now faces the difficult task of managing the crisis against the backdrop of the high expectations set out in the 2008-12 Government Action Plan (GAP) and the National Development Strategy (NDS). The NDS and the GAP articulated an ambitious medium-term development agenda, including goals to use the mining sector as a springboard for development of a knowledge-based economy, improve living standards, reduce disparities, protect the environment, and improve transparency and accountability. But as the impacts of the global crisis on Mongolia have become apparent, the Government has rapidly shifted focus from this development agenda to short-term crisis management.*

39. *The Government has set an ambitious macroeconomic program designed to restore economic stability through fiscal and monetary reforms and to safeguard the poor and maintain social stability through improving the social safety net. The Government seeks to achieve these goals through a budget adjustment that improves fiscal sustainability, proactive monetary policy to safeguard international reserves, initiating a comprehensive overhaul of its social transfer programs to improve targeting and increase support for the very poor. The*

Government is also planning an overhaul of its fiscal framework to avoid future boom-bust cycles. The Government has already begun to take important steps within this framework. An amended 2009 budget approved by Parliament in March projects a 5.4 percent of GDP deficit in 2009, based on revised revenue forecasts, substantial cuts in capital expenditure and a hiring freeze on civil servants. As a step to restoring confidence in the Mongolian tugrik and the local financial sector, the Bank of Mongolia has raised its policy rate to 14 percent from 9.75 percent and increased the banks' capital adequacy ratios.

40. *The Government is also placing a high priority on bringing new strategic mineral deposits into production.* With large fiscal shortfalls, the Government is seeking to move forward rapidly with the stalled investment agreements. In March, Government submitted a draft investment agreement for the Oyu Tolgoi mine to Parliament for ratification (review in progress).

B. Development Challenges

41. *Over the medium-term, Mongolia's most significant development challenge is how to overcome the natural resource curse and transform its natural resource endowment into renewable assets for sustainable and broad-based development.* The current economic downturn has highlighted the need to improve macroeconomic management to reduce the impact of future commodity price cycles. It has also underscored the need to develop and maintain a competitive and stable investment climate to promote mining sector and economic diversification. A parallel medium-term challenge is to how to reduce vulnerabilities and disparities between and within rural and urban populations. Achieving more sustainable management of the country's rich natural resources will be critical for reducing vulnerability as well as for future growth in industries such as tourism. The experience of other mineral rich countries highlights the importance of governance reforms in order to convert mineral assets into development results.

42. *While the downturn has shifted the focus of policy makers to short-term crisis management, it also has brought renewed attention to a reform agenda that can lay a stronger foundation for achieving medium-term goals.* Several urgent challenges will need to be addressed if the country is to successfully weather the current crisis and set in place a foundation for future growth, poverty reduction, and greater economic resilience.

43. *First, Mongolia has to undertake a mix of policy adjustments and financing to meet its twin deficits.* Given the magnitude of the fiscal adjustment, the Government is reprogramming existing budget resources to target urgent priorities. The fiscal adjustment will need to take place urgently and will even then extend over several years. In addition, Mongolia needs to tap additional sources of financing to smooth the adjustment. Care will have to be taken that the financing is obtained in ways that do not impose unsustainable debt burdens for in the future or rely on selling off its natural assets cheaply.

44. *Second, it will be important to protect vulnerable groups from the twin impacts of high inflation and the abrupt economic downturn.* To ensure that the poor are protected, the fiscal adjustment will need to be smoothed out over several years. Given the magnitude of the fiscal shock, the existing social protection programs need to be re-targeted to the poorest Mongolians. To improve fiscal sustainability and protect the poor, it will be critical to consolidate multiple and overlapping programs and re-target them toward the poorest

Mongolians. There is also significant room to improve spending efficiency of health funds, including better allocation of health spending towards essential services, and state funding for tertiary education. At the same time, the government and its development partners can scale-up or move forward programs which generate employment.

45. *Third, the Government will need to stabilize and restore confidence in the financial sector.* Clarifying the blanket deposit guarantee, resolving any problems with commercial bank(s) quickly, while setting the right precedent for future bank failures, and strengthening supervision will be key short-term measures. Addressing liquidity problems and providing Mongolian commercial banks with the necessary knowledge to effectively manage the challenges of the global crisis will also be important.

46. *A fourth urgent challenge is to quickly develop and put in place crisis management capacity in the key economic management areas.* These areas include macroeconomic and fiscal management, investment planning (including prioritizing maintenance of existing infrastructure), social protection, banking supervision, and mining investment negotiations. As the crisis abates, this crisis management capacity could then gradually shift into supporting the medium-term development agenda.

IV. BANK GROUP'S TRACK RECORD

47. *The World Bank's 2004-2008 Country Assistance Strategy was implemented during a time of economic growth and expanding government revenues, fueled by rising copper prices and good weather, and during a time of political flux.* The 2004-08 CAS was aligned with the Government's Economic Growth Support and Poverty Reduction Strategy (EGSPRS), which set an ambitious and detailed set of outcomes against which progress could be monitored. Following the 2004 general election that resulted in parliament divided almost evenly between the two major political parties, the EGSPRS had limited traction, and successive coalition governments brought frequent changes to the policy agenda and a period of prolonged political uncertainty. As a result the Bank's program did not include the anticipated policy lending series; it instead concentrated on the agreed investment lending, AAA, and non-lending technical services, with an increasing emphasis on assisting policy makers and the public to learn about the experiences of other mineral-rich countries and related policy options.

48. *The Bank Group responded flexibly to the changing situation, and evaluations of selected projects and AAA found that implementation has generally been satisfactory.* Bank-financed projects successfully introduced and piloted innovations (e.g., in student reading, livestock insurance, community participation in investment decisions, a universal access fund for ICT) and generally met their development objectives, albeit with some delays. IEG's evaluation of four projects in Mongolia over the last five years found all to be satisfactory, although disbursement fell below EAP averages in some years. A QAG assessment of eleven Mongolia AAA products (FY02-06) found them to be of high quality and gave them an overall satisfactory rating. IFC's support for developing the legal framework for leasing, which resulted in the promulgation of a leasing law, and support of establishment of Mongolia's first private credit bureau through its advisory services, were also notable achievements.

49. *A draft CAS Completion Report and Client Survey provide some lessons to inform the ISN:* (i) Strong outreach, understanding of the political economy, and flexible programming are critical in a fast-changing and uncertain policy environment; (ii) Greater emphasis on short, just-in-time policy notes and on dissemination can enhance the impact of AAA; (iii) Platforms combining multiple projects, AAA, and TA over an extended period of time can yield strong results; (iv) WBG resources can effectively catalyze additional resources for Mongolia.¹² Before the most recent economic developments, a client survey conducted in 2007-8 to support preparation of a new CAS found that clients think Mongolia's top development priority is government effectiveness and governance, that the Bank should focus its efforts primarily on increasing employment, economic development and growth, and that the Bank should do more to safeguard against corruption in Bank programs, and to support efforts to improve transparency in governance.

50. *A desk review of the Mongolia portfolio from FY05-08 found that overall portfolio performance was good, with room for improvement.* Mongolia's portfolio grew from 10 projects in FY04 to 13 projects with \$156 million in net commitments in FY08. (Disbursement rates fluctuated above and below EAP averages, in part due to frequent changes in government policies and project counterparts during the CAS period that complicated portfolio management and led to frequent project delays. Improvements were made in financial management of the portfolio; and with Bank assistance, the government implemented a new audit strategy improving the competitive selection of auditors for Bank- and ADB-funded projects. (The Bank continues to support the Mongolia National Audit Office (MNAO) to improve its capacity to audit government accounts and to gradually cover all donor-funded projects.) Mongolia projects posted below-average ratings for most quality-at-entry parameters, though they scored better than EAP averages for quality of supervision and quality at exit. The review raised some concerns over complex project designs, government ownership, and use of parallel PIU structures. The desk review found good performance of the \$32 million trust fund portfolio, with strong disbursement and overall satisfactory progress.

V. INTERIM STRATEGY

A. Rationale for World Bank Group's Interim Strategy

51. *The proposed Interim Strategy is intended to provide a bridging framework for an 18 month period until economic conditions stabilize.* Mongolia is one of the East Asian countries hardest hit by the global economic slowdown, and there is a high degree of uncertainty over the depth and duration of the impacts. Therefore the ISN positions the Bank to support the Government in addressing urgent crisis needs and easing the fiscal adjustment, but also to support renewed efforts to make reforms that will reduce the impact of future shocks. As conditions stabilize and there is a clearer planning horizon, we anticipate concluding a four-year CPS supporting Mongolia's medium term agenda.

¹² During the 2004-08 CAS period, the Bank helped Mongolia to access additional financial resources including: (i) \$29 million Education for All - Fast Track Initiative grant funds; (ii) \$11 million in Netherlands Government grants for an integrated program of environmental activities; (iii) grants and co-financing in support of rural development (\$13 million from the EU) from multiple donors.

52. *The proposed ISN refocuses WBG assistance building on a process of strategy formulation over the past 24 months.* A draft CAS Progress Report (PR) was initiated in early 2007; then, at the Government's request, rather than proceeding with the PR, the team accelerated preparation of a new four-year Country Partnership Strategy in mid 2007. However, the draft CPS was delayed following an unexpected change in Government in late 2007, and again by the June 2008 parliamentary elections. Discussions on the four-year CPS re-started when the new Government took office in late September 2008, just as the full impacts of the global economic crisis were becoming apparent in Mongolia, along with the need for a further shift in strategy. In early 2008, it was determined that an Interim Strategy would better meet Mongolia's evolving situation and needs.

B. Strategic Focus Areas under the ISN

53. *Under the ISN, the WBG program of assistance will support the Government in two strategic areas: (i) management of Mongolia's mineral-based economy, including short-term crisis response and medium-term policy reforms; (ii) protecting the poor and vulnerable.* Assistance will focus on supporting the Government's short-term crisis response. IDA resources during the ISN period will be deployed primarily to development policy credits (DPCs) that will help to ease the fiscal adjustment while also supporting key short- and medium-term policy reforms. Active projects and analytical work are also being realigned, as appropriate, to meet current and emerging needs while retaining a focus on reforms and capacity building to address Mongolia's complex medium term issues. Results milestones during the ISN period are outlined in Annex 1.

ISN pillar 1: Strengthen management of Mongolia's mineral-based economy

54. *The Bank will support the Government's immediate crisis response and associated reforms with potential to improve medium-term management of the country's mineral-based economy.* Recent economic events have highlighted the risks stemming from the country's natural resource dependence, and the overarching challenge that the country faces to improve management of its mineral-dependent economy. The downturn has also highlighted shortcomings in domestic policies – fiscal, monetary, banking, social, mining regime – that in turn have amplified impacts of steep declines in global prices of copper and other commodities. The Government has responded with an ambitious short-term macroeconomic program to navigate the adjustment as well as to put in place policy reforms to make Mongolia's mineral-dependent economy more resilient in the medium-term. The Bank Group will provide support to help Government ensure fiscal sustainability, protect the poor, provide a stable and competitive investment climate for the mining sector, and strengthen the banking system.

55. **Ensuring fiscal sustainability.** Fiscal impacts have been exacerbated by rapid expansion and weak targeting of expenditures and investments, which in turn reflect underlying weaknesses in budget formulation. In the short term, the Bank via the DPCs expects to support the Government's immediate fiscal response to the downturn by establishing adequate safety nets and ensuring proper maintenance of infrastructure. For the medium-term, the DPCs will support Government policy and institutional reforms to position Mongolia to more effectively manage future upturns in mineral prices, including through planned reforms to improve the fiscal framework, strategic planning and capital budgeting.

Building on ongoing Bank support for public financial management, this is expected to include strengthening the legal framework for planning and budgeting (Fiscal Responsibility legislation), strengthened institutional structure (e.g, capacity building of the planning agency), and improved systems (new budgeting system, system integration).

56. **Encouraging mining investments.** The downturn has also underscored the need to ensure that Mongolia's mining regime is competitive and stable and to resolve remaining ambiguities in the legal and regulatory frameworks in order to continue to attract world class investors. The World Bank Group will continue and as needed deepen its support in these areas via the DPCs, ongoing TA projects on mining and governance, and just-in-time policy analysis. Support is expected to include: review of minerals policy on state equity participation and mining licensing; formulation of cadastre regulations consistent with international good practice; review of the fiscal regime for mining including options for taxation and revenue management that provides for saving windfall revenues; and development of standard mining investment agreements.

57. The Government is also seeking support to manage and catalyze the large infrastructure investments needed to develop major mining deposits. The Bank's draft Southern Mongolia strategy identifies key infrastructure options and trade-offs for planned developments in the area, including environmental and social risks and mitigation measures. It is expected to provide inputs into preparation of a new infrastructure project designed to strengthen planning, prioritization of investments in S. Mongolia, and structure public private partnerships. Such development in southern Mongolia could, over the medium term, anchor future Bank Group operations (traditional IDA investments, IDA and MIGA risk guarantees, and IFC investments). The Bank Group will continue to explore the prospects for enclave financing for infrastructure investments that generate foreign exchange. Subject to suitable agreements with Government and/or private sector investors, IFC could provide support for appraising and structuring relevant projects, making minority equity investments, and mobilizing long-term debt financing.

58. **Restoring confidence in the banking sector.** The severe terms-of-trade shock has exposed vulnerabilities in Mongolia's banking system, exacerbated by rapid credit expansion that occurred during the recent commodity boom. Building on long-term WBG support to Mongolia's financial sector (including a Financial Sector Assessment Program 2007-8, an ongoing financial capacity building project, and IFC investments and TA), the Bank is supporting immediate response measures to address bank failures and strengthen the banking system. An ongoing private sector development credit (PSDCII) has been amended to support a special portfolio diagnostic and audit of a failed bank. The Bank is also helping the Bank of Mongolia to strengthen its day-to-day monitoring of banks; advisory support for the establishment of an adequately resourced crisis management unit is under discussion.

ISN pillar 2: Protecting poor and vulnerable people

59. *The Bank Group is intensifying support to the Government to help poor and vulnerable groups get through the crisis, while also strengthening policies and building institutional capacity to reduce future vulnerability.* This will include complementary support, aligned with ADB assistance, to help the Government overhaul its system of social

protection. It will also involve redirecting ongoing support aimed at helping vulnerable populations in rural Mongolia and in Ulaanbaatar.

60. **Retargeting social transfers to the poorest.** The rapid and untargeted expansion of social transfers, funded by revenues from high commodity prices in recent years, is now straining fiscal sustainability and also potentially limits the availability of resources to the neediest people. ADB and the World Bank are supporting Government efforts to streamline social protection resources and ensure that they are directed to the poorest and most vulnerable people. Under the joint DPC matrix, the ADB will support Government to provide for immediate social assistance needs as well as introduce a comprehensive reform program to consolidate and improve targeting of existing social transfers. The World Bank will provide complementary support for better targeting, including through planned TA to help develop a new proxy-means test, and strengthen monitoring and evaluation of social transfers. Trust funds have also been mobilized to support improved targeting of health finance including development of a new regional allocation formula to improve outcomes of mothers and infants; development of "pay for performance" indicators and measures to improve antenatal and postnatal delivery services; and a model for hospital optimization and rationalization in UB city.

61. **Reducing rural vulnerability.** The WBG has long supported a package of assistance designed to improve livelihoods of rural populations, with a special emphasis on creating conditions to reduce rural vulnerability through better service delivery and environmental management. Where possible, these initiatives are being redirected and accelerated to address short-term crisis needs.

- Enhance rural service delivery. In response to the crisis, the Bank is seeking to accelerate disbursements under a community-driven local initiatives Fund supported under the second phase of the Sustainable Livelihoods Program APL (SLPII). Discussions are also underway to expand the Fund with an enhanced focus on food security, if additional financing can be raised from possible financiers (e.g. the EU, Global Food Crisis Response Fund, other sources). Bank-financed initiatives to expand rural access to ICT, renewable energy, and primary school reading programs will also continue.
- Improve access to rural financial services. The SLPII project and IFC investments will continue to expand rural access to microcredit and other financial services, in coordination with commercial banks, NBFIs, and other external partners. Additional finance is being sought to ensure sustainability and expand geographic coverage of the ongoing Index-Based Livestock Insurance Project, an innovative and award-winning pilot project that is introducing market-based insurance products to herders that provide coverage in the event of catastrophic weather events. Additional finance would allow livestock insurance to be introduced in more provinces, build the necessary institutional framework to sustain the insurance, and pre-finance an important potential government liability that insures herders against major natural disasters.
- Reduce vulnerability through better management of natural resources. The Bank will also continue to support initiatives to reduce rural vulnerability through improved management of the environment and natural resources. Under the second phase

of the Sustainable Livelihoods Program APL, the Bank is helping authorities to scale up activities to reduce pastoral risk, including improved systems to manage pastures, strengthening weather and pastoral risk forecasting capacities, encouraging formation of herder groups to carry out mitigation activities, and enhancing emergency response capabilities (e.g., hay and fodder reserves). In addition to SLP II activities to improve pasture management, the Bank has also been developing pilot projects to improve forest and biodiversity management and to promote sustainable ecotourism, though these are unlikely to be finalized during the ISN period due to limited IDA resources.

62. **Help vulnerable populations in Ulaanbaatar**, with an emphasis on improving the livelihoods of peri-urban ger area residents. These activities include: (i) continued development of water kiosks that provide clean water to peri-urban residents under the USIP-II project; (ii) additional financing of an ongoing Energy project to support urgent, staged upgrading of Ulaanbaatar's antiquated electricity distribution infrastructure in Ulaanbaatar, a priority that is highly complex and of high government priority given deep cuts in the 2009 public investment program; (iii) formulation of a ger area development strategy. A project to reduce Ulaanbaatar air pollution is also being prepared and could be finalized during the ISN period. Air pollution in Ulaanbaatar, one of the coldest capitals in the world, has become extremely severe, reaching about seven times WHO target values in the most polluted parts of the city in winter time.

Cross-cutting ISN theme: Building capacity to manage the crisis and improve governance in the medium-term.

63. *The two pillars will be supported by a set of activities that help build Government capacity to provide for urgent needs while continuing to strengthen related institutional capacities for the medium-term.* Activities to be supported include:

- Current technical assistance projects (GAP, ECTAC, Mining TA) are being adjusted to link with these emerging priorities, drawing on findings under the recently completed Public Expenditure and Financial Management Review (PEFMR) and other studies. The Bank will continue to support efforts to increase budget transparency, including Mongolia's good progress in implementing the Extractive Industries Transparency Initiative.¹³
- The Mining TA and GPF will begin activities to strengthen government and independent capacity for mining and related economic policy analysis. The ongoing Mining TA will also support development of governance, financial and fiduciary arrangements for the Erdenes state holding company consistent with corporate governance principles.
- A statistical capacity building project, under preparation, can improve the quality of key statistical systems and strengthen targeting of development resources, critical to the enhanced budgetary management envisaged under the DPCs,

¹³ Mongolia is about to complete its second reconciliation report since it joined EITI in 2006. It has been identified as one of four countries in line to be declared as "EITI compliant" following an independent validation.

including economic management, social protection, banking sector supervision, and mining sector development.

- The ECTAC project, the DPCs, and the Southern Mongolia Infrastructure Strategy now underway will support the recently established National Development and Innovation Committee to strengthen public investment program planning and implementation.
- The ongoing Bank-financed rural program will help to build capacities to reduce the vulnerability of herders by strengthening systems that reduce pastoral risk as well as to protect and extend gains made to extend climate emergency, microfinance, telecommunications, and social services to rural residents.
- The Governance Partnership Facility grant will also support results milestones through independent analysis, public outreach on select policy issues, and introduction of demand-side tools to foster transparency and accountability.

C. ISN Approach

64. *To support the new Government in responding first to the food crisis, and subsequently, to the challenges of the global economic crisis, the Bank has adapted its ongoing program and customized its CY2009-2010 program to reflect evolving needs.* During this interim period, the proposed Interim Strategy program has six features:

- *Significant policy lending complemented by select, high impact investments.* Two Development Policy Credits (DPCs) totaling SDR 40 million (US\$60 million at present exchange rate), representing two-thirds of the notional IDA 15 envelope, will support a strong program of policy reforms (para 54) and provide budgetary support to meet the fiscal shortfall. The first Credit is envisaged in early FY10. A few high-priority investment operations would also be presented for consideration in FY10 or FY11. Specific operations would be determined in accordance with Government priorities, consistent with agreed criteria: (i) responsiveness to urgent crisis needs, including protecting the poor and vulnerable; (ii) managing critical infrastructure; (iii) generating employment for vulnerable groups; (iv) building capacity needed to manage the crisis.
- *Need-specific portfolio restructuring and accelerated implementation.* The Bank has been reviewing the ongoing IDA portfolio to modify, accelerate and, as appropriate, expand components of existing operations that address current vulnerabilities, encourage employment generating investments, and build capacity needed to help manage the crisis.
- *Enhanced IFC support.* IFC will continue to support the Government in addressing weaknesses in the financial markets and real sectors through investment and advisory services. Mongolia may also participate in or benefit from IFC's global crisis response initiatives and activities.
- *Intensified roll-out of the knowledge program.* The Bank Group's analytical and advisory program has intensified its real-time policy advice and analytical products to respond to the crisis. This work underpins the proposed DPC policy program in fiscal

management and the banking, financial and social sectors, poverty reduction and social protection. Support to date has included: a joint Bank-GOM high-level Economic Policy Conference in late October focusing on options to manage macroeconomic risks and development in a resource-based economy; a series of quick-response, short analytical pieces (Economic Quarterly, note on the emerging impacts of the financial crisis, preparation of a rapid food crisis assessment); a review of Mongolia's financial sector vulnerabilities; and day-to-day advice. Ongoing technical assistance is being re-aligned to emerging needs, particularly in the financial sector. IFC's Advisory Services program is enhancing its support for improving the business environment and strengthening financial markets.

- *Expanded trust fund leveraging.* Mongolia benefits from considerable donor support with \$32M in grant trust funding supporting, inter alia: education reform, sustainable livelihoods, environmental improvements, public administration, and governance enhancement. To meet emerging priority needs, additional trust fund resources are being sought for high impact activities (e.g., to scale up small-scale vegetable production under the Sustainable Livelihoods Program, strengthened financial sector oversight and supervision).
- *Results orientation.* The ISN program, while designed to support the Government in meeting new and evolving challenges, maintains a focus on Mongolia's medium term challenges. The ISN results matrix promotes accountability.

D. ISN Implementation

65. **Program Financing.** In FY09, as a result of improved debt sustainability, Mongolia became a "green light" country, moving from a blend of IDA grant and credits to IDA-credits only status. This status will be monitored as the impact of the current crisis unfolds. Mongolia's indicative IDA envelope is around SDR 20 million (\$30 million) per annum for FY09 and FY10, with actual allocations during ISN period determined on an annual basis according to specific criteria¹⁴ The WBG will continue to mobilize trust funds and co-financing to leverage Bank Group budget and IDA resources. IFC investments have totaled approximately US\$60 million and its current pipeline portfolio is approximately \$50 million however, it is unclear at this time what levels of investment may be possible in the next 12-18 months given the constrained economic environment.

66. **WBG Capacity.** The Bank Group has strengthened its *in-country capacity and program management* to support the government in these challenging times. In addition to bolstering its national staff capacity in FM and Procurement, the Mongolia Country Office now includes an international mining specialist and an infrastructure specialist and several staff seconded from other international aid agencies. In addition the country team has designated platform leaders who serve as focal points for program related work in each of the platforms. IFC's *'frontier investment team'* in the East Asia and Pacific Region has placed an

¹⁴ Estimates of IDA for FY09-11 are indicative only and can change. Actual allocations in these years will depend on: (i) total IDA resources available, (ii) the country's performance rating; (iii) the performance and assistance terms of other IDA borrowers; (iv) the terms of IDA's assistance to Mongolia (grants or credits) (v) the number of IDA-eligible countries. IDA allocations are made in SDRs based on performance, and the US\$ equivalent is dependent upon the prevailing exchange rate. Since Mongolia is at a low risk of debt distress, it will receive all its allocations in the form of credits unless its debt sustainability position changes.

intensified focus on Mongolia. As part of the EAP *decentralization* program, a Sector Manager responsible for the Sustainable Development portfolio in Mongolia is now located in Beijing. Fifty percent of the Mongolia SD portfolio is now managed by task team leaders located in the field.

67. ***IFC and MIGA.*** The International Finance Corporation (IFC) will continue to address weaknesses in the financial markets and real sectors through investment and advisory service programs. This work includes: (i) strategies to assist investment clients with liquidity; (ii) developing the non-bank financial sector including leasing; and (iii) providing training in best practices to help banks through the economic crisis, such as NPL management and corporate governance. IFC investments in the real sector will help diversify Mongolia's economic base. IFC has made investments in the real sector, including food & beverages, properties, cashmere, and is exploring opportunities in agribusiness, energy, energy-efficient building materials, mining and mining-related infrastructure. IFC will also support reform to strengthen small businesses and help diversify the economic base – including through a program to improve the business environment by reforming the inspections regime. In response to the global financial crisis, IFC has ramped up support to developing countries aimed at addressing problems experienced by the private sector. These include initiatives to support microfinance institutions, relieve liquidity stress, expand trade financing, and provide banks with skills to help them cope with the crisis. Mongolia will participate in these initiatives where feasible. The Multilateral Investment Guarantee Agency (MIGA) will also continue to supplement the work of the Bank and the IFC by offering its guarantee product in support of private investment into the country.

68. ***Governance.*** Improved governance will be a key factor in Mongolia weathering the crisis successfully and in meeting its own ambitious development goals. The ISN program directly focuses on several governance results and milestones, incorporated in the ISN results matrix (See especially indicators under the “Enhancing management of a mineral-based economy” section), that directly areas studied under the recently concluded Governance Assessment (see paragraphs 36-37). To support these results, a three-year Bank-administered *Governance Partnership Facility grant* will provide additional resources to promote better informed economic and mining policy analysis and debate, and strengthened transparency and accountability at key points across the extractive industry value chain. This will support expanded outreach and dissemination activities, greater emphasis on transparency and accountability in Bank-financed projects and activities, and to further engage Government counterparts, civil society, and the private sector by improving dissemination of information on project objectives and information and engaging beneficiaries and civil society in design and monitoring activities. In the short term, this facility will be used to engage the key stakeholders on the extent and implications of the economic crisis, and on the policy options moving forward. In the medium-term, policy-relevant analysis and debate on managing the mining revenues, social protection, the banking sector and mining development will be supported by the facility. Finally, the facility will support civil society monitoring activities of the government's performance on crisis management and the policy reform agenda.

69. ***Knowledge Program.*** During the interim strategy period, the main emphasis in the Bank's analytical and advisory program will be on providing real-time policy notes and advice to support the Government's crisis response and to underpin the proposed DPCs. This includes work on fiscal management and the banking, financial and social sectors, poverty

reduction and social protection. Ongoing work in critical areas will proceed, including a series of policy notes supporting a southern Gobi regional development strategy; an Ulaanbaatar ger area development strategy; a Livestock Sector Survey; work on air quality in Ulaanbaatar; heating policy reform; capacity building in energy; and continued policy analysis on urban and rural service delivery, municipal management, tariff reform, environment, and poverty reduction policy from a multi-sectoral perspective. *IFC's Advisory Services program* will focus on improving the business environment and strengthening the financial markets sector, in close coordination with its investment program. This includes building a private credit information company, bank training, corporate governance, and support for the leasing and housing finance sectors. It is also working with other organizations on price differentiation for cashmere and on reform of the business inspections regime.

70. **Partnerships.** The Bank will continue to work actively to align its support with other external partners, and to mobilize additional bilateral and multilateral financial resources to help Mongolia weather the current economic downturn. External financing for Mongolia has been relatively high, primarily focused on infrastructure and other public investment. Mongolia continues to benefit from high levels of ODA, which on a per capita basis (of almost \$100/person) are among the highest in the world. Annual ODA levels have remained stable in recent years at \$200-250 million per year, though they have made up a declining share of GDP as growth has picked up. Multiple partners are active in Mongolia, with Japan, ADB, and the World Bank providing the largest sources of financing. The U.S.-financed Millennium Challenge Corporation (MCC) signed a compact with the GOM in October 2007 with a 5 year commitment of \$285 million. Donor programs, with some exceptions, have tended to be extra-budgetary, unpredictable, with limited consensus on sectoral policy, institutional and investment priorities. However, there are good examples of donor coordination, such the education sector donor consultative mechanism, which the global Fast Track Initiative funds have helped to incentivize. The annual *Donor Technical Meetings* jointly developed with the government and partners have been institutionalized. These meetings have resulted in enhanced and more cohesive policy and program coordination and an improved focus on critical policy issues, including the financial sector, private sector development and the February 2009 meeting on the current crisis.

VI. MANAGING RISKS

71. Key risks to the interim strategy include:

- The risk that insufficient crisis management capacity exists to correctly assess the extent of the crisis and formulate and implement the appropriate policy response(s) in a timely manner. The IMF, the ADB and the World Bank are providing policy analysis, advice, tools and TA to the relevant government counterparts in the priority areas. However the need is great and both government and parliament would benefit from in-house policy making capacity, which will be supported under ongoing TA projects on economic policy making, governance assistance, and mining as well as by the new Governance Partnership Facility. The risk that policy makers will be unable to muster sufficient ownership to undertake the necessary reforms and sustain momentum on a coherent set of policy actions. The multilaterals and bilateral partners are jointly working with the Government to define a coherent policy package and to disseminate the rationale with key stakeholders. The Program also benefits from

enhanced engagement with parliament through study tours, briefings and seminars. There is some Bank-financed and grant TA in place to further deepen this national dialogue. The recently approved GPF grant to support governance reforms will be used to support public awareness of the development impact of policy options under consideration as well as to create civil society capacity to monitor government's adherence to, and progress on, the policy actions.

- The risk of further, as yet unforeseen external shocks that significantly worsen the current situation and hurt the poor. The Bank will be scaling up existing livelihood-supporting activities under its projects and provide TA to improve the targeting of social protection programs.
- The risk that governance impediments/corruption undermines progress on the country's medium-term policy agenda and/or that weak governance affects the WBG portfolio adversely. At the country level, ongoing Bank Group supported project activities to promote transparency and accountability in public financial management and public administration will be augmented by activities under the new Governance Partnership Facility grant. As for the Bank Group portfolio, activities to strengthen governance are underway on a number of fronts, including: support for the Government's new audit strategy; recruitment of additional FM and procurement capacity in UB; intensified portfolio management; and placement of a sector manager in Beijing with oversight responsibility;