

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

STRATEGY FOR MONGOLIA

As approved by the Board of Directors at its meeting on 21 October 2009

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I. EXECUTIVE SUMMARY

Mongolia has an established multi-party system, a pluralistic society, and is making good progress towards the market-orientation of its economy in compliance with the principles of Article 1 of the Agreement Establishing the Bank. The latest parliamentary elections in June 2008 were considered by independent observers generally free and fair and, after a period of post-electoral uncertainty, resulted in the formation of a coalition government between the Mongolian People's Revolutionary Party (MPRP) and the Democratic Party (DP), the two major political parties of the country. As a reflection of the democratic achievements of the country, the presidential election on 24 May 2009 brought victory to the opposition candidate, in an election recognised as fair by domestic and international observers.

Since the adoption of the first country strategy in 2006, Mongolia has experienced robust growth. The economy grew by 9 per cent on average during the past 3 years and per capita GDP increased from US\$ 871 in 2005 to US\$ 1,970 in 2008. However, there has been little improvement in poverty reduction as the poverty headcount ratio only declined from 36.1 per cent in 2003 to 35.2 per cent in 2008. The government continues to place poverty reduction as a national priority and launched a National Development Strategy in 2007.

The global financial crisis did not affect Mongolia up through the middle of 2008, however the country is now facing an economic downturn. The significant decline in global commodity prices in autumn 2008 – in particular copper prices – has negatively affected both fiscal and external accounts from the second half of 2008, both of which showed a deficit.. While the Mongolian banking sector is not exposed to external financing, conditions deteriorated during 2008 as the two main financial channels (i.e. deposits and interbank financing) became vulnerable. Commercial banks significantly reduced new lending and the banking sector could face challenges in terms of its capitalization and consolidation.

The government was relatively quick and comprehensive in responding to these difficulties, deciding to guarantee bank deposits and approving a US\$ 1.1 billion economic stimulus plan in March 2009. Subsequently, the government agreed with the IMF on a US\$ 229 million stand-by arrangement. In October 2009, the Mongolian Government signed an important investment agreement with Rio Tinto/Ivanhoe Mines for the exploitation of the Oyo Tolgoi copper and gold mine. It is possible that on the back of this, in 2010 other large mining agreements will follow, most notably related to the Tavan Tolgoi coal mine deposit.. Assuming the fiscal stimulus is effective and the major investment agreements materialise as mentioned before, the country may be back on the road towards robust and stable economic expansion.

Mongolia made good progress in a number of structural reform areas, including price and trade liberalisation as well as privatisation, while progress in corporate restructuring and governance lags behind. The banking system has grown in size and financial regulation has improved though the sector is currently facing significant challenges which need to be addressed. Some infrastructure improvements have been made, but commercialisation and private sector participation in infrastructure is at an early stage of development. Against this background, the transition challenges for the next Strategy period would be:

- Facilitating enterprise restructuring and improving corporate governance
- Consolidating and strengthening the financial sector
- Managing minerals wealth and diversifying the economy
- Improving the business environment

- Promoting commercialisation and private sector participation of public infrastructure.

Given the macroeconomic environment and the stage of reforms mentioned above, the Bank will focus on the following operational priorities in the next strategy period:

(1) Financing Local Enterprise Growth and Development

The development of private businesses will remain the main pillar of the Bank's strategy. The Bank will explore possibilities of direct financing especially in the form of equity in a number of key sectors, including agribusiness, cashmere/textile, hotel and tourism, property and services, which will contribute to the diversification of the economy. The Bank will seek to attract strong and reputable international investors.

Inclusion of Mongolia within the ETC Initiative will continue to enhance opportunities to develop local projects. In its efforts to support SME development, the Bank will build further on its experience with the Turn-Around Management Programme (TAM) and the Business Advisory Service (BAS) Programme recently established.

The Bank will continue to place a special focus on micro businesses through further development of micro and small business credit lines especially in the more remote regions and administered by local partner banks.

(2) Supporting the Consolidation and Strengthening of the Financial Sector

The challenges and the nature of the issues faced by several banks require concerted efforts of all parties involved to, inter alia, strengthen the Central Bank supervision tools. The Bank will further consider increasing, on a case by case basis, its engagement in the sector with existing bank relationships as well as through the establishment of banking relations with potential new banks in the forms of equity participation, provision of credit lines and co-financing facility.

The Bank would encourage the consolidation of the banking sector as well as to strengthen institutional building programs with selected banks after consolidation thus also helping to address weaknesses exposed by the challenging financial climate. Besides providing new capital or long term funding in selected cases, the Bank will mobilise much required technical assistance in order to address existing gaps in the institutional building framework and management of individual banks and of the sector in general. The Bank will continue to work with banks which adhere to the Bank's strict corporate governance guidelines and will offer, on a case by case basis, its assistance to keep these banks well-capitalised with further capital increases as well as to assist with institutional building (including mobilising TC funding).

The Bank will continue to actively promote the Trade Facilitation Programme (TFP), and will increase financing sources for micro and small enterprises through credit lines to commercial banks and to non-banks, particularly outside the capital.

The Bank will also endeavour to support the development of non-banking financial institutions (NBFIs) such as non-bank micro financial institutions, leasing, insurance and pensions. This could be extended to include new financial instruments to address energy end-use and small-scale sustainable energy sector, such as energy efficiency and renewable energy credit lines. Also the Bank will consider supporting the development of capital market via policy dialogues with Financial Regulation Committee, via supporting for better regulatory frame works and supervisory capacity, and via contribution for improvement of corporate governance, financial reporting and disclosure.

(3) The Sustainable Development of the Natural Resources Sector

The natural resources sector is of strategic importance for the future of Mongolia as it constitutes a large part of government revenue, exports and GDP. This importance was highlighted by the signing in October 2009 of an investment agreement between the Mongolian Government and Rio Tinto/Ivanhoe Mines paving the way for the mining of one of the largest copper deposits worldwide located in the South Gobi desert. Future prosperity depends on the successful and sustainable development of Mongolia's natural resources, to the highest standards of transparency and environmental considerations.

The Bank has found significant private sector opportunities for debt and equity in mining sector with large positive transition impact and will continue to pursue such opportunities. In addition, the Bank will look at possible involvement in financing strategic deposits where the government is seeking significant private ownership. Here, the Bank could work with the government and foreign and domestic private investors in order to help ensure the right balance of state and private interests.

(4) Support for Critical Infrastructure

The investment needs in infrastructure are significant, but constrained by limited public resources and current inability to borrow on non-concessional terms. The institutional framework for PPPs is still underdeveloped; however, should any opportunities (including institutional building opportunities) arise, the Bank will stand ready to support the initiative on a selective basis. The Bank will also target projects which reduce Mongolia's existing high levels of carbon intensity and energy inefficiency.

As Mongolia will be graduating from the low income countries (such as IDA and ADF criteria), this may create new opportunities for the Bank to work in the public sector.

Cooperation with the ADB, the World Bank and key bilateral donors should ultimately allow the Bank to participate in airport, road, railways and power transmission projects. The Bank will work closely with the CAREC – the ADB supported program promoting and facilitating regional cooperation in Central Asia in the areas of transport, energy and trade facilitation.

(5) Policy Dialogue

Pursuing active policy dialogue since it became a country of operations in 2006, the Bank's leading position in private sector investment in Mongolia is an excellent platform for strengthening dialogue in areas such as corporate governance, the financial sector, mining, and the Government's relations with the investor community.

An active policy dialogue with the Bank of Mongolia will be pursued, with a focus on improving and strengthening supervision of the banking sector, encouraging consolidation, and on specific issues such as the prevention of money laundering. The Bank successfully launched the Consultative Council on Investment Climate in mid-2008 to provide not just a forum for private-public dialogue, but also a mechanism for decision making, implementation and accountability, where these elements were previously lacking from the usual dialogue between investors and the authorities in Mongolia.

Policy dialogue with the Ministry of Mineral Resources and Energy, the Mining Authority and the Petroleum Authority of Mongolia will continue, in particular in relation to the improvement of natural resources sector legislation, the development of renewable energy

projects and the effective implementation of the Extractive Industries Transparency Initiative. The Bank will also support country's initiative to study possibilities of establishment of mineral processing industry and development of necessary infrastructure for export of processed minerals.

The Bank will continue to coordinate with other IFIs, donors and the business community. The Bank's Environmental Policy and Public Information Policy will apply to all projects developed in Mongolia.

LIST OF ABBREVIATIONS

ADB	Asian Development Bank
AFD	Agence Française de Développement
AM	Annual Meeting
AML	Anti-money laundering
BAS	Business Advisory Service
BEEPS	Business Environment and Enterprise Performance Survey
BOM	Bank of Mongolia (Central Bank)
CAREC	Central Asian Regional Economic Cooperation
CAS	Country Assistance Strategy
CCA	United Nations Common Country Assessment
CCIC	Consultative Council on Investment Climate
CIS	Commonwealth of Independent States
CL	Credit Line
COMECON	Council for Mutual Economic Assistance
CPAP	Country Program Action Plan
CPI	Corruption Perceptions Index
CRC	Communications Regulatory Commission
CSP	Country Strategy and Programme
DAC	Development Assistance Committee
DIF	Direct Investment Facility
DLF	Direct Lending Facility
DP	Democratic Party
EC	European Commission
EGSPRS	Economic Growth Support and Poverty Reduction Strategy
EITI	Extractive Industry Transparency Initiatives
ETCI	Early Transition Countries Initiative
ESAF	IMF Enhanced Structural Adjustment Facility
EU	European Union
FAO	Food and Agriculture Organisation of the United Nations
EVD	Evaluation Department
FDI	Foreign Direct Investment
FI	Financial Institutions
FRC	Financial Regulatory Commission
GDP	Gross Domestic Product
GDR	German Democratic Republic
GSM	Global System for Mobile Communication
GTZ	German Technical Cooperation Fund
IBRD	International Bank for Reconstruction and Development
ICNC	Information and Communication Networking Company
ICTPA	Information, Communication Technology and Postal Authority
IDA	International Development Association
IFC	International Financing Corporation
IFI	International Financial Institution
IFRC	International Financial Reporting Standards
ILO	International Labour Organisation
IMCHM	Improvement of the Maternal and Child Health Research Centre of Mongolia
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
JFPR	Japan Fund for Poverty Reduction
JV	Joint Venture
KfW	Kreditanstalt für Wiederaufbau
LIS	Legal Indicator Survey

LTT	Legal Transition Team
MCC	Millennium Challenge Corporation
MCF	Mongolia Cooperation Fund
MCFF	Medium Size Co-Financing Facility
MCHRC	Maternal and Child Health Research Centre
MDG	Millennium Development Goals
MPRP	Mongolia People's Revolutionary Party
MF	Micro Finance
MIAT	Mongolian National Airline
MPRP	Mongolia People's Revolutionary Party
MSE	Micro and Small Enterprises
MSME	Micro, Small and Medium Enterprises
MT	Mongolian Telecom
MTC	Mongolia Telecommunication Company
NEMA	National Emergency Management Agency
NEAP	National Environmental Action Plan
NBFI	Non-Bank Financial Institution
NGO	Non-Governmental Organisation
NPL	Non-performing Loans
NPV	Net Present Value
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PAM	Petroleum Authority of Mongolia
PIP	Public Investment Programme
PPP	Public-Private Partnership
PRGF	Poverty Reduction and Growth Facility
PSP	Private Sector Participation
RR	Resident Representative
RZD	Russian Railways
SCO	Shanghai Cooperation Organization
SDR	Software Defined Radio
SME	Small and Medium Enterprise
SOE	State Owned Enterprise
SPC	State Property Committee
TA	Technical Assistance
TACIS	Technical Assistance for Commonwealth of Independent States
TAM	Turn Around Management
TC	Technical Cooperation
TFP	Trade Facilitation Programme
UNEP	United Nations Environment Programme
UNDAF	United Nations Development Assistance Framework
UNDP	United Nations Development Programme
UNICEF	United Nations International Children's Fund
UNCITRAL	United Nations Commission on International Trade Law
USAID	United States Agency for International Development
WB	World Bank
WHO	World Health Organisation
WTO	World Trade Organisation
WWF	World Wildlife Fund
Currencies	
EUR	Euro, European Union Currency
USD	United States Dollar
MNT	Mongolian Currency

II. COUNTRY STRATEGY

1. The Bank's Portfolio

1.1 Overview of the Bank's activities to date

Mongolia became a country of operation of the EBRD in October 2006. Before that, the Bank's activities were limited to TC operations. Since then, however the Bank has approved 26 projects involving loans, equity and guarantees, together with two previously signed regional mining projects. The signed commitments currently stand at EUR 126 million (total 28¹ projects), including EUR 71 million of debt/guarantees and EUR 55 million of equity.

The Bank's activities have developed well, with all signed projects being private sector deals, and reasonably well spread across sectors. These include equity in regional mining, local coal producer, drilling, downstream oil distributor, supermarket chain, and local financial institutions, and debt to financial institutions, local coal producer, beverage manufacturer, cashmere producer, property and geophysical survey company. As seen from below table, the majority of deals were natural resources, small business finance, agribusiness, FI and general industries. Although the Bank has tried to diversify its activities even in volume term, two thirds of the business volume comes from natural resources sector mainly because (i) the sector is far dominant industry branch in the country and (ii) the Bank has had no infrastructure project so far.

Table 1-1 Mongolia: Overview of the Bank's Activities to Date²

	No. of Projects	Total Project Value (EUR million)	EBRD Finance (EUR million)	Debt / guarantee (EUR million)	Equity (EUR million)	% share of Commitments
Private	28	337	126	71	55	100%
State	0	0	0	0	0	0%
Bank Equity	1	5	5	0	5	4%
Bank Lending	4	0	3	3	0	2%
Small Business Finance	4	16	12	10	2	10%
Agribusiness	4	23	14	8	6	11%
General Industry	4	9	9	9	0	7%
Natural resources	11	284	83	40	42	66%
Total	28	337	126	71	55	100%

Table 1-2 Mongolia: Trends of the Bank's Business including TFPs

	2006	2007	2008	2009	Total
Number of projects	2	7	12	5	26*
Annual business volume (EUR million)	3	33	50	26	113

*excluding two previously signed regional projects

¹ 28 projects in total include 22 investment projects, three TFP (Trade Facilitation Programme) projects and three regional mining projects.

² As of end September 2009

1.2 Implementation of the previous Country Strategy

The Bank's previous strategy for Mongolia included the following strategic priorities:

- ***Financing enterprise development***, focusing on direct financing in a number of key sectors with special priority on micro businesses, and supporting the remaining large privatisations;
- ***Strengthening the financial sector***, through credit lines and equity to local banks and NBFIs, technical assistance and TFPs;
- ***Developing in sustainable manner the natural resources sector***, with a particular focus on transparency, governance, environment and regulation, and supporting local mining companies;
- ***Supporting critical infrastructure*** projects with a clear focus on possible financing non-sovereign projects, in close collaboration with other donors and IFIs;
- ***Maintaining policy dialogue***, to promote capital market development, improve the business environment and support reform efforts, and to form a new consultative council on investment climate.

Although the previous strategy was devised before Mongolia became a country of operation, the Bank has developed a very strong flow of new business, which has allowed good progress to be made in implementing the Strategy, in particular in private sector development, banking and natural resources sector. Due to the inability of state and municipal entities to borrow on non-concessional terms, projects have been limited to the private sector.

Private Sector Development

The Bank had discovered that Mongolia has a significant and flourishing local private sector, and many current opportunities being developed by the Bank are indeed with local enterprises. Of particular note is the need for equity (nearly 50 per cent of our signings last year were equity investment). Privatisation of large state-owned enterprises has slowed down, those remaining being either financially unviable or to be kept under state control for strategic reasons.

During the strategy period, the Bank has signed six DLF deals in the agribusiness, general industry, property, and mining related service sector, and two DIF deals in retail chain and drilling companies. DLF and DIF products are well adapted to Mongolian business environment where the local banks are unable to satisfactorily meet financial needs of the growing and expanding SMEs.

Through TAM (already active) and BAS (launched in 2008) the Bank offers support to local managers.

Strengthening the Financial Sector

The financial sector is also developing into a key area, with financing for micro-enterprises and SMEs through partner banks, as well as a clear need for equity participation to strengthen capital bases and to help improve strategy and governance and to introduce new products.

- The Bank has provided credit lines to three local banks for SME and micro lending. Due to the current crisis, the Bank is considering further debts to selected banking clients

which meet the Banks' corporate governance guidelines. The TFP facilities have become important sources of finance for the partner banks. The Bank has continued to improve the levels of corporate governance in the participating banks through specific technical assistance.

- On the equity side, the Bank has participated in the increase of capital of two local banks. In conjunction with these capital increases the Bank has provided a capacity building technical assistance to these clients.
- On the regulatory and supervisory side, the Bank has provided TC to Financial Regulatory Commission for the enhancement of Mongolian insurance regulation.

Developing in Sustainable Manner the Natural Resources Sector

This sector is of strategic importance for the future of Mongolia. The Bank has worked on a range of mining deals with both local and foreign investors, with both debt and equity elements. During the previous strategy period, 68% of signed deals by volume were natural resources sector projects. Policy dialogue is focusing on the sustainable development of Mongolia's strategic deposits, including appropriate environmental considerations.

The Bank's first signing in 2007 was for a locally-owned coal mine and included an important component of clean-coal technology financing. The Bank's latest signed mining deal was a financing of equity into a wholly-Mongolian-owned mining company Energy Resources (ER). The Company is owned by 3 of the largest private groups in Mongolia, including MCS, Petrovis, and Shunklai. All of these three groups have established track records in developing various businesses in Mongolia (consumer goods, heavy machinery distribution, downstream petroleum, energy), both by themselves and in JV with foreign partners. All these large mining deals were rated as excellent transition impact. In addition, the Bank has provided debt and equity financing to the second largest oil distributor for the expansion and upgrade of its distribution network, balance sheet restructuring, and the introduction of convenience goods shops and ATMs at prime sites.

Support for Critical Infrastructure

The Bank has explored some private sector projects in renewable energy and aviation sector. However, municipal infrastructure is turning out to be difficult due to the inability of the sovereign or the municipalities to borrow, or to guarantee, non-concessional loans. We have discovered that the blending of EBRD finance with significant grant funding – designed to achieve a blended concessional rate – does not in fact work in the Mongolian context.

However, over the next few years Mongolia will graduate away from concessional finance so, during the Bank's next strategy period – and subject to a change in legislation – the door may open for us to consider infrastructure projects including municipal and regional transport projects.

Policy Dialogue

Relations between investors and the authorities is an issue taken seriously in Mongolia, with regular meetings (sometimes chaired by the President) and active chambers of commerce and business associations though elements of decision making, implementation and accountability are sometimes lacking in these public-private dialogue. Therefore the Bank launched in mid-2008 the Consultative Council on Investment Climate ('CCIC') aiming at creating a venue of direct dialogue between the decision-makers, local and foreign business community and

donors. The quarterly meetings of the CCIC have been chaired by the Prime-Minister or the Deputy Prime Minister. .

The Bank is also providing significant TC support, and many TC projects have significant importance for the future of Mongolia: EUR 0.3 million for Upgrade and Enhancement of Insurance Regulations; EUR 0.29 million for Renewable Energy Regulatory Development Road Map; EUR 2.0 million for Capacity Building for Mining sector; EUR 0.3 million for Ulaanbaatar Clean Air Initiative; and EUR 2.2 million for Development of a Digital Geological Information System Dataset.

1.3 Transition Impact & Lessons Learned

1.3.1 Influence on the Transition Process

The Bank has built up unique position in financing the private sector in Mongolia where it is becoming clear that the emerging dynamic private sector will be the engine for the next stage of Mongolia's development. Our projects are in their early stage. They currently carry their full *potential* transition impact but as expected, it will take some more time to find confirmation of realised impact "on the ground".

Private Sector Development

Six Direct Loan Facility (DLF) projects were provided in the agribusiness, general industry, property, and mining related service sectors, which required longer maturities and larger amounts than offered by the local financial market. These projects started to have significant impact on the improvement of corporate governance and transparency of companies by the introduction of regular financial reporting and audits. These clients expanded the market and enhanced competition.

One project to finance a local supermarket chain (DIF) has also contributed to market expansion, but the transition impact will be derived from improved backward linkages by imposing stricter quality and health requirements on their suppliers as well as better contract terms. The equity participation allowed for improvements in business standards in the company (i.e. independent board representation, IFRS and new internal incentive schemes).

The Bank is also providing TAM (already active in Mongolia, the extension for 2009-2012 was recently approved by TC Com) and BAS (launched in 2008) programmes. These programmes are helping to improve skills and business practices (including financial reporting, accounting and marketing) of mainly small and medium sized enterprises in Mongolia.

Financial Sector

The Bank has achieved transition impact in the Mongolian banking sector though a lot remains to be done as the challenges faced by the sector and by a number of individual banks are numerous. The provision of credit lines for SME and micro lending has helped the market expansion of private companies particularly in rural areas. The Trade Facilitation Programmes are contributing not only to more regional trade activities but also to enhancing the corporate capability and reputation building of Mongolian banks.

On the institutional side, the Bank's involvement, including equity participation and the provision of TCs including under TFP, are helping to improve corporate governance standards and businesses practices. On the regulatory and supervisory side, the Bank has provided TC to the Financial Regulatory Commission (i.e. independent regulator for non-bank financial institutions) for the enhancement of Mongolian insurance regulation.

Natural resources sector

The Bank's operations have made a large impact in the natural resources sector. In fact, the "excellent" transition impact potential rating was given at Board approval to all three large projects in this area. While the mining sector remains dominated by the state, the Bank has greatly contributed to fostering private sector involvement in mining. The Bank's operations have also contributed to the implement of Extractive Industry Transparency Initiatives (EITI) at the corporate level (as well as at the national level though policy dialogue). The projects also required the introduction of high standard environmental/social management, transparency and corporate management.

The Bank's operations are also helping bring new market products. For example, the project for the second largest oil distributor contributes to the introduction of "one stop shopping" market model (i.e. convenience goods shops and ATMs, etc. at petrol stations). Part of Bank's financing for MAK (one of the largest private mining company) was granted for the production of clean coal (first time in the country). The equity investment in Energy Resources was the first institutional investment into a wholly-Mongolian-owned mining company.

Policy Dialogue

From the inception, the Bank has conducted significant policy dialogue with the authorities. The Mongolian President visited the Bank in 2007 and the Bank's president and first vice president as well as other senior banking officials visited Mongolia and engaged in policy dialogue during the past strategy period.

The Bank has established a Consultative Council on Investment Climate (CCIC), supported by a TC, to create a venue of direct dialogue between the decision-makers, local and foreign business community and donors.

In the mining sector, the Bank has been part of the IFI initiative to advise the government to establish a fair, transparent and sustainable framework for mining sector development. The Bank has also contributed to creating the capacity of the mining authorities to build up the database for mining assets (this will contribute to improved transparency of mining sector information). The Bank is also conducting a policy dialogue to strengthen the regulation for the renewable energy sector (Renewable Energy Regulatory Development Road Map) and for the introduction of commercially driven mechanisms to tackle air pollution problems in Ulaanbaatar (Mongolia Clean Air Initiative). The Bank also participates in the Energy Working Group which coordinates the efforts of donors and the authorities to reform the Mongolian energy sector.

1.3.2 Financial Performance of Existing Portfolio

Currently, out of 27³ active projects, 21 are at the disbursement stage, 6 are repaying. It is still too early to judge the performance of the portfolio as most deals only recently disbursed or just started repaying. However, two projects have encountered some difficulties: an equity deal in a small foreign mining service venture and one bank affected by the ongoing financial crisis and accumulated NPLs. All exposures continue to be non-sovereign. Equity represents a high 51 per cent of operating assets.

1.3.3 Mobilisation of Co-Financing

Only one project to date has been formally co-financed; this is the MCS Coca Cola bottling plant expansion financing for which was syndicated with Cordiant Capital on the basis of EBRD debt of US\$ 7.0 million and Cordiant Capital debt of US\$ 6.0 million. This transaction is one of the few recorded syndications in the Mongolian market place and should have a good demonstration effect for future co-financings when the market recovers.

1.3.4 Lessons Learned

The Bank has financed a total of 26 investment projects for a total amount of EUR 113 million since 2006 (table 1-2) and in the process the EBRD has established itself as the leading institutional investors in the private sector. The Bank's experience to date has produced some lessons learned:

- Albeit in an environment dominated by donors and concessional financing, the Bank has proven it possible to promote real investment and restructuring and built a strong profile for private sector activity as the driver for Mongolia's next stage of development;
- Even in a country that has been heavily reliant on official aid and assistance, a vibrant business culture and entrepreneurial spirit can flourish with access to debt and equity financing on a commercial basis (and capacity-building TC);
- ETCI has proven to be a very good mechanism for addressing private sector development in Mongolia. This eases procedures for small investments via DLF/DIF and MCFE and ensures access to TC for due diligence, monitoring and implementation. It also encourages active participation of various teams of the Bank, including micro financing, agribusiness and TAM/BAS.
- It is possible to raise standards of corporate governance and transparency, as well as the best international environmental, health and safety standards in the Mongolian mining sector by financing local private companies. In addition, this brings a new spirit of economic dynamism and sustainable economic growth to remote areas stimulating new small businesses, with the help of also TAM and BAS programmes.
- In the case of purely locally owned financial institutions, capital injections must be accompanied by a very robust Institutional Building Plan and an additional regular detailed review of operations and possibly additional audits instilling proper decision making and accountability is at times required.
- TC funded consultancy is important in assisting local businesses and banks in capacity building. The Bank's impact is enhanced by its ability to bring different products to a single client;

³ One project completed.

- TC funded due diligences (technical, legal, financial, environmental, social and post investment/monitoring) are vital for local SME clients to conclude financings with the Bank. Such due diligences can be quite expensive for SMEs because of a shortage of local experts who meet the Bank's requirements, and neutrality of opinion is important in small country like Mongolia. Vital is also ongoing TC support for Independent Board Members for the Bank's equity investments;
- Private sector investments can be complemented with specific sector reform components via expanded dialogue with the Government in fields such as renewable energy.

1.4 Portfolio Ratio

During the last strategy period, all projects have been purely private (100% private), mainly in the natural resources and financial sector. This ratio corresponds to the priorities of the Bank's country strategy and the framework of the ETC Initiative.

2. Operational Environment

2.1 General Reform Environment

2.1.1 Political Developments

The country's progress in democratic transition is evident. Mongolia has a developed multi-party structure and a vibrant network of NGOs. The media are free to report on a wide range of issues and there is an increasing adherence to the rule of law and respect for human rights.

The 1992 Constitution established a parliamentary system of government with a single-chamber 76-member parliament, the State Great Khural, elected every four years. The last parliamentary elections took place in June 2008 and were characterised by independent observers as being, on balance, free and fair. The political process in Mongolia is traditionally strongly influenced by the two major political parties – the Mongol People's Revolutionary Party (MPRP) and the Democratic Party (DP).

The latest presidential and parliamentary elections were not an exception. The MPRP increased its majority in the legislature but the electoral results were contested by the DP. The post-electoral uncertainty lasted for about two months and ended in August 2008 with the DP stopping its boycott of the newly elected parliament. Although the MPRP had sufficient majority to form a single-party government, the party opted for a coalition government with the DP as a minority partner.

The coalition structure of the new government, which comprises the two major political forces of the country, allows moving forward in a more coordinated manner. This also contributed to a less turbulent period of government at a time when the country is faced with pressing economic and social challenges exacerbated by the world economic crisis.

The 24 May 2009 presidential election brought victory to the opposition candidate, a two-time former Prime Minister Tsakhiagiin Elbegdorj. The election took place in a peaceful environment and fears that a close election result could renew the civil unrest that marred last year's parliamentary polls did not materialise.

2.1.2 Legal Reform

In the last two decades, the legal system of Mongolia has undergone major reforms. The 1992 constitution, which is still in force, created the foundation for a democratic state based on republican principles. The Mongolian leadership has adopted as its strategy an open internal market by encouraging foreign investments and trade. Commercial legislation is being adopted based on international best practices, and this has created a relatively favourable business environment. However, maintaining a business presence remains a challenge, and the administrative infrastructure and the existing tax system constitute major obstacles to business activities.

As the transition from a planned system towards a market economy has been introduced, many laws have been adopted regulating commercial entities, tax matters, banking activities, securities markets, arbitration and currency exchange. The adoption of the Civil Code in 2002 has been a major step in laying the foundations of a modern civil law system. The proper implementation of its provisions through secondary legislation and court practice

remains, however, a challenging goal for the local legislature and judiciary. In addition, judges tend to adopt rather simplistic and sometimes arbitrary decisions, and there are reports of widespread corruption.

In addition, commercial lending is troubled by high interest rates, lack of long term lending and an unsatisfactory institutional environment. It is hoped that new legislation on bankruptcy, tax incentives and loan facilities will be put in place in the near term to address such concerns. New regulations such as the Mongolian Corporate Governance Code and the draft Public-Private Partnership Law seem to indicate a willingness to tackle long standing issues. The government should focus on implementing legislation providing for a sound basis for private investment and covering secured transactions, although there are signs that these changes are in development.

2.1.3 Business Environment

The business environment in Mongolia remains relatively good by regional standards. According to the World Bank's 2009 Survey of Doing Business, Mongolia outperforms its regional neighbours (i.e. China and Russia) and other Central Asian countries on most indicators. The results were particularly encouraging in the areas of starting a business, protecting investors, and hiring and firing workers. Overall, Mongolia ranked 58th out of 181 countries in 2009.

However, according to the latest EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS) perceptions of managers suggest that many challenges remain. Businesses perceive registration procedures of movable and immovable properties to be cumbersome and legal enforcement and the court system remain weak. Access to finance remains the biggest problem for businesses, but particularly for micro and small businesses. While tax rates are in fact lower than most countries, businesses still consider tax rates to be a major obstacle to doing business.

Table 2-1 Percentage of the firms feeling problem in various business aspects, 2008

	Micro and Small Companies	Medium and Large Companies
Access to finance	64.1	58.7
Tax rates	56.4	52.7
Business licensing and permits	51.3	50.3
Corruption	46.2	47.9
Transport infrastructure	39.5	46.1
Business inspections	38.0	38.3
Customs and trade regulation	34.9	39.5
Crime, theft and disorder	31.8	35.3
Tax administration	29.7	28.7

Note: The ratios of the firms responded as feeling moderate, major or very severe obstacle of doing business.

Source: EBRD/ World Bank, BEEPS (2008).

Corruption remains a challenge in Mongolia. According to BEEPS, about half of the businesses perceive corruption as a business obstacle. According to the latest Transparency International's Corruption Perceptions Index (CPI-2008), Mongolia is doing better than all the CIS countries, ranked 100th out of 180 countries.

2.1.4 Environmental Issues

The Mongolian environment has a large variety of features. The northern part of the country is covered by forest mountain ranges and the southern part by desert, desert steppe, and steppe areas with low mountains. The western part is dominated by high snow-capped mountains and glaciers and the eastern part by vast plains and wild heaths. Mongolia is home to some of the last remaining populations of a number of animal species and sub-species internationally recognized as threatened or endangered. Mongolia's diverse and distinctive vegetation includes over 100 plant species that are listed in the Mongolian *Red Book* as rare or endangered.

There are a number of environmental issues and concerns in Mongolia, which include a shortage of precise data and estimates on water, forest and other reserves as well as on the numbers of protected and endangered species, and lack of sustainable management plans for natural resources; reduction of biodiversity and threat of extinction of a number of endangered species due to illegal poaching and loss of habitats due to deforestation and rangeland degradation; damage to wetlands and waterways as a result of industrial activities (mining, large-scale hydropower stations); desertification and overgrazing due to unsustainable herding practices; soil erosion, degradation of landscapes and pollution of water caused by mining industry; forest destruction due to illegal logging and man-made fires; rapid raise in water demand and insufficient supply as well as increased level of economic activities in key watershed areas; air pollution caused mainly by coal-based power generation plants and other industry as well as by coal fired heating stoves used by individual dwellings; inadequate management of hazardous and non-hazardous waste.

Mongolia is also prone to frequent natural disasters such as severe winters causing heavy accumulations of snow or ice crusts covering pastures, which prevent domestic animals from foraging in open grazing; droughts and steppe fires.

The National Environmental Action Plan (NEAP) establishes the Government's priorities and identifies issues and actions for the protection of environmental quality, natural resources conservation and institutional capacity building and covers actions to the year 2010. The NEAP includes about 25 national environmental programmes in various areas such as desertification, forestry, biodiversity, water, protection and conservation of rare species.

Key environmental laws include the Law of Environmental Protection, Law on Minerals, and Law on Protected Areas, Natural Resources Use Fee Law, and Laws on Forestry, Wildlife and Hunting, the Law on protection of Land Resources, Law on Environmental Impact Assessment and Mining Law. Mongolia is also a party to 14 International Conventions and Treaties on Environment, including Convention on Biological Diversity, Framework Convention on Climate Change and Convention on Combating Desertification.

The environmental NGO movement is largely supported by international donors and the majority of environmental NGOs are based in Ulaanbaatar. They focus primarily on environmental awareness, conservation and reforestation initiatives.

2.1.5 Social Issues

Mongolia has a population of approximately 2.7 million while the size of the country is very large (1.6 million square km). The population is concentrated in the capital city, as about half of the population live in Ulaanbaatar. Migration from rural to urban areas has been increasing in recent years as business opportunities are concentrated in these areas and living costs are

lower. As GDP grew significantly in recent years, Mongolia is now in the lower middle-income country group, according to the latest OECD DAC list.

However, while per capita income roughly doubled in the last 4 years, there has been little improvement in poverty reduction according to the latest household survey data. While the incidence of poverty was 36.1 per cent in 2002-03, the latest household survey shows 35.2 per cent of the population (or 930,000 people) remain below the poverty line (this remains significantly above the MDG target of 18 per cent by 2015). The data also show that income disparities between rich and poor and between urban and rural areas have increased. In urban areas, the reduction was larger (from 30.3 per cent to 26.9 per cent) while in rural areas, the poverty ratio actually increased to 46.6 per cent from 43.4 per cent. This indicates that the population (particularly in rural areas) do not benefit enough from economic growth. The alleviation of poverty remains a priority for the government and the authorities developed the National Development Strategy – long term country strategy to achieve growth and development – in 2007.

Given the relatively high incidence of poverty, the Bank needs to take into consideration affordability issues when developing public utility projects. While most of public utility entities remain below cost recovery levels, further tariff increases are necessary from sustainability point of view. The Bank usually considers that households are “unaffordable” when a share of household income/expenditure goes beyond 10 per cent for electricity, 10 per cent for heating and 5 per cent for water and wastewater. In Mongolia there appear to be no affordability problems for average households, but there are significant affordability problems for the poorest group of households (i.e. 10 per cent lowest income group. See Table 2-2). While electricity prices remain subsidised in many different ways (i.e. generally no affordability issues), heating and water/wastewater costs are above the affordability thresholds. This reflects the facts that Ulaanbaatar is the coldest capital city in the world and people living in gers need bottled water (i.e. very expensive to deliver compared with tap water).

Table 2-2 Affordability analysis of public utilities in Ulaanbaatar, 2007 data

	EBRD affordability thresholds	10% poorest	Average household
Electricity	10%	7.3%	4.6%
Heating	10%	15.4%	9.1%
Water/wastewater	5%	11.8%	4.1%

Source: EBRD estimates based on the data provided by the National Statistical Office.

In recent years, education and health indicators have been improving. The adult literacy rate improved to 98 percent while the infant mortality rate (under-5) fell significantly. According to the World Bank’s World Development Indicators, in 2000 the under-5 mortality rate stood at 63 (per 1,000 live births) and decreased to 43 by 2007. Life expectancy for the overall population has increased slightly in the last few years; in 2000 it stood at 64 years and by 2007 it was 67 years. Overall, the Human development Index⁴ stands at 0.72 with which Mongolia ranks 112th out of 179 countries.

⁴ The Human Development Index provides a composite measure of three dimensions of human development: living a long and healthy life (measured by life expectancy), being educated (measured by adult literacy and enrolment at the primary, secondary and tertiary level) and having a decent standard of living (measured by purchasing power parity, PPP, income).

2.1.6 Labour Issues

Unemployment seems to be underestimated in the official statistics at 3.3 per cent in 2008, but the real unemployment rate is estimated at 13.1 per cent according to the latest population census. Unemployment is higher in urban areas (18.7 per cent on average) than rural areas (10.0 per cent). However, as wage levels are significantly higher in urban areas (and poverty ratio is lower), low-income households still tend to move to urban areas.

Mongolia has ratified all of the ILO core conventions. The law specifically prohibits forced or compulsory labour, and the Government generally enforces this provision. The law in general prohibits children under the age of 16 from working, although those who are 14 or 15 years of age may work up to 30 hours per week with parental consent. However, incidences of child labour persist in Mongolia, particularly in rural areas where households make a living with livestock production, although it has been declining.

According to the latest estimates from the National Statistical Office, the number of children in the labour force is estimated at 43,158 (or 6.9 per cent of children). That said, the ILO office indicated that child labour is not an issue in Mongolia. There are practices, particularly in rural areas, children help households' work and herders' jobs occasionally. However, in most cases, helping herders' jobs is seasonal (i.e. only a few weeks a year), and parents tend to prioritise children's education. The school participation rate is actually high and improving and the education level is reasonably high in Mongolia.

2.1.7 Gender Issues

There appears to be relative gender equality in Mongolia compared to many other countries. Women play a big role in the Mongolian economy, as 51.3 per cent of those of the employed are women. Women are as educated as men. There are no significant differences in unemployment figures by gender (see Table 2-3 for details).

Table 2-3 Differences by gender in Mongolia

	Male	Female
Life expectancy at birth (years)	62.6	69.4
Adult literacy rate (%)	98.0	97.5
Economically active population (%)	48.6	51.4
Employment (%)	48.7	51.3
Unemployment rate (%)	14.1	14.2
Poverty headcount (%)	34.8	43.8
GDP per capita (PPP US\$)	3,046	2,611

Sources: UNDP Human Development Report 2007.

However, women seem to be under-represented in sectors/positions with higher wages. The poverty ratio is significantly higher for women, while per capital income for women is lower. This indicates that some unfair treatments for women exist in Mongolia.

2.2 Economic Developments and Progress in Transition

2.2.1 Macroeconomic conditions for Bank operations

During the past few years, Mongolia has enjoyed robust and stable economic expansion, the first time since the beginning of transition. The economy grew by 9 per cent on average

during the past 3 years while per capital GDP increased from US\$ 871 in 2005 to US\$ 1,970 in 2008. This was reflected in wage increases and assisted poverty alleviation in urban areas. The economy benefited from higher copper and gold prices and strong foreign direct investment (FDI). There was also an economic boom in the construction and service sectors reflecting the general economic development and large fiscal spending. The banking sector has also grown rapidly as domestic consumption and investment needs boomed. However, during the first half of 2008, increases of global food prices and energy prices fuelled inflationary pressures on the economy. Moreover, in the run-up to the 2008 elections, fiscal spending rose significantly and there were clear signs of overheating. The inflation rate increased to over 30 per cent in mid-2008 from 6 per cent in mid-2007.⁵

The banking sector deteriorated significantly during 2008 and this trend has continued in 2009. High inflation meant lack of attractiveness for banking deposits (i.e. negative real interest rates) and high costs of borrowing. While the Mongolian banking sector is not exposed to external financing (i.e. parent bank financing), two of the main financial sources (i.e. deposits and interbank financing) became vulnerable. As trust among banks was weakened (particularly after the collapse of the Anod bank), interbank transactions reduced significantly. Depositors became selective among banks and between currencies and the total deposit stock declined. As a result, commercial banks started facing liquidity problems. On the lending side, banks started avoiding long-term commitments (such as construction financing and mortgages) and focusing more on the existing customers (i.e. extensions rather than new lending). As businesses in general suffered from the slowdown of the economy and volatile exchange rate movement, banks find it difficult to find bankable clients considering current high lending costs and market risks. New lending was almost frozen after the third quarter of 2008. In December 2008, the authorities announced that Anod bank - the 4th largest bank in Mongolia - was taken under Central Bank conservatorship. The asset quality of the banking system gradually deteriorated and the average NPL ratio increased to 11.6 per cent (over 90 days past due) of the total loans by May 2009.

The other unfavourable shift was sharply reduced global commodity prices – in particular copper prices – which declined from over US\$ 8,000 per tonne in July 2008 to less than US\$ 4,000 in March 2009. This has negatively affected both the fiscal and external accounts. Both the current account and fiscal balance have fallen into deficit in 2008, and the deficits are expected to be larger in 2009. The resulting pressure on the exchange rate prompted the central bank to frequently intervene in the currency market, leading to a significant decline in international reserves from around US\$ 1 billion in March 2008 to below US\$ 400 million (about 1.5 months of imports) during the first quarter of 2009. To avoid further reduction of foreign reserves, the central bank stopped intervening in the currency market. As a result, the exchange rate depreciated rapidly against major currencies during the first quarter of 2009 (over 20 per cent depreciation in nominal terms in the first 3 months of 2009).

The government was relatively quick and comprehensive in responding to these difficulties. In November 2008, parliament ratified the legislation for deposit guarantees (only for time and savings deposits). In March the government set up a special committee to cope with the crisis, headed by the Prime Minister. Subsequently the parliament approved in March an approximately US\$ 1 billion economic stimulus plan to stabilise the banking sector and the currency as well as to fund agriculture, energy and other infrastructure. Soon after this parliamentary approval, the government reached an agreement with the IMF for a US\$ 229

⁵ Year on year inflation rate declined to 4.9 per cent by July 2009.

million credit under an 18 month stand-by arrangement. A subsequent donor meeting indicated further budgetary support of US\$ 160 million to be provided by key donors. In the same week, the central bank raised its policy rate from 9.75 per cent to 14 per cent in the effort to defend the local currency and improve the attractiveness in Togrog denominated accounts. These measures worked well. The exchange rate, which once dropped to over 1,700 against the US dollar, was significantly stabilised at Togrog 1,400-1,450 per US\$. Inflation eased significantly with the year on year rate of 4.9 per cent in July. Foreign reserves increased from roughly US\$ 400 million in February to US\$ 600 million in May (1.4 months of imports to 2 months respectively).

Another potential boost to the recovery of the country is the Oyu Tolgoi project, which concerns one of the largest copper and gold deposits in the world with an estimated investment almost equal to the size of Mongolia's GDP (over US\$ 4 billion). The government signed the Oyu Tolgoi investment agreement with the strategic investors in October 2009. If investment is made as scheduled, the impact on the balance of payments and the fiscal position will be significantly positive in future years. There are also similarly large-scale mining development plans under preparation which could materialize in the coming periods. Robust economic growth is anticipated in the medium term mainly on the back of mining sector development. In the long term, sustainable growth depends on structural reform, including the management of mining wealth, increased competition in the non-mining sector and Mongolia's better integration into the global economy.

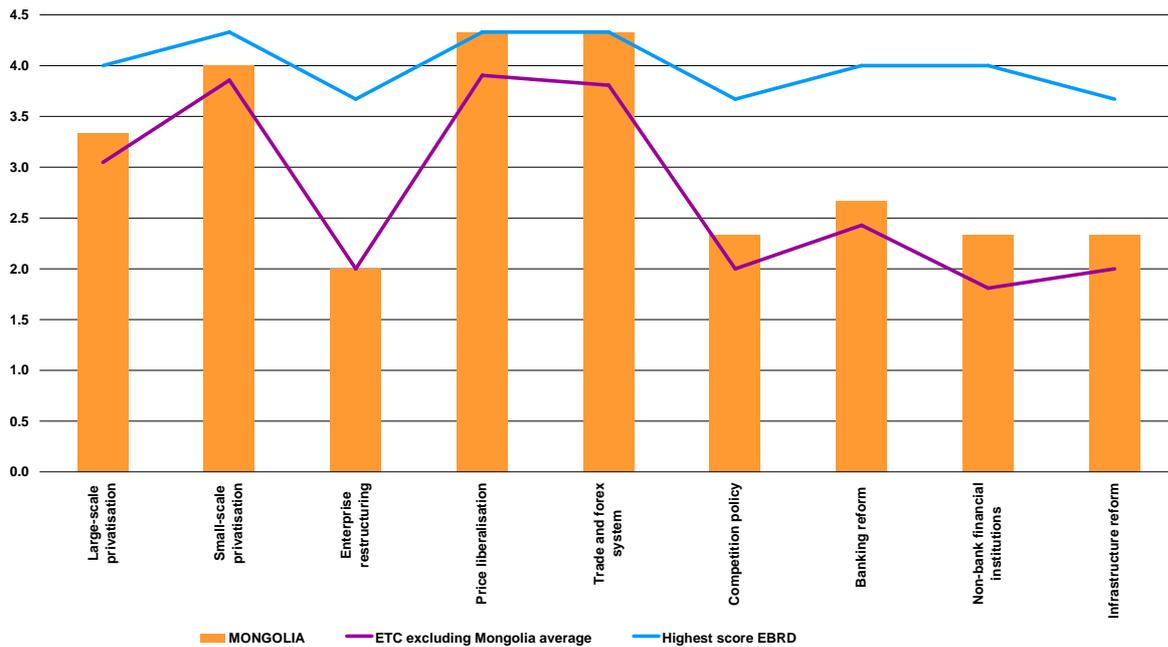
The public debt to GDP ratio remains at the moderate level at 35 per cent of GDP and debt service is marginal due to long maturities and concessionality. However, the authorities have been considering borrowing non-concessional loans from various countries and banks. The parliament authorised the government to issue commercial foreign debt of up to US\$ 1.2 billion (25 per cent of GDP). Moreover, considering new loans provided by IMF/WB/ADB/Japan and potential new loans from Russia, the debt level may increase by over US\$ 600 million (the external debt to GDP ratio will increase by 10 per cent or more). Therefore, the careful debt management is still required.

2.2.2 Progress in Transition and Remaining Challenges

2.2.2.1 Progress in Transition

Mongolia has made steady progress in transition, according to the Bank's transition indicators, and continues to be among the fastest reformers within the ETC countries (see Chart 2-1). Progress has been most pronounced in the areas of price and trade liberalisation and small and medium scale privatisation. Progress in privatisation was relatively rapid, but enterprise restructuring has proceeded slowly.

Chart 2-1 Transition Indicators of Mongolia and the ETC countries, 2008



Note: The index ranges from 1, indicating little or no progress, to 4+ pointing to standards similar to advanced economies. See Transition Report 2008 for the detailed methodological notes.

Source: EBRD Transition Report 2008.

Private Sector Development

Progress in privatisation was relatively rapid in Mongolia. Most small enterprises had been transferred to private ownership by 1993, and large-scale privatisation is at an advanced stage. Accordingly the private sector share in GDP rose to approximately 70 per cent by 2005. Most of the existing state-owned enterprises are either not attractive for the private sector or politically difficult to privatise. The state property committee formulated a new strategy on privatisation and the submitted the proposal to the parliament. The committee intends to privatise some of the coal mines, Mongolian State Airlines (MIAT) and power sector companies in the medium term.

Enterprise restructuring has proceeded slowly. Mongolia has taken several steps to harden budget constraints and improve public financial management and enterprise governance. Corporate governance is generally considered weak, in part due to lack of disclosure and transparency of corporate information and protection of minority shareholders. Many of the listed companies do not publish annual reports or hold shareholders' meetings. Listing requirements are weakly enforced. The majority of companies are not audited.

Mining sector

The mining sector is crucial for Mongolia as it constitutes a major contributor to government revenue, exports and GDP. Growth prospects and poverty alleviation would largely depend on the ways and magnitude of mining sector development, and on the participation of a wide Mongolian private sector to its growth. The transition process has been mixed in the mining sector. The coal and copper industry remains largely state-owned. Some of the state-owned coal companies are obliged to supply coal to combined heat and power plants (CHPs) at significantly lower than market prices, and making losses continuously. However, the government wishes to privatise state-owned coal companies in the near future. The state-

owned copper company is the biggest tax payer in Mongolia, but is not allowed to retain earnings and therefore needed investment can not be financed from its profits. There are a large number of small-scale miners (both for gold and coal), who are often not licensed, but the authorities' capacity to regulate these miners is limited.

For the time being, the tax burden is high for copper and gold as it remains subject to 68 per cent windfall profit tax. Other minerals (including coal) are exempt from this taxation. However, in August 2009, this controversial tax was repealed by parliament, effective from January 2011. The Minerals Law stipulates the state right to acquire up to a 50 per cent stake (34 per cent if the exploitation is privately funded) of the strategic deposits discovered on Mongolian territory. These measures have increased both the uncertainty and the actual costs of doing businesses for foreign investors in the mining sector. In October 2009, the investment agreement was signed between the government and the Canadian and UK-based mining companies, Ivanhoe Mines and Rio Tinto relating to the large Oyu Tolgoi copper and gold mining project is under the final negotiation. The project is expected to bring sizeable investments if successful almost equal to the current value of GDP (i.e. over US\$ 4 billion). It should pave the way for other large-scale mining projects in the country.

The government adopted the Extractive Industry Transparency Initiatives (EITI) in 2005. EITI supports improved governance in resource-rich countries through the full publication and verification of company payments and government revenues from oil, gas and mining. However, the implementation of the EITI remains slow both on the government and company sides.

Financial Sector Development

The banking sector has grown significantly in recent years. There are currently 15 commercial banks and all are in the private sector (except for Anod bank which is currently under Central Bank conservatorship). There is fair degree of foreign investors' participation (including IFIs and other donors). Financial intermediation has advanced rapidly over the past several years. In 2008, the government authorised the establishment of the Credit Information Bureau to collect and provide consumer credit information on individual consumers. Responding to 2007-08 construction boom, mortgage products have emerged and the authorities together with commercial banks have been trying to develop the secondary mortgage market, but so far without success.

The banking sector is facing serious challenges in terms of its capitalization, resumption of lending activities, corporate governance, Central Bank supervision and consolidation. There is hardly deposit growth while interbank market activities remain volatile in view of some unresolved systemic issues affecting a wider number of banks. In the first half of 2009, very few banks were extending new loans and the cost of lending remains high and long term maturities remain unavailable. Looking forward, Central Bank supervision needs to be enhanced through strengthening of the Banking Law and the Central Bank Law, both of which are expected to be discussed in parliament in the autumn of 2009. While the largest three banks account for 70 per cent of the deposit base, small banks, playing niche roles, will likely need to be consolidated which smaller number will also allow an improved Central Bank oversight.

The non-bank financial sector remains underdeveloped. Following the establishment of the independent regulator in 2006 – the Financial Regulatory Commission (FRC) – minimum

capital requirements were tightened. The result has been a significant reduction in the number of non-bank financial intermediaries. But still further consolidation is needed. There are about 20 insurance companies, but the former state monopoly continues to enjoy a disproportionately high market share while only limited insurance products are available. Yet there is no privately funded pension system. A limited number of leasing companies and investment funds exist in Mongolia. The stock market is not fully functioning but stock market capitalisation significantly increased in recent years from US\$ 112 million in 2006 to US\$ 723 million in 2008 (from 3.5 per cent of GDP to 16 per cent, respectively). The number of initial public offerings (IPOs) increased during 2007-08. There are a reasonable number of enterprises listed in the stock exchange, but trading remains thin.

Infrastructure Reforms

The investment needs in infrastructure are significant, but constrained by limited public resources and current inability to borrow on non-concessional terms. Most of the infrastructure assets are still owned by the state while private sector participation remains limited. Continued efforts are needed to commercialise/restructure public utility enterprises. While tariffs in some sectors have increased significantly during the last few years, there is room for further tariff reforms.

Mongolian Railways are jointly owned by the Mongolian Government and the Russian Railways on a 50 per cent basis, and not subject to privatisation. In the aviation sector, all airports and the international airlines company are owned and operated in public hands, while there are a few small-scale private airlines operating domestically. In the energy sector, power stations and distribution networks were unbundled and corporatised, but the subsequent privatisation plans have been suspended. Electricity tariffs remain below cost recovery levels and companies have large debts, which make new investments difficult.

In the telecommunications sector, the fixed-line company was separated into a network company and an operating company (of which 40 per cent is owned by Korea Telecom) in 2007. Further privatisation negotiations are on-going. The mobile market is most advanced in terms of private sector participation. Competition in the mobile phone market has increased significantly. The largest private operator, MobiCom, had enjoyed significant market dominance for some time but the award of a number of licences to new operators and the subsequent growth in their operations in recent years resulted in a fall in MobiCom's market share to around 60 per cent by 2008. The resulting increase in competition has led to a significant fall in tariffs and they are now among the lowest in the region.

On the regulation side, regulatory functions are largely separated from policy making functions and operations. In recent years, a number of independent regulators have been established, including the Communications Regulatory Commission as a telecom regulator, Energy Regulatory Authority as an energy regulator and Railway authority as a railway sector regulator. However, they are at an early stage of development and regulatory capacity and efficiency need to be improved further. As elsewhere, in Mongolia tariff adjustments are politically sensitive and have been difficult to implement. While railways (cargo) and telecommunications appear to be operating profitably, other utility companies, including most power and water companies, continue to struggle to operate on a break even basis. Establishing a sustainable financial and regulatory framework is essential to maintain and build up much needed infrastructure for Mongolia.

2.2.2.2 Transition Challenges

The following five areas are the key transition challenges for Mongolia over the strategy period:

- ***Facilitating enterprise restructuring and improving corporate governance:*** Although the privatisation process was relatively rapid, enterprise restructuring and improvement of corporate governance standards lag behind. To achieve higher productivity, significant corporate restructuring needs to be undertaken. Moreover, transparency (including accounting standards) and corporate governance need to be improved further.
- ***Consolidating and strengthening the financial system:*** Although the banking sector has grown significantly in recent years, due to the crisis the sector is currently facing a number of significant challenges which might affect a number of banks. It is, however, important for the Mongolian authorities to use this opportunity to build a solid and more sustainable financial system. The capital market remains at an infant stage and needs to be developed in all aspects, in particular with regard to transparency, governance and regulation.
- ***Managing minerals wealth and diversifying the economy:*** While a number of large-scale mining projects are expected in the future, the government needs to manage minerals wealth and revenues wisely and in a transparent way. This issue has become more imminent with the signing of the Oyu Tolgoi investment agreement in October 2009 (and the expected conclusion of the Tavan Tolgoi coal mining project) both of which will generate substantial inward investments into Mongolia the coming years. While mining has a limited life, the authorities should consider plans for sustainable development of the mining sector in the long term (through the boom-bust cycles intrinsic to commodities) and by trying to deepen and diversify the economic base during the time the economy benefits from mining related revenue.
- ***Improving the business environment:*** The business environment in Mongolia is considered as relatively good compared with the transition economies in the CIS. However, given the importance of foreign investors and the domestic private sector to the economy, the business environment should be further improved. In the mining sector, under the low commodity price environment, the government must create a sound business environment where foreign strategic investors feel comfortable to invest in Mongolia.
- ***Promoting commercialisation and private sector participation of public infrastructure:*** Given the lack of market-oriented reforms, continued efforts are needed to commercialise/restructure the remaining state enterprises. Tariffs should be increased to cost recovery levels and effectively monitored by regulatory agencies. Collection rates should be improved further while, where necessary, a fair and transparent subsidy system needs to be developed. There are massive investment needs in infrastructure but such investment costs should be in principle recovered from user charges. This is particularly challenging in the ger areas, where delivery costs are high and most people are in poverty. Mongolia has good potential for renewable energy because of its size and ample resources of wind in particular, but a supportive regulatory capacity needs to be established in order to facilitate the exploitation of this potential.

2.3 Access to Capital

During the past two decades, infrastructure investment has been neglected. As a result, large capital investments are needed to establish good transport networks and other necessary infrastructure. Public capital investments remain essentially dependent on official financing from bilateral donors and IFIs. Mongolia has held a number of successful Consultative Group meetings in the past and the donor community has been committed to support the country. Mongolia has received approximately US\$ 200-250 million of Official Development Assistance (i.e. over 5 per cent of GDP) annually. Mongolia received foreign currency credit ratings of B/Negative by Fitch ratings, BB-/Negative by Standard and Poor's and B1/watch for negative by Moody's. However, the Government has not yet issued any international bonds.

Table 2-4: Indicators of investment and access to capital

	2004	2005	2006	2007	2008 (e)
Gross fixed capital formation					
Gross fixed capital formation, US\$ Millions	472	666	1,029	1,229	2,077
Public fixed capital formation, US\$ Millions	87	74	151	394	493
in % of GDP	4.8	3.2	4.8	10.0	9.4
Private fixed capital formation, US\$ Millions	386	593	878	834	1,584
in % of GDP	21.2	25.7	27.9	21.2	30.1
Capital flows					
Net foreign direct investment, US\$ Millions	129	258	290	360	682
in % of GDP	7.1	11.2	9.2	9.2	13.0
Net portfolio investment, US\$ Millions	-53	1	1	75	-13
in % of GDP	-2.9	0.1	0.0	1.9	-0.2
Official capital flows, US\$ Millions	103	60	46	47	14
	8.5	4.9	4.0	4.0	1.1
Private transfers, US\$ Millions	146	134	77	84	100
in % of GDP	8.0	5.8	2.4	2.1	1.9
Domestic Credit, US\$ Millions	549	740	718	1,234	1,420
in % of GDP	30.2	32.1	22.8	31.4	27.0

Source: IMF World Economic Outlook, April 2009.

There are also substantial investment needs in the private sector. This is particularly true for the natural resources sector where the majority of existing deposits are yet to be exploited. Annual FDI inflows have been increasing in recent years, and the majority of FDI are in the mining sector. Other sectors, such trade, construction, tourism, livestock production, are also growing, but access to medium and long term finance remains relatively limited. Domestically most financial arrangements are short-term and interest rates remain high. Access to bank lending is especially difficult for micro and small enterprises and enterprises located in the remote region. There is a stock exchange in Mongolia, trading both equities and bonds, but the liquidity of the market is quite limited and the market is not functioning as a vehicle to raise additional funds for enterprises. There was one international bond issuance in history but follow-up attempts mostly failed, and in the new term, the scope of new bond issuance is limited.

3. Strategic Orientations

3.1 Bank's Priorities for the Strategy Period

Financing Local Enterprise Growth and Development

The development of private businesses will remain the main pillar of the Bank's strategy. The Bank will support existing clients showing good entrepreneurial spirit and transparent corporate governance needing finance when other sources are almost dried up during the current global crisis. The Bank will explore possibilities of direct financing especially in the form of equity in a number of key sectors, including agribusiness, cashmere/textile, hotel and tourism, property and services, which will contribute diversification of economy, job creation and poverty reduction of the country. The Bank will seek to attract strong and reputable international investors.

Inclusion of Mongolia within the ETC Initiative provides an access to the full range of bespoke products for medium to large enterprises including adding the Medium-sized Co-Financing Facility (MCFF). In its efforts to support SME development, the Bank will build further on its experience with the Turn-Around Management Programme (TAM) and the Business Advisory Service (BAS) Programme recently established.

The Bank will continue to place a special focus on micro businesses through further development of micro and small business credit lines administered by local partner banks, especially in the more remote regions.

Supporting the Consolidation and Strengthening of the Financial Sector

The challenges faced by the banking sector and the Central Bank require a concerted effort of all parties to, inter alia, strengthen in particular Central Bank supervision legislation. The Bank is prepared to assist the Central Bank in this process through policy dialogue and technical assistance. The Bank will further consider increasing its engagement in the sector towards the strengthening of the capitalisation of selected banks, if appropriate, and the establishment of banking relations with potential new banks in the form of equity participation, provision of credit lines and co-financing facility.

Another strategic objective of the Bank would be to encourage the consolidation of the sector and to significantly strengthen institutional building with individual banks which the Bank finances or which are eligible for Bank finance. Besides providing new capital in selected cases or long term funding, the Bank will mobilise much required technical assistance in order to address gaps in the institutional building framework of the sector, or of individual banks. The Bank will work with banks which adhere to the Bank's strict corporate governance rules and will offer, on a case by case basis, its assistance to keep these banks sufficiently capitalised.

The Bank will continue to actively promote the Trade Facilitation Programme (TFP), and will increase financing sources for micro and small enterprises through credit lines to commercial banks and to non-banks, particularly outside the capital.

The Bank will also endeavour to support the development of non-banking financial institutions (NBFIs) such as non-bank micro financial institutions, leasing, insurance and

pensions. This could be extended to include new financial instruments to address energy end-use and small-scale sustainable energy sector, such as energy efficiency and renewable energy credit lines. Also the Bank will consider supporting the development of capital market via policy dialogues with Financial Regulation Committee, via supporting for better regulatory frameworks and supervisory capacity, and via contribution to improvement of corporate governance, financial reporting and disclosure.

The Sustainable Development of the Natural Resources Sector

The Bank had found significant private sector opportunities for debt and equity in mining and petroleum sectors with the large positive transition impact since its opening. The Bank will continue to support the growth and further development of a vibrant private mining sector, both domestic and international. The Bank will also continue to support the participation of the private sector in the development of the larger strategic deposits. The government has clear motives to take more stakes in those strategic deposits, aiming at significant ownership in the long run, although currently global commodity prices are low and expected to remain low for some period. The Bank will continue to support the de-bottlenecking of mineral export routes in the country, through the upgrade of existing export routes and the establishment of new ones, especially for bulk commodities such as copper, coal and iron ore.

Further to the signing of the Oyu Tolgoi investment agreement between the Mongolian Government and Rio Tinto/Ivanhoe Mines in October 2009 related to one of the largest copper deposits worldwide (and the expected conclusion of similar investment agreement with two or more mining companies for the large coal deposit Tavan Tolgoi), the Bank will actively review possible finance opportunities in support of these mining projects which are important for the future of Mongolia.

Recognising that exploitation of mineral resources typically requires large electricity supplies, the Bank will support the renewal of Mongolia's energy infrastructure, in particular where this exploits Mongolia's ample renewable energy reserves.

Support for Critical Infrastructure

The investment needs in infrastructure are significant, but constrained by limited public resources and current inability to borrow on non-concessional terms. This being the case, the Bank has currently explored opportunities for private sector projects, such as renewable energy, telecoms and aviation transport. The Bank will therefore continue to support primarily private sector initiatives concentrating on selective projects with creditworthy sponsors. The institutional framework for PPPs is still underdeveloped, however, should any opportunities (including institutional building opportunities) arise, and the Bank will stand ready to support the initiative. The Bank will also target projects which reduce Mongolia's existing high levels of carbon intensity and energy inefficiency.

In the public sector, the Bank will continue to work selectively within the limited fiscal capacity. However, as Mongolia will be graduating from the low-income group (e.g. eligible for IDA and ADF financing), the current law prohibiting the government to receive non-concessional financing and preventing state and municipal entities from borrowing will have to be amended. This may in time create new opportunities for the Bank to work in the public sector.

Cooperation with the ADB, the WB and key bilateral donors, should ultimately allow the Bank to participate in public sector projects. The Bank will work closely with the CAREC - ADB supported program promoting and facilitating regional cooperation in Central Asia in the areas of transport, energy and trade facilitation.

Policy Dialogue

Active policy dialogue with the Bank of Mongolia will be pursued, with a focus on improving banking sector supervision, encouraging consolidation, and on specific issues such as the prevention of money laundering. The Bank successfully launched the Consultative Council on Investment Climate in mid-2008 to provide not just a forum for private-public dialogue, but also a mechanism for decision making, implementation and accountability, where these elements were previously lacking from the usual dialogue between investors and the authorities in Mongolia. Although the Council has gained in status and importance during the year, it needs to be further improved during the next strategy period.

Through targeted TC and policy dialogue, the Bank is addressing some of Mongolia's long-standing and seemingly intractable problems, such as air pollution in Ulaanbaatar, a road map for renewable energy, and the digitisation of the land cadastre to permit increases in mining exploration.

Policy dialogue with the Ministry of Mineral Resources and Energy, the Mining Authority and the Petroleum Authority of Mongolia will continue, in particular, in relation to the improvement of natural resources sector legislation (including taxation), and the effective implementation of the Extractive Industries Transparency Initiative, where the Bank will continue to work closely with all stakeholders, the World Bank, the Government, industry players and the NGO community. The Bank has shared with the Government and Parliament its willingness to support them in finding a long term sustainable and fair solution in the development of the mining industry. The Bank will also support country's initiative to study possibilities of establishment of mineral processing industry and development of necessary infrastructure for export of processed minerals.

The Bank will continue to coordinate with other IFIs, donors and the business community. The Bank's Environmental Policy and Public Information Policy will apply to all projects developed in Mongolia.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Enterprises

During the past two decades in transition, Mongolia developed a strong entrepreneurship culture, with vibrant and growing local enterprises, improving management skills and often visionary ownership. The Bank's main strategic goal must be to nurture and support this entrepreneurial spirit by providing access to long term finance (including equity) and by promoting improvements in corporate governance and helping businesses to raise all standards to international levels. It is also noted that the majority of the labour force are employed by micro, small and medium sized companies. The development of this business segment will defiantly contribute to job creation and poverty alleviation. Moreover, while Bank's operations and GDP contributions are increasingly dominated by the mining sector,

creation of more business opportunities in the (non-mining) enterprise sector will contribute to the diversification of EBRD operations and the economy as a whole.

The Bank will continue to explore both debt and equity opportunities in a range of key industry sectors, including agribusiness, textiles, pharmaceuticals, property and tourism and construction materials.

The Bank will seek to attract reputable foreign investment into the Mongolian corporate sector, the presence of which can also assist with raising standards of business conduct. Both ETCI and TAM/BAS (see Annex 9) frameworks will be crucial to the success of Bank's activities. Already DIF and DLF facilities have been approved and a new MCFE is imminent.

The main challenges facing local enterprises include access to longer term finance, improving access to markets (both domestic and overseas), and corporate restructuring leading to improved information flows, better decision-making, greater transparency overall and more effective management and shareholder relations.

An example is the cashmere sector, a traditional Mongolian industry, where greater access to end markets with a stylish design is a key ingredient for success in today's challenging economic environment. The Bank's involvement can allow the purchase of new capital equipment, often substantially computerised to raise efficiency, with TC to improve design capability, marketing skills, and hence ultimate access to overseas markets.

In the downstream agribusiness sector, where the Bank has already been active with both equity and debt for supermarkets and non-alcoholic beverages, challenges include obtaining access to the large proportion of the local population that shop in the traditional black market. This is being addressed by bringing a new shopping experience to Ulaanbaatar in the form of hypermarket development. Further challenges all include developing meat and hide processing to full environmental standards for exports. The beverage market has already benefited from the Bank's help in raising environmental standards through new water treatment facility at the Coca-Cola bottling plant.

In addition contacts with other businesses in the sector were established. The Bank will continue its focus on the retail and beverage sectors and will seek opportunities to provide financing to suppliers, using the tools available under the ETC initiative. The Bank will also continue to investigate the possibility of working with local and foreign strategic partners in agro-processing as a way to promote foreign investment and knowledge transfer. With regard to upstream activities in the sector, the Bank will examine the introduction of an agribusiness focused financing scheme by which the Bank will share the risk of a local agri borrower with local participating banks.

In the property and tourism sector, the availability of structured long term finance remains a significant challenge as local banks are unable to provide the required maturities and have insufficient experience to analyse project risks. The Bank has already financed a mixed-use property development and stands ready to consider hotel financing (on the strictest of criteria in today's market) for reputable local sponsors engaging with experienced international hotel chains to bring much needed improvement in hotel stock and related conference facilities for the burgeoning tourism and business travel market in Mongolia.

3.2.2 Financial Institutions

Support for the financial sector will remain a key priority for the Bank in Mongolia, where there is currently limited access to term finance available for commercial banks other than from IFIs. Corporate and retail customers of commercial banks find it difficult to borrow on reasonable terms, limiting the ability to start new businesses, expand existing operations, purchase or renovate real estate, etc. The Bank will seek to strengthen financial intermediation, and therefore to improve access to finance through provisions of various forms of credit lines and debt products to commercial banks meeting the Bank's financial and integrity criteria. Term financing for medium, small and micro size enterprises (MSMEs) will be a priority, but other forms of debt will be offered including but not limited to senior loans for general corporate purposes, co-financing/risk sharing under MCFF. When the mortgage related legislation is enacted and local capacity is established, the Bank may consider providing financing for mortgage loans.

The Bank will continue to actively roll out the Regional Trade Facilitation Programme (TFP) to several banks. The TFP is in high demand due to the lack of credit lines available from commercial banks for trade finance purposes. Specific support for existing partner banks will be a key challenge in this strategy period, with likely need for capital increases and further help with institutional building. The Bank will also pursue opportunities for new equity participation in banks, which will strengthen the target banks' capital base and improve corporate governance. This could take the form of straight equity, but other forms of equity and quasi-equity participation will be considered. Subordinated and convertible debt will also be considered including participation in private equity funds. In addition, the Bank stands ready to provide technical assistance and, on a case by case basis, will provide debt and equity finance in support of the expected consolidation of the banking sector. In this Bank will work closely together with the IFI's (World Bank, IFC, ADB) and the Bank of Mongolia.. Reputable foreign bank entry in this process of consolidation will be encouraged.

The Bank will seek donor funding for technical assistance (TC) to support institution building and ensure sustainability of the transferred skills. TC will be required to support the Banks in their MSME activities – MSE financing today is provided primarily by only two banks, often on a collateralised basis and SME financing has little history in the country. A Trade Finance Advisory Services consultancy programme will be required to support the TFP. It is expected that any equity participation will require TC, likely in the form of a “twinning” programme with an international bank.

Furthermore, the Bank will endeavour to support non-banking financial institutions (NBFIs), including leasing, consumer finance, insurance, pension, and non-bank micro financial institutions. The preferred method of financing for NBFIs will be equity, although term debt will be considered for leasing, consumer finance and non-bank micro financial institutions. Given the early stage of the development, TCs will be required to support the Bank's initiatives with these companies. Furthermore the Bank will focus on the capacity building in the NBFIs and security markets (e.g., local stock exchange), in particular the equity, bond, mortgage and insurance market development and local currency financing. The Bank will collaborate with other IFIs and bilateral donors who are already providing technical assistance in these areas.

Policy dialogue with the Bank of Mongolia and FRC will be pursued, with a focus on improving supervision, supporting proactively the consolidation together with Bank of Mongolia and strategic investors, and encouraging specific issues such as prevention of

money laundering and terrorist financing. Lastly, the Bank will also look into the possibility of accessing local currency funding over the medium term from local sources when suitable projects are identified. With FRC, the Bank will try to support the development of non financial institutions and capital market through improving the legal environment, institutional capacity, corporate governance and transparency in order to enable investors to make decisions based on the market information.

3.2.3 Natural Resources

Support for the natural resources sector will be a key priority for the Bank in Mongolia. Mongolia has considerable mineral resources that have yet to see significant commercial operations. However, the coal and copper sectors are dominated by the state sector, and prices and business practices are yet to be on commercial basis. The gold sector is more commercial but in recent years non-transparent business practices increased. The Bank has established a good reputation by supporting a number of competent private companies, in terms of transparency and social and environmental standards in the past two years. Given a volatile international price environment and global economic downturn, attracting experienced and financially sound strategic investors remains a considerable challenge in this sector. While commercial financing either domestically or internationally became difficult to obtain, the Bank will be able to play larger roles during the next strategy period.

Participation in selected large-scale projects with sound strategic investors remains a priority for the Bank. The Bank will also consider providing finance to reputable domestic mining companies with a proven track record or with the good potential. On a limited basis, the Bank will also work with medium-sized mining companies under the ETC framework.

The Bank will primarily focus on private sector operations. With regards to large-scale strategic mines, such as the Oyo Tolgoi project and the Tavan Tolgoi project, the Bank will consider providing finance to foreign and domestic companies which meet Bank's standards. The Bank will also consider mining-related infrastructure projects, such as power stations and railway network development (see infrastructure section).

Within a framework for improvement of competitiveness and enhancement of value added production in Mongolia, the Bank will support an initiative of the Government to support the private sector to establish mineral processing industry. In financing these projects, the Bank will continue to promote adherence to best governance, transparency and revenue management standards by requiring project sponsors to implement the Publish What You Pay (PWYP) and Extractive Industries Transparency Initiative (EITI) principles. Moreover, through its investments in the natural resources projects, the Bank will aim to foster energy efficiency and climate changes initiatives where possible.

The government is currently considering privatising state-owned coal companies. Most of these companies are not operated commercially and not making reasonable profits (e.g., in the coal sector prices are kept low by the government policy. On a limited basis, the Bank will consider providing pre-privatisation assistance (including loans and TCs). When reputable investors decide to participate at the time of privatisation, the Bank would eventually support such initiatives.

Financing of projects in the oil and gas service sector and the environmental remediation will remain an important part of the Bank's activities in Mongolia. The Bank already established a

good reputation in this respect. The Bank will continue to work with reform-minded, transparent, and competent local oil companies.

Policy dialogue with the Ministry of Mineral Resources and Energy, the Mining Authority and the Petroleum Authority of Mongolia will continue in relation to the improvement of the business environment in natural resources sector, introduction of the fair and transparent procedures for awarding and monitoring licences, and the implementation of the Extractive Industries Transparency Initiative, where the Bank will continue to work closely with the World Bank, the Government, industry players and the NGO community.

3.2.4 Infrastructure

Most of the existing infrastructures were built before 1990 and have not been significantly rehabilitated in decades. At the same time, there are new large-scale business opportunities in the south Gobi regions to support mining and mining related businesses. Infrastructure needs are significant in transport, power, and municipal sectors as explored below, with limited but growing private sector activities. According to the recent World Bank publication, the financing needs in the south Gobi regions go up to US\$ 5.2 billion. While some of the projects will be privately financed, the large part remains to be publicly financed.

Mongolia has had a strict policy on public sector borrowings. The government can only borrow money on concessional terms in accordance with the “Law of Mongolia on the Co-ordination of Foreign Loans and Grant Aid” adopted in June 2003. The law is silent about the definition of “concessionality”, but in line with IMF requirements, it is widely considered at least 35 per cent of grant element is required. Local and regional authorities can only borrow from the central Government (Article 57 of the Public Sector Management and Finance Act), in other words, loans directly to the municipalities are not allowed. The law is silent on the ability of local authorities to guarantee, but the Ministry of Finance is adamant that local authorities are not allowed to guarantee loans and no IFI or bilateral soft loan has been guaranteed by local and regional authorities.

These requirements have been large constraints for the Bank’s potential activities in infrastructure sector and during the past strategy period, the Bank has not done any public sector projects. However, this situation may change. The authorities are aware that, as per capita income has significantly increased during the past few years, Mongolia will soon not be eligible for concessional financing from the World Bank and the Asian Development Bank (i.e. IDA and ADF respectively). While public sector investment needs remain large, it will not be possible to fully rely on concessional funding from bilateral donors. Under these circumstances, the government is currently considering an amendment of the legislation. Parliament also authorised the government to raise US\$ 1.2 billion from international capital market. Under the current IMF programme, the government can borrow up to US\$ 200 million on non-concessional terms (on a stock basis).

The authorities expressed willingness to work with the Bank in the public sector. If viable projects can be developed, within the US\$ 200 million limit, the Bank could consider lending to the government directly or state entities with a sovereign guarantee.

It is also noted that business opportunities seem to be expanding for private sector projects and private public partnerships (PPP) may emerge. The authorities are keen to develop Public Private Partnerships (PPPs). The government is currently developing the PPP legislation,

assisted by USAID. Two railway licences have already been issued to domestic companies. PPP unit is being created under the government. Government capacity seems to be limited, but if appropriate opportunities arise, the Bank will consider providing assistance for these private sector projects.

3.2.4.1 Transport Infrastructure

The main challenge in the transport sector is to improve the quality of transport infrastructure in a way that is commensurate with the limited public resources available and which creates the basis for sustainable future operation of infrastructure enterprises, where possible through the attraction of private investment. While good transport infrastructure remains necessary to facilitate trade and connect major markets – both domestically and internationally. However, the country is so large while the population are relatively low-income, which makes it difficult to construct high quality infrastructure. Under these circumstances, the Bank will aim to support new investment selectively in the light of the limited borrowing capacity of the country.

Aviation Sector

Air transportation plays a key role in Mongolia as tourism is one of the promising industries and for the time being, because of lack of road networks, air transportation connect different regions among Mongolia. Under the National Development Strategy, the government put it as a high priority area for the development. The Bank is seeking to support one of the private domestic airlines, which is committed to improve management and safety standards. While there is little or no competition in the domestic aviation sector for the time being, the Bank may consider supporting other initiatives if opportunities arise.

As for international airlines, the government intends to privatise the Mongolian state airlines (MIAT) in the foreseeable future. The Bank supported MIAT for its management assistance through a TC in the past, and will consider supporting its privatisation efforts either/both before privatisation and at the time of privatisation if strategic investors are willing to co-invest, or through a selective asset backed transaction to support the acquisition of aircraft.

As for airports, there are also large investment needs, but other donors and domestic sources are already committed to support the construction and rehabilitation of international and regional airports. Thus there is limited role that the Bank can play.

Railway Sector

The main railway lines (2,215 km, Russian wide gauge) are operated by Trans-Mongolian Railways, which are owned 50/50 by the Mongolian state and Russian Railways (RZD). The Company was founded in the late-1940s by the treaty and, as such, has a unique legal status. There are a number of new railway construction/rehabilitation projects and RZD are likely to support the government's efforts in this regard. However, the unique ownership and legal status of Mongolian Railways preclude any direct co-operation by EBRD at present.

In addition, there are a number of private railway initiatives. Although the details are not yet confirmed, railways to transport minerals to China could be constructed on a PPP basis. USAID and the Asian Development Bank are supporting the government efforts to launch PPP initiatives. If such initiatives are credible and implemented in line with international best practice, the Bank could consider supporting them.

Road Sector

Out of the network of 49,250km roads, only about 15 per cent of the network constitutes paved roads. Road density is extremely low at 0.03 km per square km. Hence the investment needs in the sector are enormous. However, the investment opportunities are severely restricted by constraints on sovereign budget support and limitations on borrowing. Moreover, due to low population density and traffic volumes, construction of new roads may not yield positive economic rates of return. However, selective opportunities may exist to finance road projects, which, for example, have economic benefits linked to intra-regional integration not normally captured in standard rate of return calculations. The Bank would consider such opportunities, particularly alongside other IFIs based on a coordinated approach to sector reform.

3.2.4.2 Power Sector

Mongolia faces four main challenges in the power sector: (i) to develop a functioning market model that introduces commercial incentives to the power sector to drive down the current high levels of inefficiency and energy intensity and justify new investment, (ii) to make the transition from subsidised electricity to fully cost-reflective tariffs, (iii) to replace and renew the ageing thermal generating capacity (the youngest capacity is 28 years old) and transmission network, both to meet rising demand, especially from the country's developing minerals sector, and to improve the environmental performance and reliability of the existing infrastructure, and (iv) to utilise Mongolia's large potential for renewable power, particularly wind and small hydro.

The distinctive obstacle that Mongolia meets in rising to these challenges is the combination of its small population with its vast size. The small population, and consequently small power demand (in absolute terms), prevents it from realising economies of scale and maximises the fixed costs per unit of the power sector while the large size means those fixed costs are high. In particular servicing new, energy intensive mineral projects, or utilising Mongolia's renewables potential, is made difficult by the length, and consequent cost, of the required transmission interconnections.

Of the four challenges identified above, (i) and (ii) are primarily institutional and policy based. The international community's effort here is led by USAID and there is limited need for Bank intervention although we should stay involved. Challenge (iii) primarily revolves around the construction of the new CHP-5 plant, which was tendered with limited success recently. The Bank should explore ways to support that project if the procedures and sponsors become acceptable to the Bank. The Bank will explore possibilities to fund transmission or distribution investments, subject to being able to access a sovereign guarantee. Challenge (iv) is the most advanced through the Bank's TC support for the development of a renewables framework and the Bank's mandate with Newcom for the Salkhit windfarm. In addition, the Bank will focus on supporting the use and production of renewable energy primarily in the Central Energy System but also including, where projects are of a suitable scale, those in remote, isolated areas, keeping in mind the Mongolian high energy transport costs and the state of its energy transport infrastructure. The Bank will also consider supporting the production and use of biofuels as a measure of supporting Mongolia to reduce its GHG emissions. The development of a renewable framework will remain the Bank's priority.

There is one area where cross-sector cooperation will be required between power with natural resources and in particular the possibility of funding transmission or generation projects developed to support specific investments in that area – e.g. plants built to power particular mining exploitation projects in southern Mongolia. There are a number of new private-driven projects in south Gobi (the World Bank indicates the total investment needs in electricity amount to US\$ 2.7 billion). While the government capacity is limited to deal with PPP projects, if opportunities arise, the Bank will consider the possibility to participate in these initiatives.

3.2.4.3 Municipal & Environmental Infrastructure

There is limited financial capacity and autonomy with Mongolian municipalities. Although decentralisation is improving in recent years, the central government continues to play a key role in municipality infrastructure development. Although there are a number of public utility companies, such as bus and water companies, most of the capital costs are provided from the state as municipalities or companies do not have enough funds. While it is politically sensitive to raise tariffs, most companies do not recover their costs and there is little sustainability in these utilities.

Under these circumstances, urban transport is facing significant problems in Ulaanbaatar. Congestion, road safety, urban air pollution are becoming large concerns for the population. There are a number of new initiatives driven by the government, supported by the ADB, to develop the urban transport system in Ulaanbaatar and rural communities in the Gobi areas. While most capital investments will be made by the public sector, some of the operations could be done by the private sector (either on a lease or management contract basis). The Bank will consider supporting such initiatives in a coordinated manner with other IFIs.

In terms of public sector financing, opportunities remain limited. Municipal utilities have extensively borrowed from IFIs and bilateral sources (on-lent from the central government). It seems that the debt levels imposed on the utilities are now at unsustainable levels for most of the utility enterprises, while utility tariffs remain largely below the cost recovery levels. Under these circumstances, the Bank will support, within the existing tight affordability constraints, a commercial approach by municipal entities to improve service delivery and cost control, while introducing gradually cost recovery tariffs and improved collection practices to enable these utilities and service companies to provide a financially sustainable service in the medium term. This will require significant organisational restructuring while municipalities need to ensure that adequate project implementation and supervision capacity at enterprise and municipal level is in place to undertake new investments.

3.2.4.4 Telecoms

The Bank will continue its dialogue with the Government and suitable private telecom operators (domestic or foreign), private mobile operators and Internet Service Providers (ISPs) as well as media companies to identify financing opportunities using the full array of the Bank's instruments. The Bank will also continue its dialogue with the government in an effort to encourage the enhancement of the sector legal and regulatory environment – key drivers of inward investment in the sector and broader sector development.

The Government has proceeded with the separation of incumbent telecommunications operator Mongolia Telecom into a services only entity (MT) and a network only entity

(ICNC), as a precursor to privatisation of both. The Bank supported the development of this structure through a TC funded consultancy (Privatisation Options for Mongolian Telecom) which ran from 2004-2006. While that TC provided practical and workable options for restructuring and privatisation within the sector, the Government's delay in implementation of more than 2 years has significantly diminished the benefits the new structure was intended to bring. Nonetheless, the Bank will continue its dialogue with the Government towards the privatisation of both MT and ICNC and explore opportunities with both going forward. In the appropriate circumstances, such opportunities could include financing either or both entities, financing of a potential privatisation partner or acquisition of shares in either or both companies upon an appropriate privatisation.

In tandem with the privatisation and restructuring TC, above, the Bank's Legal Transition Team implemented a regulatory development TC project targeting three main areas: legal and regulatory policy development; sector institutional restructuring; and, technical implementation. While the technical implementation component of the regulatory development TC was implemented successfully those components dealing with legal and policy development, and institutional restructuring fared less well. Specifically, the Government appears extremely slow to take any meaningful steps to advance the adoption and implementation of a new sector regulatory policy and electronic communications law developed as part of the EBRD assistance. Nonetheless, the Bank will continue its dialogue with the Government with a view to achieving the legal and regulatory reforms contained in the policy and law proposed as part of the regulatory development TC in an effort to help enhance the environment for inward investment and broader development of the sector.

3.2.5 Energy Efficiency

Mongolia is among the most energy intensive countries in the EBRD's countries of operations. Ulaanbaatar is the coldest capital in the world which creates a large demand for heating. However as energy tariffs remain low (mostly below cost recovery, although increasing in recent years), there are not many incentives to improve energy efficiency. In that context, the technical potential for sustainable energy is extensive but there are many barriers to energy efficiency opportunities, including the lack of a policy framework, insufficient capacity of government institutions and professional bodies, information asymmetries and limited availability of technology.

A very good market entry strategy in this area is to work with local financial intermediaries on developing dedicated energy efficiency credit lines to enhance availability of financing for medium and small scale energy efficiency investments and for smaller renewable energy projects. A market demand study is in progress and this will provide the intelligence to structure the first financing instruments to exploit the poor energy intensity of the economy.

The Bank will consider efficiency and renewable energy credit lines (Sustainable Energy Financing Facility model) through the Mongolian banking sector including the necessary technical cooperation support. These financing facilities will be targeted to: (i) enhance industrial energy efficiency, particularly in small and medium size enterprises; (ii) fund small scale renewable energy projects; and (iii) improve energy efficiency in existing buildings, and (iv) enhance household energy efficiency by the measures like insulation, instalment of energy efficient heating devices.

Another area of focus can be the building sector. A major concern is the deteriorating building stock and its very low level of thermal protection and high rate of energy losses. Years of lack of any proper operation and maintenance, combined with low level of awareness have created this situation. In order to foster transition of the building sector as one of key energy consumers, the Bank intends to develop a number of initiatives which may provide tools and solutions for sustainable energy investments in buildings, including;

- Policy support on enhancing regulatory framework in the building sector will use the experience of similar projects under implementation in Kyrgyzstan and Moldova
- Mongolia will be included in the Energy Toolset, a joint initiative of E2C2, ESD and P&T Team aiming to monitor energy efficiency and market performance of the building sector in the region. The inclusion of Mongolia will allow a detailed analysis on market barriers and provide effective tools for assessment of EE opportunities;
- The energy framework for built environment projects will allow screening and identification of projects with good demonstration and replication potential;

Consequently, households and corporations could benefit from many of energy efficiency measures in the medium to long run but affordability is a massive barrier in the housing sector.

3.2.6 Environmental and Social Impact of Bank Strategy

EBRD will conduct comprehensive due diligence on projects in Mongolia in order to identify any environmental and social issues that might be associated with its activities. EBRD will also closely work with its Clients on developing Environmental and Social Action plans aimed at mitigating identified negative impacts as well as achieving compliance with the Mongolian national environmental, health, safety and labour regulations and standards and EBRD Performance requirements (2008). EBRD will also seek to identify opportunities for improvements in the areas such as energy efficiency, management of waste, environmental management and other areas.

4. IFIs and Multilateral Donors

According to the OECD, Mongolia receives roughly US\$ 200-250 million overseas development assistance on an annual basis. Looking at 2006-07 statistics, Japan is the largest donor, followed by Germany, the Asian Development Bank, the World Bank and the United States. In recent years, relationships with Russia and China have been developed and negotiations for loans and bilateral aid cooperation have been developed. EBRD is not recognised as an ODA donor but in 2008 it became the largest international contributor in terms of annual volumes.

In response to the crisis, key donors made good efforts in a coordinated manner to help the government overcome the current difficulties. The IMF announced to provide an 18 months stand-by credit for US\$ 229 million. It also estimated the amount of the further budget gap for US\$ 205 million for 2009-10. Subsequently key donors, including the Asian Development Bank, the World Bank and Japan, pledged to provide further US\$ 160 million at the Mongolia's external partners meeting in mid-March. There is some gap remaining but as some of the other key donors have not yet pledged, it is believed the fiscal gap will be fully filled, while the government will continue to improve the fiscal discipline.

The activities of key IFIs/international organisations are summarised below.

4.1 International Monetary Fund (IMF)

Mongolia joined the IMF in February 1991. The Government has been supported by the IMF in its efforts for economic reforms and poverty reduction. A three-year IMF Enhanced Structural Adjustment Facility (ESAF) programme was approved in June 1993 with a total of SDR 40.8 million, but went off-track in June 1996. Subsequently the IMF Executive Board approved a three year ESAF/Poverty Reduction and Growth Facility (SDR 33.4 million) in July 1997. The IMF Board approved a Poverty Reduction and Growth Facility (PRGF, 3-year programme for SDR 28.5 4 million) in 2001. However, this arrangement lapsed in July 2005 without the completion of the third and subsequent reviews. In April 2009, the IMF approved an 18-month stand-by arrangement in an amount equivalent to US\$ 229 million to support the country's economic stabilization. An amount equivalent to SDR51.1 million (about US\$ 76.4 million) became immediately available to Mongolia. The remaining amount will be phased in, subject to quarterly reviews.

4.2 World Bank Group

Mongolia became a member of IBRD, IDA and IFC in February 1991. The World Bank Group has assisted the country in the areas of poverty reduction, private sector development, financial sector reforms and infrastructure development. The IDA has committed over US\$ 459 million to Mongolia along with technical advice and assistance. The World Bank has completed 15 lending projects with total budget of US\$ 265 million. As of December 31, 2008 the total lending portfolio to Mongolia amounted to US\$156.6 million, of which US\$ 59 million was provided as grant. The portfolio is dominated by infrastructure, social/rural, financial and private sector development and governance/economic management projects.

The International Finance Corporation has had 11 private sector projects, totalling US\$ 68 million, in four broad areas: the development of (i) the financial sector, (ii) the natural resources sector, (iii) infrastructure and (iv) the industrial base and agribusiness sector. Its

first investment was in 1996 to a leather processing facility (US\$ 1.8 million). In 2002, the IFC made an investment to Xacbank (US\$ 0.4 million) to provide finance for micro-entrepreneurs and small and medium enterprises. In 2004, two more projects were signed to provide a US\$ 5 million investment, including an equity investment (US\$ 1.5 million) and subordinated loan (US\$ 3.5 million) to the Trade and Development Bank. In 2004, the IFC also signed an agreement with the Khan Bank, under which the IFC provides US\$ 1.2 million equity along with a US\$ 1.8 million loan in support of micro and small businesses across Mongolia.

The Country Assistance Strategy (CAS) for 2008-11 has been under preparation for a long time, but due to the need to respond ongoing crisis, the World Bank adopted its interim strategy for Mongolia for 2009-2010 in May 2009. A new interim strategy provides a framework of support for the next 18 months. Its goal is to support the government to address urgent crisis needs while also addressing longer term reforms needed to reduce the impact of future shocks. It focuses on three key areas: improving fiscal sustainability in a mineral-based economy; protecting the poor and vulnerable; and encouraging transparent and prudent mining investments and a more competitive and stable medium-term business investment climate.

4.3 Asian Development Bank (ADB)

Mongolia became a member of the Asian Development Bank (ADB) in 1991. ADB provided loans for 39 loans (projects) totalling US\$ 662 million since 1991. The country became eligible for 100% ADF grant financing in 2007-2008. Five grant projects and one grant program, amounting to US\$ 88.3 million, were approved during this period. As of 31 December 2008, there are 11 active loan projects for a total of US\$ 175.9 million. The active ADF financed grant portfolio consists of 6 projects, including 5 projects and 1 program grant for a net total of \$88.3 million. Loans have been provided in many sectors, including agriculture and natural resources, education, energy, finance, health, industry and trade, transport and communications, water supply, sanitation and waste management. ADB has also provided financial and technical assistance (TA) for projects in many sectors for a total of US\$ 70.1 million.

The indicative Country Operations Business Plan for 2009-2010, agreed with the Government on 18 February 2009, envisages the provision of US\$ 147.1 million investment (both loans and grants) and US\$ 8.5 million in technical assistance, and 11.8 million of Japan Fund for Poverty Reduction (JFPR) projects for two years. The focused areas are transport, urban development, education and social welfare sectors. This includes south Gobi development (including PPP programmes) and logistic centres. Most projects are financed by a combination of ADF loans and grants. The private arm of the ADB envisaged US\$ 4-5 million for private sector financing. Regional projects are outside these allocations.

4.4 United Nations Development Programme (UNDP)

The United Nations Development Programme (UNDP) has been in Mongolia since 1973. UNDP's country programme and related Country Programme Action Plan (CPAP) 2007 – 2011 was developed based on the Common Country Assessment (CCA) undertaken in 2005 and the United Nations Development Assistance Framework (UNDAF) 2007- 2011 endorsed by the government in 2006. The CPAP was signed by the Government of Mongolia and UNDP in February 2007. It covers five programme components including: (i) achieving

the MDGs and reducing human poverty, (ii) democracy, accountability and transparency, (iii) access to justice and human rights, (iv) energy and environmental sustainability and (v) crisis prevention and recovery. The financial resources are estimated at US\$ 28.5 million under the current programme.

4.5 EU

EC-Mongolia cooperation stands presently at a relatively limited level, bearing in mind Mongolia's level of income per capita and of poverty and the period of the 1990's when the EU-funded TACIS programme was in full swing. During recent years, two new bilateral cooperation programmes have been launched, both of them focusing on rural incomes and development. The first programme, involving an EC commitment of 9 million, focuses on animal health and livestock marketing, in a country where working rural population is composed mainly of herders. The second programme, involving an EC commitment of Euro 10 million, focuses on promoting sustainable livelihoods and sustainable development in rural areas. The first programme is implemented by the Mongolian administration; the second one is implemented by the World Bank via a WB-administered donor trust fund. Regarding future cooperation, the EC intends to slightly increase its annual commitments beyond the present Euro 3,5 million per annum in the 2007-10 programming cycle and to continue to focus on interventions aimed at poverty eradication, with perhaps more emphasis on income generation and institutional capacity building to support formulation and implementation of policies in pursuit of the Millennium Development Goals.

ANNEXES

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Annex 1 - Political Assessment

Compliance with Article 1

Mongolia is committed to and is making progress in the application of the principles of multiparty democracy, pluralism and market economics embedded in Article 1 of the Agreement Establishing the Bank. Consistent application of these principles will help to further consolidate the democratic achievements of the country.

As a reflection of democratic achievements of the country, the latest presidential poll in May 2009 brought victory to the opposition candidate, in an election recognised as free and fair by the observers.

Mongolia is a multiparty, parliamentary democracy. Since the beginning of transition, the country has adopted a liberal democratic Constitution, developed a competitive political party system, produced a vibrant civil society and made progress towards implementation of market-oriented reforms. The media are free to report on a wide range of issues and there is an increasing recognition and adherence to the rule of law and respect for human rights.

These impressive achievements notwithstanding, Mongolia continues to face many challenges. These emanate from frequent political crisis resulting in changing governments, which are confronted with the same set of crucially important issues such as widespread poverty, low living standards, corruption, handling of vast mineral resources and limited access, especially in rural areas, to health and educational opportunities.

Political Environment

Mongolia is a land locked country, which shares borders with Russia and China. Striving to maintain a balancing act with these two large countries, Mongolia developed a concept of the “Third Neighbour”, seeking to diversify its external links beyond its immediate neighbours by advancing wider regional and global relations.

The country has a harsh climate and access to basic social services remains a problem. Poverty, unemployment and significant disparities between rural and urban areas are major challenges of Mongolia’s development.

Against this background, Mongolia has made demonstrable progress towards multi-party democracy and a pluralistic society. The country has many political parties, including genuine opposition parties, and a vibrant network of NGOs, with the latter playing an active role in the country’s development. The media are generally free and there is an increasing adherence to human rights standards.

The Constitution of 1992 established a parliamentary system of government. Although the President has the power to veto legislation, he can be overruled by a two-thirds parliamentary majority of the country’s 76 seat one-chamber parliament. Since 1990 Mongolia has consolidated its democratic achievements through five parliamentary and five presidential elections, which were recognised as being in conformity with international standards for democratic elections. Local elections occurred in October 2008 with only minor reports of irregularities.

A two-time former Prime Minister Tsakhiagiin Elbegdorj of the opposition Democratic Party (DP) was elected President on 24 May 2009 with the slim majority of 51 per cent, in an election perceived as fair by independent observers. Incumbent Nambaryn Enkhbayar of the ruling Mongolian People's Revolutionary Party (MPRP) gained 47 per cent of the votes and conceded defeat even before the preliminary results were announced by the General Election Commission. The voter turnout was about 74 per cent.

Fears that a close election result could renew the civil unrest that marred last year's parliamentary elections did not materialise. The country has remained calm, following the announcement of the election results as opposed to July 2008 when thousands of rioters took to the streets following the MPRP's disputed parliamentary win the previous month.

Both candidates were running on similar political platforms with opinion polls predicting a narrow race. Enkhbayar, who was running for a second term, had hoped his leadership during the four years prior to the election would help him to regain office. The MPRP traditionally has a strong rural base. Elbegdorj's successful campaign centred on the themes of change and fighting corruption as he concentrated his efforts primarily on the urban electorate in the capital Ulaan Baatar. Small political parties Civil Will Party and the Green Party – the two other parties besides the MPRP and DP represented in parliament – backed Tsakhiagiin Elbegdorj.

The Constitution limits the President to two four-year terms in office. The President chairs the National Security Council and the armed forces. Frequent changes of government have enhanced the role of the presidency.

Members of State Great Khural, the national parliament, are elected directly for a four-year term. The last parliamentary elections took place in June 2008 and were characterised by independent observers as being, on balance, free and fair.

The political process in Mongolia is traditionally strongly influenced by the two major political parties – the MPRP and the DP. The latest presidential and parliamentary elections were not an exception. As a result of June parliamentary polls, the MPRP increased its majority in the legislature but the electoral results were strongly contested by the DP (and personally by Tsakhiagiin Elbegdorj, the DP's leader at that time). Smaller political parties fared poorly under the electoral system of multi-seat constituencies.

The post-electoral uncertainty, following the June parliamentary elections, lasted for about two months and ended in August 2008 with the DP stopping its boycott of the newly elected parliament. Although the MPRP had sufficient majority to form a single-party government, the party opted for a coalition government with the DP acting as a junior partner. The coalition government is led by the MPRP's Sanjaagiin Bayar.

The coalition structure of the new government, which now comprises the two major political forces of the country, brought opportunities for Mongolia to move forward in a more coordinated manner. This also contributed to a less turbulent period of government at a time when the country is faced with pressing economic and social challenges exacerbated by the world economic crisis. However, some prominent members of the DP felt that the party should have stayed outside of the coalition government and continued to oppose the MPRP.

Despite the difficult period of a deteriorating economic environment, due to global economic crisis and falling commodity prices, the coalition has held together.

Handling of the vast national resources is a major challenge for any government in Mongolia. In a poor country, it is not easy to strike a balance between national and industry interests. The authorities are seeking to minimise damage to investor confidence in the mining sector and to find an equitable solution appealing to wide segments of the population.

The rule of law and protection of human rights

A prominent feature of Mongolia's democratic transition is the country's commitment and increased adherence to the rule of law and human rights standards. Although Mongolia has made commendable progress in the advancement of democracy, there are areas which require improvement. These are related to increased accountability, transparency, democratic governance and decentralisation of public administration.

Mongolia ratified all major human rights treaties and protocols, including all eight International Labour Organisation (ILO) core conventions. There are no significant problems in the area of labour rights.

The UN Convention on Anti-Corruption was ratified by Mongolia and created a legal framework for fighting corruption. An Anti-Corruption Agency is responsible for investigating corruption cases. Corruption remains a major problem and more tangible practical results in combating corruption are needed. It is not accidental that an anti-corruption ticket on which Elbegdorj campaigned during the latest presidential election appealed to large segments of the electorate.

The government generally respects the human rights of its citizens. The problems noted by independent monitors include cases of child abuse, domestic violence against women, international trafficking in persons, corruption within the judicial system and police brutality in prisons and places of detention.

The media are generally free and critical of the governmental policies. There are no restrictions on access to the Internet. According to independent media monitors, violations of press freedom are rare although the government is using the state-owned national broadcaster to promote its own activities. During the 1-4 July 2008 state of emergency, following the post-electoral riots in the capital, only state-run public television and radio were allowed to broadcast. Violence against the journalists occurred during the July 1 events. There are many newspapers but their circulations are mostly small.

Annex 2 – Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 <i>Estimate</i>	2009 <i>Projection</i>
Output and expenditure							
	<i>(Percentage change in real terms)</i>						
GDP	5.9	10.1	7.3	8.6	10.2	8.9	1.0
Industrial gross output	3.0	15.0	9.6	7.0	6.9	1.5	na
Agricultural gross output	3.7	17.7	10.7	7.5	15.8	5.0	na
Employment							
	<i>(Percentage change)</i>						
Labour force (end-year) ¹	6.4	2.7	1.5	4.2	1.1	1.3	na
Employment (end-year)	6.4	2.6	1.9	4.3	1.4	1.7	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year) ²	3.5	3.6	3.3	3.2	2.8	2.8	na
Prices and wages							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	5.1	8.3	12.7	5.1	9.0	26.7	8.1
Consumer prices (end-year)	4.7	11.0	9.5	6.0	15.1	23.2	7.5
Producer prices (annual average)	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	22.0	30.4	5.4	26.2	35.5	58.5	na
Government sector							
	<i>(In per cent of GDP)</i>						
General government balance ³	-3.7	-1.9	2.6	3.3	2.8	-5.0	-6.0
General government expenditure ³	37.1	35.0	27.5	33.3	38.1	40.2	na
General government debt ⁴	87.7	72.2	56.6	43.0	36.3	33.2	na
Monetary sector							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	49.6	20.5	37.2	30.8	57.3	-5.5	na
Domestic credit (end-year)	160.8	19.9	35.9	-7.4	72.5	24.6	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	42.4	39.3	41.8	40.9	52.0	36.9	na
Interest and exchange rates							
	<i>(In per cent per annum, end-year)</i>						
Central bank bills rate	11.5	15.8	4.8	6.4	9.9	14.8	na
Deposit rate ⁵	14.0	13.2	12.6	13.5	13.4	11.7	na
Lending rate ⁵	25.5	24.0	21.6	20.0	17.1	18.6	na
	<i>(Togrog per US dollar)</i>						
Exchange rate (end-year)	1,168.3	1,211.8	1,221.0	1,165.0	1,170.0	1,267.0	na
Exchange rate (annual average)	1,142.7	1,185.2	1,205.2	1,179.7	1,169.8	1,165.7	na
External sector							
	<i>(In millions of US dollars)</i>						
Current account	-98.6	26.6	29.2	222.0	265.0	-721.9	-262.0
Trade balance	-199.3	-149.1	-155.0	29.0	-54.0	-612.5	-201.0
Merchandise exports	627.3	872.0	1,069.0	1,545.0	1,949.0	2,534.5	1,858.0
Merchandise imports	826.6	1,021.1	1,224.0	1,516.0	2,003.0	3,147.0	2,059.0
Foreign direct investment, net	131.5	129.0	258.0	290.0	360.0	585.5	409.9
Gross reserves, excluding gold (end-year)	178.0	208.0	333.0	718.0	1,001.0	657.0	na
External debt stock	1,287.0	1,429.0	1,433.0	1,529.0	1,703.0	1,961.0	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	2.0	1.8	2.5	4.6	5.0	2.2	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	34.0	7.4	2.9	2.2	2.1	2.0	na
Memorandum items							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	2.6	2.6	2.6	2.6	2.6	2.7	na
GDP (in billions of togrog)	1,660.4	2,154.2	2,779.6	3,715.0	4,599.5	6,130.3	6,294.0
GDP per capita (in US dollars)	562.7	695.2	871.4	1,191.4	1,489.4	1,970.4	na
Share of industry in GDP (in per cent)	25.3	29.9	31.1	36.0	35.3	34.0	na
Share of agriculture in GDP (in per cent)	20.1	20.9	21.7	19.5	20.5	18.8	na
Current account/GDP (in per cent)	-6.8	1.5	1.3	7.0	6.7	-13.7	-6.0
External debt - reserves (in US\$ million)	1,109.0	1,221.0	1,100.0	811.0	702.0	1,304.0	na
External debt/GDP (in per cent)	88.6	78.6	62.1	48.6	43.3	37.3	na
External debt/exports of goods and services (in per cent)	154.1	118.2	96.6	75.3	67.5	65.3	na

¹ Economically active population registered at the employment registration office.

² Officially registered.

³ General government revenue and expenditure include grants and net lending.

⁴ Direct and assumed debt of the central government and loans guaranteed by the government.

⁵ Weighted average over all maturities.

Annex 3 – Environmental Issues

Key Environmental Issues

Mongolia can be divided into six zones: mountain, mountain taiga, taiga, mountain forest steppe, arid steppe and desert. The range of geographical zones in Mongolia, accounts for the diversity of Mongolia's flora and fauna. The mountain belt regions are inhabited by some endangered animals (such as the Argali sheep, Ibex, Snow Leopard, Rock Ptarmigan and Altai Snowcock) and plants (such as the Dwarf Siberian Pine and White Gentiana). The mountain taiga belt comprises about 5% of the Mongolian territory in the northernmost part of the country. Forests in this belt are dominated by the Siberian Pine and the Siberian Larch and are inhabited by such animal species registered in the Mongolian Red Book as the Musk deer, Elk, Lynx and Eurasian Otter. The Mountain Forest Steppe belt encompasses 25% of Mongolia's territory and is inhabited by such globally endangered animal species as the Manul, Black Grouse and plants threatened by extinction such as the Mongolian Pheasant's Eye. The Mongolian steppe is dominated by many forms of feather grass and supports Mongolian gazelles' habitats. The Desert Steppe is a habitat for such animal species as the Wild Ass, Saiga Antelope, Black-tailed Gazelle and Houbara Bustard. The Desert Zone is located in the southern and south-western parts of Mongolia and contains deposits of ancient flora, fauna and mineral resources, and provides a habitat for threatened animal species such as the Wild Camel, Gobi Bear and Mongolian Agama.

To reflect the importance of Mongolia's flora and fauna and to preserve it, the Government of Mongolia has established 28 nature reserves. Currently protected areas of land cover 13.1 percent of the total land area. In order to sustain the existing range of wildlife species and ecosystems, the Ministry of Nature and Environment has set a target of 30% of the total land area to be under protected areas, including national parks, by 2030.

There are a number of significant environmental issues in Mongolia that require urgent attention and action. Degradation of land due to the extensive mining activity and lack of adequate land reinstatement measures; overgrazing around settlement areas and water points and depletion of farmland, is one such issue. A total area of the damaged or depleted land is estimated to be 121.7 million hectares. Desertification is another challenge present in Mongolia, which manifests in desertification of vegetation cover; desiccation of wetland ecosystems and increase of sand area. Today, 42.5 per cent of Mongolia's territory are categorised as deserts. Deforestation is caused by illegal timber felling; inadequate forest management and adverse anthropological impacts. Although 11.8 percent of Mongolia's territory is considered as forest fund area, only 69.4 percent of the designated forest fund area is densely covered with forests and saksaul bushes, while 8.2 percent of the total territory has sparse forest and saksaul vegetation. Mongolia has limited water resources; water resource available for consumption consists of 34.6 cubic kilometres, of which 4.96 cubic kilometres is surface water and 0.4 cubic kilometres is groundwater. Water resources are declining due to increased industries' consumption; pollution of water by mining activities, and a lack of adequate wastewater treatment facilities (around 60 per cent of wastewater treatment facilities nationwide are either not capable of fully treating wastewater or are completely out of order). Threats to biodiversity due to loss of habitats, overuse and illegal hunting, also pose significant concerns. Air quality is a significant problem in urban areas of Mongolia, particularly in Ulaanbaatar. Primary sources of air pollution are 3 thermal plants; 200 small and medium sized district heating boilers and the Ger community's traditional furnaces. During the boilers use season, 11 thousand tons of ash and coal waste are released into the air.

Increasing number of vehicles contribute to air pollution; out of 140 thousand vehicles used in Mongolia, 70 percent are 7 plus years old and do not meet ecological and safety standards. Poor management of solid waste is a growing problem in urban areas. It is estimated that about 10730 thousand cubic meters of solid waste are accumulated annually in 447 waste collection points throughout the country, of which 220 are in the capital. There are no sanitary landfills in Mongolia and solid waste accumulates in heaps on the outskirts of cities and other populated areas before being transferred to one of the three open dumpsites.

The country is also subject to winter-specific natural hazards (known as dzuds) that cause a big loss of livestock by herding communities. These are triggered by severe droughts in summer and cold temperatures and heavy snowfalls in winter; and are further exacerbated by the overgrazing of pastures in some areas and disappearance of grasslands and general environmental degradation.

National Environmental Action Plan (NEAP)

Mongolia developed a National Environmental Action Plan (NEAP) in 1993, which was updated in 2000 and, covers actions to the year 2010. The NEAP establishes the Government's priorities and identifies issues and actions for the protection of environmental quality, natural resources conservation and institutional capacity building. The NEAP is composed of three parts: (i) Principal Environmental Issues, which in turn, is sub-divided into four sub-parts: environmental protection, management of natural resources, conservation, and natural disaster mitigation; (ii) Social and Economic Dimensions; and (iii) Other Mechanisms and Responses.

The NEAP includes about 25 national environmental programmes in the areas of desertification, forestry, biodiversity, water, protection and conservation of rare species. National programmes are sub-divided into policy-oriented and action oriented programmes. Enforcement and implementation of NEAP is poor due to the financial problems. Although NEAP has detailed work plans, it has no budget estimates and there is shortage of resources, which hurdles the implementation of the NEAP. Only 2-3, out of 25 national programmes within the NEAP, are inter-sectoral and therefore obtain endorsement at the Parliament level, and receive more attention, dedicated resources and funding. Some of the projects are approved by the Cabinet of Ministers, which also facilitates the cooperation between various ministries and other stakeholders and, consequently, the implementation of such programmes. However, the action-oriented programmes are approved at the level of individual ministries and hence the ownership and buy-in of the projects is limited, and so is the cross-sectoral cooperation.

Environmental legislation

Currently there are about 28 separate environmental laws and about 160 regulations and standards. Key environmental laws include the Law of Environmental Protection (1995), Law on Protected Areas (1997); Natural Resources Use Fee Law (1995-97), Laws on Forestry, Wildlife and Hunting (1995), the Land Law on protection of land resources (1995) and the Law on Environmental Impact Assessment (1997). A new Law on Mining has been approved by the Parliament in mid-July 2006. According to the Ministry of Nature and Environment, the new Law contains provisions for mandatory EIA prior to issuing a license to a mining operator. It is not clear, however, if the newly adopted Law includes provisions on mandatory development by the Operator of the Mine Decommissioning and Abandonment Plan and/or establishing a Decommissioning and Abandonment Fund.

Mongolia is party to the Vienna Convention for the Protection of the Ozone Layer, Montreal Protocol on Substances that deplete the Ozone Layer, Convention on Climate Change, Convention on Biological Diversity, Convention to Combat Desertification, Convention on International Trade on Endangered Species of Wild Fauna and Flora, Basel Convention on Control of Transboundary Movements of Hazardous Waste and their Disposal, Ramsar Convention on Wetlands, Convention on the Conservation of Migratory Species of Wild Animals, and the Kyoto Protocol. However, to date Mongolia has not joined the Espoo Convention on Transboundary Environmental Impact Assessment or the Aarhus Convention on Access to Information, Public Participation on Decision Making and Access to Justice on Environmental Matters.

Environmental Non-Governmental Organisations (NGOs)

The NGO movement in Mongolia started as early as 1997, when the first Law on Non-Governmental Organisations was adopted. The most active development of environmental NGOs took place in 2000-2001. The environmental NGO movement is largely supported by international donors. The majority of environmental NGOs are based in Ulaanbaatar. However, recently there have been some NGOs active at aimags level (largest sub-national administrative division units) but the management capacity is poor. The majority of environmental NGOs are engaged primarily in environmental education and training activities; and in environmental conservation activities and reforestation activities to lesser degree.

Activities of other international institutions

A number of international environmental and development institutions and programmes are active in Mongolia.

UNDP is currently implementing a project on Strengthening Environmental Governance in Mongolia. The objectives of the project are (i) harmonizing and addressing key environmental and fiscal legislations and policies to facilitate sound environmental governance at all levels, (ii) strengthening institutional mechanisms to implement and monitor environmental policy at local and central level and (iii) increasing stakeholders' involvement in environmental decision-making and monitoring through public participation and information disclosure at all levels. In response to severe environmental disasters experienced by the country, UNDP, in partnership with the Government of Luxembourg, also supports capacity building of the Government of Mongolia for effective Disaster Management. UNDP supported the establishment of the National Emergency Management Agency (NEMA) in 2004 and continues to support institutional and human capacity development for disaster management. UNDP also supports empowerment of community-based and local institutions in the area of sustainable utilisation and management of natural resources, as well as initiatives on biodiversity conservation in the Altai-Sayan and Gobi regions combined with skills training of men and women, networking, knowledge management and income generating activities in an environmentally friendly manner.

The World Bank is implementing the Mining Sector Institutional Strengthening Technical Assistance Project. The project consists of four components: (a) strengthening the capacity to manage mining revenues and develop economic and sector policies; (b) improving regulatory

capacity to manage mining sector development; (c) developing the capacity for management of state equity; and (d) project management.

WWF Mongolia's current programme for 2003-2010 is in line with conservation priorities identified under the WWF Global Programmes and Altai Sayan Ecoregional Action Plan. It targets conservation of priority species and maintenance and protection of freshwater ecosystems and analyses threats to the species and biodiversity from the illegal wildlife trade, unsustainable mining practices, overgrazing and over-ambitious plans on exploitation and natural resources.

Annex 4 – Legal Transition

Commercial Legislation of Mongolia

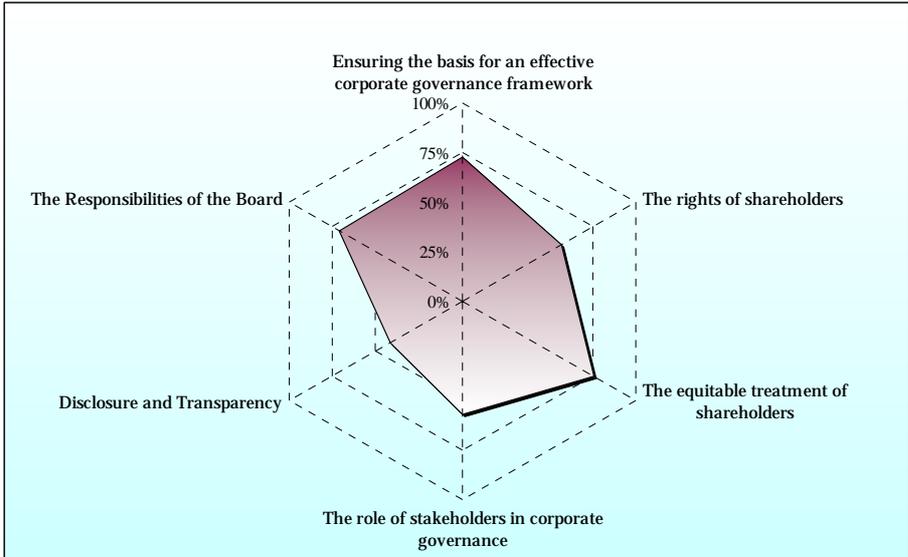
The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of such laws (also referred to as “effectiveness”). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Mongolia, accompanied by critical comments of the Bank’s legal experts who have conducted the assessments.

Company Law and Corporate Governance

The corporate governance framework is essentially regulated by the Company Law that was enacted on 2 July 1999 and amended several times since. In December 2007, a Mongolian Corporate Governance Code was issued by the Financial Regulatory Commission. The Code is composed of both mandatory and voluntary provisions, the latter being implemented according to the so-called “comply or explain” regime.⁶

According to the EBRD’s 2008 Corporate Governance Sector Assessment, (see chart below) which assessed the quality of corporate governance legislation in force in November 2007, Mongolia is in “medium compliance” with the relevant international standards (the OECD Principles of Corporate Governance). Among the shortcomings highlighted by the initiative, legislation defining rights of shareholders, and disclosure and transparency needs to be improved.

Quality of corporate governance legislation – Mongolia (2008)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximate these principles

Source: EBRD Corporate Governance Sector Assessment, 2008 assessment

⁶ The Code is available in English at <http://www.ebrd.com/country/sector/law/corpgov/codes/index.htm>

In 2005, the EBRD launched a survey for testing the effectiveness of corporate governance (how the law works in practice). Two case studies dealing with related-party transactions in a listed and an unlisted company were designed. The case studies investigated the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction was indeed entered into by the company and on how it was possible to obtain compensation in case damage was suffered. Effectiveness of legislation was then measured according to four principal variables: institutional environment, enforceability, complexity and speed. The survey revealed that procedures for obtaining disclosure and redress are complex, especially if the controlling shareholder refuses to spontaneously collaborate. Corporate information is generally not reliable and statutory auditors unable to act independently. Both conditions reduce the possibility of obtaining a successful disclosure. The absence of case law offering guidance on the interpretation of the law also adversely affects the clarity of proceedings. Enforcement procedures are difficult and very time-consuming. When considering redress, the survey reported a lack of experience and competence of the lower courts in corporate law cases and their potential partiality. This is especially true when the case is against a powerful defendant. The legislator should consider improving both the framework and the capacity of institutions to effectively implement the legislation, through adequate training and skills upgrade programs.

Concessions

Mongolia does not have a general policy framework for promoting public-private partnerships. Nor does it have a single-act law on concessions. However, a part of the Law on Public State and Local Property covers concession arrangements. In addition, various efforts have recently been undertaken to draft a new PPP Law to govern concessions among other types of agreements.

The Government of Mongolia has included the task of drafting a Public-Private Partnership Law in its 2008-2012 action plan and financial crises management plan. The National Development and Innovation Committee has created a working group to develop a PPP law. In May 2009, an early draft PPP Law was published for discussion.

The current version of the Law on State and Local Property provides for the transfer of state property to third parties by way of concession or leasing agreements with the approval of the authorised body. When it comes to land or subsoil, the matter must be specifically regulated by law. In the absence of a specific concession law, this type of arrangement may be granted under sector-specific laws such as the Petroleum Law, the Minerals Law, the Water Law, the Railway Transportation Safety Law, the Auto Transportation Law, the Health Law, the Law on Education and the Energy Law. The Government appears to have little power in awarding concessions agreements as these agreements have to be approved by the Parliament.

Generally, the Mongolian legal system does not contain extensive provisions on the scope and definition of concession related agreements. In particular, the Law on State and Local Property does not define the term “concession”. Due to this insufficient regulatory framework, the level of flexibility in terms of concession agreements remains low. The Public Procurement Law requires a competitive selection procedure for granting concession-like agreements. In addition, it should be noted that the various sector-specific laws do not provide for compensation of concessionaires in case the licence is revoked (with the exception of the Minerals Law). Mongolian law provides for a relatively developed regime of dispute resolution, including where foreign parties are involved. The Civil Code generally

permits parties to a contract to choose the applicable law and to refer their disputes to arbitration. This flexibility will be of great use to concessionaires, as the relevant sector-specific laws do not preclude such arrangements. However, in some sectors the legislation provides for mandatory application of Mongolian law (for example, the Petroleum Law).

Overall, Mongolia currently has a limited legal framework for the development of public private partnerships in infrastructure and services.

Insolvency

Insolvency is governed by the Bankruptcy Law, adopted in 1997 and most recently amended in 2002. The Bankruptcy Law provides users with basic tools for initiating insolvency and resolving resulting conflicts. However, there remain numerous concerns about the function of insolvency proceedings and the lack of experience by trustees and courts. When assessed against international standards applicable to insolvency, as per the methodology of the EBRD Insolvency Sector Assessment, the Bankruptcy Law was found to be in “low compliance” with such standards (see Chart 3).

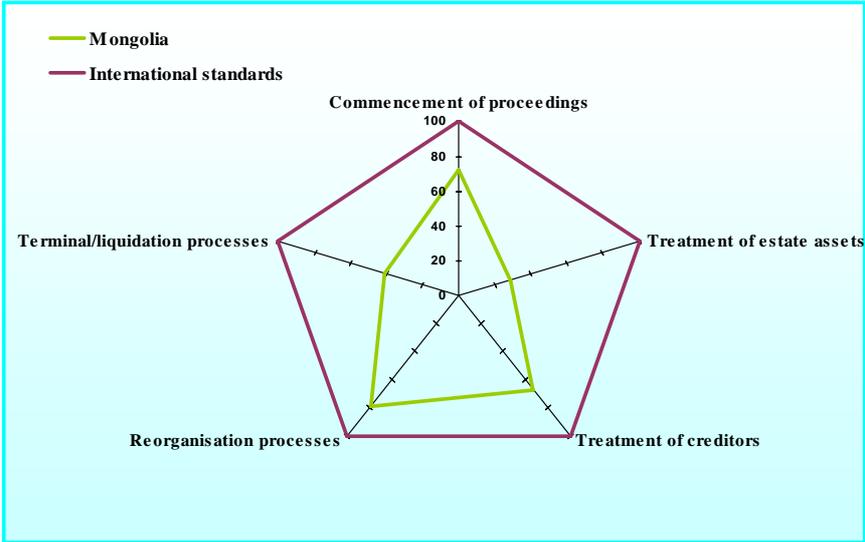
The low score reflects the law’s serious shortcomings. The definition of insolvency is a financial test, but it is unclear, stating that insolvency shall be deemed to exist when the debtor is in default for an amount representing at least 10% of its capital. Greater clarity is required, particularly with regard to the maturity of overdue debt.

The law does not provide for mechanisms allowing the trustee to obtain information on the bankrupt company’s financial condition nor does it specifically require the debtor or third parties in possession of debtor property to cooperate with the trustee. The definition of the assets that form the bankruptcy estate is poor, which complicates the recovery process. The provisions dealing with void transactions and transfers at undervalue are unclear, relying on undefined terms and the need to prove intent. In addition, the period for reviewing transactions that grant improper preferences to certain creditors reaches back only 120 days prior to the commencement of the bankruptcy case, a period that is too short and subject to abuse. Reorganisation financing is another subject upon which the law gives no guidance. Finally, cross-border insolvency proceedings are not covered at all.

The law is weak in the area of trustees (insolvency practitioners). The provisions governing the appointment of a trustee are very basic and lack implementation details. There are no criteria regarding appointment or removal of trustees, nor is there a venue to challenge the appointment by creditors or other interested parties. The law omits to regulate the remuneration and expenses of the trustees. There are no standards of professional and ethical conduct of trustees and there is no supervisory regulatory body to investigate trustees’ behaviour and practices. Also, the obligations of a trustee to report on its activity to the court or any other body are vague. Such gaps lead to weakening of the trustee profession leaving them without the tools necessary to perform their functions in an efficient manner.

These are fundamental problems. A complete reform is currently underway (led by the German technical assistance agency GtZ).

Quality of insolvency legislation – Mongolia (2006)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the international standards such as the World Bank’s Principles and guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on “Legislative Guidelines for Insolvency Law”, and others. The fuller the ‘web’, the more closely insolvency laws of the country approximate these standards.

Source: EBRD Insolvency Sector Assessment 2006

Secured Transactions

Taking security in Mongolia is mostly governed by the 2002 Civil Code, which offers a relatively detailed framework.⁷ In addition, the Law on Registration of Rights over Immovable Property contains important provisions for the perfection of security rights over property. Court-led enforcement is governed by the Law on Enforcement of Court Orders. A Law on Non-Judicial Foreclosure of Mortgaged Assets was adopted at the end of 2005 but was then subject to constitutional challenges and has now become a dead letter. Sector specific laws also include regulations that would apply: for example, the Minerals Law has provisions that apply to the charge of mining licences.

Although the Code is relatively recent, the legal provisions applicable to security over immovable and movable property (equipment, inventory, receivables, etc) are not adapted to market economic practices and it is difficult to see the market expanding without comprehensive reform taking place. The type of movable assets and rights that can be offered as collateral is limited and does not allow for generally described assets (e.g. inventory, future equipment) to be charged. The system allows for registration of the pledge over movable property in the Land Registry (that is, against the asset’s title), which is in most cases impractical and unnecessarily limiting. Users complain that the enforcement process is slow and inefficient. As explained above, the Bankruptcy Law is wholly inadequate. As far as mortgages are concerned, most of the complaints focus on the registration process at the Land Registry and the enforcement. A new mortgage law and mortgage securities law have been in the making for some time now.

The EBRD is currently working with the Ministry of Justice to provide technical assistance for the reform of the legal framework for security rights over movable property (pledge law), which would include a complete new Law on Pledge, thorough revision of the Civil Code relevant legal provisions and the development of a specific pledge register. Progress has been quite slow until now - especially on the pledge register development and the EBRD is urging

⁷ Articles 153-185.

the government to speed up the process and invest the human resources needed to move forwards.

Securities Markets

In Mongolia the basic legislation on securities market is contained in the Securities Market Law (enacted on 12 December 2002 and amended in November 2005) and in the Law on the Financial Regulatory Committee (issued on 17 December 2005 and amended in July 2006). The Securities Market Law regulates the issuing, registering and trading of securities, the transfer of securities' ownership rights and details of investor protection and supervision of brokers. The Financial Regulatory Committee Law regulates the establishment, organisation and operation of the Financial Regulatory Committee (FRC), the Mongolian market regulator, and provides for the coordination and monitoring of financial services. With the enactment of the Financial Regulatory Committee Law the supervision of securities market participants, insurance companies, non-bank financial organisations, and credit and savings cooperatives was assigned to the FRC, while the Bank of Mongolia (the Central Bank of Mongolia) regulates the operations of Mongolia's commercial banks.

The Mongolian Stock Exchange is the only stock exchange in the country. It was created as a privatisation device and still remains largely a secondary market dedicated to this function. There are about 380 listed companies. In 2008, the FRC suspended trading in 166 listed companies for lack of trading, non-compliance with regulations, and minority shareholder abuses. At the end of 2008 the capitalisation of the market was about USD 407 million.⁸ Clearing and settlement of securities is performed by the Securities Settlement and Centralized Depository Centre LLC. There are no collective investment schemes in Mongolia and no legal regime in place for pension funds.

According to the EBRD Securities Markets Legislation Assessment conducted in 2007, the country was found to be in "medium compliance" with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO), showing a number of shortcomings in the securities markets legal framework, especially in the "market intermediaries", "secondary markets" and "financial instruments" sections. In particular, the legislation on ongoing disclosure and liquidity and solvency requirements for intermediaries, procedures for dealing with intermediaries in financial difficulties, conflict of interests, consumer protection rules, practices for monitoring large exposures and derivatives are weak.

In order to understand how securities market legislation works in practice, in 2007 the EBRD undertook a Legal Indicator Survey ("the LIS") on securities markets. Practitioners in the region were asked to comment on a hypothetical case study, advising an investor who lost his savings after buying shares in a national company's Initial Public Offering (IPO), misled by erroneous information in the prospectus. In particular, the Survey concentrated on effectiveness of prospectus disclosure requirements, private and public enforcement mechanisms and authority of the market regulator. The LIS found that IPOs are not common in Mongolia and bank financing is still the main source of financing for Mongolian corporations. The law provides for some general requirements regarding IPO prospectuses but these guidelines are not sufficient. In practice, prospectuses lack sufficient depth and sophistication to be an effective tool for investors, even with regards to the information

⁸ Data from the Federation of Euro-Asian Stock Exchanges website (<http://www.feas.org/MemberIndex.cfm>)

required by law. Private enforcement mechanisms allow for several courses of action but their effectiveness is low: procedures are complex and the expected recovery rate from legal action is very low. Securities markets institutions are unable to provide the necessary support to court action while the experience of courts, prosecutors and securities market regulator in complex corporate law cases needs to be enhanced.

The legislator should carefully assess the compliance of national legislation with international standards and consider improving both the framework and the capacity of institutions in effectively implementing the legislation, through adequate training and skills upgrade programmes. Further, the Government should promote the development of institutional investors in Mongolian capital markets especially through pension and investment funds.

Telecommunications

Institutional framework: The Communications Regulatory Commission (CRC) is responsible for the whole range of communications regulatory functions in Mongolia, including licensing, numbering, SMP designation and operating conditions, interconnection and tariffs, spectrum management, radio frequency allocation, dispute resolution, investigations, compliance including consumer protection, technical standards and the management of the universal service fund. It also provides inputs on policy formulation. The Information Communications Technology and Postal Authority (ICTPA) is responsible for the development and coordination of communications policy. The ICTA is not a Ministry but has previously acted on a par with a ministry in terms of decision-making. It reports directly to the Prime Minister's Office. The government has a 55% holding in Mongolia Telecommunication Company (MTC), with Korea Telecom possessing a 40% stake and 5% belonging to private Mongolian citizens. The government holds 100% of the Information and Communication Networking Company (ICNC).

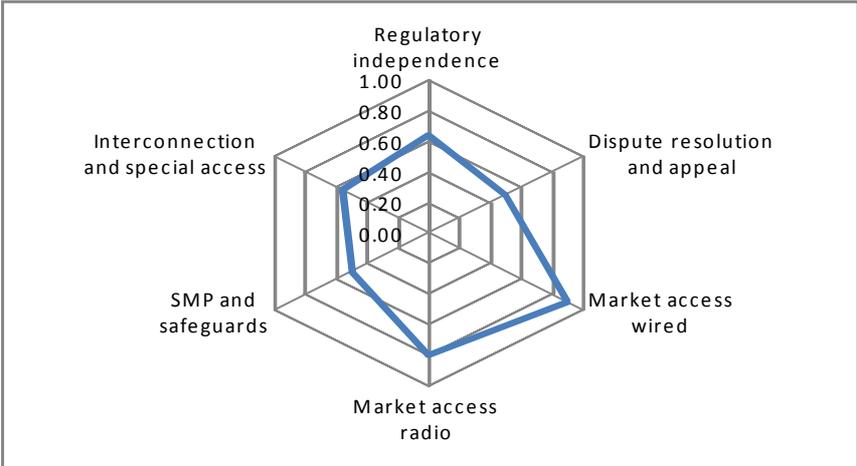
Regulatory independence: The Prime Minister nominates the Chairman and 6 non-executive Board Members of CRC on the basis of a proposal from the cabinet. The Government ratifies the annual CRC budget and CRC will have its financial report published and audited annually. The top management of the regulator can legally own up to 20 percent of common stock of a telecoms operator but it is hoped this allowance will be removed by a new code of conduct. CRC is financed through licence fees, regulatory service fees, and spectrum usage. There is no legal requirement to perform a public consultation before making regulatory decisions. There is also no legal requirement for publication, but a website has now been established as the source for consultations.

Market access and authorisation: More recently, the CRC has encouraged fair competition in defined markets, partly through increased transparency in its decision-making process. The Law on Communications 2001 liberalised the telecommunications market, although there is evidence that certain sectors (such as mobile telephony) were liberalised, to an extent, before 2001. The public fixed telephony market is technically a liberalised market but there is limited competition. MTC has the vast majority (94%) of fixed lines, with Railcom – a subsidiary of the national railway company – possessing a limited market in a small region (along its rail corridor). Authorisation is by individual licence. A new licensing regime was introduced in Mongolia in January 2008; however it is still in the process of being implemented by CRC. It emphasises technology neutrality and unification of old (separate) licences. The fees are to be set at a low rate so as not to dissuade entry/investment. Under CRC's procedure, frequency licensing should allow "first come first served". According to

the Radio Frequency Law, a tender will be announced if there are 2 or more bidders. This is reflected in the tender’s conditions. CRC determines the annual fee which depends on the power of the transmitters. The Law of Communications 2001 offers wide-ranging (general) dispute settlement powers. There is no appeals body per se; the court may be referred to if there is a dispute.

Assessment: In a 2008 assessment of the communications sector of EBRD Countries of Operation the sector regulatory regime Mongolia was deemed to have “Medium Compliance” when measured against international best practice.

Key indicators for Mongolia from the EBRD Assessment



This spider diagram includes six main group indicators. For each indicator, the diagram presents the scores as percentages of the maximum achievable score. The scores begin at zero at the centre of the chart and reach 1.00 at the outside, so that in the overall chart, the wider the web, the better the score in the assessment.

(see <http://ebrd.com/country/sector/law/telecoms/assess/index.htm> for more details).

Annex 5 – Approved Bank Operations as of end September 2009

SECTOR NAME	COMMITMENT				NET PORTFOLIO			
	No of project	Total project cost	EBRD Funding	% of total EBRD	Portfolio	% of Portfolio	Undrawn commitments	Operating assets
Corporate								
Agribusiness	4	23	14	11%	14	12%	0	14
General Industry	4	9	9	7%	9	8%	1	8
Subtotal	8	32	23	18%	23	21%	1	22
Natural Resources	11	284	83	66%	70	63%	11	59
Financial Institutions								
Bank equity	1	5	5	4%	5	5%	0	5
Bank lending	4	0	3	2%	3	2%	0	3
Small business finance	4	16	12	10%	10	9%	0	10
Subtotal	9	21	20	16%	18	16%	0	18
COUNTRY TOTAL	28	337	126	100%	110	100%	12	98

Annex 6 – Indicative Project Pipeline as of end September 2009

	Number of Transactions	Amount in EUR million	% of Grand Total (No of Transactions)
ENTERPRISE SECTOR			
General Industries	2	6	13%
Agribusiness	0	0	0%
TOTAL	2	6	13%
FINANCIAL INSTITUTIONS	4	23	25%
NATURAL RESOURCES	8	106	50%
INFRASTRUCTURE			
Transport	0	0	0%
Power and Energy	2	19	13%
TOTAL	2	19	13%
GRAND TOTAL	16	153	100%

* The list of pipeline projects does not represent any commitment by the Bank. It does not include potential projects that might emerge later during the strategy period.

Annex 7 – Technical Co-operation Portfolio

Commitment Number	Commitment Name	Euro Committed	Euro Disbursed	Fund Approved Date	Commit. Stage Name
EBSF-2008-07-07	Mongolia: Zoos Bank	600,000	15,000	16/07/08	Committed
EBSF-2008-09-18F	Initiation and support of the BAS Programme in Mongolia (ESSF)	298,160	0	19/09/08	Committed
EBSF-2008-12-83	Mongolia Multi-Bank Framework : MSME Lending and Leasing	500,000	0	08/12/08	Committed
EBSF-2009-02-21F	TAM - Petrovis	75,000	0	17/02/09	Committed
ETCF-2006-12-45	Mongolia Multi-Bank Framework : MSME Lending and Leasing	1,000,000	661,346	07/12/06	Disbursing
ETCF-2007-02-13	Mongolia: Upgrade and Enhancement of Insurance Regulations	300,000	26,665	22/02/07	Disbursing
ETCF-2007-07-36	Mongolia: Investment Council - Head of Secretariat	70,848	26,545	20/07/07	Disbursing
ETCF-2007-08-37	Investment Council in Mongolia: Executive Assistant to the Head of the Secretariat	13,939	6,751	06/08/07	Disbursing
ETCF-2007-09-42	Investment Council in Mongolia - Miscellaneous	36,781	34,864	05/09/07	Disbursing
ETCF-2007-10-46	Technical Capacity Building for Erdenes and MRPAM - Part A	115,000	0	25/10/07	Committed
ETCF-2007-10-47	Technical Capacity Building for Erdenes and MRPAM - Part B	83,600	0	25/10/07	Committed
ETCF-2008-03-12	Ulaanbaatar City Clean Air Initiative - Phase I	325,000	68,879	28/03/08	Disbursing
ETCF-2008-07-22	Mongolia: Secretariat to the Investment Council - Legal Expert	18,010	8,875	08/07/08	Disbursing
ETCF-2008-07-24	Investment Council in Mongolia: Economic/Financial Consultant	18,011	8,875	14/07/08	Disbursing
ETCF-2008-07-26	Mongolia: Zoos Bank	600,000	15,000	16/07/08	Committed
ETCF-2008-08-29	Investment Council in Mongolia: Economic/Financial Consultant	12,150	5,062	28/08/08	Disbursing
ETCF-2008-12-43	Mongolia Multi-Bank Framework: MSME Lending and Leasing	500,000	0	08/12/08	Committed
ETCF-2008-12-44	Investment Council in Mongolia: Economic/Financial Consultant	10,158	2,282	11/12/08	Committed
ETCF-2009-01-01	Investment Council in Mongolia	23,222	15,299	08/01/09	Disbursing
JAP-2007-05-21F	TAM - Screenings in Mongolia	50,500	7,537	03/05/07	Disbursing
JAP-2007-10-47F	TAM - Khatamsuikh impex Co.	74,440	19,537	10/10/07	Disbursing
JAP-2007-10-48F	TAM - Newcom Systems	74,440	47,028	10/10/07	Disbursing
JAP-2007-10-49F	TAM - TavanBogd cosmetics Co.	74,440	38,337	10/10/07	Disbursing
JAP-2007-10-50F	TAM - United Solutions International Inc	74,440	31,830	10/10/07	Disbursing
JAP-2007-10-51F	TAM - Nomun Inter Trade	74,440	55,442	17/10/07	Disbursing
JAP-2007-12-65	Mongolia: Renewable Energy Regulatory Development Road Map	290,000	141,500	14/12/07	Committed
JAP-2008-03-06F	Darkhan Nekhil JSC	74,440	30,026	18/03/08	Committed
JAP-2008-03-07F	TAM - Monrud	74,440	20,051	18/03/08	Disbursing
JAP-2008-03-08F	TAM - Munkhiin Tun	74,440	21,240	20/03/08	Disbursing
JAP-2008-04-11F	TAM - Geomandal LLC	74,440	13,577	29/04/08	Committed
JAP-2009-02-03F	TAM - Gobi	74,440	0	04/02/09	Committed
LUX-2007-12-08	Mongolia: Environmental and Social Impact Assessment (ESIA) of Salkhit Uul Wind Farm	76,000	60,800	18/12/07	Disbursing
LUX-2008-09-13F	Initiation and support of the BAS Programme in Mongolia (Luxembourg)	100,000	1,577	19/09/08	Disbursing
MONF-2002-01-01	Mongolia Cooperation Fund Implementation TC - Office Rent	6,587	6,587	23/01/02	Closed
MONF-2002-04-04	Mongolia: Master Plan Study of the Civil Aviation Sector	358,543	358,543	04/04/02	Closed
MONF-2002-07-05	Mongolia Corporate Governance Assessment	6,612	6,612	12/07/02	Closed
MONF-2002-07-07	Hiring of an Office Manager - contract extension	9,360	9,360	31/07/02	Closed
MONF-2002-10-10	Mongolia Technical Cooperation Fund	20,270	20,270	11/10/02	Closed
MONF-2003-03-02	Mongolia Technical Cooperation Fund Implementation TC - Extension of Office Rent Agreement	5,296	5,296	13/03/03	Closed
MONF-2003-03-03F	Continuation of TAM Programme in Mongolia	913,420	873,886	19/03/03	Disbursing
MONF-2003-04-01F	Mongolian Bankers' Training Programme	288,545	288,545	22/04/03	Closed
MONF-2003-04-02	MIAT Management Contract	643,287	643,287	24/04/03	Closed

Commitment Number	Commitment Name	Euro Committed	Euro Disbursed	Fund Approved Date	Commit. Stage Name
MONF-2003-05-01	Mongolia power sector: Private sector participation	271,282	271,282	23/05/03	Closed
MONF-2003-05-02	Improving Corporate Governance Legal Framework and Practice in Mongolia	198,276	198,276	29/05/03	Closed
MONF-2003-10-03	Mongolia - Training on international banking operations	18,407	18,407	07/10/03	Closed
MONF-2003-10-04	Mongolia - Training on international banking operations	19,200	19,200	07/10/03	Closed
MONF-2003-11-07	Mongolia Technical Cooperation Fund - Extension of contract for the Office Manager for MCF and the office budget	16,704	16,704	18/11/03	Closed
MONF-2003-12-08	AG Bank - Micro Credit Advisors	799,140	799,140	07/12/03	Closed
MONF-2004-01-01F	Training for Mongolbank (Euromoney and Central Banking Publications)	29,835	29,835	23/01/04	Closed
MONF-2004-05-02	The Downstream Petroleum Industry in Mongolia: Development of Refining Capacity towards Sustainable Economic Development	49,497	49,497	17/05/04	Closed
MONF-2004-05-03	Privatisation Options for Mongolia Telecom	345,630	345,630	17/05/04	Closed
MONF-2004-06-04	Extension of MCFund office rent in Ulaanbaatar, Mongolia	4,163	4,163	23/06/04	Closed
MONF-2004-07-07	MIAT Management Contract: Extension of contract	392,681	392,681	15/07/04	Closed
MONF-2004-07-08	Mongolia - Additional Trade Finance Training to Mongolian bankers	23,793	23,793	21/07/04	Closed
MONF-2004-07-09	Mongolia: Training for Mongolian bankers on International Fraud and Money Laundering	21,959	21,959	21/07/04	Closed
MONF-2004-07-10	Mongolia: Treasury Products and Risk Management Training	26,470	26,470	21/07/04	Closed
MONF-2004-10-11F	SME Management Training	56,151	56,151	06/10/04	Closed
MONF-2004-10-12	Mongolia Technical Cooperation Fund	17,836	17,836	28/10/04	Closed
MONF-2005-02-02	Mongolia Cooperation Fund Office Rent	3,084	3,084	28/01/05	Closed
MONF-2005-04-03	Privatisation Options for Mongolia Telecom - Redefinition of Phase 3 (Existing TC)	200,000	200,000	08/04/05	Closed
MONF-2005-04-04	Evaluation: Mongolia Cooperation Fund Mid-Term Review	64,723	64,723	08/04/05	Closed
MONF-2005-07-05F	Mongolia: Improving Secured Transactions Regime (Phase 1)	180,000	97,884	26/07/05	Disbursing
MONF-2005-08-06	Mongolia: Credit Analysis Training for Mongolian Bankers	17,628	17,628	25/08/05	Closed
MONF-2005-09-07	Mongolia: Telecommunications Regulatory Development Programme	749,995	749,995	27/09/05	Closed
MONF-2006-01-01	Mongolia: Capital Markets Review and Strategy Recommendations	49,160	49,160	13/01/06	Closed
MONF-2006-01-02	Mongolia: Technical Assistance in respect of the Possible Rehabilitation of Domestic Airports	350,000	297,151	25/01/06	Disbursing
MONF-2006-02-03	Mongolia Technical Cooperation Fund Office Rent	4,162	4,162	16/02/06	Closed
MONF-2006-07-04F	TAM - Goyo	110,000	102,693	07/07/06	Disbursing
MONF-2006-09-05	Mining Authority Capacity Building	55,127	55,127	07/09/06	Closed
MONF-2006-09-06	Mining Authority Capacity Building - Module D	20,204	20,204	26/06/06	Closed
MONF-2006-09-07	Mining Authority Capacity Building	25,081	25,081	26/09/06	Closed
MONF-2006-10-08	Privatisation Options for Mongolia Telecom	50,000	50,000	23/10/06	Closed
MONF-2006-11-09	Mongolia: TFP UCP 600 Seminar	12,320	12,320	08/11/06	Closed
MONF-2006-11-10	Mongolia: TFP - Advisory Services on Trade Finance	163,070	163,070	08/11/06	Closed
MONF-2007-01-01	Ulaanbaatar Financial Due Diligence and IFRS Audit	69,888	69,888	25/01/07	Closed
MONF-2007-01-02	Ulaanbaatar Urban Transport Project: Project Preparation Advisory and Due Diligence	32,777	32,777	29/01/07	Closed
MONF-2007-02-03	Technical Assistance to EBRD for business Plan Preparation and Portfolio Prioritisation for MAK Mining Company	90,000	73,916	12/02/07	Disbursing
MONF-2007-04-04	Mining Authority Capacity Building - Reimbursement of staff travel and translation costs	20,000	14,554	10/04/07	Disbursing
MONF-2007-06-05F	Mongolia medium sized enterprise projects support facility	800,000	278,012	06/06/07	Disbursing
MONF-2007-06-09F	Feasibility Study for a BAS Programme in Mongolia - Framework	34,482	28,289	26/06/07	Disbursing
MONF-2008-01-01F	TAM - Samoson	75,200	64,972	10/01/08	Disbursing
MONF-2008-01-02F	TAM - Metro Express	33,000	19,471	10/01/08	Disbursing
MONF-2008-01-03F	TAM - NIG	41,820	33,968	28/01/08	Disbursing
MONF-2008-01-04F	TAM - NIG	32,180	25,966	28/01/08	Disbursing
Total in EUR		13,687,621	8,441,428		
No of Commitments:		84			

Annex 8 – Technical Co-operation Project Pipeline

Project Title	Amount (EUR)	TC Com Approved (Y/N)	Team	Status of Funding
Investment Councils in selected ETCs	359,000	13/05/2009	SEECCA	Cofinancing - ETC Fund & SSF
Secured transactions reform implementation	350,000	N	Legal Transition	
Ulaanbaatar Clean Air Initiative - Phase II	796,425	03/06/2009	Legal Transition	Submission states: ETC/SSF funding will be sought.

Annex 9 - TAM/BAS Activities

Previous TAM/BAS experience in Mongolia

TAM/BAS supports economic transition by achieving enterprise change in potentially viable micro, small and medium-sized enterprises (MSMEs) in the EBRD countries of operation. Since inception in 2001, TAM/BAS in Mongolia has mobilised over €3.6 million. Funding has mainly been provided by Japan, the Netherlands, Luxembourg, and Taipei, China, the multi-donor EBRD-Mongolia Cooperation Fund and the EBRD Shareholder Special fund

TAM

TAM supports the introduction of international best practice in SMEs with the potential of becoming future leaders in their market through the introduction of international Advisors from developed countries with 15-20 years professional experience in the relevant sector. TAM projects typically last around 18 months. The Programme also carries out seminar and training activities promoting international best practices by disseminating successful case-studies to entrepreneurs. Since inception in 2001, TAM has undertaken a total of 41 projects, 19 of which are still in progress, with the scope to start 7 more projects in the near future, currently at the pre-project, screening stage. TAM projects have a wide coverage across industry sectors with Food Manufacturing, Textiles and Pharmaceuticals the most common sectors. TAM has worked with a fairly even distribution of micro, small and medium-sized enterprises. The geographic distribution of projects has been concentrated on the capital, with nine in ten projects concerning enterprises in Ulaanbaatar. Of projects fully completed, 88% have been rated satisfactory or better. What has been identified as a key factor for TAM project success has been the degree of willingness and eagerness of the staff of assisted enterprises to learn from the TAM team.

BAS

BAS acts as a facilitator for the use of local, private-sector consultants by MSMEs to obtain a diverse array of services. BAS works on the demand and the supply side. By assisting individual enterprises to engage with local consultants on narrowly-based, specific projects with a rapid payback, it stimulates demand and the understanding of the potential benefits of using external consultants. It also directly increases the supply and quality of local advisory services, through targeted market development activities. BAS supported projects typically last around four months. BAS established operations in Mongolia in October 2008. In the next three years, BAS plans to undertake business advisory projects with more than 200 MSMEs, as well as targeted market development activities. Although its operational resources will be based in its office in Ulaabaatar, BAS will focus on underdeveloped and rural areas. Emphasis will also be given to energy efficiency/renewable energy, environmental protection/certifications, gender equality and assisting minorities.

An undeveloped MSME sector dominated by micro enterprises

MSMEs account for more than 90% of company registrations and over 70% of GDP. Virtually all MSMEs are privately owned, with the state's company holdings concentrated on large, strategically important infrastructure and mining enterprises. The composition of the MSME sector has changed little over time. The majority of Mongolian MSMEs have no more than five employees and more than 95% of companies have less than 50 employees. Family-owned businesses are very common, especially in the agricultural sector. Most MSMEs are engaged in retailing and other services. Mongolian MSMEs compare poorly with other Early Transition Countries (ETCs) on several measures of technology absorption, in terms of auditing/accounting standards, bureaucracy (especially licences/permits), registering property, protecting investors and paying taxes. The sector faces serious challenges in terms of

Government policy and coordination of efforts

production quality, export opportunities, investment finance, and business sophistication more generally.

International donors have played a key role in establishing a system of MSME support organisations in Mongolia. Chambers of commerce and employers' associations have a wide national coverage, and are complemented by several industry associations and governmental agencies.

BAS should work with these organisations to reach out to potential clients, especially in rural areas. However, these organisations have limited capacity and experience. Given the high spill over potential it is recommended that they, like MSMEs and local consultants, are also included as possible BAS clients.

The highest governmental authority dealing with MSME policy issues is the SME and Technology Development Department, which sits within the Ministry of Industry and Trade. A law has been passed which supports the establishment of a separate MSME agency to implement policy. One of the agency's tasks will be to create business incubators in provinces. For overall planning and coordination of MSME policy, a special SME National Council will be established with representatives from ministries, chambers of commerce, MSME federations and the mayor's office of Ulaanbaatar city.

International donor activities

Although the international donor community in Mongolia is very active in terms of the volume, diversity and geographical spread of projects, there is little risk of counterproductive overlap between TAM/BAS and other donor-funded operations. This is because no other donor programme is able to cover all regions of the country as TAM/BAS sets out to do, and also because of the very large pool of enterprises that have never received international donor assistance (the Mongolian Co-operative Training and Information Centre estimates that only 10% of MSMEs have received donor funding). BAS is also fairly unique in its intention to expand operations in Mongolia at a time when many other donors are scaling down their operations.

Market for local consultancy services

BAS Mongolia has registered over 40 local consultants representing 15 different consulting firms and associations. These cover a wide range of services including accounting and finance, management, information technology, marketing, business planning, investment, human resource management, software development and system analysis.

Enterprises are open to business advice and are willing to undertake advisory projects. Thanks to long-term activities of international donor programmes (GTZ, USAID, UNDP, Merci Corps, and the TAM Programme among them), a high proportion of Mongolian MSMEs sees the value of business advisory services, and is willing to pay at least part of the costs. It should be stressed that Mongolian MSMEs expect high quality consulting and training from both local Mongolian and international experts.

Recommendations for future TAM/BAS interventions

The complementary TAM and BAS Programme instruments can be flexibly designed to address the problems faced by Mongolian enterprises and give much-needed momentum to the development of private-sector MSMEs. Sustainability of the impact of TAM/BAS operations in Mongolia will be achieved by providing management advice and mentoring (primary expertise of TAM) and consultancy market development activities geared to building a sustainable infrastructure of business advisory services (key competence of BAS).

In terms of economic sectors, TAM/BAS will attempt to focus on those with the greatest export potential, including food-processing, textiles, and machinery and equipment, as well as sectors that support successful exports, such as logistics for mining operations. The travel and transport services also have high export potential. TAM/BAS will attempt to diversify the geographical spread of its activities beyond Ulaanbaatar to the large cities of Darkhan, Erdenet and Choibalsan. TAM/BAS will

Continuation of TAM	<p>seek to complement its enterprise assistance role with market development activities in order to maximise the Programme's transition impact.</p> <p>The main impediments faced by Mongolia MSMEs, which could be addressed by the TAM Programme relate to product quality, marketing, and from an organisational management perspective, strategic planning, human resources and more effective delegation of management responsibilities.</p>
and BAS	<p>The main impediments faced by Mongolian MSMEs which could be addressed by BAS Programme relate to management effectiveness, employee skills and product quality issues. These impediments can be addressed through targeted advisory services, including assistance with business planning, improved management controls, HR training, staff training, engineering studies and other consultancy services.</p> <p>The BAS grant should remain a key component of BAS assistance, helping financially constrained enterprises to access consultancy services. A Grant Guideline Matrix is proposed in order to prioritise intervention, maintain additionality and to avoid duplication of efforts from international donors. Higher grants should be given to:</p> <ul style="list-style-type: none"> • Micro and small enterprises, particularly women-owned and women-managed, the group with the least experience with business advisory services and lowest level of business sophistication. • Enterprises located outside of the capital and other large cities, as these tend to need the most help, and often find it difficult to access appropriate business advisory services and do not have the necessary financial resources to pay for them. • Projects aiming to improve market performance (i.e. long term viability and contribution to GDP) and to improve energy efficiency and environmental management.
in addition to targeted market development activities	<p>It is recommended to complement TAM/BAS assistance at the enterprise level with the following market development activities in order to maximise the Programme's transition impact in Mongolia:</p> <ul style="list-style-type: none"> • Visibility and dissemination: The TAM/BAS Programme should take steps to promote the use of business advisory services (for example by disseminating successful case-studies to entrepreneurs) and TAM should organise more seminars and trainings related to international best practices. • MSME and consultancy training: The TAM/BAS Programme should broaden the supply of advisory services and address the existing gaps by providing trainings and seminars covering core consultancy skills as well as more sophisticated areas of advisory assistance, in need from Mongolian MSMEs. • Support to and development of existing relevant local institutions – particularly in relation to the market for local business advisory services: It is recommended that relevant employers' and industry associations are included as possible BAS beneficiaries in order to strengthen their capacity.
Addressing cross cutting issues	<p>TAM/BAS will aim to expand its work in Mongolia in relation to energy efficiency/renewable energy (EE/RE), environmental protection (EP) and environmental certification (EC) programmes. As a normal element of its support to MSME development, TAM/BAS identifies energy-saving opportunities and advises on reducing environmental pollution. EE/RE, EP and EC initiatives are often addressed together, in order to find comprehensive solutions to environmental degradation and inefficient energy usage. In addition, BAS provides higher subsidy rates for energy efficiency and environmental management projects and raises</p>

This Brief as contribution to EBRD's policy dialogue and input for enhanced linkages with banking

awareness of related issues through market development activities. TAM/BAS will also promote women entrepreneurship and female participation in business as an avenue to achieving its transition mandate in the country. Gender considerations will be a key component of TAM assistance, whilst BAS will provide higher grants for women-owned and managed enterprises and will organise targeted workshops to encourage business start-ups.

This Country Brief strengthens the EBRD's policy dialogue toolkit by analysing the business environment and identifying key challenges faced by the MSME sector. TAM/BAS can also contribute to strengthened linkages with EBRD banking activities by referring successful Mongolian enterprises it works with to the EBRD, or EBRD-related financial institutions, for investment consideration. TAM/BAS can also provide project assistance to enterprises in the EBRD's pre- or post-investment phases.

In line with TAM/BAS Strategic Plan 2008-2010, TAM/BAS will continue to assist the Bank to meet its objective of creating a commercially viable project pipeline for the Bank by (1) helping to identifying potential pipeline (pre-investment), (2) providing "consulting and business" services for the preparation and support of Bank private enterprise financing projects and for the enterprises themselves, and (3) providing candidates for non-executive board member positions. TAM/BAS will link MSMEs in need of finance with available EBRD instruments, including direct investments, as well as credit lines from EBRD-supported local banks.

In addition, TAM/BAS will participate in the integrated development of an industrial cluster in the area surrounding a coal mine in the South Gobi Region of Mongolia, in which the Bank has a sizeable investment. Assistance is expected to foster industrial linkages leading to sustainable development in the region.

Annex 10 - Bilateral Assistance

France

Since 2003, the French Ministry of Foreign Affairs has been running a fund dedicated to food assistance in Mongolia. This fund is now entirely geared towards micro-credit operations to the benefit of nomadic populations. In particular, it supported the replenishment of livestock after the severe droughts which affected Mongolia a few years ago. It is now mainly financing housing improvement and the purchase of basic agricultural equipment as well as seeds.

In 2008, France and Mongolia approved two financial protocols. These soft loans, in process of implementation, are financing the building of a water treatment plant in Erdenet (Euro 9 million) and the equipment of an air quality monitoring system in Ulan Bator (Euro 2 million).

In 2009, the French government extended the mandate of *Agence Française de Développement* (AFD) and *Proparco* (AFD's affiliate dedicated to private sector) to Mongolia.

Under decentralized bilateral cooperation, several French local authorities are also conducting projects in health and education sectors in Mongolia.

Germany

Germany and Mongolia have enjoyed extremely friendly relations, which have grown out of the longstanding links between Mongolia and the former German Democratic Republic (GDR). Many people in Mongolia can speak German. The development co-operation that currently exists with Mongolia began in 1991, following the country's political and economic transformation. Before that, Mongolia had received development support from the GDR. The GDR was the main donor of aid through COMECON after the Soviet Union.

With commitments and commitment authorisations of around EUR 268 million since 1991, Mongolia is one of the countries that receive most support from Germany per capita. This is in part a reflection of the special long-standing friendly relations between the two countries and in part in recognition of the democratisation of Mongolia and the country's efforts in terms of structural reform and poverty reduction.

German-Mongolian development co-operation initially focused on the central problems of the country:

- Establishment of a market economy and support for economic reforms (including the associated legal framework and a functioning financial system),
- Infrastructure for energy and transport, areas of particular importance for the country,
- Environmental protection (protection of natural resources, renewable energies).

In October 2001, it was agreed that, in view of changing circumstances (developments in the country, involvement of other donors) and in order to improve efficiency, co-operation would in future concentrate on the following priority areas:

- Sustainable economic development (formerly: economic reform and development of the market system),
- Environmental policy (including energy efficiency, renewable energies and natural resources).

Measures should also concentrate more on rural areas.

Overview of commitments (since 1992)

	Commitments 1992-2001 ¹⁾	2002/03 (Two-year commitment)	2004/05 (Two-year commitment)	2006/07 (Two-year commitment)	2008/2009 (Two-year commitment)	Sum total of commitments to date (from 1992)
	EUR mln (DEM mln)	EUR mln	EUR mln	EUR mln	EUR mln	EUR mln
FC	78,23 (153)	10	9 +9,3 ³⁾	9	9,0	124,53
TC in the strict sense	62,9 (123)	10 +1 ²⁾	11 +1 ⁴⁾	9,5 +0,5 ⁵⁾	9,5 +2,0 ⁶⁾	107,4
Subtotal	141,13 (276)	21	30,3	18,5	20,5	231,93
TC in the broad sense					2,0	36,2
Total⁷⁾						268,13

1) In 1998, two-year commitments were introduced

2) Commitment during Parliamentary State Secretary Eid's visit to Mongolia: EUR 1 million for „Training and re-training of lawyers”

3) a) EUR 3.0 million Special funding for measure of global significance (energy efficiency),

b) EUR 3.0 million (2005 commitment authorisation) secondary loan with equity features to the XAC Bank micro finance institution with conversion option,

c) EUR 3.3 million (2005 commitment authorisation) loan programme to promote housing construction

4) Special funding for measures of global significance (HIV prevention measures)

5) Special commitment of EUR 0.5 million (2007 commitment authorisation) for environment communication and environment education

6) Special commitment of EUR 2.0 million for biodiversity and climate change

7) Excluding funding from the German states and other German ministries

Source: German Federal Ministry for Economic Co-operation and Development (BMZ)

Italy

With regard to the cooperation activity between Italy and Mongolia we are aware of a project aimed at sustaining the Mongolian Authorities in improving the health system in the country.

Said project, approved by the Italian Authorities on October 9th, 2006, concerns in particular the “Improvement of the Maternal and Child Health Research Centre of Mongolia (IMCHM)” and foresees a soft loan of Euro 5.160.000 and a grant of Euro 396.000. The Memorandum of Understanding between the Italian and the Mongolian Government was signed in November 2007. The project strategy is to improve the capacity of the N. Gendenjamts’s Memorial – Maternal and Child Health Research Centre Hospital in Ulaanbaatar (MCHRC) through: (i) responding (at highest referral level) to the mother and child health problems, (ii) strengthening its capacities as teaching and research centre, (iii) supporting the strengthening of managerial and organizational skills of its managers, (iv) supporting the improvement of the MCH referral system (with some selected provincial hospitals in Ulaanbaatar).

The main activities envisaged by the cooperation project, which should soon start its implementation phase, are the following: supply of equipment; civil works (building renovation and improvements); training of medical doctors and nurses; training of maintenance engineers and technicians; improvement of communication and referral system in six hospitals (related to MCH).

Japan

Since Mongolia started its transition in politics and economics in 1990, Japan has been actively engaged in supporting the process through its official development assistance programme. In the early stage of transition, Japan’s support mainly focused on stabilizing the turbulent economy and the mitigation of social constraints by Balance of Payments supports (approximately USD140 million in 1990-93) while investing in the rehabilitation of key

infrastructures such as main railway lines and a power station (approx. USD160 million during 1991-95) with grants and concessional loans.

In November 2004, Japan compiled "the Country Assistance Program for Mongolia" as a basic document which indicates the policy directions of Japan's assistance to Mongolia. This document articulates the Japan's overall goal as the support of Mongolia's self-improvement efforts toward poverty reduction through sustainable economic growth and clarifies the following four priority areas:

1. Support for institution building and human resource development necessary for promoting a market economy.
2. Support for rural development (support for certain model development areas centred on regional development hubs, revitalization of pasture, livestock breeding and farming).
3. Support for environmental protection (preservation of the natural environment as well as appropriate utilization of natural resources, and measures against environmental problems in Ulaanbaatar).
4. Support for development of infrastructure to promote economic activity.

Japan is currently extending assistances according to these priorities and the major projects by loan and grant schemes in recent years include two-step loan for SMEs development and environmental protection (ODA Loan: JPY 2,981 million or EUR 22.1 million), construction of a new airport (ODA loan: JPY 28,807 million or EUR 213.7 million), improvement of primary education facilities (grant: JPY 7,441 million or EUR 55.2 million), improvement of the arterial road (grant: JPY199 million or EUR 1.5 million) and construction of railway fly-over (grant: JPY 3,658 million or EUR 27.1 million). Most recently, USD 50 million budget support to Mongolia was announced in March 2009. Technical assistances cover such subjects as environment, legal reform and human resources development.

Korea

Mongolia was the first socialist country in Asia to form diplomatic ties with Korea in 1990. Since then, the bilateral relation has shown steady improvement, together with the introduction of the market economy in Mongolia. Given that Korean government's recent plans to expand development and cooperation by increasing its official development assistance (ODA) to a level commensurate with Korea's economic status in global economy, assistance to Mongolia is now occurring at much faster rate.

Assistance to Mongolia from Korean Economic Development Cooperation Funds (EDCF) has increased from USD 5.2 million in 1991 to USD 84 million in 2008. In terms of the cumulative committed amount, Mongolia ranked 14th among the 45 recipient countries, sharing 2.0% of total EDCF. The EDCF has contributed to developing mainly the ITC/transportation/energy/health sector and government communications network.

Mongolia is classified as priority recipient countries in Korean grant aid. The amount of the grant to Mongolia has also sharply increased from USD 1.5 million in 1991 to USD 12.3 million in 2008, which increased 105.4% from the previous year. The total amount of cumulative contribution reached to USD 39 million by 2008. In terms of the grant commitment in 2007, Mongolia ranked 10th among the 170 recipient countries, sharing 2.6% of total grant for the recipient countries. The grant was donated mainly for the development of the infrastructure/human resource/rural/health sector, disaster relief and reconstruction, MDGs, NGO and international institutions activities.

Korean direct investment in Mongolia in 2008 increased 31.7%, USD 58.4 million from the previous year. Due to the worldwide financial crisis, the growth rate for investment in 2008 decreased to 31.7% from 128.6%, the previous year. The number of new Korean enterprises established in Mongolia by direct investment increased 46.3%, 79 enterprises in 2008 from the previous year. In terms of industry, investment in the information and communication sector has been the most significant, followed by investments in mining, leasing and construction.

Korea-Mongolia Bilateral Assistance (1991-2008)

USD million	1991~2000	2001	2002	2003	2004	2005	2006	2007	2008	Total
EDCF	33.7	-	-	-	23.9	-	26.3	-	-	83.9
Grant Aid	8.5	2.1	0.9	1.7	1.8	2.8	3	6	12.3*	39.0
FDI	11.6	2.6	2.9	1	3.3	6.7	19.4	44.3	58.5	150.3

* Preliminary figure

Korean Government will continue to make efforts to contribute to the development of Mongolia in the hope to play a major role in strengthening the economic and diplomatic ties between the two countries.

Luxembourg

In addition to having been a donor to the EBRD Mongolia Cooperation Fund with a financial contribution of EUR 1 million, Luxembourg enjoys an ongoing fruitful bilateral cooperation programme with Mongolia, which focuses mainly on the health, environment and finance sectors.

A health care programme aimed at improving the prevention and treatment of cardiovascular diseases has been launched in 2001 and funding from Luxembourg has been extended through 2010 for a total budget of EUR 2.5 million.

As a complement to this programme Luxembourg is supporting a maternal health telemedicine project for EUR 1 million. A Mongolia/China cross-border HIV prevention project is being supported by Luxembourg funding of EUR 230,000.

In the environment sector Luxembourg has contributed EUR 1 million to a disaster mitigation and management system in Mongolia.

In the financial sector, the Luxembourg Government has made available more than EUR 1 million to cover Mongolian technical assistance needs through training and advisory programmes, most of which have been provided by the Luxembourg agency ATTF ("Agence de Transfert de Technologie Financière"), created in 1999 at the initiative of the Luxembourg Government with the objective to transfer banking and financial know-how especially to emerging countries.

ATTF partners in Mongolia include the Ministry of Finance, the Bank of Mongolia, the Association of Mongolian Insurers and the Financial Regulatory Commission (FRC). Topics covered encompass the functioning of a financial centre; banking and financial industries in a market economy; credit assessment; banking risks; banking performance; banking marketing and strategic planning; branch management; external and internal audit; international financial markets; globalisation; risk management; asset and liability management; private banking;

new financial products; communication skills; leadership; human resources management; anti-money laundering.

Starting in 2009 a capacity-building and training programme for the FRC will be rolled out for an initial amount of EUR 2 million. Luxembourg is also funding a EUR 1 million capacity-building programme for the development of the micro-insurance market in Mongolia. Furthermore an amount of EUR 500,000 has been used to fund a programme aimed at strengthening the Mongolian pension system.

In addition, Luxembourg funding has also been devoted since 2005 to cover the tuition fees of students from Mongolia to attend full-time courses at the Luxembourg School of Finance.

In light of the above, total financial aid extended by Luxembourg to Mongolia currently stands at EUR 10.5 million.

Netherlands

The main goal of the Dutch financed development cooperation programme in Mongolia is to create a sustainable environmental situation which enables economic development and hence contributes to poverty reduction. Therefore the Dutch development cooperation programme is focused on the environmental sector.

The selected priorities are based on the latest Mongolian and Dutch policy developments, other donor activities and the Mongolian commitments through international conventions on Climate Change and Biodiversity. The ultimate goal of the environmental programme is to assist Mongolia in achieving the international targets of sustainable development and (indirectly) poverty reduction as formulated in the United Nations Millennium Development Goals and the targets set at the World Summit on Sustainable Development.

Concretely, the environmental programme focuses on the following themes that are deemed especially relevant to Mongolia:

- Protection and sustainable use of the environment (with focus on management of steppes, forest and water);
- Increased access to drinking water;
- Adaptation to Climate Change.

The environmental programme will be implemented according to the Paris Declaration and the EU Code of Conduct, with specific attention to optimizing harmonization and alignment between donors and the Government of Mongolia, and according to the principles of sustainable development.

The activities that are supported by the Dutch development cooperation programme match the abovementioned priority areas, have to be in line with the Mongolian action plans and other development strategies of the Mongolian government, and with the Dutch policy on development cooperation, including the so-called “GAVIM” objectives (Dutch acronym for good governance, poverty reduction, women and development, institution building, and environment). The Dutch policy focuses on a result-oriented approach and activities should clearly contribute to the Dutch targets on achieving the Millennium Development Goals.

The main project partners are various Mongolian Ministries - in particular the Ministry for Nature, Environment and Tourism - USUG with Vitens Evides International, Mongolian and Netherlands' Red Cross, Hustai Trust, World Bank, GTZ, UNDP, FAO and The Asia Foundation.

The annual budget for the implementation of the 'Multi Annual Strategic Plan for Development Cooperation in Mongolia' is around 9 million Euro. The 'Multi Annual Strategic Plan for Development Cooperation in Mongolia' is coordinated by the Embassy of the Kingdom of the Netherlands and assisted by the Netherlands' Embassy Liaison Office in Ulaanbaatar, Mongolia. Between 2001 and 2008 the Netherlands has, in total, given 47 million USD of ODA to Mongolia. (The Netherlands is therefore the biggest EU Donor after Germany). The current budget is 8.2 million Euro per year.

USA

The U.S. Agency for International Development (USAID) plays a lead role in providing bilateral development assistance to Mongolia. The program emphasizes one major theme: sustainable, private sector-led economic growth and more effective and accountable governance. Total USAID assistance to Mongolia from 1991 through 2008 was about \$174.5 million, all in grant form. USAID Mongolia's FY 2007 budget of \$6.625 million a year promotes: a) economic growth by focusing on activities that support macroeconomic policy reform, energy sector restructuring, financial sector reform, and micro and small enterprise development; and b) governing justly and democratically by focusing on activities supporting judicial sector reform, electoral reform, parliamentary reform, and anti-corruption.

In most years since 1993, the United States Department of Agriculture has provided food aid to Mongolia under the Food for Progress and 416(b) programs. The monetized proceeds of the food aid (\$4.2 million in 2006) are used to support programs bolstering entrepreneurship, herder livelihood diversification, and better veterinary services.

The United States has also supported defence reform and an increased capacity by Mongolia's armed forces to participate in international peacekeeping operations. Mongolia has contributed small numbers of troops to coalition operations in Iraq and Afghanistan since 2003, gaining experience that enabled it to deploy armed peacekeepers to both UN and NATO peacekeeping missions in 2005.

The Peace Corps has approximately 100 volunteers in Mongolia. They are engaged primarily in English teaching and teacher training activities. At the request of the Government of Mongolia, the Peace Corps has developed programs in the areas of public health, small business development, and youth development. In 2005 and 2006 Mongolian Government officials, including President Enkhbayar and Prime Minister Elbegdorj, requested significant increases in the number of volunteers serving in country. The Peace Corps has responded with a commitment to make modest annual increases until 2010.

Mongolia was one of the first countries eligible for the new Millennium Challenge Account initiative that began in 2004, administered by the Millennium Challenge Corporation (MCC). On October 22, 2007, at a White House signing ceremony, President Bush and President Enkhbayar signed a Millennium Challenge Compact for Mongolia that calls for \$285 million to be spent on four projects over a five-year period beginning in September 2008. The Compact will support efforts to broaden and deepen economic development in Mongolia by focusing on four key areas, including rail modernization, property rights, vocational education, and health.

Annex 11 – Assessment of Transition Challenges

The table below provides an overall Assessment of Transition Challenges rating for 2009 (as Mongolia was not included in the 2005 assessment). Scores range from negligible, small, medium and large. “Negligible” means that the remaining challenges are minor and that the sector is well advanced in moving towards a well-functioning market economy. “Large” means that the remaining challenges are major and that this dimension of the sector is at an early stage of reform. The overall rating in 2009 is based on individual ratings for market structure and market-supporting institutions and policies (see methodology annex circulated separately).

Mongolia	Market Structure	Market Institutions	Overall 2009
Agribusiness	Medium	Medium	Medium
General Industry	Large	Medium	Large
Property and Tourism	Large	Large	Large
Telecom	Large	Medium	Medium
MEI	Medium	Large	Large
Natural Resources	Medium	Large	Large
Power	Large	Large	Large
Sustainable Energy	Large	Large	Large
Transport	Large	Medium	Large
Banking	Medium	Medium	Medium
Insurance and financial services	Large	Medium	Large
MSMEs	Large	Medium	Medium
Private equity and capital markets	Large	Medium	Large

1. Assessment of Transition Challenges by Sector

1.1. Corporate

Agribusiness

Market structure: Medium

Institutions/policies: Medium

Mongolia has started comparatively early to liberalise the trade and price regime and completed the liberalisations by 1996. Subsidies to the agricultural sector are also minimal with the exception of government intervention on bread prices. Large and small scale privatisation is largely complete. However competition and restructuring of the agribusiness sector along the whole value-chain remains slow and modern retail hasn't developed as yet. Quality and hygiene standards remain a major challenge for the whole sector. The biggest bottleneck seems lack of financing to rural areas and insufficient investment into rural infrastructure including warehouses, logistics, specialised infrastructure and primary processing assets.

General Industry

Market structure: Large

Institutions/policies: Medium

General industry faces limited market distortions. Large-scale enterprises are almost fully private and in some cases, have attracted foreign investors. However, a majority of foreign direct investment to date has been in the mining sector. Expansion of private enterprises and restructuring of former state-owned enterprises are key to improve productivity and efficiency. Strengthening of market supporting institutions to ease market entry and exit, improve corporate governance and business standards is also a major challenge.

Property and Tourism

Market structure: Large

Institutions/policies: Large

The property market is at early stages of development and there is a severe shortage of quality housing, and a lack of supply for modern commercial property in all sub-segments. The legal system does recognize the concept of collateralized assets and there is no mortgage law. Therefore the mortgage market remains very small. However, to increase liquidity (buy/sell mortgage assets from banks and other investors), commercial banks and the central bank established the Mongolian Mortgage Corporation. The inability of Mongolians easily to register and obtain clear titles to their land poses a serious obstacle to the promotion of real property ownership and is an impediment for investors seeking land for commercial, agriculture, tourism and industry development. Some progress has been achieved in the context of a “Cadastral Survey and Land Registration Project”, which supported the mapping of land parcels slated for privatization. The accuracy, accessibility and efficiency of the formal system for recognizing and transferring land rights is expected to improve in the context of a “Property Rights Project”, which is currently being implemented. Tourism is a growing industry in Mongolia and there are a number of foreign invested hotels in Ulaanbaatar, but significant challenges remain, especially in rural areas. Tradability of land is limited de facto.

Telecommunication

Market structure: Large

Institutions/policies: Medium

The telecoms market was fully liberalised by 2001, but there is still limited competition in the fixed-line market as the five alternative operators managed to capture only about 10 per cent of the market. The regulator is financed through license fees, regulatory service fee and spectrum usage, but the existing level of maximum fines allowed is insignificant and interconnection remains an issue. Access, especially in rural areas, and affordability are a challenge, but universal access fund was established and there is transparent system to bid for the government subsidies to establish telecom networks in rural areas. Two additional mobile licenses were awarded in 2005/2006 to Unitel and rural mobile operator G-Mobile, bringing the total number of mobile network operators to four, resulting in explosive growth of Mongolia’s mobile industry and reducing the market share of the dominant MobiCom from some 90 per cent few years ago to 65 per cent in June 2008. Internet penetration is strong in the urban centres, but the rural sector is also catching up with over 50 per cent of provincial centres having high speed Internet access. Broadband subscriber penetration rate, however, is still very low.

1.2. Energy and Infrastructure

Municipal and Environmental Infrastructure

Market structure: Medium

Institutions/policies: Large

The 1995 Water Law allowed municipalities to manage water and wastewater provision and set tariffs (and regulation). Private sector participation so far has been limited to a few management contracts. Tariffs are relatively close to cost recovery for most services/ user groups, but access to piped clean water is very limited even in the capital Ulaanbaatar. The sector is least advanced in terms of metering.

Public bus companies have been corporatised, but the bulk of investment is financed by donors. Very little progress has been made with commercialisation of transport services and tariffs are too low. Urban transport planning is underdeveloped and traffic management is at an incipient stage.

Natural Resources

Market structure: Medium

Institutions/policies: Large

Mongolia's mining sector is a major contributor to the national economy, accounting for almost 30 per cent of GDP and 65 per cent of export revenues. Mines are corporatised but the state still dominates coal production and subsidises producers which are loss makers. Mongolia also has small oil reserves but lack of refining capacity has left the country reliant on imported fuel. The petroleum retail market has been liberalised and is dominated by private players, following the acquisition of the ex state-owned monopolist, NIC, by Petrovis. Competition is still constrained by the limited number of players and Petrovis-NIC large market share.

Market supporting institutions and policies are still weak and there are large gaps. Recent changes to the regulatory regime governing the mining sector risk undermining the country's attractiveness to foreign investors. A new mining law introduced in 2006 raised royalty rates on metals extraction, and removed some tax holidays. In May 2006 the government also introduced a windfall tax on copper and gold producers. The new law also gives the government the right to acquire up to a 34 per cent stake in strategic deposits explored with private funding, and up to 50 per cent in those developed with some state funding.

The implementation of the EITI is playing a key role in strengthening resource revenue management and transparency. Mongolia issued the first report in February 2008, covering company payments and government receipts in 2006. However, the auditors identified a number of issues requiring further investigation. The Bank mobilised donor funding for capacity building in favour of the Mineral Resources Authority of Mongolia (MRPAM), an implementing agency of the Mongolian Ministry of Industry and Trade which is responsible for issuing mineral licenses. The agency is not yet fully independent and a key challenge ahead will be to strengthen its capacity, especially in view of the greater role that the state is likely to take in the mining sector going forward. Developing a system of effective regulation will be key.

Power

Market structure: Large

Institutions/policies: Large

The Mongolian power system is corporatised and legally unbundled but still state-owned. It faces significant practical challenges because of the small size of the power market in a very large country. Privatisation attempts failed because of the weak regulatory framework and heavy debt overhang. Recently a new CHP was tendered on a concession basis but there was only one bidder, a Chinese corporation with whom discussions are ongoing. The generation system therefore remains ageing, polluting and inefficient while also heavily dependent on Russia for system balancing. There are a number of PPP projects in south Gobi under discussion, driven either by the opportunity to sell power to China or the need for power to support mineral exploitation. To allow these to progress the regulatory and contractual capacity of the government to cope with PPP projects needs to be strengthened. Tariffs have been increased but remain below cost recovery levels. In 2008, the government decided to provide limited amounts of electricity for free to low income households. The transition challenges in the energy sector include the restructuring of power sector companies, cleaning up of their debts, much needed improvement of environmental practices, as well as strengthening the independence of the regulator and gradual introduction of market liberalisation. Tariff methodologies also need to be revised to attract investment into ageing and inefficient assets. Mongolia has introduced a feed-in tariff mechanism to support the exploitation of its considerable renewable energy resources (notably wind) but the regulatory regime surrounding this is weak and developments are slow.

Sustainable Energy

Market structure/outcomes: Large

Institutions/policies: Large

Energy tariffs are still not costs reflective and do not include environmental costs. Therefore price signals do not provide incentives to use energy efficiently and to invest in RES projects. The legal framework is missing and institutions are weak or non-existent. The extensive use of coal, coupled with inefficient equipment, generate high energy and carbon intensities. No energy efficiency law, policies or agencies exist. There are no specific policies or incentives for RE implementation. The UNFCCC and Kyoto protocol has been ratified, but no climate policies have been developed.

Transport

Market structure: Large

Institutions/policies: Medium

Railways are owned and operated by the Mongolian Railways, which is a 50:50 joint venture between Russian railways and the Mongolian Transport Ministry since 1949. The railway operates profitably, but the sector is under-funded and there are serious capacity constraints. There is no private sector involvement, but currently some PPP projects are under consideration. In 1997, a first business plan was prepared and the cost accounting system improved. The further expansion of commercial railway capacity is needed.

The road network covers about 11,000 kilometres, of which only about 13 per cent is paved. The Ministry of Roads, Transport and Tourism has overall responsibility for roads policy, with the Roads Authority (a division of the Department of Roads and Transport) responsible for construction and maintenance. Despite Mongolia's high percentage of unpaved roads, the government budgets less than 1 per cent of GDP for maintenance expenditures. The road authorities need to improve the efficiency and transparency of road construction and maintenance.

1.3. Financial Institutions

Banking

Market structure: Medium

Institutions/policies: Medium

Bank lending has expanded rapidly recently, but this expansion slowed markedly from 2008. Access to finance has improved considerably, with market competition being very strong in urban areas. In and around the capital city market saturation and over-indebtedness have become material issues of concern. This also holds for some rural areas, where consumer financing has made important inroads. Non-performing loans have recently increased. Remaining transition challenges include broadening the equity base of banks, expanding the maturity of available loan products, fulfilling the demand for local currency lending, introducing leasing, and introducing health, cattle, crop and other forms of insurance. The institutional framework of the financial sector has improved in recent years, through the establishment of an independent regulator in 2006 and the establishment of a Credit Information Bureau. A deposit insurance scheme is still lacking.

Insurance and financial services

Market structure: Large

Institutions/policies: Medium

Regulation and supervision of non-bank financial institutions was set out in several laws passed in the early 2000s. The state insurance company was privatised in 2004 and a number of new companies entered the market, however, the former state monopoly continues to enjoy a disproportionately high market share. The

life insurance market is virtually non-existent, and there is also unmet demand for health, cattle, crop and other forms of insurance. The state (defined-benefit) pension system remains largely unreformed, with no private pension funds to date. The leasing sector remains relatively underdeveloped.

Micro, Small and Medium-sized enterprises

Market structure: Large

Institutions/policies: Medium

While the government has made progress with financial sector reforms, the cost of and access to finance still present obstacles for some enterprises. A credit information bureau is being established. Although MSME lending is currently provided by a small number of banks and often still on a collateralised basis, bank lending has expanded rapidly over the last years, but has come to a halt more recently. Access to finance has improved considerably, with market competition being very strong in urban areas. In and around the capital city, market saturation and over-indebtedness have become material issues. This also holds true for some rural areas, where consumer financing has made important inroads. Non-performing loans have recently increased as well as currency mismatching as banks tend to lend in US\$ while enterprises revenue streams are in local currency. Long term financing remains difficult to access throughout the country.

Private equity and capital markets

Market structure: Large

Institutions/policies: Medium

Securities legislation showed some weaknesses, for instance in money laundering, and the effectiveness of implementation was found lacking. The local stock exchange is not fully functioning (only limited hours and trading remains thin), and listing requirements and their enforcement is weak (e.g. most of listed companies do not publish annual reports or do not hold annual meetings). Nevertheless, in 2008, stock market capitalisation increased significantly to US\$ 723 million (about 16 per cent of GDP) from US\$ 112 million in 2006. There have been seven initial public offerings (IPOs) during 2007-08 after several years of no issuances. A commercial private equity sector is yet to develop and to date a few international private equity funds showed interest and started operations in Mongolia but their activities remain limited. A challenging business environment, limited investment opportunities and poor exit prospects all conspire against this sector.