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# Mongolia: Strengthening Fiscal, Financial, and Economic Resilience Subprogram 1

## Project Name

Strengthening Fiscal, Financial, and Economic Resilience Subprogram 1

## Project Number

55209-003

## Country / Economy

- Mongolia

## Project Status

Closed

## Project Type / Modality of Assistance

- Loan

## Source of Funding / Amount

Loan 4356-MON: Strengthening Fiscal, Financial, and Economic Resilience Subprogram  
1

### Source

### Amount

Ordinary capital resources US\$ 100.00 million

## Operational Priorities

- OP1: Addressing remaining poverty and reducing inequalities
- OP2: Accelerating progress in gender equality
- OP6: Strengthening governance and institutional capacity
- OP7: Fostering regional cooperation and integration

## Sector / Subsector

- **Finance** / Finance sector development
- **Public sector management** / Public expenditure and fiscal management

## Gender

Effective gender mainstreaming

## Description

Mongolia's current growth trajectory is a critical period to implement and accelerate structural reforms. More specifically, these reforms should address challenges related to strengthening public financial management, the finance sector, and the role of the private sector in the quest for economic diversification.

The proposed program comprises a set of complementary medium-term structural reforms, focused on strengthening the country's fiscal, finance sector, and economic

resilience against the impact of exogenous shocks. More specifically, the program supports medium-term reforms focused on (i) improving domestic resource mobilization, by leveraging a critical set of tax administration and tax policy reforms; (ii) boosting debt sustainability through improving debt management and the management of sovereign liability risks; (iii) improving finance sector stability and resilience through strengthened banking sector supervision and regulation, enhancing NPL resolution, and promoting financial consumer protection; and (iv) strengthening the upstream environment for private sector development through relevant legal reforms, support for public private partnerships; and reforms focused on turning the Development Bank of Mongolia into an institution with a viable value proposition and operating model.

## Project Rationale and Linkage to Country/Regional Strategy

Favorable macroeconomic conditions and outlook. After a 4.6% gross domestic product (GDP) contraction in 2020, and weak growth of 1.6% in 2021, Mongolia's economy expanded by 5.0% in 2022. While the first three quarters of 2022 were characterized by continued trade disruptions with the People's Republic of China (PRC) and the impact of the Russian invasion of Ukraine, economic prospects and expectations have improved since the fourth quarter of 2022. This is mainly because of the reopening of the PRC's economy, strong external demand, recoveries in coal production and merchandise exports, successful refinancing of a sovereign bond, and the stabilization and subsequent rebounding of foreign exchange reserves. After a deficit in 2022, the current account recorded a sizeable surplus in 2023 and foreign exchange reserves increased considerably. According to the Asian Development Outlook April 2023, growth is forecast to reach 5.4% in 2023 and 6.1% in 2024.

Sustainable debt over the medium term amid fiscal consolidation. Increased revenues of the Government of Mongolia led to improvements in fiscal performance registering an overall fiscal surplus of 0.8% of GDP in 2022, compared with a deficit of 3.1% in 2021 and 9.5% in 2020. The economy also recorded a fiscal surplus of about \$580 million in the first half of 2023, underpinning overperformance of revenues and fiscal consolidation. Meanwhile, the structural fiscal deficit has been significantly reduced from 12.3% of GDP in 2020 to 6.7% in 2021 and 1.9% in 2022. It is projected not to exceed 2.8% of GDP during 2023-2024 and to level out at 2.0% from 2025 onward. Mongolia's public debt-GDP ratio in 2022 equaled 72%, which is 5.1 percentage points below the 2019 level, underpinning efforts to reduce public debt exposures. In January 2023, the government successfully refinanced a \$530 million international bond, which matured in May 2023, substantially reducing the external debt repayment risk by maintaining its access to international debt markets. The IMF has assessed that while Mongolia's public debt remains high, it is sustainable over the medium term, supported by fiscal consolidation.

Structural development constraints. The reliance on mining revenues renders the Mongolian economy vulnerable to exogenous shocks. Consequently, the country experiences repeated boom-and-bust cycles. The current growth trajectory is the third major expansionary economic cycle since 2008, making it a critical period for the country to implement and accelerate structural reforms to sustain growth and strengthen its fiscal, financial, and economic resilience. These reforms should address critical challenges related to public financial management, the finance sector, and the role of the private sector in the quest for economic diversification.

Public financial management challenges. The dependence on mining revenues also imparts volatility to Mongolia's public finance (resource mobilization, public expenditure, and debt management). During the coronavirus disease (COVID-19) pandemic, Mongolia's tax-GDP ratio dropped from 25.9% in 2019 to 22.7% in 2020. While this was a significant decrease, it still put the country well above the 19.8% average for Asia and the Pacific. Recovery has since been steady, with the tax-GDP ratio gradually increasing from 25.9% over 2021 to 29.4% over 2022 and 33.3% for the first quarter of 2023, signaling continued recouping.

Notwithstanding these positive developments, Mongolia's tax administration and collection systems have structural weaknesses that compromise the government's tax mobilization potential. These include outdated institutional and organizational arrangements, gaps in tax compliance (resulting in tax arrears), weaknesses in risk management, weak taxpayer services, and low tax literacy. Mongolia is also not yet fully compliant with critical international tax cooperation treaties, although important progress has been made in this area. Finally, the tax administration and its information systems need to be made more responsive to gender-specific needs, e.g., in micro, small, and medium-sized enterprises (MSMEs).

A second structural constraint concerns weaknesses in public debt management. The risks associated with contingent liabilities linked to sovereign guarantees, build and transfer concession agreements, and state-owned enterprise debt pose a threat to fiscal sustainability. Significant gains could be made by adopting a risk-based approach to issuing sovereign guarantees and by adopting a contingent liability management mechanism.

Finance sector constraints. The finance sector is dominated by banks, which account for more than 90% of its assets. The five systemically important banks (SIBs) meet the prudential requirements of the Bank of Mongolia (BOM), including their capital adequacy and liquidity ratios. Core challenges are the need for enhancements to banking regulation and supervision, combined with the need to improve the banks' asset quality. Risks are underpinned by the volatile economic conditions, global monetary policy tightening, and tightening of external financing conditions. Additional monetary tightening by the BOM in tandem with global trends, combined with domestic inflationary pressures, could further tighten domestic financing conditions, including for MSMEs. Higher interest rates could trigger a rise in banks' NPL ratio, which was 8.6% as of July 2023 (while high, this is a decline from the recent peak of 11.5% in October 2022). Weakening of banks' balance sheets could undermine their capacity to extend credit to support a sustained economic recovery.

The initial public offering of the five SIBs by June 2023 strengthened banks' capital adequacy. It also resulted in more diversified shareholder ownership, strengthening corporate governance. The legal environment of financial consumer protection needs substantial improvement. Despite an increase of 4.3 times in total market capitalization over the past 4 years (as of May 2023), capital markets remain shallow and cannot offer a stable source of long-term finance to improve the country's public debt profile and to foster private sector development and economic diversification.

Supervisory and regulatory frameworks need further alignment with international standards, as outlined in the BOM's comprehensive Medium-Term Banking Sector Strengthening Program for 2020-2023. This program followed the IMF's Extended Fund Facility, 2017-2020, which featured several key reforms in the finance sector,

including improving the capital adequacy of banks and the resolution of NPLs. A key challenge for NPL resolution is a lengthy insolvency procedure, which requires legislative improvements. Efforts to enhance banking sector supervision and regulation need to be well designed and sequenced. In addition, developing local currency domestic bond markets could contribute toward a stable source of long-term finance for corporations, thereby supporting business development and performance. It would also allow the re-establishment of a local currency yield curve to promote domestic capital market development.

Challenges to economic diversification. A key long-term development challenge for Mongolia is to diversify its narrow economic base, which would contribute to economic resilience. Mongolia's mining sector accounted for 27.3% of GDP and 93.0% of exports in 2022, underpinning the economy's vulnerability to swings in global commodity markets. The vast potential to develop non-mining sectors has not yet materialized. MSMEs are often constrained by lack of finance. Measures to alleviate financing gaps will improve MSME performance and make the economy more gender-inclusive (the MSME sector has particularly high women's participation and ownership). In addition, the private sector plays a negligible role in infrastructure investment. Recent developments in the upstream environment, including the approval of the PPP law and the ongoing preparation of several PPP regulations, could unlock PPP investments. However, the institutional framework still poses several constraints to developing bankable projects. Legal and regulatory reforms are needed to improve the investment climate for domestic and foreign investors in non-mining sectors. Finally, the DBM should play a strategic role in promoting economic diversification and improving competitiveness, but significant (corporate) governance and balance sheet challenges prevent it from delivering on that role.

Alignment with New Recovery Policy and Strategy 2030. The program is aligned with the government's overall development objective of fostering an inclusive and resilient economy in the longer term. The program is also aligned with the following Asian Development Bank (ADB) Strategy 2030 operational priorities: addressing remaining poverty and reducing inequalities; accelerating progress in gender equality; strengthening governance and institutional capacity; and fostering regional cooperation and integration. The program supports the overall objective of ADB's country partnership strategy for Mongolia, 2021-2024 of laying resilient foundations for inclusive and sustainable growth.

Impact

## **Project Outcome**

Description of Outcome

Progress Toward Outcome

## **Implementation Progress**

Description of Project Outputs

Status of Implementation Progress (Outputs, Activities, and Issues)

Geographical Location

Nation-wide

## **Safeguard Categories**

Environment

C

Involuntary Resettlement

C

Indigenous Peoples

C

## **Summary of Environmental and Social Aspects**

Environmental Aspects

Involuntary Resettlement

Indigenous Peoples

## **Stakeholder Communication, Participation, and Consultation**

During Project Design

During Project Implementation

## **Contact**

Responsible ADB Officer

Rosenkranz, Peter C.

Responsible ADB Department

Sectors Group

Responsible ADB Division

Public Sector Management and Governance Sector Office (SG-PSMG)

Executing Agencies

*Ministry of Finance (formerly Ministry of Finance and Economy)*

## **Timetable**

Concept Clearance

23 May 2022

Fact Finding

23 May 2022 to 30 May 2022

MRM

09 Aug 2023

Approval

05 Oct 2023

Last Review Mission

-

Last PDS Update

09 Oct 2023

## Funding

### Loan 4356-MON

#### Milestones

| Approval    | Signing Date | Effectivity Date | Closing     |         |             |
|-------------|--------------|------------------|-------------|---------|-------------|
|             |              |                  | Original    | Revised | Actual      |
| 05 Oct 2023 | 19 Oct 2023  | 09 Nov 2023      | 31 Mar 2024 | -       | 13 Mar 2024 |

#### Financing Plan

##### **Total (Amount in US\$ million)**

|              |        |
|--------------|--------|
| Project Cost | 100.00 |
| ADB          | 100.00 |
| Counterpart  | 0.00   |
| Cofinancing  | 0.00   |

#### Loan Utilization

|                            | Date        | ADB    | Others | Net Percentage |
|----------------------------|-------------|--------|--------|----------------|
| Cumulative Contract Awards | 06 Jun 2024 | 100.00 | 0.00   | 100%           |
| Cumulative Disbursements   | 06 Jun 2024 | 100.00 | 0.00   | 100%           |

Project Page <https://www.adb.org/projects/55209-003/main>

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Date Generated 20 July 2024

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