FINANCIAL SECTOR REFORMS IN MONGOLIA

By

Buyankhishig Khulan

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfilment of the requirements
for the degree of

MASTER OF PUBLIC POLICY

2004

FINANCIAL SECTOR REFORMS IN MONGOLIA

By

Buyankhishig Khulan

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
for the degree of

MASTER OF PUBLIC POLICY

2004

Professor Sang-Moon Hahm

ABSTRACT

FINANCIAL SECTOR REFORMS IN MONGOLIA

By

Buyankhishig Khulan

Notwithstanding considerable efforts in reforming the financial sector, many transition economies still face a number of challenges. These include strengthening legal and regulatory framework, encouraging competition among financial institutions and deepening financial markets. Financial markets in many transition economies are fragile and often lack ability to satisfactorily perform their economic functions. In this regard Mongolia, a landlocked country with its 2.5 million people and sandwiched between Russia and China, has taken steps towards sweeping reforms in its economy since 1990. The lessons from experience of other transition economies indicate that Mongolia's experience may replicate that of other transition economies that liberalized their financial sectors too rapidly and before the pre-conditions for a successful liberalization had been attained. In Mongolia's case it also appears that the rapid liberalization of the financial sector may have benefited the economy but it also been costly given the weaknesses in basic infrastructure, such as banking skills, poor rules of disclosure, and weak accounting and auditing standards.

ACKNOWLEDGEMENTS

I would like to express my utmost appreciation to the KDI School of Public Policy and Management for providing me an excellent opportunity to study in Korea and make friends all over the world. Words of deep gratitude go to all distinguished lecturers who imparted their invaluable knowledge and experience to us, in particular Prof. Sang-Moon Hahm, supervisor of my thesis for his helpful comments and guidance. Finally, I would like to acknowledge the warm encouragement and kind support of all staff members at the School of Public Policy and Management as well as all fellow participants.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF BOXES

LIST OF ABBREVIATIONS

AG	Agricultural Bank
ADB	Asian Development bank
BOM	Bank of Mongolia
CPI	Consumer Price Index
GDP	Gross Domestic Product
GOM	Government of Mongolia
IMF	International Monetary Fund
MNT	Mongolian togrog
NSO	National Statistical Office
PB	Post Bank
PEB	People’s Bank
RB	Reconstruction Bank
SB	Savings Bank
SOEs	State Owned Enterprises
TDB	Trade and Development Bank
UB	Ulaanbaatar
USAID	United States Agency for International Development
UNDP	United Nations Development Programme
WB	World Bank

INTRODUCTION

Notwithstanding considerable efforts in reforming the financial sector, many transition economies still face a number of challenges. These include strengthening legal and regulatory framework, encouraging competition among financial institutions and deepening financial markets. Financial markets in many transition economies are fragile and often lack ability to satisfactorily perform their economic functions.

Mongolia, a landlocked country with its 2.5 million people and sandwiched between Russia and China, has taken steps towards sweeping reforms in its economy since early 1990s. The financial sector reform was a key component of Mongolia's economic transformation toward a market-based economy. Until 1990 the Mongolian economy was based on a centrally planned model that had been adopted more than six decades ago. The financial sector was characterized by mono-banking. The State Bank of Mongolia was responsible for the regulation of the note circulation and handling of foreign exchange, including international reserves. At the same time the State Bank was the sole source of credit and served as the fiscal agent of the Government by collecting and disbursing revenue to support government and public enterprise activity. Mobilization and allocation of resources were determined by the central plan. Money and capital markets as well as non-bank financial intermediaries were virtually nonexistent. The picture changed when Mongolia started its transition to a market-oriented economy in 1990. As a main condition to secure smooth transformation from centrally planned economy to a new market-oriented one and to restore economic growth, the concept of an efficient, well-functioning financial system has become more important. With help of international financial institutions, Mongolia took steps to reform its financial system, as a result a two-tiered banking system was introduced; 5 commercial banks were established; supervisory power over financial intermediaries and greater autonomy was given to the Bank of Mongolia /the former State Bank of Mongolia/ under the Banking Act, which became effective from May 1991; the Mongolia Stock Exchange was also established.

Mongolia's financial sector development has received relatively limited attention in the past in the literature on financial reforms of transition economies. Although more than a decade passed since the wide-range reform program was put in place, Mongolia's financial sector has still a long way to go to achieve a truly market-oriented system that is more efficient and more stable. The main purpose of this paper is to examine the financial sector reforms carried out in Mongolia over the past ten years by identifying implications of the reform actions and comparing the results vis-à-vis other transition economies. The focus is given primarily on the banking sector development. The paper reviews the initial macroeconomic as well as financial situation at the early stages of Mongolia's transition to a market economy, describes the specific financial sector reform actions undertaken, their effects on monetary control, and the efficiency of financial intermediation and attempts to summarize the main lessons of the reforms. The organization of the paper is as follows. Chapter I provides a conceptual framework for the financial sector reforms, related issues, including sequencing and prerequisites for successful financial reforms. Chapter II reviews initial conditions in relation to both general economy and the financial sector. Chapter III takes a close look at the reforms in the financial sector through analyzing three different stages of financial sector development in Mongolia. The general lessons from the reform experiences are summarized at the end of the chapter. Chapter IV compares the reform efforts in other transition economies, namely CIS and CEE countries with that in Mongolia. Approaches taken in reforming the financial sectors in these countries are discussed and respective lessons are derived.

Concluding remarks contain a summary of main findings and suggestions and key policy issues that need to be addressed in the near future.

CHAPTER ONE. CONCEPTUAL FRAMEWORK

1. Understanding Financial Liberalization

Financial sector liberalization is viewed as a set of operational reforms and policy measures designed to deregulate and transform the financial system and its structure with view to achieving a liberalized market oriented system within an appropriate regulatory framework.[1] The basic premise of financial reform is that government intervention should not prevent market signals from directing the allocation of resources. Voluntary, market-based decision-making is facilitated by an efficient financial system. Until the 1980s, however, the development and efficiency of financial systems were severely undermined by government efforts to promote economic development through interest rate controls, directed and subsidized credit programs, and heavy fiscal burdens. The result was more distorted financial sectors, sub-optimal saving rates, and misallocation of investment. Empirical research shows a negative correlation between financial repression and the real rate of growth. McKinnon (1973) and Shaw (1973) have argued that a regime of financial repression, involving such policies as government controls on interest rates, or direct controls on credit allocation, tends to retard financial development and economic growth. King and Levine (1993) have tested the hypothesis that financial deepening induces growth using data on 80 countries over the period 1968-1990. They showed that various measures of financial development are strongly associated with real per capita GDP growth, the rate of physical capital accumulation, and improvements in the efficiency in which economies employ physical capital. They also show that financial development is a good predictor of future rates of economic growth, physical capital accumulation and economic efficiency improvements.

In a modern economy, an efficient financial system is essential to facilitate economic transactions and specialization in production. A stable currency and an efficient payment system reduce uncertainty and costs of economic transactions. Financial assets with the full range of yield, liquidity and risk characteristics encourage savings in financial forms. Access to a variety of financial instruments enables economic agents to pool, price and exchange risks. A more robust and balanced financial system thus contributes to growth and stability of the economy. By achieving and sustaining macroeconomic stability and by building better rule-based supervisory and regulatory systems, governments can lay the foundations for smoothly functioning financial systems. The objective of financial sector reform therefore has been to address these issues and thereby to enhance the role of the financial sector in the development of the economy. The development of the financial sector is intimately related to the development of the whole economy. At the same time, instability in the macro economy usually reverberates into the financial sector and vice versa. The contribution of finance to growth is best seen, however, in terms of an efficient and adaptable payments system (in order to have a reliable means of payment) and in terms of savings mobilization and resource pooling.

2. Sequencing the Reform

Financial reforms carry risks if they are sequenced inappropriately and insufficiently supported, and the academic literature on sequencing has tended to place financial sector reforms relatively late in the overall sequencing of reforms and to favor a

---

[1] Editors R. Barry Johnston, V.Sundarajan, 1999. *Sequencing Financial Sector Reforms*

gradualist approach. But if one takes into account the cost of maintaining the controls on the financial sector – in terms of low savings mobilization, capital flight, lack of monetary control, and an efficient allocation of resources – together with benefits for stabilization, economic growth and efficiency of successful reforms, then a strategy of more rapid financial sector reform could be desirable in terms of achieving better economic performance. However, the literature suggests broad propositions on the optimal sequencing of economic reforms, including that: (1) macroeconomic stabilization is a prerequisite to structural reforms; (2) the liberalization of domestic financial markets should precede the removal of controls on international capital flows; (3) trade and real sector reforms should precede capital account liberalization. In general, macroeconomic stability and reasonably sound banks are viewed as prerequisites for successful financial sector reforms.

CHAPTER TWO. THE MACROECONOMIC AND FINANCIAL ENVIRONMENT

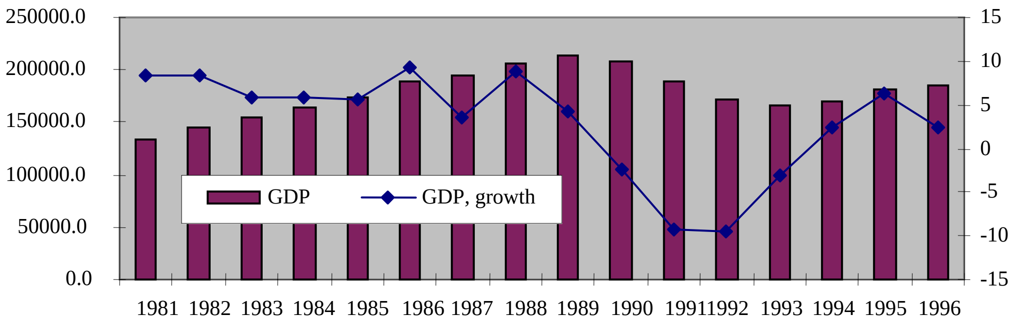
1. General economic environment

Initial conditions

In July 1990, immediately after the first multi-party elections, the Mongolian government launched far-reaching reforms aimed at creating a market-based economy. At the same time, Mongolia suffered three acute external shocks: an aid shock, a trade shock and a macro-economic shock. Financial assistance from the Soviet Union was reduced from 1.233 million USD in 1989 to zero in 1991. This aid shock, which is estimated to have been equivalent to as much as 30 per cent of the GDP, had a dramatic effect on the external accounts as well as on the government budget. The aid shock was made worse by a severe trade shock. Until 1990 approximately 90 per cent of Mongolia's external trade was with the Soviet Bloc countries, primarily the Soviet

Union. The implosion of the Soviet Union caused a near collapse of the trade. The problem was aggravated by the centrally planned nature of trade, which had resulted in a lack of horizontal contacts between trading enterprises. The combined effect of these two factors was a fall in imports from 963.0 million USD in 1989 to 374.5 million USD in 1993. Exports, too, fell, albeit less dramatically, from 721.5 million USD to 365.8 million USD in the same period. The macro-economic shock was a combination of several factors: a macro-economic crisis resulting from the aid and trade shocks and an acute lack of economic expertise in the country. In the past Soviet advisers had provided much of the economic expertise, which, in any case, was woefully inadequate for dealing with macro-economic management problems in the context of a market economy. The introduction of world market prices created a fourth shock with severe long-term implications for the economy. The structure of the entire economy as well as the choice of production technology in all fields had been based on the assumption of unlimited supply of virtually free energy. Thus, enterprises not only lost their markets, but their production technology was overnight rendered hopelessly uneconomic. With strong support from donors the Government launched an ambitious program to complete the transition to a private sector-led market economy, accelerate economic growth, and reduce poverty. Financial sector restructuring and modernization were components of the program, which also included measures to reduce inflation; liberalize input and output prices; rationalize the tax regime; downsize the state; create a legal and institutional framework conducive to private sector development; and establish a safety net for the poor. The first few years of the 1990s were characterized by considerable economic turmoil. Consumer prices averaged 187 percent between 1991 and 1993, with an inflation peak of 325.5 percent in 1992. During the same period real GDP fell by approximately 20 percent. The economy turned around in 1993/94 as GDP began to grow again at a steady although not very high rate. By 1996 GDP was almost back at its 1989 level, although in per capita terms it was still some 44 per cent below the 1990 level. (Table 1)

Figure 1. Mongolia: Gross Domestic Product, 1981-1996



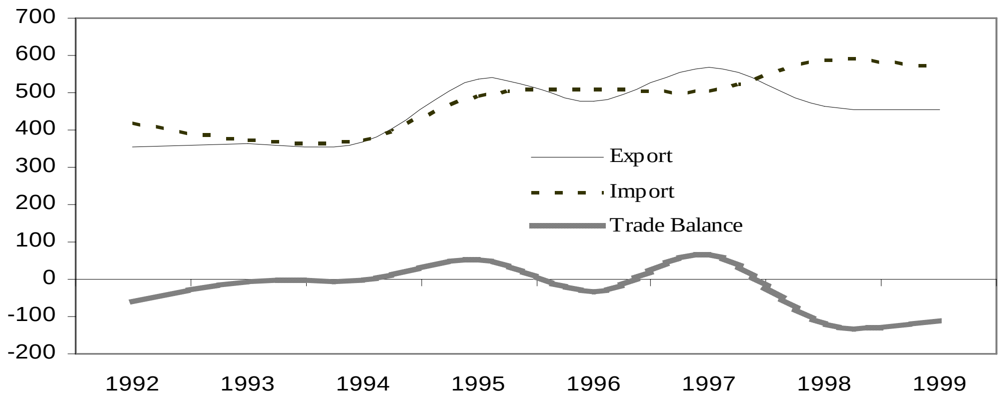
Source: Ministry of Finance and Economy of Mongolia

Other economic indicators, too, improved substantially. Inflation was gradually brought down from 66.3 per cent in 1994 to 6 per cent in 1998. The collapse of the external trade was halted and both exports and imports began gradually to increase again. The improvement in the foreign trade was intimately linked to an impressive re-orientation of the trade pattern. By 1998 Russia accounted for only 12 per cent of the exports and 31 percent of the imports, while China, Switzerland, Japan and South Korea had emerged as major trading partners. A sharp increase hit the trade deficit in 1998, due to a drastic decline in copper prices, did not alter the positive picture with regard to trade but underscored the vulnerability of the external sector to price fluctuations of key raw materials.

Table 1. Macroeconomic indicators 1990-2003 /in percent of GDP, unless otherwise indicated/

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Real GDP growth (%)	-2.5	-9.2	-9.5	-3.0	2.3	6.3	2.4	4.0	3.5	3.2	1.1	1.0	4.0	5.5
Industry (%)	0.3	-12.5	-9.7	-6.4	1.7	17.4	-2.0	-3.3	4.2	1.1	2.7	16.5	4.7	0.5
Agriculture (%)	-1.3	-4.4	-2.1	-2.7	2.7	9.5	4.7	4.3	6.4	4.2	-14.9	-18.5	-10.7	4.5
Consumption	92.0	90.9	76.1	87.6	88.7	78.2	72.7	68.5	79.8	85.6	83.6	83.1	-	-
Private	62.2	65.8	57.3	61.0	60.4	63.0	57.8	56.1	63.3	68.6	66.3	62.6	-	-
Government	29.8	25.1	18.8	26.6	28.3	15.1	14.9	12.4	16.5	17.0	17.3	20.5	-	-
CPI (annual % change; end of period)	-	52.7	325.5	183.0	66.3	53.1	44.6	20.5	6.0	10.0	8.1	8.0	1.6	4.7
Total revenue and grants	50.9	38.1	26.6	34.7	31.0	26.3	25.2	26.7	29.4	28.8	34.4	39.4	38.4	40.7
Total expenditure and net lending	94.2	70.3	40.2	52.5	44.2	31.5	32.7	34.5	41.9	39.4	42.1	43.9	44.4	45.2
Current budget balance	-8.8	-13.3	-1.7	5.9	3.2	6.2	4.0	1.6	-0.7	-0.3	3.1	5.7	4.4	8.1
Overall budget balance	-43.3	-32.2	-13.5	-17.7	-13.3	-5.2	-7.5	-7.8	-12.5	-10.6	-7.7	-4.5	-6.0	-4.5
Export (in millions of USD)	660.7	346.5	355.8	365.8	367.0	537.4	475.8	568.5	462.3	454.3	535.8	521.5	524.0	615.9
Import (in millions of USD)	924.0	486.5	418.4	374.5	374.9	488.9	510.8	503.4	582.4	567.3	614.5	637.7	690.7	801.0
Trade balance (in millions of US $)	-263.3	-140.0	-62.6	-8.7	-7.9	48.5	-35.0	65.1	-120.1	-113.0	-78.7	-116.2	-166.7	-185.1
GDP (in millions of USD)	1902.7	145.5	144.6	532.8	690.4	1218.3	1159.2	1049.0	971.5	905.6	946.6	1016.3	1117.5	1188.4
Population (thous. persons)	2149.3	2187.2	2215.0	2250.0	2280.0	2293.7	2329.9	2311.3	2344.5	2359.0	2390.5	2425.5	2458.9	2489.7
GDP per capita (USD)	885.3	66.5	65.3	236.8	302.8	531.2	497.5	453.9	414.4	383.9	396.0	419.0	454.5	477.3

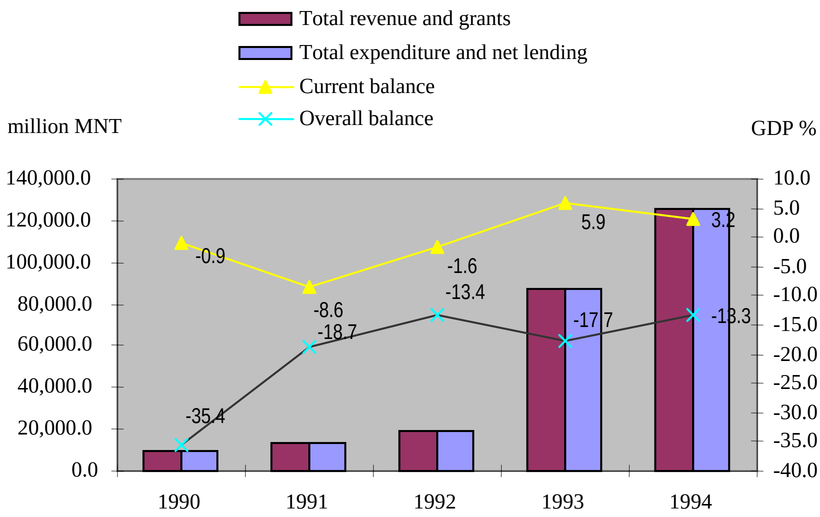
Figure 2. Mongolia: Foreign Trade Balance, 1992-1999 (in millions USD)



Source: Ministry of Finance and Economy of Mongolia

The fiscal sector, too, has by and large developed satisfactorily. However, in the early stages of transition the fiscal deficit soared high reaching 35.4 percent in 1990. But it averaged around 16 percent during 1991-1994. In later years it has been kept within manageable proportions, except in 1998 when a mini-crisis due to the fall in copper prices affected the budget. (Table 1)

Figure 3. Mongolia: Fiscal Balance, 1990-1994



Source: Ministry of Finance and Economy of Mongolia

The changes that occurred in the initial stages of the transition spawned a vigorous private sector response, enabling the overall level of economic activity to recover, despite the progressive shrinkage of activities that dominated the economy under the old regime. Following the initial transition period, when the output plummeted, Mongolia achieved a sustained recovery during 1994-1999, with real GDP growth averaging 3.4 percent, exceeding the 0.8 percent population growth rate.

2. Financial Sector Situation

Initial conditions

Prior to 1991, when Mongolia's transformation from a centrally planned to a market-based economy was initiated, the financial sector operated under the monobank system administered by the State Bank. Under the Council of the Ministers' decrees of 1954, the State Bank was empowered to carry out both central banking functions including the issuance of currency, the management of official foreign exchange, and the provision of credit according to the annual credit plan developed in line with the annual production plan. Commercial banking operations were undertaken by 21 branches of the State Bank and their 19 regional divisions, 164 subdivisions, and 260 savings institutions (teller unit). These regional divisions and units provided full banking services, which included accepting deposits, extending credit, and executing orderly settlements of payments among economic agents.

Access to bank credit was restricted to enterprises in production sector and to a few enterprises in the service sector; government and budgetary entities were not permitted to use bank credit directly. The aggregate amount of credit to be extended was centrally determined, and the State Bank allocated global amounts among its regional branches, which were in turn, distributed by branch managers to enterprises. All credit was extended without collateral, partly reflecting the lack of a legal framework for property transfer. Bank credit comprised two categories: short-term and long-term mainly for capital investment; short-term credit was available only to state enterprises and cooperatives primarily to meet seasonal liquidity needs; no short-term credit was extended to the household sector, which was, however, permitted to borrow long-term loans. Deposits offered by the State Bank consisted of three broad types: current accounts, savings account, and foreign currency deposits. Until 1989, current accounts with checking facilities were available only to the general government and economic entities in production sector, but subsequently began to be held as well by private cooperatives. Savings deposits were available only to households, while foreign currency deposits were held mainly by Mongolian foreign trading companies.

Monetary policy was framed by the Council of Ministers, of which the Chairman of the State Bank was a member, and the State Bank implemented decisions on monetary policy in coordination with the Ministry of Finance. Monetary policy was generally passive, as the banking system's role was to allocate credit according to an annual credit plan so as to ensure the attainment of output and investment objectives. Liquidity and credit were regulated solely through administrative control and quantitative limits. Consequently, interest rates were seldom adjusted and were kept low (2-4 percent per annum, with loan rates generally below deposit rates), although they tended to be positive in real terms reflecting the virtual nonexistence of inflation.

Credit expansion was generally modest prior to 1991, as the credit plan was elaborated taking into account the expected mobilization of deposits. Despite signs of acceleration in 1990, domestic credit growth averaged 7 percent per year during 1988-90. (Table 2) At the end of 1990, domestic credit stood at MNT 6.6 billion, of which credit to non-banks (public enterprises and private sector) amounted to MNT 8 billion as the government's net position with the banking system registered a surplus. Among non-banks, public enterprises were predominant borrowers, accounting for 94 percent of total credit; about 70 percent of credit extended to non-banks represented short-term credit. Reflecting the limited expansion in domestic credit, the growth of broad money was also fairly moderate, averaging about 14 percent during 1988-90. Of the total outstanding of broad money at the end of 1990, narrow money accounted for 85 percent.

Table 2.Mongolia: Monetary Survey, 1988-1990

	1988	1989	1990
	(in millions of MNT, end of period)		
Net international reserves	290	308	270
Other foreign assets (net)	-251	-41	-364
Net domestic assets	4735	4821	6552
Domestic credit	5786	5903	6574
Net credit to government	-2209	-2050	-1454
Credit to non-banks	7995	7953	8028
Public enterprises	(7606)	(7562)	(7550)
Private sector	(389)	(391)	(478)
Other items net	-1051	-1082	-22
Broad money	4774	5083	6458
Narrow money	3022	3505	4750
Currency in circulation	526	577	737
Demand deposits	2496	2929	4013
Public enterprises	(2117)	(2518)	(3439)
Private sector	(384)	(411)	(573)
Quasi-money	1753	1578	1708
Time/savings deposits	(1585)	(1478)	(1557)
Foreign currency deposits	(168)	(100)	(151)
		(annual percentage change)	
Domestic credit	6.5	2.0	11.3
Credit to government	9.1	7.2	29.1
Credit to non-banks	1.7	-0.5	0.9
Public enterprises	0.6	-0.6	0.2
Private sector	27.1	0.5	22.3
Broad money	9.1	6.5	27.1
Narrow money	6.6	16.0	35.5
Currency in circulation	7.4	9.7	27.7
Demand deposits	6.4	17.4	37.0
Quasi-money	13.9	-10.0	8.2

Source: The Bank of Mongolia

The initial conditions for financial sector reforms are summarized in Table 3.

Table 3. Mongolia: Summary of Pre-reform Situation

	Mongolia
Macroeconomic situation	
Fiscal situation	Serious difficulties
Monetary situation	Non market system; high inflation
Exchange rate system	Controlled rates
External debt	Heavily indebted
Structural situation	
Price system	Comprehensive controls
Regulatory system	Central planning system
Tax system	Undeveloped
Trade system	State trading
Exchange controls	
• Current account	Controlled system
• Capital account	Controlled system
Financial sector	
• Interest rate controls	Comprehensive
• Public ownership	Total
• Central bank independence	None
• Indirect instruments	Not developed
• Money market	Non-existent
• Prudential regulation	Undeveloped
• Bank supervision	Undeveloped

CHAPTER THREE. FINANCIAL SECTOR REFORMS

Financial sector reforms are expected to produce certain desirable effects, some of which are specific to the financial sector and can be mainly or exclusively attributed to these reforms, whereas others are more macroeconomic in nature and can not be easily disentangled from the effects of overall macroeconomic policies and structural reforms. The more direct financial sector reforms (accompanied by appropriate monetary policies) can be judged on the basis of some indicators including the reduction of monetary expansion and inflation, the maintenance of positive real interest rates, the increase in financial deepening, the growth of credit to the private sector in real terms, decline in normal interest rate spreads, and reduction in operating costs. The following four indicators were chosen in the case of Mongolia to assess the financial sector performance at different stages of its development: (i) financial deepening, measured by the ratio of M2/GDP, which shows the size of the formal financial intermediary sector relative to economic activity, (ii) amount of cash outside banks to money supply (iii) total loans made by the banking system to GDP; and (iv) total time deposits of the banking system to GDP.

Table 4. Mongolia: Main indicators of financial intermediation, 1991-2003

	1991	1992	1993	1994	1995	1996	1997
M2/GDP %	52.4	27.6	21.9	23.7	18.5	19.9	20.4
Cash outside banks/ M2 %	17.1	14.1	20.5	24.4	25.1	32.5	29.3
Total loans/GDP %	68	40.4	16.2	16.3	11.5	10	6.1
Total time deposits/GDP %	10.6	9.3	5.2	8.9	7.0	5.4	5.4

	1998	1999	2000	2001	2002	2003
M2/GDP %	20.5	23.8	25.4	29.7	37.9	51.6
Cash outside banks/ M2 %	33.7	39.6	39.0	33.0	25.7	18.7
Total loans/GDP %	10.5	8.4	6.6	12.1	18.6	32.4
Total time deposits/GDP %	5.5	5.5	6.4	9.1	13.4	21.0

Source: The Bank of Mongolia

On the basis of the trends and changes in indicators of financial intermediation for the past ten years it is possible to distinguish three different periods of development for the banking system:

- Transition to a market-based financial system: Evolution of institutional and policy reforms (1991-1993)
- Period of banking crises following liberalization in the economy (1994-1999)
- Stabilization of the banking system since 1999.

The main objectives of the financial sector reforms in Mongolia over the last decade were to institute a market-oriented financial system with improved monetary control and efficient financial intermediation. However, the reform objectives varied at different stages of the financial sector development.

1. Transition to a market based financial system: Evolution of institutional and policy reforms (1991-1993)

Mongolia completed the first phase of banking sector reforms soon after it started on the path of market-based overhaul of the economy in 1990. These were confined to few immediate objectives of dismantling the monobanking system and establishing a two-tier banking system. The Bank of Mongolia was given considerable autonomy and mandate for maintaining monetary stability and supervising operations of commercial banks. Reforms began with the split-up of the state mono-bank into a central bank (Bank of Mongolia or BOM) and five commercial banks: the Investment and Technological Innovation (ITI) Bank; Trade and Development Bank (TDB); Ardyn (or Peoples') Bank; Agricultural Bank (AB), and Insurance Bank. Banking legislation and regulations were prepared with donor support. In 1991, BOM also began licensing private banks. During the first half of the decade, ten small private commercial banks were licensed: Mongol Post; Cooperative, Exim /UB/; Industrial (later changed to Innovation); Business; Central Asia; Mercury; Selenge; Autoroad; and Bayanbogd.

Under the centrally planned economy, holding foreign currency was prohibited and severely punished. Beginning almost right at the start of the transition in 1991, citizens and residents were allowed to hold foreign currency; foreign currency deposits and loans were instituted in commercial banks; the US dollar became a medium of exchange alongside the MNT; and capital account controls were eliminated. Until 1993, the official exchange rate was fixed and kept far below the market exchange rate. At the beginning of the transition, interest rate controls were lifted; however, bank interest rates lagged far behind inflation, which accelerated dramatically in the early 1990s. In 1993, the BOM instituted an interest rate floor on commercial bank time deposits, to ensure that these interest rates would be positive in real terms.

Unfortunately, in 1991 when first commercial banks started conducting their business the central bank lacked institutional infrastructure and experience to carry out monetary policy and system of bank supervision was absent. As a consequence, M2 aggregate shot up by 77 percent in 1991, 32 percent in 1992, 227 percent in 1993 with concomitant rise in inflation of 325.5 in 1992, which has been worst inflation experience for single year in Mongolia.

In addition, during these period some officials in the top management of the Bank of Mongolia have been implicated in unfortunate foreign exchange trading ending in substantial losses, which further hindered both prestige of new central bank and its operational stability.

Until the introduction of the interbank clearing system, an abuse of "free borrowing of loan resources" had became a wide-spread practice among banks, in particular, the ITI and the Cooperative banks. The following strategically ill-fated deficiencies and mistakes have influenced the internal activities of commercial banks: an absence of understanding on asset and loan quality, accounting practices based on old, socialist time rules, lack of internal control procedures, competing with each other through loan making to attract new customers, total absence of loan appraisal techniques, and the establishment of many redundant branches in the countryside where the scope for profitable businesses was limited. On external side, lack of any real estate to be pledged against loan, "loan appraisal" based on a piece of paper called project, infancy of domestic and foreign trade, inflationary and exchange rate uncertainties, ongoing price liberalization process, vagueness of existing legal documents regulating loan relations, unsatisfactory observance of few legal regulations all together have undermined the bank soundness and sustainability.

Choosing bank customers by sectoral breakdown (the most visible example was Agricultural bank) was a basis for future bank-related troubles. The following measures have been taken in the context of financial reform to set up basic infrastructure to allow the central bank to conduct monetary policy:

- In May 1991 the Banking law has been passed.
- In second half of 1991, minimum reserve requirements and minimum deposit rates to be paid to saving accounts of individuals have been introduced.
- By introduction of clearing system in August 1992, bank funds have been separated.
- In September 1992 first prudential ratios have been enforced by the Bank of Mongolia.
- In October 1992 the limits on central bank lending to commercial banks have been imposed,
- In March 1993 general guidelines on bank onsite inspection and loan classification regulations have been adopted.
- With introduction of floating exchange rate of Togrog in May 1993, the exchange rate determined by the market.
- Adoption of new chart of bank accounts from January 1994.

In addition, supervision system of commercial banks was taking a certain shape.

2. Period of banking crises following the liberalization in the economy (1994-1999)

As a result of poor lending decisions made in 1991-1993, loan portfolio and consequently financial positions of commercial banks started to deteriorate from 1994. The banking crises in 1994-1999 came in two waves: the first wave in 1996 involving Ardyn and ITI banks, the second wave in 1998-1999, which resulted in restructuring of ITI, Reconstruction and Agricultural banks. The early signs of worries were forced acquisitions of the Mongolian cooperative bank by Ardyn and Selenge bank by ITI bank in 1994. These acquisitions were the first attempts by the Bank of Mongolia to restructure the bank sector. It provided emergency liquidity support to Ardyn and ITI banks amounting to MNT 5 billion or 2 percent of GDP. The BOM also placed two other insolvent banks (Mercury and Business) under conservatorship; however, the financial condition of banks, 95 percent of whose assets remained in the state hands, continued to deteriorate following a brief respite. Table 5 demonstrates a share of NPL within total loan portfolio for some of these troubled banks, that were later liquidated.

Table 5. Mongolia: The NPL ratio of troubled banks /in billions of Togrogs/

	Insurance	Ardyn	ITI	Reconstruction
	12/13/1996	12/13/1996	11/30/1999	11/30/1999
NPL	4542	15992.1	14058.6	8012.7
Total outstanding loans	5509.2	27699.6	14586.1	8012.7
NPL ratio %	82.4	57.7	96.4	100

Source: The Bank of Mongolia

By 1996 the Mongolian banking sector was fraught with significant level of financial disintermediation, with the banking sector being unable to support the real sector performance. Commercial banks had a loan to deposit ratio of more than 80 percent and, despite the short maturities of loans in general, were unable to maintain sufficient liquidity to service the needs of their clients. The five largest banks, which controlled about 94 percent of the deposits, were regularly violating minimum reserve requirements, credit expansion and clearing liquidity norms stipulated by the BOM. Four of the five largest commercial banks and three of the smaller, privately owned ones were technically insolvent partly as a result of the carryover costs associated with inherited and directed loans on the part of State Banks but also the result of (i) poor management, (ii) weak regulatory/supervisory framework, and (iii) weak skills base. Accordingly, extensive reforms of the Bank of Mongolia's regulatory and supervision functions and of commercial banking practices were urgently needed. Faced with a major banking crisis, a flight from the domestic currency (in 1994, about 60 percent of the money supply was constituted by foreign currency) and acceleration of inflation, in December 1996, the Government launched a major restructuring of the banking system that was intended to eliminate insolvencies, restore public confidence and halt disintermediation. This effort was supported by the IMF (through ESAF), the Asian Development Bank (ADB), through its Financial Sector Policy Loan and two TA loans, and the World Bank (through its Banking and Enterprise Structural Adjustment Credit) and BELTAC. Two large insolvent banks - Ardyn and Insurance with almost one-half of the bank assets were liquidated. The liabilities and performing assets of the defunct banks were transfered to two newly-created state banks. The Savings Bank inherited all household deposits and was designed only as a deposit taking institution. The Reconstruction bank inherited all performing assets and was designed as a specialized financial institution. The two banks also received interest bearing government bonds in lieu of the nonperforming assets of the liquidated entities. The Mongolian Asset Recovery Agency (MARA) was established with Government funding to take over these nonperforming assets.

The cost of the 1996-97 restructuring exercise as measured solely by issuance of Government restructuring bonds, amounted to MNT46 billion (7.8 percent of GDP). Other costs, such those relating to retrenchment, were not quantified. The largest of the remaining problem banks, Agricultural and ITI banks, were placed under rehabilitation through Memoranda of Understanding with the BOM. The following reform actions were taken place during this period:

- A law on solvency was approved to regulate creditor and debtor relations under bankruptcy conditions and to institute the necessary procedures for rehabilitation or liquidation of insolvent entities.
- A Credit Information Bureau was established to monitor loan defaulters.
- The Banking law was amended to facilitate the collateralized lending, and
- Loan loss classification norms were tightened.

The second wave of the banking crisis started early in1998, as a result of the impact of the large external shock on the liquidity and profitability of major corporate clients; persistent managerial and governance problems in several big banks, political uncertainty, and inadequate supervision. The three banks, the Reconstruction Bank, ITI Bank, and Agricultural Bank, comprising 21.4 percent of total bank assets, became illiquid and insolvent. By end -1998, 41 percent of all bank loans were classified as nonperforming (up from 30 percent in 1997), of which 70 percent were concentrated in the three above-mentioned banks. The ratio of total bank assets to GDP continued to decrease in 1998, falling to 22 percent, compared to 23.6 percent in 1997. (Table 6)

Table 6. Mongolia: Ratio of Total Bank Assets to GDP, 1997-1999

	1997	1998	1999
Banks total assets	196,279,783.90	179,483,901.30	200,193,013.80
Banks total assets/GDP	23.6	22.0	21.6

Source: The Bank of Mongolia

Total loans of banks reached MNT 78.2 billion at the end of 1999, which is lower than MNT 8.1 billion from that of in 1998. While the bank loans constituted 50.9 percent of total bank assets in 1996, the ratio declined to 38.0 percent in 1999. The classification of total loans by commercial banks is shown in Table 7.

Table 7. Mongolia: Total loans of banks and their share, 1997-1999 (in thousands of MNT)

	1997	1998	1999	1997	1998	1999
Trade and Development bank	13,934,374.8	32,758,670.8	24,299,086.1	27.0%	37.9%	31.1%
Golomt Bank	4,049,472.8	5,726,252.6	8,553,289.7	7.9%	6.6%	10.9%
Anod Bank			1,589,890.3	0.0%	0.0%	2.0%
Mongol Post Bank	887,791.5	1,399,087.1	3,897,122.9	1.7%	1.6%	5.0%
Ulaanbaatar City Bank		336,854.0	1,027,729.7	0.0%	0.4%	1.3%
Zoos Bank			895,822.9	0.0%	0.0%	1.1%
Agricultural Bank	4,078,585.0	4,809,755.0	3,528,108.0	7.9%	5.6%	4.5%
Erel Bank		1,605,040.0	2,195,178.7	0.0%	1.9%	2.8%
Transport Development Bank	558,608.2	1,057,888.0	774,508.9	1.1%	1.2%	1.0%
Innovation Bank	1,347,771.8	1,515,121.0	1,305,710.3	2.6%	1.8%	1.7%
Credit Bank		622,544.5	1,031,376.8	0.0%	0.7%	1.3%
Savings Bank	132,785.0	434,356.0	368,149.8	0.3%	0.5%	0.5%
Other banks	26,526,353.9	36,062,454.3	28,782,526.7	51.5%	41.8%	36.8%
TOTAL	51,515,743.0	86,328,023.3	78,248,500.8	100.0%	100.0%	100.0%

Source: The Bank of Mongolia

In late 1998, the government carried out the following policy measures:

- In September 1998 the Banking law was amended, significantly strengthening the regulatory framework for banks, the minimum capital requirement was raised from MNT 400 million to MNT 1 billion. The amended Banking law empowered the BOM to ensure improved banking governance (for instance, individuals of doubtful character can be prohibited from managerial and board positions and BOM can convene shareholders' meeting). It also substantially improved financial disclosure requirements and established the legal basis for bank audit standards.

- An automatic loan rescheduling for defaulting borrowers were proscribed.
- A new sector wide accounting standard, developed with ADB assistance, became effective.
- In September the BOM withdrew the licenses of three small insolvent banks (Mongol Business, Mercury, and MM Invest banks)

Early results of the reforms were encouraging. Bank deposits increased in 1997, signaling return of confidence and the ratio of non-performing loans to total loans decreased to 28.8% at the end-1997 from 50.9% in 1996. (Table 8)

Table 8. Mongolia: Nonperforming loans of the banking sector, 1992-1999

	1992	1993	1994	1995	1996	1997	1998	1999
Total loans	19.1	31.6	52.8	62.7	64.8	50.4	85.6	77.5
NPL	1.1	4.1	7.3	13.5	33	14.5	32.6	42.1
NPL ratio %	5.8	13	13.8	21.3	50.9	28.8	38.1	54.3

Source: The Bank of Mongolia

Interest rates on deposits, which had been negative in real terms, to the detriment of price stability and financial intermediation, moved to positive levels. Bank profitability, liquidity and capital adequacy improved. A significant development was the emergence of a private bank, Golomt, as important and viable institution. Other fledging nonbank financial institutions, such as the stock exchange, securities firms and pawn shops, also emerged. Outside of the financial sector, remaining price controls on electricity, heating, water, and rents were largely eliminated. The tax system was overhauled to further curb price distortions and reduce the tax burden on the private sector: virtually all import duties were abolished, and corporate and personal income taxes were simplified and marginal rates sharply reduced. Excise taxes were rationalized, government fees and charges were adjusted to improve cost recovery and efficiency, and a value added tax was introduced. Government's transfers to state enterprise sector was drastically curtailed hardening budget constraints. Privatization of non-financial enterprises also accelerated, yielding revenues equivalent to 1.5 of GDP in 1997 and 1.7% of GDP in 1998.

Despite these improvements, however, several important weaknesses and institutional deficiencies persisted, which were exacerbated by the unfavourable external environment during 1998, and contributed to a serious deterioration of the financial condition of the banking system. A number of factors combined to a further weakening of the system. Briefly, these factors included, inter alia,

- Delays in introducing and enforcing prudential regulations,
- Weak management and governance of banks,
- Limited skills in credit/risk management and weak internal control,
- Inadequacies in legal framework, particularly with regard to bank insolvency, conservatorship, receivership, and recovery of bad debts,
- Prevailing default culture,
- Delayed and inadequate bank supervision, and
- Politicizing of banking policy issues.

There was also the impact of large external shocks- including a sharp fall in commodity prices- on the profitability and cash flow of major corporate clients and emergence of serious managerial and governance problems at the Reconstruction Bank, which later was liquidated. The unsuccessful attempt at addressing the prevailing default culture further eroded confidence in the banks. Further, as the fiscal position of the Government deteriorated, banking system's claims on the Government accumulated, while the Government did not make full interest payments on these liabilities. The combination of these factors made it extremely difficult to secure additional capital in the banks, which was a critical component of the bank restructuring strategy. To amplify its problems, the banking sector was forced to reschedule an increasing portion of its loans, as its major clients were also under financial stress. Banks contributed to the unsupervised accumulation of problem loans as they concealed, to the extent possible, the quality and quantity of their problem loans failed to provision adequately against them.

3. Stabilization of the banking sector since 1999

Since liberalization, the banking sector has experienced a number of shocks and failures, most notably in 1994, 1996 and 1998. As discussed above the upheavals resulted in combinations of liquidations, rehabilitations and forced consolidations, some of which involved some of the largest institutions. These restructuring of the sector were accompanied also by substantial institutional, regulatory and policy reforms, implemented with strong financial and technical support from donor organizations. The stabilization of the banking sector has been observed since late 1999 as the confidence in the system was restored. (Box 1) The positive improvements within the banking system during this period can be attributed to the following factors:

- Lessons and experiences of past two periods have been very valuable.
- With stabilization of the banking system, confidence of the public and entrepreneurs towards banks has greatly increased bringing funds in a form of

current accounts, time deposits into banks which, in turn, has allowed banks to significantly increase their lending reviving channels of financial intermediation.

- Since 1999 MNT exchange rate vis-a-vis US dollar has been stable and inflation has been contained at the predictable levels.
- Competition within the financial sector received a substantial boost; in 2001 alone 2 banks with domestic capital /Inter, Capitron/, branch of foreign bank /Menatep SP/, bank with mixed domestic and foreign funding /XAS/ and NBFI with large foreign investment /Chingis Haan NBFI/ were established with total of 22.7 billion Togrogs of capital injection.
- Activity of the Agricultural bank with extensive rural branch network has been revived.
- Numerous NBFIs, Agricultural and HAS banks started working with microlenders which have been in the past largely ignored by bigger banks.
- Principal amendments concerning legal provisions on lending and loan collateral have been approved by Parliament in early-2001.
- The government direct intervention in resource allocation through directed credits were completely eliminated.
- The management and internal supervision of the banks has improved and there was strengthening of activities of independent internal audit units.
- Slow evolution of the Bank of Mongolia's supervision geared towards preventive risk evaluation.

With institutional structure of the banking system being set up, the Bank of Mongolia has approved principal document titled "Medium term strategy of the financial system development" in early 2000.

In 2000 the World Bank approved the Financial Sector Adjustment Credit (FSAC) to support a further round of financial sector reforms based on a detailed financial sector review and curtailing the amount of public funds involved. Initiatives included privatizing the largest bank and strengthening the legal and regulatory framework.

A summary of the main reforms in the financial sector and of other economic reforms is presented in Table 9.

BOX 1. The structure of the financial sector.

An extremely low intermediation level characterizes Mongolia's financial sector. Net banking system assets accounted for 20 percent of GDP and the ratio of private credits to GDP was only 4 percent by end-2000, with no penetration by foreign banks and very high state participation. Cross-country evidence indicates that opening domestic financial markets to foreign financial institutions brings significant increases in stability and efficiency (Litan et al., 2001). Entry by foreign banks tends to aid diversification of domestic risks, enhance competition and efficiency, and lower moral hazard.

The banking sector is highly concentrated. As of the end of 2001, 16 banks and 28 non-bank financial institutions were providing banking services through their 538 offices (105 branches, 419 sub-branches, & 13 cash offices) located in all aimags of the country. At the aimag and soum level 12 banks have 436 representative offices, which is 65 offices more than in 2000. Rural offices represent more than 80 percent of all banking offices. This reflects lack of a sound and safe multi-tiered financial service network.

During 2001, total assets of all banks increased dramatically and a ratio of M2 to GDP, which as an indicator to determine scope of financial intermediation, increased by 4.3 percentage points to 29.7 percent compared with 2000. Reduction of interest rates in international markets, attendant improvements in the domestic financial market and a rise in the deposit base has been facilitating lending activity of banks.

The central bank has continued to strengthen its prudential guidelines for banks, raising the minimum capital requirement for new banks to MNT 4 billion (approximately US$4 million) on July 1, 2001.

16 banks were conducting operations in the banking sector, of which 2 banks were state owned, 4 banks had state participation in their equity funds, and 10 banks were owned by the private sector. As of the end of 2000, 69.9 percent of all deposits, 81.7 percent of all current accounts, and 91 percent of government funds were concentrated in the partial and fully state owned banks. As a result of competitive pressure from private banks these ratios were decreased to 58.6, 77.9, and 89.4 percent respectively thereby increasing the market share of the later. Total assets increased by 47.4 percent or by MNT 107 billion representing 29.4 percent of GDP. This massive growth was associated with the expansion of current accounts, deposits, government funds and equity capital.

Total loans outstanding reached MNT 135.1 billion, accompanied by an increase in public and private sector lending of 68 percent and 250 percent respectively. This shows the increasing role of banks in financing in the real economy and a deepening of financial intermediation. In other words, during previous years, liquid and foreign assets represented the major share of total assets while the share of domestic credit was less than 25 percent. This picture has changed, as seen by the share of loans at the end of 2000, which soared to 40 percent, with a tentative pressure for further rise.
Regardless of the tremendous growth in loans outstanding, BOM bills still remains only a small portion of total assets in the banking system, thereby supporting a liquidity ratio that has stayed above the required minimum and implying the possibility for further increases in financial intermediation through monetary policy instruments.

In 1998, the ratio of non-performing loans to total loans was 38.1 percent, in 1999 -54.3 percent, and in 2000 - 23.8 percent, while in 2001 it decreased by 15.7 percentage points to 8.1 percent. Most loans classified as non-performing were granted before 1999-2000. Progress in the recovery of loans has been assisted by improvements in the banks' credit policies and amendments in legislation which have helped mitigate credit risks.

Source: The Bank of Mongolia.

Table 9. Mongolia: Main financial and economic reforms

Financial sector reforms	
Interest rate liberalization	A major liberalization of interest rate was announced in September 1991, when the BOM sharply increased its lending rate to commercial banks and signaled its intention to adjust the rate periodically.
Capital account liberalization	Liberalized in 1991
Indirect mon.pol. instruments	The role of indirect instruments in regulating credit expansion increased with the introduction of central bank bills in November 1993.
Money market development	At early stages of development
Reserve requirement	Early steps to develop indirect monetary management included the introduction of reserve requirements in September 1991.
Central bank independence	Central bank Law was adopted in 1992
Prudential regulation	In September 1992 first prudential ratios have been enforced by the Bank of Mongolia
Bank supervision	Initial steps were taken in 1992 by the BOM
Restructuring	Started early 1994 (the BOM merged the insolvent Cooperative Bank with Ardyn and Selenge Bank with ITI)
Privatization	The first privatization took place in September 2002. (Trade and Development Bank)
Other financial sector reforms	In 1996 the Mongolian Asset Recovery Agency (MARA) was established with Government funding to take over nonperforming assets. The Mongolian Stock Exchange was also established.
Other economic reforms	
Fiscal reforms	The first Budget Law was approved in conjunction with the 1993 budget, together with the Constitution and the General Tax law, clarified the sources of revenues accruing to the central and local governments. The procedures for cash management were improved, a treasury function and debt registry were introduced, a monthly fiscal reporting system in line with standard IMF classifications was created.
Privatization of state enterprises	The privatization program was launched in July 1991 with the objective of selling 44 percent of state-owned assets by means of vouchers that were distributed to the entire population.
Price liberalization	Started in early 1991 with liberalization of prices on agricultural outputs.
Trade reform	In early 1990s the trade liberalization was accelerated through the abolition of state orders for exports and imports by allowing the private sector to purchase the most commodities for export, except for meat and live animals, at freely determined prices. As of 1990, the monopoly of state trading corporations over foreign trade was abolished.
Exchange rate regime	A floating exchange rate regime was adopted in May 1993.
External debt	A decision was made by the countries of the former CMEA to settle on a bilateral basis in transferable rubles mutual demands and obligations.

4. Lessons from Past Reform Efforts

The assessment in the previous section raises questions about the lessons that can be drawn from past efforts to reform the financial system in the transition to a market-oriented economy. There are several areas where past reforms have been deficient. These deficiencies need to be carefully taken into account in designing a new strategy for future reforms.

Weaknesses in the essential building blocks to support a market based financial system. These include absence of requisite banking skills, weaknesses in the legal framework to support and enforce financial contracts, and lack of transparency about the financial health of firms and banks due to under-developed accounting and auditing standards. While attempts have been made to strengthen banking skills with technical assistance support from donors, the design of the reforms program has not taken adequate account of the severe shortage of skills. The deficiencies in other fundamental building blocks are equally serious. There are ambiguities and gaps in the legislation relating to the protection of parties to financial contracts, including laws pertaining to the transfer of private property rights. Unless these deficiencies in the administration and enforcement of the law are not addressed, they will undermine the basis on which sound banking decisions can be made. Some banking decisions also require transparency about the financial health of firms. It is difficult to make an assessment without help of audited financial statements that can be relied upon. This has not been possible in the early stages of development and so banks boils down to making decisions based on personal references, physical checks etc. These are characteristics which are more akin to banking by informal lenders and cannot form the basis of a modern efficient market based banking system. While accounting and auditing standards are being strengthened, it would be a mistake to assume that the banking system can develop without a coordinated investment in improving the standards of accounting and auditing.

Lack of a credible Government committed to honor contracts and to ensure protection of private rights. A necessary condition for developing well-functioning markets is the establishment of credible commitments on the part of the Government to honor contracts. Payment arrears by the Government, failure to fulfill its obligations to service debt, and high profile policy reversals after the private sector had made investments signaled to the public that the Government is not committed to ensure protection of private rights. In such a context, financial liberalization is likely to lead to disastrous results, as has been demonstrated in many countries undergoing a transition to a market based economy.

Inappropriate sequencing of reforms. Policy reform measures to liberalize interest rates, entry of private banks, and the capital account of balance of payments were introduced before the preconditions for their successful implementation had been attained including: (i) development of the essential building blocks; (ii) an effective regulatory framework and the capacity to supervise the banking system and enforce the regulatory framework; and (iii) effective steps towards macroeconomic stability including control of the budget deficit, which is particularly important for successful liberalization of the capital account but applies more generally to reduce the risk of the banking system being used as a tool for financing government expenditures.

The pervasive involvement of the state in the allocation of financial resources. A major anomaly in the process of liberalization has been the extensive government equity holding of commercial banking institutions. Banks which are wholly or partly owned by the Government account for 90 percent of the assets of the banking system.

This dominance of the system by the government is incompatible with the development of a banking system where the Government's role in the allocation of resources is to be replaced by the market. It is possible for the conflict inherent in the government owning banks that it also supervises to be resolved through adequate corporate governance. In most developing countries state ownership of the banking sector has been characterized by inefficiency. In Mongolia, all the banks of any significant size have been state owned. It is also notable that in 1996, restructuring of the banking system involved the closure of two state-owned banks – Savings Banks and Restructuring Bank.

CHAPTER FOUR. FINANCIAL SECTOR REFORMS EXPERIENCE

1. Evidence and Lessons from Other Transition Countries

All the former centrally planned economies in transition to a market based financial system inherited similar financial structures. Their common features were absence of financial markets and irrelevance of financial variables for the real economy, especially the enterprise sector. All have endured large structural shocks, in the form of price liberalization, the creation of markets, and elimination of soft budget constraints liberalized or privatized previously state-run enterprises. All have needed also to create a credit system, hopefully achieving a balance between providing liquidity to viable firms while maintaining incentives for efficient behavior. In this context, all financial intermediaries inevitably have been subject to high risks and limited efficiency gains. Mongolia's financial sector reform experience can be compared with that of other transition countries, especially those in the Commonwealth of Independent states (CIS). (Table 10)

Table 10. Comparative Data on the Structure of Banking System

	Number of Banks	Number of SOCBs	% share of assets of top 5 banks	M2/GDP (%)	Currency/ M2 (%)	Number of Banks per 100.000 inhabitants 1/
Albania	8	3	100	45	37	
Armenia	37	5	85	23	42	9
Azerbaijan	197	4	n.a.	26	64	21
Belarus	52	7	75	11	25	4
Bulgaria	34	7	90	91	15	5
China	19	7	90	91	15	
Croatia	47	19	70	21	24	12
Czech Rep.	58	1	69	74	10	4
Estonia	16	1	70	20	44	11
Georgia	203	5	90	3	56	20
Hungary	41	3	63	43	26	4
Kazakhstan	167	4	90	11	58	8
Kyrgyz Rep.	17	3	90	11	78	
Latvia	40	3	55	30	43	17
Lithuania	27	3	70	17	42	4
Macedonia	40	3	97	25	22	4
Moldova	27	4	85	8	51	
Mongolia 2/	16	4	84	19	39	1
Poland	73	5	66	31	26	2
Romania	28	7	74	15	30	1
Russia	2561	1	33	15	42	14
Slovak Rep.	30	2	79	67	13	4
Slovenia	34	2	70	37	10	19
Tajikstan	14	14	90	42	58	
Turkmenistan	21	11	90	13	47	
Ukraine	217	2	70	16	37	
Uzbekistan	35	29	95	79	26	
Vietnam	62	4	90	22	58	
Comparator countries 3/						
United Kingdom	530		29		3	
France	419		43		6	
Spain	154		39		13	
Greece	154		63		17	
Denmark	124		77		4	
Turkey	68		45		10	
Venezuela	41		n.a.		9	
Argentina	166		40		22	
Developed countries	192		50		9	

Notes: 1/ Average for 1993-1997
2/ All data for Mongolia refer to December 2001. Data for the other transition countries are for mid 1995
3/ Data for OECD countries refer to 1992.

Before discussing possible ways forward for Mongolia, it is helpful to view its difficulties confronted in the transition process in the context of lessons from these transition experiences. Recent research highlights both a number of common outcomes and a number of important policy pointers. The outcomes include:

- Low level of financial intermediation: with few exceptions previously centrally planned economies display a much lower degree of financial deepening, even after several years, than market economies at similar levels of per capita income.
- A prevalence of loosely-supervised banks created or controlled by domestic enterprises, and for whom banks became captive lenders, leading to soft budget constraints and higher default risks.
- Over-banked markets, despite recurrent consolidations and liquidations of failed banks.
- A vicious cycle of high real interest rates, accompanied by large spreads between lending and deposit rates, and rising levels of non-performing loans.
- "Hiding" of persistent bad debt problems behind ad hoc solutions, leading banks to seek to regroup their losses through even higher spreads and self-defeating purchases of government bonds.
- Absence of explicit deposit insurance schemes, leaving banks more at risk of bank runs.

While there are some common features, two quite different solutions can be detected between the Central and Eastern European (CEE) countries and the former Soviet Union/ Commonwealth of Independent States (CIS) countries which display much lower money to GDP. The strategies adopted broadly differed between those countries that had already undergone partial processes of decentralization and reform – mainly the CEE countries – and those that had not – mainly CIS countries. The difference in initial conditions at transition appears significant, in that the partial liberalization process at least created a minimal set of market institutions that proved critical for the success of full-pledged market reforms. Consequently the development of well-functioning trade-credit markets in countries like Hungary and Poland, contrasted with the explosion of inter-enterprise arrears and barter in CIS countries. Arguably, the different starting points also allowed the CEE-type countries to pursue a more gradual and cautious approach to transition, while the CIS-type countries were forced or induced into more rapid financial liberalization. But it can also be argued that the rapid liberalization in the latter countries increased their vulnerability to financial crisis. It might not be fair to claim that these policies – such as allowing unregulated entry of banks and totally deregulating the capital account of the balance of payments – were the cause of financial crises. The financial liberalization strategies followed by the relatively "advanced" CEE-type reformers differed from those of the CIS-type in several ways which may have contributed to the development of different degrees of systemic risk. First, the CEE-type countries adopted a cautious approach to bank entry and lending to liberalized domestic firms. By contrast, the CIS-type typically allowed many more banks to be created by, and to lend to, domestic enterprises and – despite some subsequent consolidations and liquidations – permitted their markets to become "over-banked". Thus, whereas Poland, Hungary, and the Czech and Slovak Republics averaged 4 banks per 100.000 inhabitants in 1993-1997, many CIS type countries had between 10 and 20 banks per 100.000 inhabitants. Moreover, loosely-supervised CIS banks, controlled by firms, led to captive loan markets for the firms, softer budget constraints and higher default risks. In the "advanced" countries, however, credit for domestic firms, other than unreformed state-owned enterprises (like utilities), was limited, forcing firms to be more reliant on self-financing. The constrained availability of bank credit led to the growth of the private trade-credit markets, which allowed firms to economize on their cash holdings, thereby freeing up more resources for self-financing – in social terms, a much less costly mechanism than default for compensating for the lack of bank credit.

Second, CIS-type countries were more prone to "hiding" bad-debt problems behind ad hoc solutions, whereas CEE-types tended to tackle them through comprehensive re-capitalization policies. The result was a greater tendency to allow banks in CIS-type economies to try to recoup their losses through much higher spreads between lending and deposit rates and through purchase of government bonds – a self-defeating strategy, since the asset base tends to shrink and the composition of loan portfolios tend to worsen, as a result of adverse selection. Third, CEE-type countries typically were much slower to liberalize their capital accounts, and particularly to retain controls on portfolio investments – a practice that (at least in the case of Hungary, not Czech Republic) did not seem to inhibit FDI flows, interfere with banking activities or general macroeconomic instability. And fourth, CEE-type reformers were much more likely to adopt explicit deposit insurance schemes, in the absence of which – despite reduced moral hazard – banks in CIS type economies were more at risk of bank runs.

These "qualitatively" different outcomes and behavior patterns clearly warrant explanation. The possibility that they can be explained away by the hyperinflation, which affected many CIS-type economies at the start of transition, can be discounted, partly because several of the CEE-type countries also experienced hyperinflation, and partly because many CIS-type countries did not enjoy much subsequent re-monetization, despite achieving lower inflation rates than some of the "advanced" reformers. Low inflation therefore, is not a sufficient condition for getting these economies out of their “low level of monetization” situation, though it is a necessary one. A more satisfactory explanation is that the different behavior patterns constitute rational responses, at the microeconomic level, to the different conditions obtaining in two types of transition countries. In general terms, as is well known, an individual borrower will opt for default when the benefits of doing so – the extra liquidity gained – exceed the cost. It can be shown, however, that generalized default can emerge as a widespread and persistent phenomenon when institutional factors – such as weak bankruptcy procedures and high expectations of bail-out – systematically reduce the costs of continuing arrears. This could well explain the increased tendency to default in those transition economies in which the effective risk of bankruptcy is reduced. Escape from such a “trap” will require not only the usual macroeconomic measures to restore financial stability, but also remedies for the institutional shortcomings.

2. Implications for Mongolia

Since 1990, Mongolia has made considerable strides, in often, difficult domestic and external circumstances, in transforming its economy to a market one. The strategy pursued to date has been accompanied by a sustained recovery of economic activity since 1993 with slight fluctuations due to external developments and weather related conditions. The magnitude of the financial crises occured in the past however, underscored two major shortcomings. First, all of Mongolia's efforts to reform the financial system have failed to eliminate the conditions that seemingly predispose the system to revert to recurrent states of crisis. Second, failure of the financial system was a major drag on the economy, holding back the rate of development and progressive improvements in living standards.

Experiences of transition economies show a number of challenges that should be addressed: absence of well-functioning capital and private credit markets, the perpetuation of inefficient and crisis prone financial institutions, prevalence of financial indiscipline, including growth of involuntary credit in the form of payment arrears etc.

CONCLUDING REMARKS

The development of an efficient and viable banking sector is necessary to support sustainable economic growth in Mongolia. Recognizing the importance of this sector many international financial organizations have been working closely to assist Mongolia in overcoming the structural problems and to accelerate the process of building a stable and efficient financial sector in Mongolia.

The experiences with financial sector reforms provide a number of important lessons. First, financial sector reforms require that mutually supporting reforms be undertaken in a number of areas – monetary and exchange, prudential, and structural. Reforms to certain sectors, such as monetary and exchange systems, can perform a critical catalytic function and help to provide momentum to the reform process. However, these reforms need to be concomitant with the strengthening of institutional structure to ensure that the liberalizations induce the appropriate responses in terms of resource mobilization and allocation and help to avoid banking crises. Banking sector weaknesses should be addressed at an early stage in the reforms through, among other things, implementation of a critical mass of accounting rules, prudential norms, supervisory procedures and bank restructuring. The parallel development of critical money, exchange, and capital market institutional instruments should facilitate money and exchange system reforms. These institution building reforms can thus promote more efficient credit and foreign exchange allocation and support macroeconomic adjustment by safeguarding against a financial crisis, and by allowing for a more rapid introduction of indirect and more efficient monetary instruments, as well as external liberalization.

The lessons from experience of other transition economies indicate that Mongolia's experience may replicate that of other transition economies that liberalized their financial sectors too rapidly and before the pre-conditions for a successful liberalization had been attained. In Mongolia's case it also appears that the rapid liberalization of the financial sector may have benefited the economy but it also been costly given the weaknesses in basic infrastructure, such as banking skills, poor rules of disclosure, and weak accounting and auditing standards.

While drawing on lessons from the past, the strategy to accelerate the construction of a sound and efficient financial system should entail the following aspects:

- In view of the characteristics of Mongolia as a small economy, dependent on the exports of a few commodities and highly vulnerable to terms trade shocks, the reform and the development of the financial sector needs to be closely coordinated with other economic reforms, including fiscal reforms and the national development strategy and programs to diversify the economy to reduce the risks facing the real and financial sectors.

- Facilitate the development of sustainable rural financial financial institutions and markets to provide payment systems and banking services appropriate to conditions existing in sparsely populated such as Mongolia and which can respond flexibly to on-going structural changes in the economy. A high priority needs to be given to further develop and establish financial network in rural areas to maintain financial services.

- Consolidate the banking system to enhance effective competition by the emergence of a relatively small number of sound banks and encourage international banks to take an equity stake in domestic banks or open branches in Mongolia, to lower the cost of intermediation and with it real interest rates, to improve governance with bank privatization and set the stage for the development of money markets.

BIBLIOGRAPHY

Barry R. Johnston, SundararajanV., ed. *Sequencing Financial Reforms: Country Experiences and Issues.* Washington D.C.: International Monetary Fund, 1999

Bank of Mongolia. *Annual Report 1993.* BOM, 1994 (in mongolian)

Bank of Mongolia. *Annual Report 1998.* BOM, 1999

Bank of Mongolia. *Monthly Statistical Bulletin.* BOM, 1995-2003

Carl-Johan Lindgren, Gillian Garcia, and Matthew I. Saal. *Bank Soundness and Macroeconomic Policy.* Washington D.C.: International Monetary Fund, 1996

Elizabeth Milne, John Leimone and others. *The Mongolian People's Republic Toward a Market Economy.* International Monetary Fund, 1991

Enkhuyag B. *Lessons from Past Ten Years of Transition in the Banking System of Mongolia and Future Objectives.* BOM, 2000

Fabrizio Coricelli. *The Financial Sector in Transition: Tales of Success and Failure.* University of Siena, CEPR and Central European University, 1999

Frederick N., Bat Suvd and others. *The Mongolian Economy: A Manual of Applied Economics for a Country in Transition.* UK: Edvard Elgar Publishing Limited, 2000

Gerard Caprio, Patrick Hononan, and Dmitri Vittas. *Financial Sector Policy for Developing Countries.* Washington D.C.: The International Bank for Reconstruction and Development/The World Bank, 2002

Giorgio Gomel. *Banking and Financial Sector in Transition Countries and Convergence towards European Integration.* Banca d'Italia, 2002

International Monetary Fund. *IMF Economic Reviews: Mongolia.* IMF, 1996

International Monetary Fund. *Mongolia: Further Development of the Central Bank and the Banking Sector.* IMF, 1994

Jose M. Fanelli and Rohinton Medhora., ed. *Financial Reform in Developing Countries.* New York: St. Martin's Press, 1998

Mario I. Blejer, and Marko Skreb. *Financial Sector Transformation: Lessons from Economies in Transition.* Cambridge: Cambridge University Press, 1999

Paul J.Siegelbaum. *Financial Sector Reform in the Transition Economies: What Have We Learned; What Are the Next Steps?* World Bank, 1997

The Asia Foundation. *Mongolia's Political and Economic Transition: Challenges and Opportunities.* The Asia Foundation, 2001

UNDP. *Mongolia Toward a Stable and Open Market Economy*. Country Report 15. 1994