

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

STRATEGY FOR MONGOLIA

As approved by the Board of Directors at its meeting on 25 June 2013

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EXECUTIVE SUMMARY

Mongolia continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank.

Since the beginning of transition two decades ago, the country has adopted a liberal Constitution, developed a competitive political party system and established a vibrant civil society. The media are free to report on a wide range of issues and there is a general increasing adherence to the rule of law and respect of human rights, though significant challenges remain.

A major challenge for the new Government, established following the June 2012 parliamentary elections, is to manage transparently the wealth generated by vast natural resources in a country with significant levels of poverty. Mongolia's future is closely tied to the development of the minerals sector and a key task, going forward, is to put in place accountable institutions and policies that ensure transparent wealth management, a stable macro-economic environment and a business environment that supports further development of the private sector.

Mongolia has experienced a major mining boom. Growth accelerated from 6.4 per cent in 2010 to 17.5 per cent in 2011 before slowing down somewhat to 10.2 per cent year-on-year in the first nine months of 2012. High prices of copper and other commodities and expansionary fiscal policy have also contributed to the strong growth performance. Inflation has remained high and volatile, driven mainly by significant increases in public sector wages and social transfers before the June 2012 general elections.

Output growth is estimated to have reached around 11 per cent in 2012 and is expected to remain high in the medium term, supported by high commodity prices and major forthcoming investments in the mining sector. Despite sustained high commodity prices, public and external debts are projected to continue rising as mining projects and related infrastructure require significant public and private investments. The economy remains vulnerable to a renewed downturn in global commodity prices, which may weaken investment and economic activity and may lead to a slowdown in mining activities.

Mongolia's rapidly growing economy offers increased opportunities but also poses new challenges. The basic principles of good public governance – adherence to the rule of law, strong institutions, accountability and transparency of government and a stable investment climate – are increasingly relevant for Mongolia in the next strategy period.

Although Mongolia is relatively far advanced in terms of promoting private ownership, the country still faces substantial transition challenges. The Bank, due to its deep and broad engagement in the Mongolian private sector, is well placed to continue to support the private sector and the development of market institutions in the country. The key challenges and strategic orientations for the coming Strategy period are:

- **Promoting diversification through support for non-resource sectors.** Mongolia's mining boom has resulted in an increased dependence on volatile commodity revenues. The relative weight of the mining sector in the economy needs to be reduced over the medium term through supporting development of a potentially competitive non-extractive sector. The Bank will aim to deepen and expand its engagement with the Mongolian non-extractive private sector through provision of financing, advisory and technical assistance, as well as through policy dialogue aimed at developing an enabling business climate and the appropriate institutional and legal frameworks.
- **Promoting sustainable growth through broadening access to finance.** As the economy receives large and increasing inflows of capital and commodity revenues, it is particularly important to develop a strong financial sector capable of channelling these inflows throughout the economy, allocating resources efficiently through effective intermediation contributing to the growth of the private corporate and SME sector. . The Bank will support the financial sector through SME-debt programmes, equity and specific technical assistance programmes.
- **Promoting responsible mining and strengthening governance institutions.** Mongolia's mining boom should be leveraged to attain the country's development and transition goals. This requires further strengthening of market and governance institutions and developing a transparent, effectively regulated mining sector and a long term framework for managing commodity revenues. The Bank will continue to offer debt and equity finance to reputable local mining companies which meet its high environmental, health, safety and corporate governance standards. To attract foreign capital, Mongolia will need to provide a stable business environment, including prudent fiscal policies and adherence to the rule of law. In support of institutional building, the Bank will increase its engagement with the authorities through high level policy dialogue, institutional capacity building programmes and, in close cooperation with other IFIs, assist in strengthening the framework and policies for (mineral resource) revenue management.
- **Modernising infrastructure and bringing in the private sector.** Mongolia's domestic and international trade expansion will rely on accelerating development of the country's infrastructure, which needs to be achieved within a limited fiscal space, thus calling for exploring avenues for private sector participation. The Bank will support rehabilitation and development of Mongolia's infrastructure, including through development of renewable energy, adoption of sustainable tariffs, commercialisation and modernisation of state-owned public utilities, and structuring viable PPPs where possible.

In all these activities the Bank seek to align its operations with the priorities of the Mongolian Government and will cooperate closely with other international financial institutions and multilateral and bilateral partners, including the European Union. The

Bank will engage in active policy dialogue and continue to provide technical assistance to maximise transition impact in Mongolia.

1 THE BANK'S PORTFOLIO

1.1 Overview over Bank activities to date

Mongolia became an EBRD country of operation in October 2006. Prior to 2006, the Bank's activities in Mongolia were limited to technical assistance programmes funded by donors (EUR 5.9 mn). From 2006 to 2012, the Bank signed 52 projects including debt, mezzanine, equity finance and trade finance guarantee facilities for an aggregate amount of EUR 690 mn. During the same period, the Bank committed EUR 14.6 mn in technical cooperation programmes through its Legal Transition Programme, Enterprise Growth Programme (EGP) and Business Advisory Services (BAS) and other programmes.

In the current strategy period, the Bank's engagement in Mongolia expanded steadily. Today, EBRD is the leading financier of the Mongolian private sector both in volume and number of transactions. The Bank signed 41 projects for a cumulative amount of EUR 666 mn, and mobilised an additional EUR 1.4 billion in third party investments. The average transaction size was EUR 6.4 mn, excluding two very large mining (related) transactions. The Bank provided support to over 250 micro, small and medium-sized enterprises (MSMEs) through EGP, which committed EUR 2.9 mn, and through BAS, which committed EUR 2.7 mn during the strategy period.

During the strategy period, EBRD's operating assets have grown to EUR 385 mn (65% of portfolio). The Bank's current stock of projects is well-diversified, with 50 per cent in the industry, commerce and agribusiness sectors, 35 per cent in the natural resources and power sector and 15 per cent in the financial sector. Reflecting the general capital intensive nature of the extractive sector, 79 per cent of the Bank's total outstanding loan portfolio as of end 2012 relate to energy sector projects, 14 per cent to industry, commerce and agriculture projects and 7 per cent with financial institutions.

Since the start of its operations in Mongolia, all EBRD financed projects have been concluded with private sector corporates, mainly with Mongolian enterprises.

Table 1: Portfolio Development in Mongolia as of 31 December 2012

SECTOR	NET CUMULATIVE BUSINESS VOLUME			CURRENT PORTFOLIO STOCK				
	Number of projects	EBRD signed	EBRD % of Total	Number of projects	Portfolio	% of Portfolio	Operating Assets	% of Operating Assets
<i>Amount in EUR million</i>								
Energy	20	521	76%	16	459	77%	295	77%
Natural Resources	18	485	70%	14	423	71%	266	69%
Power and Energy	2	36	6%	2	36	6%	29	7%
Financial Institutions	8	62	9%	7	47	8%	39	10%
Bank Equity	1	5	1%	1	5	1%	5	1%
Bank Lending	2	25	4%	3	21	4%	21	6%
Insurance, Fin Services	0	0	0%	0	0	0%	0	0%
Small Business	6	32	5%	5	21	3%	13	3%
Industry, Commerce & Agri	24	107	15%	23	89	15%	51	13%
Agribusiness	7	69	10%	6	56	9%	34	9%
Equity Funds	2	8	1%	2	8	1%	1	0%
ICT	1	1	0%	1	1	0%	1	0%
Manufacturing & Services	14	28	4%	14	23	4%	15	4%
Property & Tourism	0	0	0%	0	0	0%	0	0%
Infrastructure	0	0	0%	0	0	0%	0	0%
Municipal	0	0	0%	0	0	0%	0	0%
Transport	0	0	0%	0	0	0%	0	0%
TOTAL	52	690	100%	46	595	100%	385	100%

Table 2: Portfolio Development in Mongolia from 2009-2012

Amount in EUR million	2009	2010	2011	2012	Development over end 2009 - 2012
Net Cumulative Business Volume	132	306	364	690	+€558m
Current Portfolio Stock	114	268	308	595	+€481m
Number of Operations	23	30	36	46	+ 23 operations
Operating Assets	98	221	238	385	+€287m
% Undrawn	14%	18%	23%	35%	(MAK II largely undrawn at this stage)
					(cumulative 2010- 20 12)
Annual Business Volume	31	185	62	419	+€666m
Number of Operations	8	13	12	16	+41 projects
Gross Disbursements	43	138	29	188	+€355m
Annual Cancellations	0	25	0	0	€25m
Active Pipeline Stock	181	609	630	480	
Private Sector Share (% Portfolio)	100%	100%	100%	100%	
Non Sovereign (% Portfolio)	100%	100%	100%	100%	

1.2 Implementation of the previous country strategy

The previous country strategy was approved on 21 October 2009 and identified the following strategic priorities:

- To finance local enterprise growth and development, including exploring the possibilities for direct financing especially in the form of equity in key sectors attracting strong and reputable international investors.
- To support the consolidation and strengthening of the financial sector, including improving the capitalisation of selected banks to provide long term funding coupled with institutional building initiatives with individual banks, promoting the Trade Facilitation Programme (TFP) and supporting the development of non-bank financial institutions.
- To support the sustainable development of the natural resource sector through providing debt and equity finance to privately owned mining companies and requiring adherence to the highest environmental, transparency and corporate

governance standards; to consider supporting rehabilitation of Mongolia's energy infrastructure, particularly in the renewable energy segment.

- To support private sector initiatives for the development of critical infrastructure mainly through Public Private Partnership's (PPP) and, within the limited fiscal space available for non-concessional funding, to consider financing sovereign public infrastructure projects.
- To engage in active policy dialogue with the Bank of Mongolia on improving the banking sector supervision and regulation and to encourage sector consolidation; continue to support the Consultative Council for Investment Climate as a platform for public-private sector dialogue; and further support the effective implementation of the Extractive Industries Transparency Initiative (EITI).

Mongolia witnessed a remarkable economic transformation during the strategy period as it recovered from the 2009 financial and banking crisis to become the fastest growing economy in the world with an annual 17 per cent GDP growth in 2011. The economic recovery, supported by a US\$ 225 mn IMF stand-by programme, was largely driven by the rapid development of Mongolia's natural resources industry and the recovery of commodities prices. Of particular significance was the signing of the landmark Oyu Tolgoi (OT) investment agreement in 2009 which launched the development of the largest undeveloped copper mine in the world, brought substantial FDI into Mongolia, and paved the way for other agreements with international mining companies.

The EBRD was able to contribute to these positive developments, as the Bank increased the number of projects signed from a 24 in 2009 to 52 at the end of December 2012 (with a respective increase of portfolio stock during the same period from EUR 132 mn to EUR 690 mn).

Financing local enterprise growth and development

The Bank, using products available to it under the Early Transition Country Initiative (ETCI), provided direct (or indirectly through local banks) EUR 32 mn of debt or equity finance through 15 projects to corporate enterprises in the beverage, cashmere, telecommunication and pharmaceuticals industries. The transition impact achieved in the corporate sector was mainly related to increased competition, higher level of transparency and corporate governance standards, adoption of IFRS, and introduction of modern (including energy efficient) technologies.

The Bank continued to provide technical assistance through the EGP, through which it provided EUR 2.9 m of technical support to enable 46 primarily mid-sized corporates to access international best practice. In addition BAS implemented 222 local advisory projects with individual MSMEs, most of which have less than 50 employees, as well as a number of market development activities.

Supporting consolidation and strengthening of the financial sector

Due to the collapse in commodities prices, the Mongolian economy was significantly impacted by the global crisis of 2008-2009. The economic downturn and the related depreciation of the local currency negatively affected the private sector. This in turn

put substantial pressure on the Mongolian banking sector and contributed to the failure of two mid-size Mongolian banks. The bankruptcy of EBRD's investee commercial bank at the end of 2009 due to weak corporate governance practices and inaccurate financial reporting highlighted the need for strengthening of the central bank's supervision framework as well as the need for more stringent corporate governance standards in the sector. The EBRD provided technical assistance to fund the appointment of an experienced interim-management team of a state owned 'bridge bank' responsible for managing the performing loans of one of the failed banks. This contributed to a more transparent insolvency process related to the failed bank.

The EBRD also continued to support the banking sector through providing debt and equity finance to selected partner banks. The Bank's focus has been on expanding the lending capacity of local banks to Mongolian private corporate enterprises. The Bank provided in aggregate EUR 66.2 mm of medium-term debt to Mongolian banks through three credit lines (including EBRD's first local currency denominated facility) and two Medium-sized Co-Financing Facilities (MCFF). On the equity side, the Bank strengthened capitalisation of one of its partner banks, which enabled that bank to continue to expand its lending to the SME sector while complying with the regulatory minimum capital ratios. On a case-by-case basis, the Bank complemented its financial programs with capacity building programmes with partner banks including those aimed at strengthening risk management capabilities.

The sustainable development of the natural resources sector

The natural resources sector was the principal driver of Mongolia's exceptional economic growth during the previous strategy period. The Bank provided debt and equity finance to a selected number of emerging Mongolian mining companies allowing these companies to capitalise on the favourable conditions in the global commodities (especially gold, iron and coal) and financial markets. The Bank, has been leading the transition process towards responsible mining in Mongolia by promoting the highest environmental, social, health and corporate governance standards. Through third party syndication, the Bank has further been instrumental in mobilising international debt finance for the Mongolian mining sector.

In parallel to one major mining investment, the Bank provided small business support to develop a local supply chain near the investee mine. Market development activities reached more than 100 beneficiaries/SMEs in three South Gobi towns and contributed to growth in local employment, conclusion of a number of supply contracts between SMEs and the mine, and improved access to finance through local banks. The Bank aims to repeat this successful model with future mining investments.

Support for critical infrastructure

In the energy sector, the Bank has been instrumental to the development of a high transition impact first industrial wind power project in Mongolia. The Bank's early stage equity seed capital to the local project sponsor contributed to the signing of the first-ever power purchase agreement between a state-owned energy transmission company and a privately owned power generator. This allowed the EBRD (and a co-financier) to co-fund through additional equity and debt the construction of a 50 MW

wind park. The wind park, the first renewable project under the 2007 Renewable Energy Law, is expected to become fully operational in 2013.

Policy dialogue

The Bank engaged with the financial authorities to discuss ways of managing the inflow of large natural resource revenues. The Bank provided technical assistance to the Bank of Mongolia to develop an inflation targeting capacity programme. This programme, established in close coordination with the IMF and the World Bank, also assists the BoM in improving its communication strategy with the financial markets

The Bank provided capacity support to the Mongolian secretariat of the EITI which contributed to Mongolia becoming EITI Compliant in 2010. The Bank further engaged with the Ministry of Finance and the Bank of Mongolia to provide technical support for the establishment of a deposit insurance agency. The Bank continued its support for the Ulaanbaatar Clean Air initiative aimed at reducing air pollution in the capital city. EBRD's support contributed to the establishment of a Clean Air Fund in 2011 and the passing in 2012 of a comprehensive Clean Air Law.

The Bank, in collaboration with the UN Commission for International Trade Law (UNCITRAL) and the World Bank, completed in 2012 a review of Mongolia's most recent public procurement law aimed at improving transparency, increased participation by SME's in public tenders and civil society participation in public procurement processes. The Bank continues to engage with the government and other IFI's to promote the adoption of a modern and sound secured transaction law which is a key legal reform to increase SMEs' access to finance. The Bank provided support to the Consultative Council for Investment Climate, a donor funded platform established by the Bank in 2008 to improve public-private dialogue. The Bank decided to discontinue the CCIC as alternative public-private platforms have emerged or grown since 2008 (including the Business Council of Mongolia) which are better positioned and have more capacity to take the dialogue to the next stage.

1.3 Transition impact of the Bank's portfolio

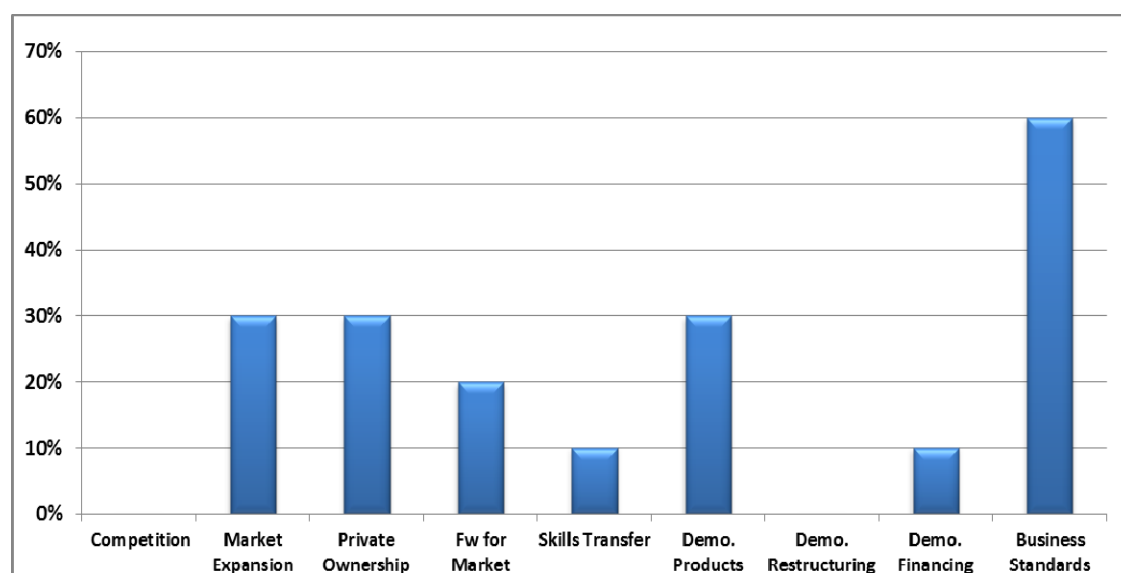
From November 2009 through December 2012, 10 transition-rated¹ operations were signed in Mongolia. All of these new operations were rated as having 'Good' or 'Excellent' transition impact potential, which well exceeds the institution-wide target of 80 per cent of projects to be assessed 'Good' or 'Excellent'. This includes three projects assessed with 'Excellent' transition potential. Two of them are related to the development of the first successfully financed renewable energy project and the first privately owned generator in Mongolia – Salkhit wind farm. The operations therefore can have a positive demonstration effect of introducing replicable renewable energy products and carbon trading schemes to an economy with significant potential in this area. The Bank's participation in the multi-sector private equity investment vehicle (Mongolia Opportunities Fund) has also been rated with 'Excellent' transition impact potential. As this is the first institutional private equity fund for Mongolia, it can potentially expand the market for corporate finance, introduce an additional

¹ 10 additional operations were signed in this period in Mongolia that were not individually rated; these are sub-projects under frameworks (MCFF, DIF and DLF) which are rated and monitored at the facility level only.

competitive source of capital, demonstrate new financing methods, and improve the standards and business conduct for investee companies.

The transition objectives of projects signed during the strategy period reflect the sector distribution of the Bank’s activities in Mongolia in 2009-2012, as well as existing transition gaps in the country. 6 out of 10 rated operations were signed in the energy sector (including renewable energy), which traditionally address transition impact by targeting better standards and regulatory improvements, as well as introduction of new replicable products. The remaining projects in the corporate and financial sectors address expansion of competitive market interactions and advancing business standards. This has resulted in rather diversified transition objectives, with a concentration on corporate governance improvements (Figure 1).

Figure 1. Targeted transition objectives in Mongolia (share of projects), Nov 2009 - Dec 2012



The performance of Mongolia’s portfolio from a transition perspective has been satisfactory. There were 14 operations in the country’s active TIMS portfolio² at end-December 2012. The average rank of Mongolia’s active portfolio stood at 4.58, below that of overall Bank operations (4.08) and above the institutional ceiling.

The below average score can be attributed in part to the immaturity of the portfolio: most projects only recently entered the portfolio (8 out of 14 projects have been signed since 2009) and as such are yet to undergo an upgrade which normally follows a decrease in risks to transition. Four projects have mostly achieved their expected transition potential³. Eight operations, or more than half of the total, are generally on track to achieving their transition objectives.

² Refers to all active operations more than 6 months since signing and are monitored for their transition impact at least once

³ Rank is a combination of the relevant rating for transition impact potential and risks to transition impact. Expected transition of operations is usually monitored once a year and is ranked numerically from 1 to 8, with 1 to 3 indicating mostly realised impact, 3 to 6 – generally on track to achieve transition objectives, and 7 to 8 – minimum transition impact or excessive risks.

Finally, two operations, representing 14 per cent of the country's portfolio, have failed to achieve their envisaged transition impact. The transition impact potential for both of these operations in the financial sector has been significantly downgraded due to negative impact of the financial crisis and, more importantly, internal accountability problems that led to misuse of funds and the bankruptcy of the investee bank.

2 OPERATIONAL ENVIRONMENT

2.1 Political Context

In the regional context, Mongolia stands out as a country which has made significant progress towards pluralistic democracy. Since the beginning of transition two decades ago, Mongolia has adopted a liberal Constitution, developed a competitive political party system, and established a vibrant civil society. 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, though significant challenges remain. The democratic credentials of the country have been recently buttressed by a unanimous decision of the OSCE to accept Mongolia as a member.

The political process in Mongolia is traditionally influenced by the country's two major political parties – the Mongolian People's Party (MPP) and the Democratic Party (DP). The last presidential election in 2008 and the latest parliamentary election in 2012 were not an exception. The MPP was a dominant political faction (holding 46 out of 76 seats in parliament) until the June 2012 elections when the DP took the plurality of the seats in the new legislature.

However, DP's plurality was not sufficient to form a single-party government, thus compelling the DP to enter into a coalition with smaller political parties, namely the Justice Coalition and the Civil Will/Green Party. Against the backdrop of emerging resource nationalism, the Justice Coalition, comprising the Mongolian People's Revolutionary Party (MPRP) and the Mongolian National Democratic Party (MNDP), received considerable support, becoming the third major political group in the country.

The new government, headed by the DP Prime Minister Norovyn Altankhuyag, outlined three main objectives: reducing unemployment through job creation, fighting corruption and making public officials more accountable; and enacting and completing major development and construction projects.

There has been strong demand from parliamentarians since the election in June 2012 to review the Oyu Tolgoi (OT) investment agreement, which some members of the new government are believed to support in principle.

The robustness of Mongolian political governance institutions will be tested by challenges associated with resource-intensive growth and the need to ensure shared benefits of development.

See Annex 1 for a detailed political assessment.

2.2 Macroeconomic Context

Mongolia has experienced a major mining boom. Growth accelerated from 6.4 per cent in 2010 to 17.5 per cent in 2011 before slowing down somewhat to 12.3 per cent in 2012. High prices of copper and other commodities and expansionary fiscal policy have also contributed to the strong growth performance.

Higher commodity revenues also led to strengthening of the togrog, although this trend has been arrested and partially reversed in 2012 as the global economic environment weakened. The Central Bank has been able to build up reserves of around US\$ 4 billion (around 8 months of imports) and extended its swap line with China to US\$ 1.6 billion. The Development Bank of Mongolia managed to place US\$ 600 mn in government-guaranteed five-year bonds at 5.75 per cent yield which was followed by a debut Sovereign issue for US\$ 1.5 bn with an even lower yield suggesting continued investor interest in Mongolia.

Inflation has remained volatile, predominantly at elevated levels (11.3 per cent at end-February 2013). The recent rise in price level was driven mainly by significant increases in public sector wages and social transfers before the June 2012 general elections.

Growth is expected to accelerate again in 2013 as Oyu Tolgoi mine, one of the largest copper and gold deposits in the world, comes on stream, and remain high in the medium term. Oyu Tolgoi and other major forthcoming investments in the mining sector will continue bringing in substantial investment over the next 2-3 years (FDI exceeded 35 per cent of GDP in 2011 and 2012). Negotiations on the development of a major coal deposit, Tavan Tolgoi, are on-going, and there are plans to build a new 1,100 km West-East railway link.

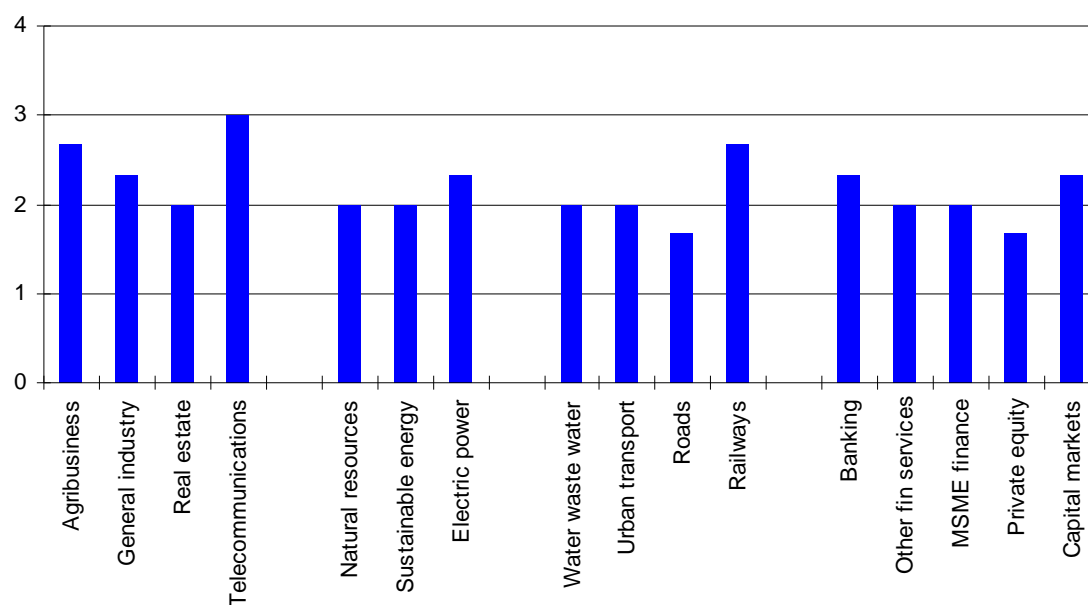
Despite sustained high commodity prices, public and external debts are projected to continue rising as mining projects and related infrastructure require significant public and private investments. The economy remains vulnerable to a renewed downturn in global commodity prices, which may weaken investment and economic activity and lead to delays with key mining projects. Developing manufacturing sectors in a volatile macroeconomic environment will also present a major challenge as will dealing with a possible appreciation of the Togrog eroding Mongolia's price competitiveness ('Dutch disease').

See Annex 7 for a table with Selected Economic Indicators.

2.3 Structural Reform Context

Mongolia is relatively far advanced in terms of promoting private ownership. At the same time, further efforts are needed to strengthen market institutions and address shortcomings in standards of corporate governance and business conduct. The remaining transition challenges in Mongolia are predominantly assessed as large, although some sectors, including agribusiness and railways, are more advanced in transition (Chart 2.1).

Figure 2.1. Mongolia: Transition Scores, by Sector, 2012



Source: EBRD Transition Report 2011.

Mongolia continued experiencing an extraordinary mining boom, with foreign direct investment reaching 50 per cent of GDP in 2011. Consequently structural reforms were predominantly aimed at strengthening the framework for dealing with the resource boom. In October 2010 Mongolia achieved compliance with the Extractive Industries Transparency Initiative (EITI), the global standard for improved transparency in the oil, gas and mining sectors.

The Fiscal Stability Law, which strengthens fiscal discipline, was passed in June 2010 and will come into full force in 2013-14. It introduces a transparent formula for copper price projections (one of the key fiscal parameters) and provides for the establishment of a stabilisation fund, into which excess commodity-related revenues could be paid during the periods of high commodity prices. Such a stabilisation fund would be complementary to the existing Human Development Fund which is currently used, *inter alia*, as a vehicle for distributing cash transfers to the population. The Integrated Budget Law passed in December 2011 further improves reporting of government contingent liabilities and strengthens public investment planning.

The authorities have adopted a number of laws to meet growing investment and infrastructure needs in connection with the forthcoming expansion in mining activity. These include the State Policy on PPPs which was adopted in October 2009, the Law on Concessions (January 2010) and a Railway Policy (July 2010). To further facilitate much-needed investment in infrastructure and other development projects the government set up the Development Bank of Mongolia (DBM). The DBM, which officially opened in May 2011, is a state institution with a broad development mandate, which is expected to focus on infrastructure, including infrastructure for social housing projects.

In May 2012 a new law on foreign investment was adopted. This law requires approval from both government and parliament for any foreign investments that buy a

stake of more than 49 per cent in businesses in certain strategic sectors. Amendments passed in April 2013 subsequently relaxed certain provisions of the law. In particular, parliamentary approval now only applies to companies with state participation, while investments in strategic sectors by private foreign firms are subject to government approval. Whilst the law only applies to new investments, it is also applicable when changes are made to existing investments.

The Mongolia Stock Exchange (MSE) reached an agreement on a partnership with the London Stock Exchange (LSE). Under the Master Service Agreement signed in April 2011, the LSE is helping MSE to upgrade its IT trading platform and build up capacity, also in anticipation of possible (dual) listings by Mongolian mining companies.

See Annex 2 for a more detailed assessment of transition challenges.

2.4 Business Environment

The business environment in Mongolia remains relatively good by regional standards but progress over the last three years has been mixed according to the World Bank's 2012 *Doing Business* surveys. In *Doing Business* 2013 Mongolia ranks 76th among the 185 countries surveyed, up from 86th position in 2012 (but down from the 58th position in 2009). Mongolia scores particularly well in the areas of contract enforcement, investor protection and property registration, while the overall rating is constrained by low scores for access to electricity and trading across borders.

According to the 2008-09 round of the World Bank / EBRD Business Environment and Enterprise Performance Survey (BEEPS), the main obstacles to doing business according to firms surveyed in the country are access to finance, tax rates and lack of a skilled workforce. Corruption is also perceived to be a significant challenge. According to the 2012 Transparency International Corruption Perceptions Index (CPI), Mongolia ranks 94th out of 176 countries. Due to changes in TI's methodology in 2012, comparisons with previous year's scores are not possible.

2.5 Social Context

Mongolia is the least densely populated country in the world, with up to half of its 2.8 million population living in the capital city of Ulaanbaatar. Migration from rural to urban areas has been increasing in recent years as business opportunities and living conditions are perceived to be better in these areas. However, living conditions in the ger districts of large cities can be very poor. Moreover, such migration contributes to pollution, in particular in winter in Ulaanbaatar, when low-quality coal or other combustible material is burnt in stoves for heating.

The mining boom of recent years brought about a rapid increase in average per capita incomes. Consequently, the level of poverty (using the national definition based on the minimum consumption basket) declined from 35 per cent in 2007 to 30 per cent in 2011 (and from 47 per cent to 33 per cent in rural areas). The unemployment rate declined from the peak of around 12 per cent following the 2008-09 crisis to below 8 per cent, although it still exceeds 15 per cent in South Gobi aimag. Life expectancy has been increasing reaching 68 years (65 years for men and 74 years for women) but remains modest by international standards.

The second round of the EBRD-World Bank Life in Transition Survey conducted in 2010 attests to a relatively high degree of life satisfaction in Mongolia: 54 per cent of respondents characterized themselves as satisfied or very satisfied with their lives, compared with the average of 43 per cent across EBRD countries of operations. This in part reflects rapid growth in incomes in 2010. By contrast, the crisis of late 2008-early 2009 had hit Mongolian households very hard. As many as 83 per cent of survey respondents have been negatively affected by the crisis, and almost 40 per cent had to cut back on consumption of basic items.

Despite geographical challenges, basic education is provided universally, with an estimated literacy rate and a gross enrolment rate of around 97.5 per cent.

2.6 Legal Context

The Bank's recent assessments show that Mongolia's legal and judicial regimes have not kept pace with the recent economic developments in the country. In particular, reform is urgently needed to support non-resource sector development. The Civil Code provisions applicable to security over movable property (equipment, inventory, receivables, etc.) are not adapted to market economic practices. Introducing a modern legal regime for taking security interests, including expanding the choice of assets available for pledging and improving the enforcement procedures, would help the Bank in its support to the SME sector. A modern and easily accessible register of pledges is also needed.

The legal framework for public-private partnerships benefits from a good-quality concession law passed in 2010. During the new strategy period, the Bank intends to support reform efforts to improve public procurement legislation.

Mongolia is in the early stages of developing its capital markets. Work is needed to strengthen legislation to attract more investment, both from abroad and locally. As part of the EBRD Local Currency and Local Capital Markets Development Initiative, the Bank conducted an assessment in October 2011, which highlighted a number of areas in need of reform, such as investors' civil remedies against local debt capital market participants and disclosure requirements for debt offerings.

In addition, the EBRD *Judicial Decisions Assessment 2011* found that the quality of court judgments in commercial law matters in Mongolia was among the weakest in the region. The Bank is currently helping to put in place more systematic and targeted judicial training in areas of commercial and administrative law.

For a more detailed legal assessment see Annex 3.

2.7 Energy Efficiency and Climate Change Context

The high energy intensity of the Mongolian industry (in particular mining) offers a significant potential for energy efficiency (EE) improvements. Mongolia's energy intensity is twice the EU average. The industrial sector is the most energy intensive. Nevertheless, there is still a lack of awareness of EE among a significant part of the economy and local financing institutions which are still often unfamiliar with EE projects. In addition, Mongolian retail electricity rates are currently maintained well below even a basic cost of service rate. The rates are so low that many energy

generators cannot cover their service costs without direct government assistance. This has led to slow the development of EE projects.

Coal fired power generation dominates the country's electrical energy supply (96 per cent of energy generation) and remaining generation is mainly supplied through oil fired plants (approximately 3 per cent) and renewable energy (less than 1 per cent). Coal dominates heating supply which is significant in Mongolia given severe climatic conditions.

Mongolia has an ambitious National Renewable Energy Programme (NREP) which sets targets to increase the renewable sources of supply from under 1 per cent in 2005, to 3-5 per cent in 2010 and 20-25 per cent by 2020. The subsidisation of Mongolia's energy system represents a challenge to RE development. Institutionally, Mongolia has made significant strides and there is a sound regulatory framework and operational structure. Additional clarity of roles and responsibilities would serve to heighten investor confidence in the sector, and additional renewable energy incentives and support schemes would likely increase needed investment.

Climate change adaptation

Mongolia's exposure to climate change risks lies mainly in its dependence on agricultural production and on the vulnerability of its water resources to shifts in precipitation patterns, as described in Mongolia's Second National Communication to the UNFCCC (2010). Projected climate change impacts on water resources in Mongolia present a complex picture with a high level of uncertainty and regional variability. The overarching picture is one of shifts in hydrological patterns which may result in increased surface flows in certain river basins and in some seasons, reductions in surface runoff in others, and shifts in the seasonality of spring floods.

Climate change adaptation for Mongolia includes the improved management of water resources, including encouraging the efficient use of water resources, promoting water saving technologies, water metering systems and water recycling. Reducing the loss of water from its distribution and water transmission systems is also identified as a priority. Improvements in water efficiency will help overall water resource management, as well as public health and environmental benefits.

In response to these needs, the Bank will look for opportunities to support optimising water efficiency in water-intensive sectors and industries such as agribusiness, manufacturing and mining, and improvements in water infrastructure to contribute towards water conservation.

3 STRATEGIC ORIENTATIONS

Mongolia's rapidly growing economy offers increased opportunities but also poses new challenges. The basic principles of good public governance – adherence to the rule of law, strong institutions, accountability and transparency of government and a stable investment climate – are increasingly relevant for Mongolia in the next strategy period.

Although Mongolia is relatively far advanced in terms of promoting private ownership, the country still faces substantial transition challenges. The Bank, due to its deep and broad engagement in the Mongolian private sector, is well placed to continue to support the private sector and the development of market institutions in the country. The key challenges and strategic orientations for the coming Strategy period are:

- **Promoting diversification through support for non-resource sectors.** Mongolia's mining boom has resulted in an increased dependence on volatile commodity revenues. The relative weight of the mining sector in the economy needs to be reduced over the medium term through supporting development of a competitive non-extractive sector. Potentially competitive viable industries may include those in agribusiness, local manufacturing and tourism where Mongolia has high untapped potential. This requires adoption and implementation of an appropriate market framework as well as encouraging private sector participation to avoid the pitfalls of purely state-led industrial development. The Bank will aim to continue its engagement with the Mongolian non-extractive private sector through provision of financing, advisory and technical assistance, as well as through policy dialogue aimed at developing an enabling business climate and the appropriate institutional and legal frameworks.
- **Promoting sustainable growth through broadening access to finance.** As the economy receives large and increasing inflows of capital and commodity revenues, it is particularly important to develop a strong financial sector capable of channelling these inflows throughout the economy, allocating resources efficiently through effective intermediation and allowing for these financial resources to benefit the growth of the private sector. This requires strengthening banking regulation and supervision, improving corporate governance and business conduct of banks, strengthening the deposit insurance system, supporting development of capital markets through upgrades to legal and physical infrastructure and improving access to finance in remote areas of the country and strengthening non-banking financial institutions (including micro-finance institutions and leasing companies). The Bank will support the financial sector through SME-debt programmes, equity and specific technical assistance programmes.
- **Promoting responsible mining and strengthening governance institutions.** Mongolia's mining boom should be leveraged to attain the country's development and transition goals. This requires further strengthening of market and governance institutions and developing a transparent, effectively regulated mining sector and a long term framework for managing commodity revenues. The Bank will continue to offer debt and equity finance to reputable local mining companies which meet its high environmental, health, safety and corporate governance standards. To attract the required foreign capital, Mongolia will need to provide a stable business environment, including prudent fiscal policies and adherence to the Rule of Law. It is also important to develop backward and forward linkages to mining operators. The Bank will engage actively with its mining clients with the aim to build local mining supply chains and will consider investments in mineral-based processing industries supported by reputable and financially strong operators. In support of strengthening of public sector governance, the Bank will increase its engagement with the authorities through high level policy dialogue and institutional capacity building programmes. In close cooperation with other IFIs,

the Bank will consider providing assistance to strengthen the framework and policies for (mineral resource) revenue management, including through the EITI. The Bank will actively engage with the Mongolian Government to promote enhanced transparency and disclosure in the mining sector, including in Concession Agreements.

- **Modernising infrastructure and bringing in the private sector.** Mongolia's domestic and international trade expansion will rely on accelerating development of the country's infrastructure, which needs to be achieved within a limited fiscal space, thus calling for exploring avenues for private sector participation. The Bank will support rehabilitation and development of Mongolia's infrastructure, including through development of renewable energy, adoption of sustainable tariffs, commercialisation and modernisation of state-owned public utilities, and structuring viable PPPs where possible.

In its investments in Mongolia, the Bank will pay close attention to the need for sound environmental management and resource efficiency, in line with its Environmental and Social Policy, in consideration of the country's specific challenges (see section 3.2).

3.1 Key Challenges and Bank's Operational Response

3.1.1 Promoting economic diversification through support for non-resource sectors

Transition Challenges

- Building on its commodity boom, Mongolia needs to create a business enabling environment and support the development of private enterprises in non-mining sectors of the economy with high standards of corporate governance and business conduct. Achieving this also requires provision of the necessary legal and ICT infrastructure.
- Integrating a nomadic culture into the supply chain of a modern agricultural industry will require substantial improvements in the agricultural infrastructure in the rural areas. There is also a large scope for improving productivity and efficiency of enterprises along the entire value-added chain, including lifting and hygiene standards and developing modern retail.
- Supply of modern residential, commercial and tourism-oriented property needs to be improved in a sustainable manner with due regard to environmental and energy efficiency issues.

Operational Response

The EBRD will use a range of ETCI instruments to support enterprises in the non-mining manufacturing sectors. The Bank will continue to provide support to privately-owned manufacturing and service companies, including to enterprises with export potential, such as cashmere and wool as well as enterprises that can effectively compete with imported product alternatives, like construction material and pharmaceutical producers. The Bank will also consider participating in larger scale bankable industrial processing projects supported by reputable and financially strong

strategic sponsors. The Bank will pursue emerging ICT business opportunities, including in the telecommunications sector.

The Bank will support development of a modern agribusiness sector through financing of both retail and food processing companies contributing to the development of modern retail outlets and improved food quality, health, safety and corporate governance standards. The Bank will also support initiatives by its client food processing companies to create backward linkages to agricultural producers contributing to raising competitiveness in the sector and fostering inclusive development. In consultation with its local partner banks the Bank will consider the possibility of launching a pilot agribusiness debt finance programme that would fit Mongolia's nomadic culture and practices.

The Bank will support private sector initiatives in property and tourism. The Bank will consider energy efficient property projects aimed at developing affordable residential dwellings, quality office space, warehouses/logistic facilities, business and mid-range hotels and modern retail facilities. The Bank will support projects with improved health & safety practices during construction. In tourism, the Bank will consider supporting the development of tourism infrastructure and services to improve Mongolia's attractiveness as a tourist destination.

The Bank will continue to support small businesses in Mongolia through technical assistance. The Bank's Enterprise Growth Programme (EGP) will focus on delivering substantial managerial and structural changes and the introduction of international best practice to SMEs by engaging experienced international executives and industry experts as advisers. The Business Advisory Services (BAS) programme will enable MSMEs to access a diverse range of consulting services by facilitating projects with local consultants on a cost-sharing basis. In addition BAS will undertake market development activities to develop the business consultancy services sector and continue the ETCI accounting improvement programme to support clients' access to finance.

Policy dialogue

In support of the rule of law and Mongolia's general business environment, the Bank will continue to provide legal transition support to create a commercial law curriculum to improve the understanding of Mongolian judges of commercial law issues.

The Bank will continue to work together with other IFI partners to support the adoption and implementation of the secured transaction law and the related establishment of a moveable asset registry, which should increase access by corporates in the non-extractive sectors, including SMEs, to bank finance.

3.1.2 Promoting sustainable growth through broadening access to finance

Transition Challenges

- The financial sector is an important conduit of commodity revenues to the wider economy with a key function of ensuring effective allocation of financial

resources towards the most effective uses in terms of investment in physical infrastructure and other projects as well as use of human capital.

- The institutional framework in the financial sector needs to be strengthened further to ensure financial stability and sustained financial deepening. It is also important to further strengthen the role of the supervisor and to improve standards of governance and risk management practices of banks, as well as strengthen the legal framework for collateralised lending and deposit insurance.
- MSMEs in the remote and rural areas remain underserved by the financial system and competition is weak in certain areas outside major urban centres. Access to finance at competitive terms in these areas is key to ensuring inclusive and sustainable nature of growth in Mongolia.
- Mongolia continues to attract foreign investments and it will be increasingly important to channel the portfolio investments effectively, so that these capital flows facilitate the country's economic development in a sustainable manner. As Mongolia becomes a middle income country, it will be also important to build a domestic capital market in which savings of the Mongolian people could be effectively mobilised to support the country's economic development. Mongolia is still in the very early stage of developing its capital markets, and there is a large gap to fill.
- Sustainable growth building on natural resource wealth will also rely on deepening of the non-bank financial sector and development of pension management industry. Non-bank financial services, including insurance, a secondary mortgage market, privately owned pension funds, asset management and leasing needs to be developed in terms of legal and regulatory environment, capital base and widening of the product range as well as in terms of strengthening the skills base.

Operational Response

The Bank will consider possible opportunities to provide additional capital to reputable local banks with an aim to continue to improve corporate governance standards in the sector. Mongolian banks are in need of additional capital to fund the expected growth of their loan portfolios, which is fuelled by the mining boom. To support the growth of the banking sector, the Bank will consider providing equity or quasi-equity to banks which comply with EBRD's corporate governance standards. The Bank will also consider acting as an anchor investor to Mongolian banks considering an initial public listing on an international stock exchange. The Bank will also support strengthening the deposit insurance system.

The Bank will aim to increase the availability of medium term finance to local MSME's through existing and new intermediating partner banks. The Bank will seek to strengthen financial intermediation with local commercial banks through the provision of various forms of medium term debt products to be on-lent to the private sector. The Bank's MSME debt facilities and its co-financing and risk share facilities (MCFF) will remain the cornerstone of the Bank's engagement with the financial sector. To facilitate increased trade between Mongolia and its trading partners, the Bank will also continue to actively roll out the Regional Trade Finance Facilitation Program (TFP) to current and new customers.

The Bank will aim to widen access to MSME finance by engaging with alternative, non-banking financial service providers such as micro-lenders targeting niche MSME markets underserved by the banks. The Bank will also review financing opportunities with local equipment leasing companies backed by reputable sponsors. In close consultation with its partner banks, the Bank will review opportunities to contribute to inclusive growth in the rural areas, including through improved access to finance at competitive rates for women-owned businesses in the country side.

To improve the access to local currency funding and in line with EBRD's 2011 Local Currency and Debt Capital Markets Initiative, the Bank, subject to support from the local authorities, will continue to promote MSME local currency medium-term credit lines to eligible partner banks (as well as directly to SME corporates). The Bank will also consider providing technical and/or financial support to privately owned insurance companies and pension funds both of which are essential elements for the development of local debt capital markets.

Policy dialogue

The key component in the policy dialogue in the financial sector will be institution building, through work with the financial authorities as well as with the local banks. The Bank will continue to engage with the financial and regulatory authorities to support reforms aimed at further strengthening of the banking and non-banking financial sector, including improved banking regulation and supervision. In close consultation with all stakeholders, the Bank will explore areas of support for possible consolidation of the banking sector as well as the privatisation of State Bank.

The Bank will continue with its technical support programme to establish a deposit insurance agency replacing the existing government guarantee on bank deposits.

The Bank will engage in active policy dialogue and provide technical assistance where appropriate to support the development of Mongolia's local currency and capital markets. The Bank will continue to review with its partner banks areas of technical support in risk management and corporate governance.

3.1.3 Promoting responsible mining and strengthening governance institutions

Transition Challenges

- To ensure that the mining sector becomes an engine for inclusive, sustainable growth it is crucial to promote transparency, good governance (including open procurement processes), the introduction of advanced technologies and high standards of business and environmental conduct in mining.
- A key challenge is to develop a system of effective regulation for the mining sector, the main driver of Mongolia's economic development. Such a system would need to ensure transparent and sustainable revenue management.
- To promote a sustainable mining sector it is important to increase value-added content of the domestic industries related to natural resources and strengthen linkages between the mining sector and local suppliers.

Operational Response

Promoting responsible mining will be an important priority for the Bank in Mongolia. EBRD will continue to offer debt and equity finance to reputable local mining companies which meet EBRD's high environmental, health, safety and corporate governance standards. The Bank's engagement will focus on private independent domestic and international mining companies at various stages of the mining development cycle. The Bank will encourage investment by reputable international mining operators, working with local mining companies to provide the necessary risk bearing capital as well as to engage in skills transfers thereby contributing to building a Mongolian mining skill base and improved governance standards. The Bank will consider investments in smaller mining projects including, on a selected basis, early stage mining exploration projects.

Through its engagement with mining projects, the Bank will review opportunities to support both upstream linkages and downstream value chains. The Bank will consider providing (possibly co-funded with mining companies) technical assistance support to upstream SME mining supply companies, with particular focus on supporting, through BAS Mongolia, local SME businesses located near the mines (including practical support, for instance supporting local SMEs in obtaining loans from local banks). The Bank will consider providing (possibly on a limited recourse basis) debt and equity finance to privately owned commercially viable downstream mineral processing plants backed by reputable and financially strong private sponsors and subject to the Banks' environmental and social policies.

The Bank will consider providing selective financial and technical support to state-owned mining entities which are to be privatised. In such cases, the Bank's technical assistance support can extend to changes in the field of management systems, corporatisation, good corporate governance, transparency and the introduction of international best practices for health, safety and environment. An important requirement for engagement by the Bank with state-owned entities will be an acceptable corporate governance framework ensuring the mine operates on a commercial basis and at arm's length from the state.

Policy dialogue

Continued technical support by EBRD to the Mongolian secretariat of the EITI will remain a cornerstone of EBRD's policy dialogue in the mining sector. An effective EITI framework is an important component of the institutional and governance framework, as it is an independent monitor of sector receipts and revenues. Mongolia became an EITI-compliant country in 2010 and the Mongolian secretariat is being supported by both World Bank and EBRD technical assistance programmes. Additionally, the Bank, through its mining finance projects, will continue to promote adherence to best governance, transparency and revenue management by requiring its project sponsors to comply with EITI principles as well its information provisions.

The Bank is considering providing technical assistance support to the Mongolian mining sector association aimed at improving the procurement processes of its members (and to provide the same, on a case by case, basis to individual mines) which can lead to improved access by local SMEs to mine procurement opportunities.

To help ensure sustainable mining development, the Bank will seek opportunities to promote technical capacity building in the Government and amongst local stakeholders, including local governments, to enhance environmental regulatory, monitoring and evaluation capacity.

3.1.4 Modernising infrastructure and bringing in the private sector

Transition Challenges

- Success of diversification policies will depend on adequate provision of supporting infrastructure. A modern power generation system is needed to meet the growing power demands of the population, the mining industry and other fast growing industries in an efficient and environmentally sustainable manner. Power sector companies are old, polluting and inefficient and need to be replaced. Tariff methodologies need to be reviewed to make tariffs cost-reflective, and incentives for improving energy efficiency in various sectors of the economy need to be strengthened.
- Mongolia has high potential with regards to renewable energy, in particular in wind power, which remains largely untapped.
- The challenges in the water, solid waste and public transport sectors include commercialisation of operations of utilities with a view to improve service provision. This includes the development and application of modern tariff methodology focusing on cost recovery within affordability constraints; introduction of metering where suitable; improved collection rates; financial and operational performance improvement and stakeholder participation programmes.
- In the urban transport sector, there is a need to increase the autonomy of publicly owned companies, develop contractual arrangements with the municipalities, prepare the framework for private sector participation, and improve operational performance and the quality of service. The safety and technical regulations also need to be improved. Further challenges include the development of an integrated urban road management system in Ulaanbaatar.
- Road construction and maintenance are characterised by insufficient funding, transparency and competition. Ensuring sustainable funding for road network requires a reform of road user charges and budget allocations. Private involvement in this area is at an early stage of development.
- Further improvements are needed in governance and transparency of the incumbent railways, alongside further commercialisation of its operation. The existing network is in need of modernisation and development of new routes under the new institutional model allowing for private sector participation under concession agreements.

Operational Response

The Bank will continue to lend its support to rehabilitating Mongolia's aging power infrastructure and developing renewable energy projects. The Bank, in close consultation with other IFI's, will consider providing financing (most likely on a PPP basis) to replace the aging power infrastructure in Mongolia. The Bank's financing will be conditional upon adherence to, *inter alia*, the Bank's procurement policies. Building on its successful first wind park project where EBRD acted as the anchor investor, the Bank will support financially viable private sector wind power

initiatives backed by reputable private sponsors. The Bank also stands ready to review commercially viable renewable initiatives in other areas such as solar and, possibly, hydro supported by reputable and financially solid private sponsors.

The Bank will provide support to the development of Municipal Environmental Infrastructure (MEI). The Bank will consider financing improvements in critical municipal and environmental infrastructure, both through sovereign and sub-sovereign structures throughout the country. The projects will contain a substantial TC-enhanced policy dialogue component geared at improving the quality and reliability of services, commercialisation, including a tariff reform, and improving the regulatory framework.

To provide support to the development of Mongolia's transport infrastructure, the Bank will consider financing the expansion of the railway infrastructure. The Bank will focus in particular on possible PPP projects in the South Gobi with reputable sponsors. The construction of railways for bulk commodities like coal will generate substantial economic benefits and reduce the environmental impact, including contributing to protection of the local biodiversity. The Bank will consider supporting a possible reform program with UB Railways through providing financial and technical assistance to commercialise and modernize its operations.

Policy dialogue

The Bank will provide technical support to strengthen governance, institutional capacity and commercialisation of municipal infrastructure. The Bank may also provide capacity building and sector development support, including to regulators.

Mongolia is expected to substantially increase its public spending on infrastructure and a strong public procurement framework and its implementation will therefore be increasingly important. Such a framework will allow improved access by local suppliers to the public sector procurement process and therefore can contribute to the diversification of the economy. Moreover, a robust public procurement framework incorporating proper checks and balances will increase transparency and can significantly contribute to the institution building of government agencies. To that end, the EBRD started in 2011, together with the UN Commission on International Trade Law (UNCITRAL) and the World Bank a comprehensive review of the Mongolian public procurement law. The review was completed in 2012 and a policy workshop to discuss assessment results and recommendations for further sector development is scheduled in 2013.

The Bank aims to conclude its technical support to the Government's coordinated efforts to improve the air quality in Ulaanbaatar during the strategy period. The Bank's intervention has been focused on: (i) capacity building for the newly established Clear Air Fund, (ii) development of a system of clean fuel distribution in the ger districts in Ulaanbaatar and, (iii) a public awareness program to facilitate public support for the initiative.

3.2 Environmental and Social Implications of Bank Proposed Activities

The Bank's Environmental and Social Policy and Performance Requirements will continue to apply to all projects carried out in Mongolia. The Bank will work closely with clients on developing Environmental and Social Action Plans with the objective of mitigating negative impacts and ensuring compliance with Mongolian national standards and the applicable EBRD Performance Requirements. It will be important to identify any vulnerable populations that may be disproportionately affected by the projects and to ensure that stakeholder engagement activities include any marginalised groups. Health and safety is also an important consideration for all projects and the Bank will work with clients and sponsors to promote the development of an appropriate safety culture and performance.

Environmental issues in Mongolia vary with geographical location. In the north, the geography is dominated by forested highlands while the south is a lower lying desert and steppe where water stress is a significant issue.

The forest lands to the north are vulnerable to illegal logging and fires, both man-made and naturally occurring. While infrastructure is better developed in the north, there are still considerable improvements to be made in that infrastructure in regards to road construction and power distribution for example, and impacts to water quality, biodiversity and the local population will require to be managed appropriately.

The vulnerability of shallow groundwater is a particular issue in the south, where both the local population and biodiversity depend on wells and springs which tap this resource. This limited resource can be impacted by, for example, activities such as road development cutting through shallow geology, excavation related to mining or other industrial development removing the water bearing horizons, and pollution from industrial activity. The Bank will continue to seek and encourage co-operation with government and industry in approaching conservation and protection of this resource at a regional level. Furthermore, the Bank will explore opportunities to work with the Mongolian Government on a regional biodiversity strategy given likely on-going impacts of mining development on this fragile ecosystem.

The rapid development of the natural resources sector and associated infrastructure in the south, and elsewhere in the country, presents both risks and opportunities to develop capacity to manage environmental and social impact in a more structured manner and consider the cumulative impact of the developments. Given the proliferation of mining activities, particularly in the South Gobi, the Bank will work with the Mongolian Government and other MDBs on the development of a regional water strategy that takes account of (1) sustainable water resources for mines and residents; (2) pasture management for livestock improvement; and (3) wildlife conservation needs. A regional groundwater management plan will also need to be created to guide sustainable allocation and inform granting of future water permits.

Climate change related impacts to this resource could have significant impacts to the environment and population given the extreme vulnerability of the groundwater resource. EBRD will seek opportunities for investments that improve the climate change resilience of all vulnerable sectors and enhance the protection of vulnerable resources.

Mongolia has a diverse and distinctive flora and fauna, including a large number of rare and endangered species, the distribution of which varies across the country. The low population density, coupled with a historical lack of industrial development, has resulted in Mongolia being one of the key last remaining ranges for a significant number of species such as the Khulan and Houbara Bustard. Protection of these endangered species shall be a feature of the Bank's investments in areas and regions where such flora and fauna are present.

In terms of social issues, Mongolia supports a small population with a low density across the country. The population of Ulaanbaatar has grown significantly over the past years via migration from the countryside and the infrastructure in the city is subject to pressures related to this growth. The rural population typically follows a herding lifestyle, although a smaller farming sector is present, and risks to these individuals and groups include desertification, pastureland degradation due to overgrazing, soil erosion and direct pollution impacts from the rapid industrial developments occurring in various regions throughout the country.

Gender

In accordance with its current Gender Strategic Initiative, the Bank will work with its clients in Mongolia in selected areas to promote economic opportunities for women. In the Natural Resources sector, in particular in mining, the Bank will identify opportunities to work with its clients to promote equal opportunities in the work place as well as in SME mining supply companies. In line with the new MEI Policy, projects will be designed and implemented, to the extent possible, so as to ensure that services are responsive to the needs of both men and women. In the corporate sectors, energy and infrastructure sectors clients will be encouraged to promote equal opportunities in access to employment and in the work place and provided with support where necessary. The Bank will work with its clients in the financial institutions sector to identify ways, where appropriate, to support women entrepreneurs in terms of facilitating their access to finance and supporting their business activities, in particular in rural areas.

4 ACCESS TO CAPITAL: PRIVATE AND PUBLIC SOURCES OF FINANCE

4.1 Access to capital

The banking system in Mongolia has been historically highly concentrated. The level of concentration has further increased considerably, as two large banks went into receivership in 2008-09. As a result, the top 3 of the 14 banks account for around 80 per cent of the banking system assets. The banking system saw very rapid rates of credit growth, of around 60 per cent per annum in recent years and over 80 per cent in the consumer segment. At the same time, as the deposit base also expanded rapidly, the loan-to-deposit ratio remained below 100 per cent and deposits continue to be the most important source of funding. The ratio of private sector credit to GDP exceeded 50 per cent by end-2011. So far, there has been no entry of foreign strategic investors

into the market, perhaps owing to its relatively small size. The level of dollarization of banking deposits and loans has remained relatively modest, at around 30 per cent.

Data on private sector external debt remain incomplete and disputed. While historically such debt was presumed to be very low, recent Central Bank estimates put it at up to 30 per cent of GDP, mostly in the mining sector.

Many rural areas of Mongolia are difficult to access and they are often served by a single credit institution, limiting effective competition in these areas. While microfinance and small enterprise finance are relatively well developed, 37 per cent of micro, small and medium-sized enterprises (MSMEs) interviewed during the 2009 round of the Business Environment and Enterprise Performance Survey (BEEPS 2009) perceived access to finance as a major or very severe obstacle to operations of the firm.

Through the EBRD's Local Currency and Local Capital market Development Initiative, the Bank conducted an assessment in October 2011 which highlighted a number of areas in need of reform. First, there is an immediate need to develop a suitable security custodial arrangement, which can address both foreign institutional and domestic retail investors' needs. A suitable security custodial arrangement must consider not only different investor needs, but also the requirements for depository, security clearing and settlement agencies, as well as the market reality if the desired arrangements could be implemented in an economically feasible manner. Second, as a first step to develop an efficient capital market, it will be necessary for Mongolia to deepen its interbank money market. Despite the stagnation of interbank money market transaction in Mongolia, the repo market has grown substantially recently, and the Bank's assessment also revealed the possible scope for improvement both in terms of the transaction mechanics and the linkage with the monetary policy implementation by the Central Bank.

In this regard, the Central Bank is already participating in the inflation targeting capacity building program which the Bank is implementing for the ETCs. This programme, established in close coordination with the IMF and the World Bank, addresses the recommendation from the assessment mission by assisting the BoM anchoring inflation expectations thus creating stronger incentives for local currency savings.

Mongolia has a public credit information reporting system (registry) and a private credit information bureau is being set up. The survey of credit information bureaus, their customers and regulators conducted by the EBRD in 2010-11 suggests some need for further improvements to the legal framework for credit reporting systems.

The Mongolia Stock Exchange (MSE) has operated since the early 1990s but capitalisation, liquidity and trading volumes have remained fairly low. With the mining boom under way, demand for a well-functioning stock exchange has increased. Capitalisation of the MSE stood at around US\$ 1.3 billion (under 20 per cent of GDP) in the first half of 2012. Although the MSE lists over 300 companies (of which many are not in compliance with the MSE rules), liquidity remains relatively low, with a turnover-to-capitalisation ratio of around 17 per cent in 2011 (and thus a turnover of less than 4 per cent of GDP). The MSE entered into a Master Service

Agreement with the London Stock Exchange (LSE). LSE is expected to help MSE to upgrade its trading platform and build up capacity.

Mongolia has a long-term foreign-currency sovereign rating of B1 from Moody's, B+ from Fitch, and BB- from Standard & Poor's. The sovereign rating is sensitive to the outlook for commodity prices.

4.2 MDB finance and collaboration with other IFIs and multilateral donors

The EBRD closely coordinates its investment activities and policy dialogue efforts and technical assistance initiatives with the IMF, World Bank and ADB and with private sector focussed donors. In view of EBRD's increased depth and breadth of activities, it will further increase the coordination with IFI's and donors on private sector development programmes. The Bank's role in supporting the development of larger infrastructure related projects is set to increase (with a focus on PPP's) and this will require enhanced co-operation with other IFI's.

Formal donor coordination is carried out through an annual donor coordination workshop organised by the World Bank in which EBRD participates, although informal donor coordination, made possible by the small size of the community, is more regular and effective.

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

International Monetary Fund (IMF)

Since 1991, the Mongolian Government has been supported by the IMF in its efforts for economic reforms and poverty reduction. The IMF's 18-month Stand-By Arrangement, approved in April 2009 with an amount of US\$ 229 mn, and was successfully concluded in October 2010.

The main goal of the IMF supported economic programme was to ensure that Mongolia quickly returned to a path of strong, sustained, and equitable growth with low inflation. The government's commitment to implement sound policies was a critical ingredient to the success of the program.

Further to the completion of its Stand-By Arrangement, IMF reduced in 2011 its presence in Mongolia though regular post-IMF programme monitoring visits are being organized to discuss with the authorities the economic outlook and policy challenges.

EBRD will work closely with the IMF to explore opportunities for complementary technical support to general or sector specific development or capacity building programs, in particular with the Ministry of Finance and the Bank of Mongolia.

World Bank Group

Mongolia joined the World Bank Group and its IDA (International Development Association) in February 1991. As per the end of December 2012, the World Bank has provided US\$ 578.8 mn to Mongolia, assisting the country in the areas of poverty

reduction, private sector development, financial sector reforms and infrastructure development. US\$ 52.5 mn of the financing was on IDA grant terms and US\$ 525.9 mn was on IDA credit terms. Mongolia also has received an additional US\$118.5 mn from the World Banks' global donor trust funds.

As of the end of December 2012, there are 13 active IDA-supported investment and technical assistance operations with US\$ 211.1 mn in commitments, and 14 active recipient-executed trust funds in the portfolio with a total donor commitment of US\$ 63.8 mn.

In the Country Partnership Strategy for 2012 – 2017, the World Bank identifies three areas of support: to enhance Mongolia's capacity to manage the mining economy sustainably and transparently; to build a sustained and diversified basis for economic growth and employment in urban and rural areas; and to address vulnerabilities through improved access to service, better safety net provisions and improved disaster risk management.

EBRD will work closely with the World Bank to explore opportunities for complementary technical support to general or sector specific development or capacity building programs, in particular with the Ministry of Finance, Financial Regulatory Authority and the Bank of Mongolia.

International Finance Corporation (IFC)

IFC offers three lines of services, investment services, advisory services and finance through its asset management company, a wholly owned subsidiary of IFC created to channel resources held by sovereign funds, pension funds and other institutional investors to investment opportunities in the developing countries.

Since 1997 IFC has been active in Mongolia concluding as per the end of 2012 15 private sector projects with total commitments of US\$ 311 mn in three broad areas: the development of (i) the financial sector, (ii) infrastructure and (iii) the industrial base, property and agribusiness sector. The outstanding and committed portfolio of IFC's investment in Mongolia as of the end of December 2012 is US\$ 267 mn across nine clients.

IFC's investment services provide a broad suite of financial products including loans, equity, trade finance, structured finance, risk management products in all sectors. IFC's advisory services offer advice in a broad range of topics aimed at private sector development, ranging from to support the Government to implement reform to improve the business environment to promoting access to finance and corporate governance.

In the previous strategy period, IFC and EBRD have worked closely on the secured transaction reform and when jointly investing into a (first) non-mining industry focussed on-shore Mongolian private equity fund. EBRD is expected to continue to work closely together with IFC to support possible other high risk and high transition impact private sector initiatives. In addition, EBRD is cooperating with IFC on a possible debt finance package to the Oyu Tolgoi project. Other areas of cooperation

between the Bank and IFC could be on projects related to the development of infrastructure, mainly power and railways.

Asian Development Bank (ADB)

Mongolia became a member of the Asian Development Bank in 1991. To date, ADB has been the government's single largest source of official development financing. It has extended at the end of 2012 48 loans totalling US\$ 918.4 mn, which includes one OCR loan totalling US\$ 29.7 mn. . ADB 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. To date, ADB also provided technical assistance support amounting to US\$ 80.6 mn and grants under the Japan Fund for Poverty Reduction totalling US\$ 34.2 mn.

In 2007, Mongolia became eligible for the concessionary Asian Development Fund (ADF). Since then, ADB has extended 12 ADF funded projects for a total of US\$172.2 mn. In 2011, at the request of the government, Mongolia was reclassified as an 'ADF blend country' giving it access to ADB's ADF as well as ADB's ordinary capital resources.

ADB's regional cooperation and integration-related support to Mongolia is delivered through the Central Asia Regional Economic Cooperation (CAREC) programme and country lending operations. Major achievements include start-up of an US\$ 45 mn project to develop a regional multimodal logistics centre in Zamyn Uud (South Gobi) and the development of joint customs control with the People's Republic of China.

According to ADB's 2012-2016 Country Partnership Strategy, ADB will concentrate its support for on growth and inclusive social development on four sectors: transport, energy, water supply and other municipal infrastructure and services, education and health.

EBRD will work closely with the ADB to explore opportunities to co-financing projects on a PPP basis in support of the development of the power and heat generation, municipal and environmental infrastructure and the (railway) transport infrastructure in Mongolia.

United Nations Development Programme (UNDP)

The United Nations Development Programme (UNDP) has been in Mongolia since 1973. Under the 2007-2011 UNDP country programme, UNDP contributed USD 24.2 mn on a grant basis. The Government of Mongolia and the United Nations Development Programme have developed the UNDP Country Programme Action Plan (CPAP) for 2012-2016 which covers three principal areas: (i) Democratic governance, (ii) Poverty reduction and achievement of Millennium Development Goals and, (iii) Environment and sustainable development. The financial resources required for the current program are estimated at US\$ 28 mn.

4.3 Cooperation with the European Union

Since the political reforms started in Mongolia in the early 1990s, relations between the EU and Mongolia have developed progressively and currently four EU Member States have embassies in Ulaanbaatar. The inclusion of Mongolia as a country of operation for the EBRD and the opening of the EBRD office in Ulaanbaatar in 2006 has added another dimension to the European-Mongolia cooperation. The EU is planning to sign a Partnership and Cooperation Agreement with Mongolia in 2013 that will open the door for more intense and deep cooperation with both the Mongolian authorities and other donors and IFI's present in the country.

The EU-Mongolia Strategy Paper for 2007-2013 identifies sustainable employment, the improvement of living conditions in the countryside and the slowdown the rural exodus as its main focus. A main objective is to support poverty alleviation by allocating 80 per cent of the cooperation budget to sustainable rural development. EU support during that period included two bilateral cooperation programmes both of them focusing on rural incomes and development. The first programme (EUR 9 mn) focuses on animal health and livestock marketing, the second programme (EUR 10 mn) focused on promoting sustainable livelihoods and sustainable development in rural areas. The first programme is being implemented via Technical Assistance to the Ministry of Industry and Agriculture (MoIA) while the second program was successfully concluded through an EU contribution agreement with the World Bank, which coordinated the implementation of the project via a multi-donor trust fund.

In 2011, the EU signed a contribution agreement with the EBRD for a five-year, EUR 4.0 mn, comprehensive SME development programme with interventions at macro level (i.e. to improve regulatory environment for Mongolian SME's), meso level (i.e. to strengthen Mongolian business advocacy associations) and, micro level (i.e. to provide direct technical assistance individual SME's).

The EU has started in 2012 its Development Cooperation Instrument (DCI) programming exercise 2014-2020 and will develop its Multi-Annual Indicative Programme 2014-2020 during the first half 2013. Future interventions will continue to focus on sustainable and inclusive growth and institutional capacity building to support the formulation and implementation of policies in pursuit of the Millennium Development Goals (MDG). Particular attention will be given to support Mongolia's aim to adapt to European principles, norms and standards. The EU's future programme will be in line with and fully supportive of Mongolia's national development plan.

The Bank will continue, through regular joint steering committee meetings, work closely together with the European Union to implement a 5 year (2012-2016) EU funded programme aimed at strengthening the SME business enabling environment in Mongolia.

ANNEX 1 – POLITICAL ASSESSMENT

Mongolia continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank.

Since the beginning of transition two decades ago, the country has adopted a liberal Constitution, developed a competitive political party system, and established a vibrant civil society. 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 of human rights, though significant challenges remain.

The main challenge for the new Government, established following the June 2012 parliamentary elections, is to manage transparently the wealth generated by vast natural resources in a country with significant levels of poverty. Mongolia's future is closely tied to the development of the minerals sector and a key task is to put in place accountable institutions and policies that ensure shared benefits of growth.

Free Elections and Representative Government

Free, fair and competitive elections

The law provides citizens the right to change their government, and this right is exercised in practice through regular elections based on universal suffrage.

Since 1990 Mongolia has consolidated its democratic achievements through six parliamentary and five presidential elections, which were recognised as being largely in conformity with international standards for free, fair and competitive elections.

In December 2011 the Electoral Code was amended to allow 28 out of 76 seats in parliament to be elected under proportional (party list) representation, with the remaining 48 elected from 26 multi-member electoral districts. The law established a mandatory 5 per cent threshold to be awarded seats under proportional representation. The proportional seats in parliament created better opportunities for smaller political parties to increase their role in Mongolian politics, which was traditionally strongly influenced by the country's two major political parties – the Mongolian People's Party (MPP) and the Democratic Party (DP).

The last parliamentary elections took place on 28 June 2012 and were broadly in line with international standards. They were recognised as an important step in the strengthening of democracy in Mongolia. Domestic and independent international observers were allowed to monitor the elections.

The elections brought victory to the opposition Democratic Party (DP). Due to the cases of malfunctioning of the electronic voting machines, the incumbent Mongolian People's Party (MPP), and some smaller parties, called for a manual re-count of the votes in disputed electoral districts. MPP boycotted the first sessions of the newly-elected Parliament, demanding resolution of electoral irregularities.

Fears that a close election result could renew the civil unrest that marred the 2008 parliamentary elections did not materialise. The changes in the electoral legislation allowed a higher degree of representation of different political forces in parliament.

The last presidential election took place in 2009. Former Prime Minister Tsakhiagin Elbegdorj of the (at that time) opposition DP was elected President with a majority of 51 per cent. Nambaryn Ekhbayar of the MPRP conceded defeat after receiving 47 per cent of the votes.

Separation of powers and effective checks and balances

Mongolia is a democratic and unitary republic. The head of state is the president, directly elected for four years. The Constitution limits the president to two four-year terms in office. The prime minister is the head of government. All legislative power is vested in the State Great Khural, Mongolia's unicameral parliament, which has 76 members who are elected by popular vote for a term of four years.

A separation of powers and responsibilities between the legislature, the executive, and the judiciary is enshrined in the Constitution. A formal separation of powers is laid out in the 1992 Constitution, however members of parliament simultaneously hold posts in the cabinet, which has been allowed after the Constitution was amended in 2000. In principle, holding office in two separate branches of government could compromise horizontal accountability and undermine parliamentary oversight of the executive. However, in practice, the State Great Khural has been actively exercising its oversight function in recent years, frequently summoning the ministers to parliamentary hearings. The judiciary is largely independent but its independence is hampered by a number of factors, outlined below.

The government introduced several initiatives aiming at promoting transparent governance. The Law on Preventing Conflict of Interest in the Public Service, adopted in January 2012, was an important step towards increasing transparency within the government and preventing abuse of office. The Freedom of Information Law of June 2011 has granted every Mongolian citizen the right to seek information from government institutions and authorities about their activities, human resources, budget, finance and procurement of goods and services.

Despite these achievements, there is a need for further enhancement of information disclosure practices, improvement of the capacity to conduct policy analysis on draft legislation, and the methods of implementation and performance evaluation of the public administration.

Effective power to govern of elected officials

Mongolia's elected officials have considerable power to govern without constraints on their power.

The military is under firm civilian control and does not play a significant role in the political decision-making process.

Civil movements report that financially powerful oligarchs have some influence on the government. There are large companies and groups that fund political parties. These groups exert some influence on the government, including via mass media.

Civil Society, Media and Participation

Scale and independence of civil society

Mongolia has a vibrant and, to a large extent, well organised civil society, which has played an important role in facilitating the transition from communism to a pluralistic democracy since the early 1990s.

Civil society takes an active part in initiating new laws and regulations, and is capable of exercising pressure to ensure proper implementation of the adopted legislation. To strengthen networking and exchange between civil society organisations, a Civil Society Council was established in 2008. The Council represents the common interests of many NGOs, trade unions, civic and human rights movements and aims to liaise between the government and civil society organisations.

Civil society groups working on human and women's rights issues have developed good partnerships, and they exert effective pressure on policy-making and the legislature. In recent years, due to the growth of the mining sector and its impact on the environment and on the local communities, the number of interest groups involved in environmental protection has grown noticeably.

Independent pluralistic media that operates without censorship

The media in Mongolia are free to report on a wide range of issues. There are currently about 40 broadcasting channels and 16 daily newspapers. The Media Freedom Law, enacted in 1998, prohibits state ownership of media. According to specialised reports, the overwhelming majority of the media is operating without state interference but in a number of cases links between media owners, state officials and major political forces are reported. This is particularly evident during election campaigns.

Multiple channels of civil and political participation

The legislature is legally obliged to seek feedback from stakeholders and the general public while drafting a new law. To this end, the parliament, on the initiative of civil society, organises seminars, workshops and public hearings where draft laws are discussed with the representatives of civil society organisations which are active in the particular field.

In 2009 the President's office established a so-called Citizen's Hall, a public hearing forum designated to encourage civil participation in the planning and decision making process of the legislature. While the citizens in the Citizen's Hall do not have law-making powers, the process helped to forge citizens' engagement through consultations. Despite these initiatives, some civil groups insist on the need to 'institutionalise' the consultation process, thus making it less *ad hoc*.

Freedom to form political parties and existence of organised opposition

The political process in Mongolia is traditionally strongly influenced by the two major political parties – the MPP and the DP. The latest presidential (2008) and parliamentary elections (2012) were not an exception. The former Communist Party, the MPP, was a dominant political faction (holding 46 out of 76 seats in parliament) until the June 2012 elections, with the DP taking the majority of the seats in the new legislature. However, this majority was not sufficient to form a single-party government, thus compelling the DP to enter into a coalition with other political parties, namely the Justice Coalition, and the Civil Will/Green Party.

Against the backdrop of emerging resource nationalism, the Justice Coalition, comprising the Mongolian People's Revolutionary Party (MPRP) and the Mongolian National Democratic Party (MNDP), received considerable voter support, becoming the third major political group of the country, with 11 seats in the newly-elected parliament.

The key changes in the party system of Mongolia in 2010 had an impact, together with other factors, on the outcome of the 2012 general elections. The MPRP changed its name to the MPP (dropping the word 'revolutionary' from its title). The Supreme Court has acknowledged the MPP as a successor of the MPRP. The former president and MPRP leader Nambaryn Enkhbayar quit the party in protest and launched a new political party under the old name. While the MPP has split, smaller parties have undergone a process of integration. Expecting to achieve better results in the 2012 general election, the Civil Will Party and the Green Party have merged in 2011.

Rule of Law and Access to Justice

Supremacy of the law

Article 14 of the Constitution guarantees equality before the law of all citizens regardless of their ethnic origin, language, race, age, sex, social origin or status, property, occupation or post, religion, opinion or education.

The case of former President Nambaryn Enkhbayar, who has been sentenced to 4 years in prison on charges of corruption, is often cited as a proof that politicians in Mongolia cannot place themselves above the law. However, supporters of Enkhbayar claimed that this was a case of selective application of justice.

Independence of the judiciary

The judiciary is independent but citizens complain about corruption and nepotism in the judicial system. In their contributions to a UN human rights review, human rights organisations reported that due to pressure from the authorities judges cannot work independently and are susceptible to corruption.

Although the judiciary is largely independent, there are still factors hampering its independence, including insufficient salaries of judges, an overall underdeveloped culture of the rule of law in the political system, and an insufficient enforcement of the rules regulating the independence of the judiciary.

Government and citizens equally subject to the law

The right to a fair trial is enshrined in the legislation and public officeholders are subject to prosecution when they violate the law. However, in practice officials who break the law and engage in corruption are not always or sufficiently punished.

The law provides for the right to a fair public trial. Closed proceedings are permitted in cases involving state secrets, rape cases involving minors, and other cases provided by law.

Effective policies to prevent corruption

Corruption is perceived to be a serious problem in all branches of power and at all levels of government. The Independent Agency against Corruption is the government body responsible for fighting corruption. Public faith in the agency was low as it was not always viewed as politically impartial. On Transparency International's Corruption Perception Index in 2012, Mongolia ranked 94 out of 176 countries.

There is an understanding in the country that fighting corruption is essential for transparent and successful economic development. This is especially relevant now when the strength of the democratic institutions of the country will be tested by the quality of transparent management of Mongolia's vast mineral resources.

There were steps towards a merit-based appointment of civil servants. Although senior official positions are often distributed according to party affiliation and therefore subject to change where there is a change in government, civil servants particularly in executive positions are recruited through an examination offered and administered by the Civil Service Council.

Civil and Political Rights

Effective guarantees of fundamental rights and freedoms

Fundamental democratic freedoms and liberties are guaranteed by the Constitution and generally respected in practice. Mongolia ratified all major human rights treaties and protocols, including all core International Labour Organisation conventions. The country has a National Human Rights Commission. Its mandate includes the review of complaints on human rights and freedoms.

Although the Constitution guarantees freedom of expression and human rights, NGOs specialising on media freedom criticise provisions of the Criminal Code and the Law on State Secrets which prevent journalists from enjoying the rights to freely acquire and publish information. Some journalists who accused public officials for corruption were themselves charged for libel or defamation.

Freedom of association and assembly are protected by the Constitution, laws on trade unions and NGOs and the Law on the Registration of Legal Entities. In general, the citizen groups and NGOs are free from state intrusion and interference.

The law provides for freedom of movement within the country, foreign travel, emigration and repatriation, and the government generally respect these rights.

There are no government restrictions on access to the Internet. Individuals and groups could engage in the peaceful expression of views via the Internet, including by e-mail.

In January 2012 the Parliament ratified the Second Optional Protocol to the International Covenant on Civil and Political Rights aiming at the abolition of the death penalty, which follows the moratorium on the use of the death penalty established in January 2010.

Political inclusiveness for women, ethnic and other minorities

There are no legal impediments to the participation of women, ethnic or other minorities in government and politics but their numbers remained small. Equal rights for women are enshrined in the Constitution but it is important to eliminate discrimination against women in real life in a variety of contexts including employment and family. There were reported cases of discrimination and violence against LGBT (lesbian, gay, bi-sexual and transgender) persons, as well as ethnic minorities, with a number of Chinese residents in Mongolia being subject to harassment and intimidation.

After the Election Law was amended to provide that at least 20 per cent of the candidates proposed by a political party or coalition shall be represented by women, the representation of women in the newly-elected parliament increased to 9 MPs. After the elections the female MPs formed a parliamentary group, and held a meeting with representatives of women's NGOs to discuss policies to support women.

Freedom from harassment, intimidation and torture

The law prohibits torture and other cruel, inhuman, or degrading treatment or punishment.

However, there were reports that the police, especially in rural areas, occasionally abused prisoners and detainees. There were cases where force was used unnecessarily, particularly to obtain confessions. During 2011 the Office of the State Prosecutor received 50 complaints against officials suspected of torture. Of these, 37 were dismissed for failure to comply with the relevant code's definition of torture. The government has plans to amend the Criminal Code to define torture as a crime in line with the UN Convention against Torture.

ANNEX 2 – ASSESSMENT OF TRANSITION CHALLENGES

Sectors	Market structure	Market-supporting institutions
Corporate sectors		
Agribusiness	Medium	Medium
Manufacturing and Services	Large	Medium
Real estate	Large	Large
Private equity	Large	Medium
Telecommunications	Large	Medium
Energy		
Natural resources	Medium	Large
Sustainable energy	Large	Medium
Power	Large	Large
Infrastructure		
Water and wastewater	Large	Large
Urban transport	Large	Large
Roads	Large	Large
Railways	Medium	Medium
Financial institutions		
Banking	Large	Medium
Insurance and financial services	Large	Large
MSME	Large	Large
Capital markets	Large	Medium

INDUSTRY, COMMERCE AND AGRIBUSINESS

Agribusiness

Market structure: *Medium*

Market institutions: *Medium*

Key challenges: (i) further advance reforms in road and rail sectors to facilitate private investments in the sector in the rural areas; (ii) enhance hygiene, quality and traceability standards to improve competitiveness and marketability; (iii) optimise agricultural production in the context of nomadic structures

Mongolia started comparatively early to liberalise the trade and price regime and completed the liberalisations by 1996. Subsidies to the agricultural sector were generally minimal with the exception of government intervention on bread prices, but increased since 2008 via “The 3rd Campaign of Reclaiming Virgin Lands” which included provision of subsidised inputs and lending. In recent years, grain yields have increased but prices still lack competitiveness due to the use of obsolete technique and infrastructure (irrigation). Intensive livestock farming for milk and meat sector similarly suffers from lack of investments over the years as well as structural

challenges in a sector dominated by nomadic traditions. Large and small scale privatisation is largely complete. However competition and restructuring of the food sector along the whole value-chain remains slow and modern retail has only recently started to develop. Quality, hygiene and traceability standards remain a major challenge for the whole sector. An important bottleneck seems lack of financing to rural areas and insufficient investment into rural infrastructure including transportation services, warehouses, logistics, specialised infrastructure and primary processing assets. The livestock sector which accounts for most of the agricultural output in the country is highly vulnerable to extreme weather conditions and may benefit from the introduction of weather insurance system, a pilot for which has been launched by the World Bank in 2006 and should be expanded in the course of 2012.

Manufacturing and Services

Market structure: *Large*

Market institutions: *Medium*

Key challenges: (i) strengthen public administration and judiciary to further promote new entry and exit and create an environment to support the growth of small and medium-sized enterprises; (ii) enhance corporate governance and business practices of large group companies; and (iii) establish centralised collateral registration and related by-laws to ease access to financing.

Manufacturing and Services 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. Improved competitiveness and expansion of private enterprises and privatisation of state-owned enterprises are the key remaining challenges to improve productivity and efficiency. Mongolia appears to have an adequate competition law and it established some positive track record of competition enforcement. Nonetheless, according to World Bank Doing Business 2012, there remain still obstacles in starting a business, obtaining construction permits and resolving insolvency. The lack of centralised collateral registration office and related legislation is a significant hurdle for enterprises to obtain financing from multiple sources. Significant challenges remain in corporate governance standards and transparency of emerging private group companies.

Real estate

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) increasing supply of affordable housing, well designed commercial property, especially outside the fast developing office segment in Ulaanbaatar; (ii) streamlining property-related bureaucracy and ensuring transparency in land sales and property registration; and (iii) improving building standards across segments, with particular focus on energy efficiency and sustainability.

The property market is at relatively 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 mortgage market remains small. Challenges related to

registering and obtaining clear titles to 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 privatisation. The accuracy, accessibility and efficiency of the formal system for recognizing and transferring land rights are expected to improve in the context of the “Property Rights Project”. There are a number of modern hotels in Ulaanbaatar, but significant challenges remain, especially in rural areas. Gaps in terms of the development of modern primary and secondary legislation supporting the sustainability of real estate (energy efficiency, impact on environment) are still large. Public awareness of the sustainability issues is also low.

Private equity

Market structure: *Large*

Market institutions: *Medium*

Key challenges: (i) improving understanding of and broadening companies’ access to PE and VC financing; (ii) facilitating the launch of (SME-focused) PE and VC funds; (iii) facilitate improvements in the governance standards and investment principles in the Fund sector; and (iv) increasing interest in Mongolia (outside large mining-related companies) among reputable international Sponsors and LPs.

A viable private equity industry is gradually being established, in part through entry of foreign private equity funds that establish representative offices in the country and have started sourcing transactions. Two country focused funds have been identified (one of which focusses entirely on mining) and Mongolia is included in the portfolio scope of one regional fund manager. The country has a relatively high level of active capital invested primarily due to the impact of one large mining investment made by a USD 2.5 bn fund based in China (estimated at 2.7 per cent of GDP), however, capital available is estimated to amount to only 0.7 per cent of GDP. Whilst much of the investment attention is fixed on the mining extractive industry, the first country focussed SME private equity fund in Mongolia was launched in 1H2011; the Fund included international professionals combined with a locally based team. Participation by local institutional investors is limited to corporates, while other institutional investors have negligible investments. Mongolia’s conformity with OECD’s Principles of Corporate Governance is relatively good. However, a difficult business environment, limited investment opportunities and poor exit prospects all negatively affect growth of the sector.

Telecommunication

Market structure: *Large*

Market institutions: *Medium*

Key challenges: (i) privatising the fixed line incumbent Mongolia Telecom; (ii) further developing the regulatory framework; and (iii) further developing the telecommunications infrastructure (broadband internet, mainly outside larger urban areas).

The telecommunications sector is regulated by the Communications Regulatory Commission of Mongolia (CRC). The regulatory framework is still relatively far from best practices (e.g. in terms of the implementation of competitive safeguards such as local loop unbundling or number portability). To address the challenge of low access, a universal access fund was established with a transparent system to bid for the government subsidies to establish telecom networks in rural areas.

The fixed-line incumbent, Mongolia Telecom, continues to be majority state-owned (with a significant minority stake of Korea Telecom) but it is included in the list of state-owned companies that the government intends to privatise. The incumbent faces competition mainly from mobile operators. In the mobile segment, there is competition between four operators, MobiCom, Skytel, Unitel and G Mobile. Three of the operators are offering 3G services. The maturing mobile segment has recently seen explosive growth and reduction of the market share of the dominant MobiCom from some 90 per cent few years ago to about 50 per cent in 2009. Internet penetration is strong in urban centres, but the rural sector is also catching up. Fixed broadband penetration rate, however, is still very low and some areas are not yet connected to the Internet.

ENERGY

Natural Resources

Market structure: *Medium*

Market institutions: *Large*

Key challenges: (i) improve transparency of the licencing process; (ii) allow state-owned companies to be operated on an independent economic basis; (iii) implement existing legislation, that enables a stable and investor-friendly environment, and develop well-functioning institutions to contain macroeconomic volatility triggered by natural resources revenues; (iv) leverage the mining boom to develop the mining supply chain and create a favourable climate for economic diversification; (v) support the expansion of the oil downstream sector, enhance competition in the fuels distribution sector; and (vi) strengthen the independence and the technical capacity of the regulatory bodies, namely, the Energy Regulatory Administration (ERA), the Mineral Resources Authority of Mongolia (MRAM) and the licensing body for the oil and gas industry, the Petroleum Authority of Mongolia (PAM)⁴.

In Mongolia, where mining accounts for about a fourth of economic activity, a number of large private companies are operating in the sector. Yet, the state maintains a strong influence and control in the extractive sector with the control of large mining groups.

The mining law introduced in 2006 raised royalty rates on metals extraction, and removed some tax holidays. Moreover, Mongolian legislation entitles the state to control 34 per cent (or 50 per cent if it has funded exploration) of any 'strategic' mining operation (operations are defined as having the potential to exceed 5 per cent of GDP at full development). In May 2012, the Parliament passed a new legislation

⁴ Until 2010, MRAM and PAM were part of the Mineral Resources and Petroleum Authority of Mongolia (MPRAM).

restricting foreign ownership of “strategic industries”, including mining, banking and telecommunications. The law was subsequently amended in April 2013. It requires parliamentary approval of acquisitions of stakes of 49 per cent or more in businesses in strategic sectors in case of investor companies with foreign ownership. Investments by private foreign firms are subject to government approval.

The petroleum retail market has been liberalised and is dominated by private players, following the acquisition of the formerly state-owned monopolist, NIC, by Petrovis. Mongolia issued the first EITI report in February 2008 and reached compliance status in October 2010. The responsibility for issuing mining licenses rests with the Mineral Resources Authority of Mongolia (MRAM), the implementing agency of the Mongolian Ministry of Industry and Trade. The agency is not yet fully independent and a key challenge ahead will be to strengthen its capacity.

Sustainable Energy

Market structure: *Large*

Market institutions: *Medium*

Key challenges: (i) introduce cost reflective tariffs for end consumers; (ii) develop and implement legal and institutional framework for supporting sustainable energy; and (iii) strengthen capacity for implementation of sustainable energy and carbon finance projects.

Energy tariffs are still not cost reflective and do not include environmental costs. Therefore price signals do not provide incentives to use energy efficiently or to develop renewable energy tariffs. The UNFCCC’s Kyoto protocol has been ratified, and more recently a National Action Program on Climate Change has been developed and a National Climate Committee has been established. These developments warranted an improvement in the transition gap rating for market institutions in the country. However, an effective legal framework is still missing and institutions supporting sustainable energy are weak or non-existent. For example, no energy efficiency law, policies or agencies exist, although a Renewable Energy Law was passed in 2007 supporting RE by a preferential right to sell the output and a feed-in tariff guaranteeing at fixed, long-term price. One wind project is in the process of construction as a result of this law. The extensive use of coal, coupled with inefficient equipment, generate high energy and carbon intensities, continues to create the need for more investments in low carbon supply and more efficient use of energy.

Power

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) increase the corporatisation of the state-owned entity; (ii) establish an independent regulator; and (iii) introduce cost reflective tariffs for end consumers along with adequate measures to protect vulnerable consumers

The Mongolian power system is partially corporatised and legally unbundled but still almost entirely 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. The single buyer market is heavily regulated although there are efforts to auction incremental demand among existing generators. The generation system is ageing, polluting and inefficient while also heavily dependent on Russia for system balancing and the provision of peak power. 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 well below cost recovery levels which in turn create a need for substantial fiscal transfers to support the power sector. 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. Tariff methodologies also need to be revised to attract investment into ageing and inefficient assets. Mongolia has introduced a feed-in tariff mechanism to promote the use of renewable energy resources.

INFRASTRUCTURE

Water and wastewater

Market structure: *Large*

Market institutions: *Large*

The transition challenges remains significant and are identified in the following areas: (i) improvements in regulation (e.g. development and application of the modern tariff methodology); (ii) development of contractual arrangements between the owner/policy maker and the company; (iii) further increases of tariffs and collection rates; (iv) corporate restructuring and further commercialisation (including reduced water losses and increased water quality); and (iv) introduction of meters and meter-based billing.

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 (while assets are generally owned by the municipalities). Tariff increases are somehow politicised in rural areas but close to cost recovery in the capital city (pipe water only), but access to piped clean water is limited even in the capital Ulaanbaatar. There are significant numbers of Gers (i.e. Mongolian tents) which are not connected to piped water and water is provided by communal taps and bottles (which is an expensive way and a loss making business). The sector is least advanced in terms of metering.

Urban Transport

Market structure: *Large*

Market institutions: *Large*

The transition challenges remains significant and are identified in the following areas: (i) development of city-wide urban transport policy (i.e. integrated urban transport strategy); (ii) increase autonomy of publicly owned companies and development of contractual arrangements with the municipalities; (iii) improvements

in quality of services and operational performances; (iv) initiation of steps towards private sector participation; (iv) introduction of e-ticketing system and improvements in collection rates; and (v) the development of integrated urban road and street management system.

Public bus companies have been corporatised to a limited degree in Ulaanbaatar, with the bulk of investment financed by donors and municipalities. Little progress has been made with commercialisation of transport services and tariffs are low. The concept of service agreements and standards for service regulation is still novel and not yet introduced. The collection rate is generally low while the e-ticketing system has not been developed yet. Urban transport planning is underdeveloped and traffic management and road management is at an incipient stage. Safety and parking regulations remain poor, which has limited the commercial viability of private parking investment.

Roads

Market structure: *Large*

Market institutions: *Large*

The key challenges: (i) reform of the road user charges to allow for sustainable maintenance of key roads conditions; (ii) increased competition in construction and maintenance contracts; and (iii) enhancement and transparency of regulatory activities (including public procurement).

While the population in Mongolia is relatively small to the vast land spaces in the country, building and managing road networks are truly challenging for the road agency due to the vast distances to be covered and extreme climate. 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.

Railways

Market structure: *Medium*

Market institutions: *Medium*

The transition challenges remain in two broad areas: (i) further commercialisation and improvements in governance and transparency of the incumbent railways; (ii) the development of the regulatory functions and operational successes of the forthcoming PPP projects. The lack of railway capacity is becoming a nation-wide problem (i.e. a bottleneck for sustainable growth). The modernisation of the incumbent railways and development of new networks, partly privately funded under PPP structures are immediate challenges.

Railways are owned and operated by the Ulaanbaatar Railways, which is a 50:50 joint venture between the Mongolian Government/Ministry of Roads and Transport and the Russian Government/Russian railways since 1949. The railway operates profitably (since it is largely dominated by freight operations), but the sector is under-funded

and there are serious capacity constraints. There is currently no private sector involvement, but currently some PPP projects are under preparation. Three railway licences were issued to private companies in 2009, although to date none of the licensees has been able to invest due to uncertainties about their operating licences. A railway authority was established in 2010 and a comprehensive railway policy was also adopted by Parliament in June 2010, but challenges remain due to the feasibility of some of the proposed railway extension plans.

FINANCIAL INSTITUTIONS

Banking

Market structure: *Large*

Market institutions: *Medium*

Key challenges: (i) broadening access to finance among MSMEs and retail clients, including outside the capital; (ii) facilitating improvements in internal practices of banks, including their corporate governance, risk management and disclosure of risks to borrowers; (iii) strengthening role of the supervisor, improving regulatory framework and market institutions, including through facilitating the establishment and operations of a Deposit Insurance Agency and a privately-owned Credit Information Bureau.

The banking sector in Mongolia is somewhat underdeveloped. Private sector credit to GDP has increased somewhat although remains at low levels of 26 per cent. There are 14 banks and the sector shows high levels of concentration with the top five banks accounting for over 70 per cent of the total assets. Foreign strategic investors have not yet invested in the banking sector. Deposits-to-GDP ratio increased slightly to 35 per cent. The asset to GDP ratio increased substantially from 77 per cent at end 2010 to 88 per cent at the end of 2011. In 2011 25 per cent of deposits (27 in 2010) and 30 per cent of private sector loans were denominated in foreign currency. NPLs peaked in early 2010 at 17.1 per cent; however, they have been declining – largely due to the growth in loan portfolios – in the following months and now stand at 6.7 per cent at the end of 2011. There, however, remains an overhang of overdue credit from the 2008/2009 banking crisis. A new banking law passed early 2010, clarifies on areas such as related party lending, changes in bank ownership and the Central Bank's enforcement powers with respect to regulation and supervision. The anti-money laundering enforcement has improved. Some elements of the regulatory framework remain to be developed, including a need to agree on a structure and establish a Deposit Insurance Agency that would replace the blanket deposit protection currently in place. A privately-owned Credit Information Bureau(s), for example, also need to be introduced to facilitate better credit information about borrowers in the country improving the access to finance.

Insurance and other financial services

Market structure: *Large*

Market institutions: *Large*

Key challenges: Insurance sector: (i) broadening access to insurance, including widening of a range of insurance products available; (ii) facilitating improvement of corporate governance, business conduct and skills base in the sector. Private pension

sector: (i) facilitating establishment of necessary legal and regulatory framework. Leasing sector: (i) broadening access to leasing, including widening of a range of leasing products available on the market. Other sectors: (i) development of mortgage securitisation mechanism and institutions.

The insurance sector remains highly underdeveloped. The insurance penetration is as low as 0.36 per cent of GDP. The state insurance company was privatised in 2004 and as of 2010, there were 17 companies operating in the market. It is almost entirely operated by private companies. However, the top three players hold close to 70 per cent of the market, showing high degree of concentration. The sector is dominated by non-life insurance services, while the life insurance services are virtually non-existent (they account for less than 1% of the total insurance premia). Only very basic insurance products are available and skills remain at basic levels. The regulatory framework remains underdeveloped, however, there have recently been some improvements – Mongolia has joined the IAIS and it has become an associate member of an internationally accredited actuarial body. The private pension sector is non-existent as there are currently no private pension providers and it still requires significant structural reforms. The leasing sector is nascent and leasing legislation and regulatory framework requires further improvements, including potentially considering tax incentives.

Micro, Small and Medium-sized enterprises

Market structure: *Large*

Market institutions: *Large*

Key Challenges: (i) increase lending to MSMEs by reducing costs of borrowing and addressing the mismatch in currencies between the MSMEs' borrowing (in US\$) and their revenues (local currency); and (ii) improving legal and institutional framework that supports SME access to finance including enforcement of creditor rights.

Bank lending to MSMEs accounts for an estimated 40 per cent of total domestic credit to the private sector, while the MSME sector employs around 30 per cent of the total workforce of the country. While the government has made progress with financial sector reforms, the cost of and access to finance still present obstacles for some enterprises, the former partly due to the pro-cyclical inflationary policies of the government. Access to finance has improved considerably, with market competition being 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. Long-term financing remains difficult to access throughout the country and more than a third of firms perceive access to finance as a major obstacle to doing business, according to BEEPS 2009. A private credit bureau is yet to be established (in process). There is a public registry in place that contains loan information for both companies and individuals. According to WB Doing Business, in 2012, the minimum threshold for loans to be registered in that public registry has been eliminated, leading to a significant increase in coverage of loan information to 51.4% of adults (from 19.2% a year earlier).

Secured creditors are not paid first when a debtor defaults outside an insolvency procedure and they cannot seize their collateral after reorganisation. The lack of

centralised collateral registration office and related legislation is a significant hurdle for enterprises to obtain financing using their floating assets as collateral.

Capital markets

Market structure: *Large*

Market institutions: *Medium*

Key challenges: (i) facilitating increase in liquidity in local capital markets; (ii) improving local capital markets infrastructure; and (iii) improving the legal and regulatory framework governing capital markets, including enhancing the legal framework governing securities and other financial instruments.

The public equity market capitalization was USD 1,579 mn, equivalent to just under 18 per cent of GDP in 2011, implying no change from the level in 2010. Large Mongolian companies choose to list on other stock exchanges due to the substantial capital needs coupled with the underdeveloped financial infrastructure with the result that trading on the local exchange is minimal. The listing requirements and their enforcement are weak. The Mongolian Stock Exchange has signed a strategic partnership with the London Stock Exchange in January 2011. The two exchanges will collaborate in areas such as privatisation, modernisation of technological infrastructure as well as the development of an international standard Mongolian market index.

The current Securities Market Law is rudimentary and does not provide an adequate framework for the development of an active and vibrant debt and equity capital market in Mongolia. Finally, while, currently, there is no derivatives market in Mongolia, it is noteworthy that the development of this market may be hindered by, in addition to the lack of governing framework, the risk that certain derivatives transactions could potentially be unenforceable under the Civil Code.

ANNEX 3 – LEGAL TRANSITION

Introduction

The legal environment in Mongolia presents several challenges for investors, especially outside the extractive industries. Supporting non-resource sector development will require, among other things, reforms to the framework for taking pledges, which is not supportive of modern market practices, as well as strengthening judicial capacity in the commercial sector. In addition, the legislation on capital markets needs to be overhauled to attract more investment, both from abroad and locally. Finally, developing the infrastructure sector will require improvements to legal frameworks regarding public-private partnerships and public-procurement.

Enhancing the business-enabling environment for the non-resource sector

Pledge law

Taking pledges over movable property and rights is regulated by the Civil Code. The legal provisions applicable to security over movable property (equipment, inventory, receivables, etc.) are not adapted to market-oriented economic practices. Priorities between competing pledges are based on the time of the signing of the pledge agreement which creates uncertainty as it makes it impossible for the creditors to ascertain if the assets have already been pledged in favour of other creditors. In addition, there is no modern and easily accessible register of pledges and the provisions lack clarity and precision when regulating the description of assets, secured claim and the parties' rights. As a result the market of providing finance against the movable collateral is almost non-existent in Mongolia. Introducing a modern legal regime for taking security interests, setting up the register of pledges over movable property, expanding the choice of assets available for pledging and improving the enforcement procedures would help the SME sector.

Pledge law reform has been on the reform agenda for a number of years and the EBRD has provided the Mongolian government with technical assistance for drafting a pledge law based on the principles of a modern secured transactions legal regime. Unfortunately, the reform has been stalled and no evident progress has been shown by the government since 2009 when the draft pledge law was finished. However, the new government has sent signals that they would like to see the reform taken further

Judicial capacity and contract enforcement

The *EBRD Judicial Decisions Assessment 2011* found that the quality of court judgments in commercial law matters in Mongolia was among the weakest in the assessed region (Commonwealth of Independent States, Georgia and Mongolia). As is the case in other early transition countries, judges' lack of experience with commercial law and practice, coupled with limited judicial training in such areas, adversely affect judges' ability to deal effectively with commercial law matters, particularly in the lower courts. Judges tend to decide commercial cases with reference to general principles of law and civil code provisions, rather than applying the specific commercial laws which are relevant to the case at hand. Decisions of

lower courts frequently replicate the text of parties' submissions, and court orders are often poorly matched with the parties' arguments. Particular difficulties are encountered in cases involving disputes over commercial agreements. Here, judges' lack of market experience complicates their task of understanding the underlying business dispute and interpreting the meaning of the parties' agreement.

One clear priority for reform in the area of judicial capacity and contract enforcement is systematic, targeted judicial training in areas of commercial and administrative law. The EBRD is currently working with the Supreme Court to implement a capacity building programme to raise judges' understanding of markets and the application of commercial law to practical business problems.

Strengthening financial sector and capital markets

Limited activity occurs within the fairly nascent Mongolian debt capital markets. The current securities market law provides an inadequate framework, and this seems to be one of the biggest obstacles for attracting investors (both local and also international) to this market. Moreover, the legal framework for hedging instruments (e.g. commodity derivatives that would allow mining operators to hedge their risks and exposure) is yet to be created. Cooperation with the London Stock Exchange to assist in the development of the Mongolian Stock Exchange is a very positive signal for Mongolian capital markets. A new draft securities market law is currently before the parliament but it is unclear whether or when it will be adopted.

As part of the EBRD Local Currency and Local Capital Markets Development (LC2) initiative, an assessment was conducted in October 2011 which focused on the following key aspects: (a) illiquid secondary market; (b) volatility of the equity market; (c) bank dominated financial sector; and (d) macroeconomic management, including inflation targeting.

As far as the legal framework is concerned, current priorities for reform are the following:

- Clarify the meaning of 'public securities offering' and regulate private issuance and trading of securities;
- Permit off-exchange transactions of exchange-listed securities
- Provide for investors' direct civil remedies against market participants
- Enhance the disclosure requirements for both public and private debt offerings
- Provide for use of security custodial accounts.

Promoting power infrastructure modernisation and renewable energy

Concessions/PPPs

The concession law, which will be highly relevant to the Bank's support in the power sector, is fairly recent. It is one of the few cases in the EBRD region where the law has been drafted to take account of the best internationally accepted standards and in accordance with lenders expectations in order to ensure the bankability of project finance based transactions. It explicitly provides for a good range of PPP models and security instruments, for the possibility of government support and guarantee together

with specific chapter on lenders rights, for the possibility of direct agreement between the grantor and financiers as well as for lenders' step-in right.

Mongolia's very good rules on the books have not yet led to the take-off of PPP projects in Mongolia. It is yet to be seen how these rules will work in a country without any prior concession expertise and to what extent the new law fits in the current legal framework and business environment.

Renewable energy

The government of Mongolia unofficially announced plans to improve the legal framework for the renewable energy sector by revising the energy law and the renewable energy law with a view to creating incentives for private sector participation in financing of projects. In the meantime, the government is seeking active engagement of donors and local and foreign private investors for the development of Mongolia's large renewable potential for solar, wind, hydro and geothermal energy resources.

The high level of subsidies, in combination with a small internal market and lack of infrastructure, raises significant impediments to the development of the renewable energy sector. The government should work towards removing regulatory barriers to renewable energy development and updating the grid code to prioritise and give preferential treatment to renewable generators. The government could also develop clear and transparent regulations for licensing, developing, and connecting renewable energy to the grid.

Supporting public spending for infrastructure

Public procurement

The 2006 public procurement law (as amended) (PPLM) is the centrepiece of Mongolia's public procurement legal framework. The PPLM is supplemented by a number of implementing regulations, including regulations of various stages of the procurement process, review procedures and preparation of standard bidding documentation. On an international level, Mongolia has not yet become a member of the WTO Agreement for Government Procurement (WTO GPA) though it was accepted as an observer in 1999.

In terms of areas covered and policies pursued, Mongolian law generally corresponds to good procurement practices. The modern law encourages competition, transparency and efficiency and adheres to sound principles with respect to prior determination and prior disclosure of scope and terms of procurement, as well as selection of procurement method and prescribed procedures for each procurement method. However, key areas of public procurement regulation need further legislative attention, in particular in the areas of public procurement decision-making transparency, good access to procurement opportunities for local suppliers, especially SMEs, and independent review of complaints.

The Mongolian government plans to redraft public procurement legislation and implement eProcurement reform in the coming years. The Bank has started a

technical cooperation project to facilitate market development through increasing small and medium enterprises (SMEs) participation in public tenders. The project encompasses relevant policy advice and capacity building of appropriate market participants. In addition, Mongolia applied for participation in the EBRD UNCITRAL Initiative for public procurement reform and a policy workshop planned for early 2013 is being organised, gathering together local stakeholders and policy makers. These workshops help to clarify the national government reform agenda and to structure technical cooperation projects in order to support reform efforts. Mongolia is also considering starting negotiations to access the WTO GPA.

ANNEX 4 – SMALL BUSINESS SUPPORT

The Small Business Support (SBS) team facilitates economic transition by promoting enterprise change in promising micro, small and medium sized enterprises (MSMEs) and contributing to the development of a sustainable market of local business advisory services. This is achieved through two complementary programmes, the Enterprise Growth Programme (EGP), formerly TurnAround Management, and Business Advisory Services (BAS).

Previous SBS experience in Mongolia

EGP has been active in Mongolia since 2001 with EUR 5.8 mn of donor funding from Japan, the Shareholders' Special Fund (SSF) and other bilateral donors. 80 projects have been initiated with Mongolian enterprises with an average cost of EUR 65,000. The top three industry sectors are food manufacturing, pharmaceuticals and medicine, and textile mills. To date, 63 per cent of assisted enterprises reported increases in turnover and 61 per cent increased employment. EGP also organised a number of in-company trainings and business matching visits to demonstrate and adapt international best practice.

BAS has been active since 2008 with EUR 5.4 mn from the EU, Japan, the Mongolian Cooperation Fund, Luxembourg and the SSF. 267 projects have been implemented with 222 enterprises with an average size of 42 employees. Projects have sought to improve management effectiveness and market performance. On average 77 per cent of assisted enterprises reported increased turnover, 60 per cent increased employment and 80 per cent engaged consultants again. 18 trainings and workshops were organised to develop the local consultancy and MSME market.

MSME and Consulting sector in Mongolia

The MSME sector and business environment

Mongolian MSMEs face serious challenges in terms of product quality, export opportunities, investment and business sophistication in general. The sector compares poorly with other developing countries in terms of technology absorption, trading across borders, auditing/accounting standards, resolving insolvency, bureaucracy (especially licences/permits), as well as access to credit. The absence of a thriving MSME sector as an instrument for generating income, employment and investments remains a key issue.

The consultancy market

The Mongolian consultancy sector faces medium transition challenges with regard to MSMEs. The consulting industry is still at a nascent stage of development with only a limited range of services offered. There is a strong need to develop consultants' technical skills in areas such as quality management & ISO certification, production technology & engineering, and resource efficiency. The number of consultants in Ulaanbaatar is growing rapidly however less than 2 per cent of BAS consultants are located in rural areas. The Mongolian Management Consultants' Institute (MMCI) has been established with BAS support but requires further assistance to achieve financial sustainability.

Infrastructure of MSME support

There are a number of MSME support organisations in Mongolia including chambers of commerce and business associations in sectors such as wool and cashmere, ICT and tourism. However, these organisations have limited capacity and financial strength to serve their members. The primary counterpart within the government is the SME Development Department within the Ministry of Labour. Recently formed in 2012, the Department is a growing organisation which itself needs capacity building.

SBS in Mongolia in the strategy period

SBS will continue to support SMEs throughout the strategy period in order to contribute to economic diversification and inclusive growth. SBS has launched a flagship five year programme with funding from the EU to support the development of the SME sector (2011-16). This programme features a dedicated SME policy resource in the RO in addition to the BAS team. Interventions are planned at the following levels:

- (i) *Macro-level*: MSME business enabling environment improved through facilitation of key reforms in the policy, strategic and legal-regulatory framework. The key counterpart is the newly formed SME Department in the Ministry of Labour.
- (ii) *Meso-level (intermediate)*: increased access of MSMEs to appropriate and affordable advocacy, business development and financial services. Activities will target financial intermediaries to improve access to finance and business associations and industry-specific institutions that serve the MSME sector.
- (iii) *Micro-level*: strong demand for local advisory services through demonstration of enterprise-level performance improvement in assisted MSMEs. **BAS** will seek to further extend support to MSMEs outside the capital. BAS will also aim to expand the range and sophistication of advisory services available.

EGP plans to support the transfer of management skills in enterprises in sectors with strong export potential, including food-processing, textiles, machinery and equipment, and logistics for mining operations. Tourism and transport services also have high potential. EGP will attempt to diversify activities beyond Ulaanbaatar including to Darkhan, Erdenet and Huvsgul and potentially also the South Gobi. Business matching trips for Mongolian companies to meet with counterparts and learn cutting-edge business practices in Asian and European countries are also planned.

SBS will seek to support SME access to finance to foster growth. BAS will continue to implement the ETCI Accounting Improvement Programme to raise financial management and reporting practices and standards to support clients' access to finance through the EBRD and its partner banks, as well as other financial institutions. EGP will seek to provide direct company assistance to potential agribusiness clients.

SBS will also seek to continue supporting EBRD-financed Natural Resources sector projects through the successful Local Business Development model. These programmes support inclusive and sustainable growth in the areas surrounding mining operations in particular by supporting MSMEs to become suppliers to the mine.

ANNEX 5 – TECHNICAL COOPERATION

TC COMMITMENTS BY DONOR THROUGH EBRD, 2009 - 1H 2012

Donor	TC Commitments (€)
Belgium	75,000
Early Transition Countries Fund	1,180,951
EBRD Shareholder Special Fund	4,365,952
EU	3,474,286
Japan	4,084,789
Korea	444,625
Private Donors	70,085
Taipei China	75,000
World Bank	150,000
Total	13,920,688

TC COMMITMENTS BY SECTOR THROUGH EBRD, 2009 – 1H 2012

Sector/Team		TC Commitments (€)
SME Development*	Enterprise Support	547,722
	Small Business Support Programme (formerly TAM/BAS)	7,671,185
E2C2	E2C2	90,000
Environment	Environment	58,550
Financial Institutions	FI	1,637,000
Legal Transition	Legal Transition	1,366,545
Infrastructure	Municipal and Environmental Infrastructure	2,526,577
Other	Other	23,109
Total		13,920,688

Note: Commitment values based on year end or period end data for each year.

* This sector category encompasses direct assistance to SMEs and indirect assistance through policy dialogue between the EBRD, the authorities and commercial/business associations (e.g. Investment Councils)

ANNEX 6 – SELECTED ECONOMIC INDICATORS

Mongolia	2007	2008	2009	2010	2011 <i>Estimate</i>	2012 <i>Projection</i>	2013 <i>Projection</i>
Output and expenditure <i>(Percentage change in real terms)</i>							
GDP	10.2	8.9	-1.3	6.4	17.5	11.5	16.0
Private consumption	2.7	3.0	4.8	6.0	19.9	na	na
Public consumption	23.0	21.4	-13.5	9.5	21.3	na	na
Gross fixed capital formation	27.0	17.9	-15.9	41.2	78.8	na	na
Exports of goods and services	16.9	9.9	-17.0	43.1	47.2	na	na
Imports of goods and services	19.9	38.0	-19.1	37.3	69.5	na	na
Industrial gross output	6.9	2.8	-3.3	9.9	7.6	na	na
Labour Market¹ <i>(Percentage change)</i>							
Gross average monthly earnings in economy (annual average)	49.5	41.4	5.8	23.1	18.7	na	na
Real LCU wage growth	33.9	10.5	-1.7	11.9	8.8	na	na
Unemployment rate (end-year)	2.8	2.8	11.6	9.9	7.7	na	na
Prices <i>(Percentage change)</i>							
Consumer prices (annual average)	11.7	28.0	7.5	10.1	9.1	15.0	11.7
Consumer prices (end-year)	17.8	22.1	4.1	13.0	10.2	15.0	10.1
Fiscal Indicators <i>(In per cent of GDP)</i>							
General government balance	2.7	-4.5	-5.0	1.2	-3.5	-9.5	-1.3
General government revenues	37.5	33.0	30.2	36.5	39.7	37.1	33.8
General government expenditure	35.3	37.6	35.2	37.3	43.2	45.1	36.8
General government debt	33.7	29.3	46.6	42.2	47.1	na	na
Monetary and financial sectors <i>(Percentage change)</i>							
Broad money (M2, end-year)	56.3	-5.5	26.9	62.5	37.0	na	na
Credit to the private sector (end-year)	69.9	26.9	1.5	25.5	71.8	na	na
Non-performing loans ratio	3.3	7.2	17.4	11.5	5.8	na	na
Interest and exchange rates <i>(In per cent per annum, end-year)</i>							
Deposit rate	13.4	13.6	12.9	10.7	10.5	na	na
Lending rate	19.9	20.4	20.8	17.9	15.5	na	na
Discount rate	9.9	14.8	10.8	11.0	13.2	na	na
Exchange rate (end-year)	1,170.2	1,229.0	1,446.5	1,234.1	1,374.2	na	na
Exchange rate (annual average)	1,170.4	1,169.0	1,441.0	1,357.1	1,265.5	na	na
External sector <i>(in per cent of GDP)</i>							
Current account	4.1	-13.2	-9.0	-14.9	-31.8	-31.4	-10.1
Trade balance	-1.2	-11.2	-4.1	-2.9	-9.8	na	na
Merchandise exports	46.1	45.1	41.2	46.9	41.0	na	na
Merchandise imports	-47.3	-56.3	-45.4	-49.8	-50.8	na	na
Foreign direct investment, net	8.5	14.9	10.8	25.4	52.7	18.3	13.3
Gross reserves, excluding gold (end-year)	19.2	10.1	28.3	35.4	26.0	na	na
External debt stock	37.2	29.0	66.1	62.9	108.4	na	na
Public external debt	36.1	28.6	45.1	32.9	25.1	na	na
Private external debt	1.1	0.4	21.0	30.0	83.4	na	na
Gross reserves, excluding gold (end-year)	4.8	2.1	4.0	4.2	4.9	na	na
Memorandum items <i>(Denominations as indicated)</i>							
Population (end-year, million)	2.6	2.7	2.7	2.8	2.8	2.8	2.8
GDP (in billions of togrogs)	4,956.6	6,555.6	6,590.6	8,414.5	11,087.7	13,857.2	17,747.7
GDP per capita (in US dollars)	1,607.1	2,103.5	1,683.8	2,245.8	3,116.2	3,894.5	4,987.9
Share of industry in GDP (in per cent)	35.3	28.6	28.4	31.4	28.9	na	na
Share of agriculture in GDP (in per cent)	18.4	19.2	17.9	14.3	12.3	na	na
FDI (in million of US dollars), net	360.0	586.0	570.0	1,573.6	4,620.1	2,003.4	1,866.5
External debt - reserves (in US\$ million)	759.7	1,059.3	1,726.2	1,706.6	7,225.9	na	na
External debt/exports of goods and services (in per cent)	62.2	53.7	131.4	115.0	174.7	na	na
Broad money (M2, end-year in per cent of GDP)	48.4	34.6	43.7	55.6	57.8	na	na

1 Figures do not include emigrant workers abroad.

3 Weighted average rate overall maturities

2 General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign financed public investment programmes and net lending.

ANNEX 7 – GENDER EQUALITY

Gender Inequality and Human Development

According to the UNDP 2011 Human Development Index (HDI), has a medium human development index rating. It is ranked 110th out of 187 countries, which is below the regional average for Europe and Central Asia. The HDI is comprised of three dimensions: health, education and decent standard of living. The country ranks much better in terms of the UNDP Gender Inequality Index (GII), at 70th globally. The GII is a composite measure, which captures the loss of achievement, due to gender inequality across three dimensions: reproductive health, empowerment, and labour market participation.

Labour force participation and gender pay gap

Women's labour force participation rates are lower compared to men's in Mongolia. According to the National Statistical Office, in 2011 the proportion of women aged 15 and older in the labour force was 56.1 per cent as compared to 66.7 per cent for men. There exists a gender pay gap in Mongolia, and it has been increasing over the last few years. According to the 2011 report of the International Labour Organisation (ILO), in 2000 the average wage for female wage workers was 92 per cent of that for men, while it has fallen to 83 per cent by 2011.

'Reverse' gender gaps, i.e. where men/boys are more disadvantaged than women/girls, are reported with respect to enrolment and attendance rates for all levels of education. Even for those officially enrolled, non-attendance rates are higher for boys than for girls and this increases significantly from the age of 12 onwards (UNDP 2011). The gaps reflect the growing need for boys to contribute to family incomes especially in poor rural families. According to 2011 UNESCO data, women graduates from tertiary education outnumber men graduates. Nevertheless, it is clear that the advantage that women achieved in education has not been translated into commensurate results in employment. There are gender differences in fields of study. For example, while 82 per cent of all graduates in the field of education were females, only 35 per cent of graduates in services, and 40 per cent of graduates in engineering, manufacturing and construction were female, respectively. This gender segregation in education results in occupational segregation in the labour market, as the table below shows.

Mongolia: total employment by economic activity	Male (%)	Female (%)
Mining and Quarrying	64	36
Transport, Storage and Communications	62	38
Electricity, Gas and Water Supply	60	40
Construction	57	43
Manufacturing	49	51
Real Estate, Renting and Business Activities	49	51
Financial Intermediation	40	60
Hotels and Restaurants	34	66
Human health and social work activities	33	67
Education	33	67

Source: International Labour Organization (ILO) 2008

According to the World Bank's Women, Business and the Law database, the mandatory minimum length of paid maternity leave is 120 days in Mongolia. 70 per cent of wages is paid during maternity leave. The law does not provide for paid or unpaid paternity leave. The laws oblige the employer to give the employee the same job when she returns from maternity leave. Furthermore, there are laws or constitutional provisions mandating equal pay for equal work. Women are also, by law, protected by non-discrimination practices in hiring on the basis of gender.

Entrepreneurship, access to finance

There is no significant gender difference reported in access to formal financial services in Mongolia. In fact, as with the case of education, 'reverse' gender gaps are observed in this area. According to the World Bank's Global Financial Inclusion database, (surveying approximately 1,000 people using randomly selected, nationally representative samples) in 2011 82 per cent of females as compared to 73 per cent of male adults owned an account at a formal financial institution.

According to the 2009 Business Environment and Enterprise Performance Survey (BEEPS), 52 per cent of 362 firms surveyed in Mongolia had women among its owners and, 36 per cent had a female in top management (this is a much higher score as compared to 37 per cent and 19 per cent average, respectively, for Eastern Europe and Central Asia). Of the 58 per cent of Mongolian firms within this sample that applied for a loan and had a woman among its owners, 20.5 per cent were rejected. In comparison, 23 per cent of the 41 per cent of firms with no female owners that applied for loans were rejected.

Nevertheless, women in rural areas do face barriers in accessing finance, due to the scarcity of productive employment and a limited choice of occupations. The lack of collateral has been reported one of the major challenges for women to secure finance. While under the Law on Land women and men have equal rights to access to land, land titles disproportionately reside with male household heads, which has increased as a result of the privatisation process. With respect to property other than land, there are no legal restrictions on women's equal access. However, as the government reported in 2007, 46 per cent of privatised properties such as apartments and livestock were registered only in the name of husband and 30.5 per cent jointly by husband and wife, with only 16 per cent in the name of wife.