

[ logo ]

Mongolia  
Bank of Mongolia  
Baga Toiruu 9  
Chingeltei District  
Ulaanbaatar  
Tel.:310302, Fax: 311471  
<http://www.mongolbank.mn>

To Ts. Nyamdorj, the Chairman of the Parliament of Mongolia

RE: Submission of the draft of resolution

According to the Article 10 of the Law on Central Bank (Bank of Mongolia) attached is a draft proposal of resolution on approval of the State Monetary Policy Guidelines for 2006.

Kindly consider this proposal with respect to the procedure of the plenary session of the Parliament of Mongolia and inform us about relevant decisions.

Attached please find introduction on draft proposal, current status on money supply and financial market for the first eight month of this year and future plans as per conditions of the law.

Enclosed : 13 pages

O. Chuluunbat  
President

Draft

**RESOLUTION  
OF THE PARLIAMENT OF MONGOLIA**

Date

Ref.

Ulaanbaatar

RE: Approval of the State Monetary Policy Guidelines for 2006

In matter of provision Article 25.1.7 of the Constitution of Mongolia and Article 10 of the Law on Central Bank (Bank of Mongolia), NOW, THEREFORE,

BE IT RESOLVED, that to adopt the State Monetary Policy Guidelines for 2006 as an Annex to this resolution

That to appoint the President of the Bank of Mongolia (O. Chuluunbat) shall be in charge of organization of measures for enforcement of this resolution and report to the Parliament of Mongolia on quarterly basis.,

Ts. Nyamdorj  
Speaker of the Parliament of Mongolia

### **The State Monetary Policy Guidelines for 2006**

The Bank of Mongolia will carry out the following measures for the implementation of the State Monetary Policy Guidelines as:

1. If petroleum price will not drastically grow in economic situation of the country, it is possible to keep the inflation rate expressed in Consumer Price Index at single digit rate or at 7 percent through year.
2. Continue to deepen stability of banking and financial sector by setting up a framework for unified controlling and supervision of legal bodies that maintain financial intermediation in extending of financial contracts and agreements.
3. Take measures on intensifying of foreign investments and trade by attracting long-term financial resources from foreign markets.
4. Strengthen mortgage market significantly important in society.
5. Implement measures for supply of information flow among banking and financial institutions and law organizations in order to combat against money laundering and terrorism financing with accordance to relevant law and legislation.
6. Assert new ideas and achievements regarding to appropriate management and risk controls in policy documentation of the Bank of Mongolia for the sustaining parities of financial intermediations and modify banking requirements and relevant rapports.

The Bank of Mongolia

## Introduction to the State Monetary Policy Guidelines for 2006

### One. Current status on money credit, banking and financial market<sup>1</sup>

In the first eight month of 2005 there has been crucial growth of Consumer Price Index (CPI) that has not occurred during the recent years. The growth of CPI has reached 10 percent compared to the beginning of the year increased by 11.7 percent per a year compared to the statistics of last year's August. This growth is mainly due to increase of petroleum and food prices. Such high inflation rate caused by two main types of goods supply price escalation as petroleum and meat prices (Table 1.).

Table 1. Price dynamics of meat and petroleum in 2005

	Meat		Petroleum	
	Mutton	Beef	A-76	A-93
<b>Average for 2004</b>	<b>1596</b>	<b>1724</b>	<b>527</b>	<b>577</b>
Jan 2005	1692	1863	580	640
Feb 2005	1877	2161	560	636
Mar 2005	1900	2193	590	380
Apr 2005	2186	2435	590	730
May 2005	2405	2635	650	790
Jun 2005	2601	2780	730	790
Jul 2005	2553	2656	730	790
Aug 2005	2339	2479	730	790
<b>Average for 2005</b>	<b>2194</b>	<b>2400</b>	<b>645</b>	<b>731</b>
<b>Growth (%)</b>	<b>37.4</b>	<b>39.2</b>	<b>22.5</b>	<b>26.6</b>

Source: National Statistics Office

According to the estimation of Bank of Mongolia (BoM) economists, the basic inflation calculated as subtraction of price variables for food products with most inconsistent prices as meat, vegetables, milk and fruits<sup>2</sup> from CPI and the inflation rate for 2005 is determined as 2.1 percent only whereas it is 5.4 percent compared to August 2004.

There are not many opportunities for the Central Bank to stabilize price growth derived from shock based on demand-pull economic supply. For the country as Mongolia it is more suitable to implement regulative measures by the government against noticeable growth petroleum and meat prices. For instance, the State shall implement policy measures such as direct regulation of meat supply in urban areas during spring time by the government and shorten stages of meat supply to market, rule out the monopolistic status in petroleum market and refine practice for tax imposition on oil import in current environment when oil price gradually increases throughout the world, defer price variables by introducing futures market of goods and commodities with seasonal and supply based variables, introduce renewable energy consumptions as solar and wind energies instead of carbon burning fuel. In this circumstance another example

<sup>1</sup> Current currency, banking and financial status as per 31 August 2005

<sup>2</sup> Meat, vegetables, milk and fruit prices cover 21.6 percent of CPI

can be mentioned here. According to the study provided by the Bank for International Settlements or so called the Central Bank of all central banks on worldwide economic and financial sustainability, it is stated regarding to some practices of developing countries regarding to rational risk management in extreme deviation of prices for oil and other commodities through banking and financial sector. Economic growth and development of Mongolia is persistently dependent on the world market prices on oil, gold and copper. Thus, it is necessary to provide regular price analysis of such products and commodities and insure price in terms of crucial contribution for solving such issues as keeping inflation rate at appropriate rate and stabilization of export and import.

Therefore, the Bank of Mongolia has started to implement strong monetary policy on hindering of money supply growth in economy for prevention from inflation expectation in society and uncontrolled inflation since the second half of 2004. In frame of this policy, BoM has increased interests of its main policy instrument - Central Bank Bills (CBB) up to 8-10 percent and enlarged amount at TOG 70-85 billion. As results of such measures, it is obvious that growth of money credit indicators have trends for steady decline from the first half of 2005. See the latest trends in money credit aggregates for the recent years in Attachment 1.

As per the 31 August 2005, broad money supply (M2) reached TOG 1081.2 billion that is TOG 234.2 billion or 27.7 percent higher than compared with the beginning of the year and is TOG 238.7 billion or 28.3 percent higher than compared with situation of the same period of the last year. The 69.3 percent of overall money supply growth covers from deposit savings of national and foreign currencies and 30.7 percent of outside bank money supply growth. Looking from the view on source of money supply growth the total credit to individuals and entities and corporate sector is reached TOG 750.7 billion that is 24 percent increase compared to the situation of the beginning of the year. Comparing this growth in total credit expansion with indicators of the previous years (102 percent in 2001, 71 percent in 2002, 91 percent in 2003 and 37 percent in 2004) it is relatively declined.

Despite declining trends in general level of deposit savings and credit interest in the recent years of fast increase in money supply, this decline level is not enough for real investment promotion and support. As per August 2005 weighted average interest rate of credits issued by banks in this month is 27.0 percent for annual interest of credits issued in national currency. This is decrease by 3.5 points over the same period of the last year.

With expansion of money supply there is not decline in costs that is explained by money demand in economy. In other words, there is quite absorbable money demand in economy that is independent from anyone's sense for newly supplied money. Subsequently, competition in resource allocation by small banks and high interest rates offered by Savings and Credit Cooperatives (SCC) implies on high and stable deposit saving interest rate and restricts challenges for reducing loan and credit interest rates.

In order to effective and efficient management of reserve money movement in short-term, BoM sets control and supervision on excess reserve money in banking system

and implements a program on reserve money. In the first 8 months of 2005 the reserve money growth has increased by 42 percent from the beginning of the year and by 26 percent higher than the same period of the last year and is reached TOG 334.6 billion. Percentage for outside bank money reserve is steadily declining since 2000 and as per the end of August 2005 it has reached to 56.6 percent.

For the purpose of easing money supply growth the Bank of Mongolia is allocated TOG 68.0 billion CBB as monthly average to banks. As per 31 August 2005, BoM had TOG 72.2 billion of sold bonds the weighed average interest of which is 7.2 percent.

As per the end of eighth month of 2005 the average inter-bank market exchange rate of national currency against the US dollar reached TOG 1205 that is 0.33 percent stronger than at the beginning of the year and reflects a slight depreciation of 1 percent compared to the same period of the previous year.

In the first eight months of 2005, BoM has purchased US\$ 34.1 million from banks, sold TOG 62.7 million to gold mining companies and bank, and supplied US\$ 28.6 million of net money to inter-bank currency market. This BoM's participation is 10 percent lower than it was in the same period of the last year.

Mortgage underwriting or housing loan based on credits under the guarantee of existing immovable property has significant social outcome and this type of market has been intensively introduced in Mongolia from 2004. BoM is cooperating with the Government of Mongolia in this area and study experiences of foreign countries for the development of relevant legislation in this regards, providing survey for setting up appropriate environment in Mongolia for mortgage security market and SWOT analysis of foreign countries' models for selection of suitable mortgage market model in Mongolia. From the second half of 2004 some commercial banks have started to offer mortgage underwriting services. As per the end of the first quarter 2005, the total outstanding balance of loan for long-term mortgage has reached TOG 25.3 billion in whole banking sector. Moreover, a new Law on purchase and sale of mortgage loan by non-court procedure has been adopted and enforced into life from 1 September of 2005. Thus this is essential for the development of this type of market.

Moreover, along with recovery of banking sector from 2000, credit and Togrog dominated deposits savings has been also rapidly increased however this growth has been diminished recently. Despite stable percentage of unreliable loan comprises only 7-8 percent out of total loans, the absolute amount of this loan is still increasing and calling for attention.

Recently banking institutions are not taking much attention on quality of assets and rather concentrating on quantitative achievements. Thus, BoM has taken measures on strengthening of principles for loan categories, increasing percentage in establishing of loan loss fund, tax exemption for possible loan loss fund and deposit saving interest at the policy development framework.

Recently the practice of providing financial service only by banking institutions has been changed and since 2001 such services have been provided by non-Banking Financial Institutions (NBFI) whereas Credit and Savings Cooperatives (CSC) have emerged from 2003 for providing financial intermediation for entrepreneur and public. As per 31 August 2005 there are 17 commercial banks, 133 NBFIs and around 250 CSCs are providing financial intermediation services in Mongolia.

Recently a number of entrepreneurs and individuals willing to establish NBFI are increasing and as per the first eight months of 2005, the number of license holders for running of NBFI has been increased by 17 percent and reached 133. According to the statistics for the first half of this year, these non-banking financial institutions had assets estimated at over TOG 30 billion out of which TOG 16.4 billion has been issued as credits. The overall percentage of unreliable loan comprises 5 percent of total credits that is 0.2 percent higher than figures of December 2004.

Aside from banks and non-banking financial institutions many CSC has been established since 2003 and caused tight competition in financial market. These cooperatives targeted on population groups that could not access banking and non-banking financial institutions' services. However, uncertainty in overall regulation and supervision from the government side, undefined operational standard and lack of accounting and internal controlling from ordinary investors have been revealed from partial inspection provided by BoM. In the last years a number of registered CSCs has been increased and reached 570. According to the survey carried out by BoM the total amount of all CSCs' assets is reached TOG 50 billion. However, cooperatives do not provide financial reporting and there is not maintained legal regulation for inspection and coordination. Thus, it should be noted that the total assets might be under estimated. Besides, some entities use CSC as main investment source for running of own businesses that violates the real principle stated in Civil Code as a cooperative shall be a non-profit organization.

Moreover, some criminal acts are recorded on fraudulency of SCC as means of taking money from citizens. BoM is cooperating with relevant legal and inspection authorities on providing compensation for victims. Since there are not included relevant coordination measures in none of legal acts as the Law on Cooperatives, the Law on Permission for Entities and the Law on Central Bank, there is delay in compensation measures for deposit saving holders, especially for low-income population. This matter in turn diminishing trusts of population to financial institutions and has negative consequences as risk for loss of sustainability and increasing poverty.

Taking these circumstances, it is necessary to urgently set up Financial Regulation Committee for regulation of activities of saving and credit cooperatives by its full meaning and establishing relevant supervising and inspection framework.

## **Two. Main guidelines for State monetary policy in 2006**

The main achievement in the recent years of transition period is certainly related with stabilizing inflation rate at the forecasting low level. Thus the core measures of the

State monetary policy in 2006 will be dealt with further stabilizing of inflation rate, deepening of sustainability of banking and financial sector, transition from quantitative means of competition in providing goods and services into qualitative forms, extension of terms for financial contracts and agreements for better results of financial intermediation, provision of suitable framework for unified supervision and control over financial intermediations, promotion of long-term financial resources from foreign markets for intensification of economic growth and development of the country and implementation of mortgage market that is significantly important for social securities. BoM with assistance of the Parliament of Mongolia will implement the following measures in these regards.

The main objective of the policy developed by BoM is taking measures for stabilizing CPI at the forecasting low level. Therefore, BoM considers and stated in the State Monetary Policy Guidelines for 2006 that if petroleum price will not drastically grow in economic situation of the country, it is possible to keep the inflation at single digit rate or at 7 percent per year. For this purpose BoM will continue the policy of restriction of money supply in 2006 that has been started from the second half of 2004. According to BoM statement it is possible to stabilize reserve money growth at annual rate of 15 percent throughout 2006 and keep broad money M2 growth at annual rate of 20 percent. Furthermore in case of stable petroleum price the inflation rate will be possible to control at the rate of 7 percent.

Attachment 2 provides forecasting of credit ratings estimated by BoM for 2006.

As results of maintenance of stability in banking sector since 2000, monetary aggregates as broad money M2, credit and deposit savings from low basis into rapidly increased at high level and there is a trend on slightly increasing from this high level observed from 2004. However, if CPI rate throughout 2006 will be lower than predicted level of BoM, then the Central bank will decrease CBB's interest rate for the implementation of flexible measures for economic growth.

Taking into consideration that structural grounds and seasonable fluctuations defines inflation rate mostly expressed in CPI variables, BoM will study and search on adaptation of practice implemented in own internal activities by BoM in 2005 on nominal inflation rate as deduction of main food price fluctuations from CIP announced by the National Statistical Office. BoM is planning to declare this practice in 2006. In such way, it will be possible to concentrate on inflation causes and basic factors without influence factors due to seasonal or temporary supplies.

BoM will revise existing monetary policy model of indirect coordination regulation of monetary fund in economy through reserve money and will study on possibility for economic regulation through the money value expressed by interests rather than through existing practice based on amount of money.

Subsequently, for the purpose of defining scope and time of economic influence the central bank will use reserve money tools though total monetary fund and continue to modeling of Mongolian economy and based on such model carry out research on



prediction and modeling of monetary policy impact and policy tools along with assistance of some central banks of foreign countries.

It is estimated that the net reserve of foreign currency in 2006 will be increased at the level that will suit for supply of import demand for 13 days. As per 31 August of 2005 this reserve was enough to satisfy 12 day supply demand.

Moreover, based on framework of floatable currency rate the principle of calculation of currency rate of togrog against foreign currency will be continually implemented and sustainability of togrog rate will be provided in relation to actual economic situation and external and internal factors influencing on currency rate. Measures on analyzing of factors influencing on currency rate will be carried out more frequently and measures for expansion of scope for statistical data in payment balance will be continued as well.

For the purpose of strengthening the mortgage market and setting up mortgage security market, BoM will intensify the collaboration with the Government of Mongolia, particularly in establishment of legal environment on purchase of mortgage credits and issue of mortgage bonds for sell to investors and define the main subject responsible for such trading. In order to attract investors in mortgage bills the emphasis will be paid for advertisement and announcement to public and organization of training and seminars for exchange of ideas involving commercial banks and relevant domestic institutions and regular publication of data and information in this field.

The figures and monetary indicators for 2005-2006 are getting close to the internationally accepted level of economic growth with annual growth rate at 6-8 percent and annual growth of 15-20 percent for broad money M2 and credit and deposit savings interests.

It is also planned to finalize issues regarding to operational limitations of social and commercial insurance companies and investment funds. In this respect, BoM will contribute in implementation measures of long-term financial tools in the market by amending existing legislation and law. Apart from this, BoM will provide sustainability in of price rates and positively persuade on extension of financial tools for easing inflation expectation of population and corporate institutions.

Banks implementing the main principle in banking operation as “do not put all of your eggs in one basket” in own activities and enforcing appropriate ratio of own assets supply have limitation in issuing credits according to the current legislation. At present the minimum level of cash fund of banks, one bank can issue credit for one customer not over than TOG 0.8 billion that is not satisfy current requirements of ever increasing business scope. From the other hand, in the modern world with concentration of transnational corporation with international banking requirements, some of our commercial banks’ operational scopes do not attract foreign and domestic investors. Thus, for the purpose of setting up multifaceted compact banks with universal operational

capabilities in the country, BoM is revising the lower level of bank's cash fund and planning to increase it up to TOG 8 billion from the end of the first quarter of 2006.

At present only few banks namely Chinggis Khan, Golomt and Anod have cash fund at required level. Also some banks (Trade and Development Bank, Agriculture Bank, Khas Bank and etc) have informed BoM about financial resources availability to complete level of cash fund in the stated period. Some small banks have faced with difficulties in allocation of money in cash fund. However, these banks are free to join into big banks or merge with each others, cancel banking service permission or transfer as non-banking financial institutions.

In such condition of increase level of cash fund allows enhanced credibility in risk management and with elimination of differences in assets will provide healthy environment for fair competition in this sector. As results of such administrative measures and unavailability of some commercial banks to strengthen their cash fund up to TOG 8 billion, the Central Bank will provide more consolidation measures in banking sector in 2006.

The Law on Financial Regulating Committee will be discussed at the Fall Plenary Session of the Parliament of Mongolia. Upon adoption of this law BoM will transfer inspection and regulating rights and responsibilities for NBF and CSC to this Committee. However, there are needs to elaborate procedures and measures for general inspection and regulation of financial institutions in terms of interchangeable relation of ownership and other benefits. Such procedures and guidelines will include assessment methods of financial capabilities for each financial institution and in consolidated form, so that every financial institution will be able to self-estimate own assets and payment liabilities to others at actual situation. These all will lead to sustainability of financial sector.

In 2005, BoM has started activities on changing of Mongolian practice for borrowing of financial resource on discounted basis from international banking and financing organizations into borrowing of financial resource on commercial basis from stock markets. In August 2005 BoM has worked with Fitch rating firm through Citigroup of USA and as results Mongolia has improved its crediting rating into BB. If Mongolia decides to release own bonds then there is need to consider on value and prices of bonds and thus BoM is negotiating with foreign banks on possibility to act as a manager. According to BoM, it is possible to decrease actual credit interest rates by obtaining credits from foreign market on long-term basis for supply national financial demands.

The issue of money laundering and terrorism financing activities are becoming more and more crucial in the worldwide level. In current situation when there are many occurrences of money laundering and terrorism financing measures that are scrupulously organized and mostly dealt through financial sectors of developing countries. Therefore it is necessary to set up an appropriate financial inspection and control framework for investigation, prevention and control. Moreover, there is a need to collaborate with competent foreign organization in this respect. The draft proposal of the Law on

Combating against Money Laundering and Terrorism Financing submitted to the Parliament of Mongolia states regarding to establishment of Financial Information Center (FIS) in organizational structure of BoM and that is responsible elaboration of preventive and combating measures, data gathering and providing analysis. Moreover, FIS will work on prevention of accounting keeping from unnamed and unregistered account holdings, monitor on cash in circulation, transfer and local and international money transfer.

Recently some foreign financial institutions are expressed their interest in setting up investment banking services and carry out large amount resource circulation in the territory of Mongolia. Investment banks have many advantages as reducing costs for financial intermediation, managing deposit saving risk and opportunities for national entities and corporation to access foreign markets. However, in Mongolia there is not settled legal environment and legislation for regulating and coordination of such relationship at present. Therefore it is time to change conditions provided in the Banking Law of Mongolia that limits such measures and activities.

BANK OF MONGOLIA