

PARLIAMENT OF MONGOLIA

RESOLUTION

Date: No. ... State Palace, Ulaanbaatar City

On approving monetary policy guidelines for 2010

Pursuant to provision 7 of clause 1 of Article 25 of the Constitution of Mongolia and clause 2 of Article 10 of the Central Bank (BOM) Law, RESOLVING TO:

1. Approve monetary policy guidelines for 2010 as in the Annex.
2. Assign the BOM (L. Purevdorj) with the duty to administer the implementation of this resolution and report the outcome to Parliament on a quarterly basis.

SPEAKER OF PARLIAMENT

D. DEMBEREL

Monetary Policy Guidelines for 2010

Monetary policy will aim at maintaining low stable inflation in the near and medium term. Under this framework, monetary policy will be targeted at achieving stability in the financial sector, restoring and maintaining economic growth momentum consistent with fiscal policy objectives.

1. Monetary policy

- 1.1. CPI inflation will be maintained at a single-digit level and monetary policy will also aim at reducing negative impacts of the economic cycle and restoring economic growth.
- 1.2. The principle will be to have a flexible exchange rate consistent with market conditions. International financial market and terms of trade shocks will be managed through the flexible exchange rate and monetary policy instruments to build up international reserves.
- 1.3. The domestic forex market infrastructure will be enhanced to provide for better conditions for setting the flexible exchange rate.
- 1.4. The credit shortfall in the banking sector will be halted; the BOM will take measures to encourage bank lending and facilitate credit demand.

2. Ensuring stability of the financial sector

- 2.1. In collaboration with the Government and with the support of international financial institutions, the BOM will implement policies aimed at resolving capital adequacy shortfalls of banks, increasing their liquidity, and ensuring stability of the financial sector.
- 2.2. In collaboration with relevant authorities, the BOM will introduce consolidated bank supervision for the purpose of restoring individual, business, and investor confidence in the banking sector, and committing for protection of bank customer and depositors' rights.
- 2.3. The BOM will ensure compliance with risk-based prudential ratios, tighten financial discipline, and disclose financial statements and ownership of banks.
- 2.4. The BOM will take measures to restructure the banking sector, and in collaboration with the Government, outline and implement a medium-term program that aims at establishing a banking system that is risk-resistant, founded on good corporate governance principles, and efficient in financial intermediation.

3. Other Activities of the Central Bank

- 3.1. For the purpose of achieving better transparency of BOM's activities and educating the public in monetary policy issues, the BOM will periodically conduct advocacy works on monetary policy objectives, actions taken, and expected outcome thereof.
- 3.2. The BOM will provide for uninterrupted and secure functioning of Mongolia's payments and settlement system, take initial measures to establish a legal framework for IT-based cash and non-cash (mobile banking, internet banking, card transactions etc.) payments and settlements, and launch a 24-hour clearing house for card transactions among banks.
- 3.3. The BOM will enhance the legal framework for AML/CFT, start obtaining data from non-bank institutions that are required to do so, and improve its collaboration with law enforcement agencies.

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BRIEFING NOTE ON DRAFT MONETARY POLICY GUIDELINES FOR 2010
(SUMMARY)

1. Under the framework of monetary policy objectives

CPI-inflation is down to 0.6 percent (y-o-y) owing to the relative stabilization of the exchange rate, steady decline in food prices, and absence of demand-driven inflation as household consumption remains low following an economic downturn. It is projected that inflation would stand at 2.3-5.2 percent at end-2009 and increase to 6.2-11.9 percent in 2010.

Growth projections for 2009 are 0.8-2.1 percent and for 2010 4.1-8.3 percent.

Inflation is expected to be on the upward path due to:

- Capital inflows driven by mining growth;
- Fiscal expansion owing to mining development;
- Exchange rate fluctuations; and
- Changes in prices of gasoline and food.

Under the objective of maintaining single-digit inflation, the BOM will refrain from overly relaxed monetary policy and sets out its priority as revising economic growth through low stable inflation supported by coordinated fiscal and monetary policies. The BOM will also adjust its monetary policy stance in a timely fashion to restore economic activity and ensure sustained growth as conditions for low stable inflation are provided. BOM's actions involve the following:

- Adjusting the policy rate in line with developments in key macroeconomic indicators;
- Restoring credit demand and supply;
- Restructuring the banking sector;
- Recapitalizing banks;
- Facilitating an increase in aggregate demand in line with fiscal policy objectives.

It is crucial that fiscal policy aims at providing stimulus to those economic sectors that are not recovering quickly.

However, the economy is facing a number of problems at the moment such as:

- Credit shortfall;
- Growing NPLs; and
- High fluctuations in the exchange rate.

The BOM judges that in the medium term the exchange rate should be flexible and determined by market conditions.

Building up international reserves will not only provide an explicit guarantee to the national currency in circulation, but also frame exchange rate expectations by the public and protect from speculation in the forex market. Therefore, the flexible exchange rate framework should safeguard international reserves from external shocks from capital markets, capital flows, and terms of trade.

Short-term fluctuations in the exchange rate are determined by the following factors:

- Public expectation;
- Currency mismatch of forex market participants;
- Terms of trade;
- Abrupt changes in capital flows; and
- Shocks on the domestic inter-bank market.

In the near term, prices of key imports such as petroleum and food are expected to increase much faster than prices of major export items (copper and gold), implying a possible deterioration in terms of trade in the first half of 2010. Therefore, the BOM's intervention policy in light of high uncertainty in the external sector involves smoothing sudden fluctuations in the exchange rate.

The exchange rate is expected to appreciate in the second half of 2010 as capital inflows associated with large mining developments increase. The exchange rate appreciation would allow a build-up of international reserves, to gross injection into the economy without an inflation threat, and facilitation of economic growth. However, it would also entail lower competitiveness for domestic producers and higher import demand. Thus the BOM will intervene in the forex market consistent with sustained economic growth in the long-term if the exchange rate continues to appreciate significantly.

Another major challenge for the economy is a credit shortfall in the banking sector. In the first eight months of 2009, banks improved their liquidity while excess reserves were increasing steadily. However, credit growth decelerated and turned negative in June 2009. Since November 2008, bank NPLs have tripled, with the share of NPLs rising by 11 percentage points. The following two factors caused this credit shortfall:

1. High credit growth in recent years have exceeded the economy's potential. Over the recent five years, economic growth reached 7-11 percent and banks' loan portfolios doubled. The loan-to-deposit ratio has reached 1.4. Furthermore, the bank loans were not utilized efficiently.
2. External conditions have deteriorated. Particularly, international prices of petroleum products and foods increased, copper prices fell, and capital inflows contracted. Khan Bank

postponed its issuance of US\$ 300 million bonds and Credit Suisse delayed its investment of US\$10 million in Golomt Bank.

The BOM is proposing to take the following two non-traditional policy measures first to halt the credit shortfall and ensure the banking sector stability:

1. Facilitate household consumptions and aggregate demand through higher public investment; and
2. Recapitalize and restructure banks, release funds through the purchase of bad assets.

2. Under the objective of ensuring stability of the financial sector

For the first time since 2000, Mongolian banks faced a togrog deposit run starting from September 2008, but successfully managed to halt the run by spring of 2009. The BOM provided a Tog 265 billion liquidity support to banks, which also offered a flexible treatment for its borrowers. The BOM also permitted two restructuring arrangements for loans instead of one and deferred loss provisioning temporarily.

Majority of banks are expected to face capital adequacy problems in the near future, thus the BOM is proposing the take the following actions:

- Keep a close watch on liquidity of banks and extend liquidity support if needed;
- Review loan portfolios of banks, focus on asset recovery, watch CAR developments;
- Support the Government's proposal on housing for civil servants; and
- Adjust monetary policy stance as macroeconomic conditions stabilize.

We face a need to reduce the number of banks and conduct a bank restructuring to bring the banking system to a level where it is risk resistant and efficient in multi-faceted financial intermediation.

In collaboration with the Government, the BOM will implement a medium-term bank restructuring plan with the aim of establishing a healthy banking system that is risk-resistant, founded on good corporate governance principles, and efficient in financial intermediation:

- Increase minimum capital requirement for banks to increase the ceiling on single borrower exposure and their capacity to bear risks;
- Strengthen banking supervision and ensure compliance with risk-based prudential requirements;
- Heighten governance requirements for banks; and
- Establish a deposit insurance scheme and phase out to the private sector administration.

3. Under the framework of other Activities of the Central Bank

Transparency of monetary policy and independence of policy instruments are crucial in determining inflation expectations and thereby reducing interest rates in the economy. In the current environment where effectiveness of traditional monetary policy instruments remains uncertain, it is more than important for the central bank to liaise with financial markets and the public. The BOM will focus on correcting common misunderstanding of the public through raising its reputation and effectiveness of policies.

Table 2. MONETARY AGGREGATES PROJECTIONS: Q3 2009 - Q4 1012

	Q4 2008 Actual	Q1 2009 Actual	Q2 2009 Actual	Q3 2009 Proj.	Q4 2009 Proj.	Q4 2010 Proj.	Q4 2011 Proj.	Q4 2012 Proj.
Monetary survey								
M2	2319	2413	2425	2572	2610	3210	3965	4758
Money outside banks	329	273	284	372	378	438	495	594
Deposits	1990	2141	2141	2200	2232	2772	3470	4164
Net Foreign Assets	677	689	944	986	1012	1611	1863	2171
Net Foreign Reserves	747	780	1026	1069	1096	1577	1829	2137
Central Bank	808	768	930	986	1076	1562	1704	1942
Commercial Banks	-60	12	96	83	20	15	125	195
Other items, net	-70	-91	-82	-83	-84	34	34	34
Net Domestic Assets	1642	1724	1480	1586	1598	1600	2102	2586
Net Domestic Credit	2113	2234	1940	2014	2208	2289	2713	3124
Net Credit to Government	-522	-437	-619	-584	-330	-412	-334	-100
Claims on Banks	2636	2672	2559	2598	2538	2701	3047	3224
Other items, net	-471	-510	-459	-428	-610	-689	-611	-538
Central Bank								
Reserve money	633	591	769	680	730	840	966	1140
Net Foreign Assets	805	782	1011	982	1073	1562	1704	1942
Net Domestic Assets	-172	-191	-243	-302	-343	-722	-738	-802
Net Credit to Government	-211	-106	-68	-22	64	-276	-276	-276
Credit to Banks	243	235	154	145	20	20	18	16
Less: CBB	120	154	144	240	225	273	283	349
Other items, net	-84	-166	-185	-185	-202	-193	-197	-193
Memoranda items								
Annual change of M2 (%)	-3.4	-1.7	-5.5	1.9	12.6	23.0	23.5	20.0
Annual change of RM (%)	18.4	32.1	52.2	32.7	15.3	15.1	15.0	18.0
Annual change of Credit (%)	28.2	14.4	0.0	-4.4	-3.7	6.4	23.0	29.8
M2 multiplier	3.7	4.1	3.2	3.8	3.6	3.8	4.1	4.2
Money velocity	0.82				-0.09	-0.08	-0.09	0.01
Real GDP growth	8.9	5.4	2.9	1.9	1.5	5.4	8.4	10.3
Net international reserves (US\$ mil)	637.2	503.9	651	632	690	1001	1092	1245
Annual inflation (%)	23.3	17.3	4.7	-0.8	3.4	7.9	6.3	6.0