MACROECONOMICS AND HEALTH NGO

THE NECESSITY OF LONG TERM FINANCING IN MONGOLIA

Ulaanbaatar

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The MEH undertook this research during the period of December 2012 to November 2013. The members of this Research Team are Mr. Chimeddagva Dashzeveg, Dr. Danaasuren Vandangombo and Ms. Khulan Buyankhishig, and edited by Mr. Borgil Surenkhuu.

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GLOSSARY

ADB	Asian Development Bank
BoM	Bank of Mongolia
CGF	Credit Guarantee Fund
DBM	Development Bank of Mongolia
FDI	foreign direct investment
FRC	Financial Regulatory Commission
FSF	Fiscal Stability Fund
GDP	gross domestic product
GOM	Government of Mongolia
HDF	Human Development Fund
IFAD	International Fund for Agricultural Development
IPO	initial public offering
LTF	long-term financing
MNT	Mongolian currency - tugrigs
MoF	Ministry of Finance
MOFALI	Ministry of Food, Agriculture and Light industry
MSE	Mongolian Stock Exchange
NBFIs	non-banking financial institutions
ODA	official development assistance
SCC	savings and credit cooperative
SEFIL	strategic entities foreign investment law
SME	small and medium enterprise
USD	US dollars

INTRODUCTION

This research is conducted by the "Macro Economics and Health" NGO (hereafter MEH) upon the request of the Office for the Two-Step-Loan Project for Small and Medium-Scaled Enterprises Development and Environmental Protection. The MEH undertook this research during the period of December 2012 to November 2013. The members of this Research Team are Mr. Chimeddagva Dashzeveg, Dr. Danaasuren Vandangombo and Ms. Khulan Buyankhishig, and edited by Mr. Borgil Surenkhuu.

The findings of this research are written in this report according to the following structure: Firstly, long-term financing in emerging countries is reviewed with a focus on its role in development, challenges to address and features of small and medium-scaled enterprises (SMEs) development and financing. Secondly, economic development of Mongolia is described to provide a fuller picture of key economic indicators and characteristics of monetary and fiscal policies and external trade situations. Thirdly, private financing in Mongolia is examined by introducing main features of the financial sector and ways of financing, such as direct financing, indirect financing and foreign direct investment to the country. In this part, the banking sector is examined in more detail as it performs the key role in providing financing to the private sector. Fourthly, government financing in Mongolia is summarized with a special attention given to government bond financing, the role of Development Bank of Mongolia and government saving funds, and the recent trend of official development assistances. Then, financing for SME development is discussed by introducing the current situation of SME development, government policies and institutions promoting SMEs, key features of SME financing in Mongolia and raised some issues on SMEs' demand for long-term financing. Lastly, the conclusion is provided for the demand and supply sides of long-term financing and in depth recommendations are discussed based on findings of previous chapters.

1. TERM-FINANCING IN EMERGING ECONOMIES

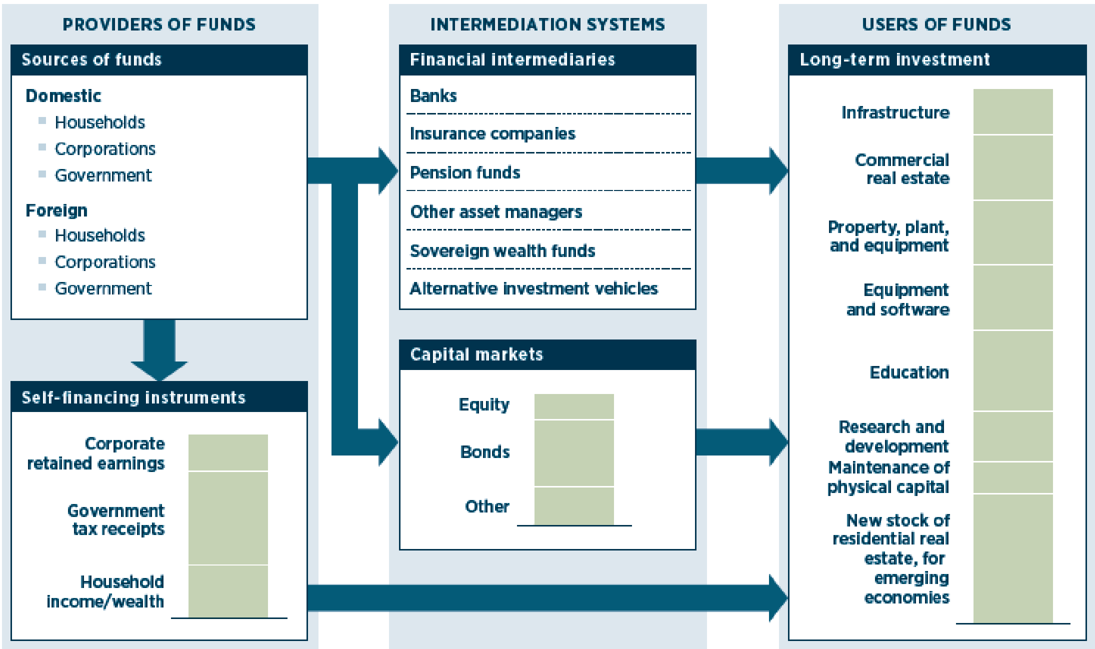
This section reviews the importance of long term financing (LTF) in economic development and discusses the main challenges of LTF. By reviewing the literature on LTF and development issues of emerging economies, it argues that the importance of LTF in economic development of these countries is unquestionable. However, poor competitiveness, undeveloped financial institutions and strict regulatory environment for institutional investors to allocate their resources in long-term projects or financial instruments result in shortages of LTF.

1.1 ROLE OF LONG TERM FINANCING

Both economic and social developments need financing, particularly long-term financing (LTF) as accomplishment and returns of development take time to payback. Despite the absence of universally-accepted single definition, LTF can be considered as a process by which the financial system provides funding to pay for investments that stretch over an extended time period.

LTF is provided by domestic and foreign households, corporations and government and facilitated by financial intermediaries, such as banks, pension funds, investment vehicles and capital markets. The Figure below illustrates the framework of LTF and relationship between LTF constituents.

Figure 1-1 Provision of financing for long term investment



Source: McKinsey Global Institute

As banks are able to more effectively monitor the financial environment characterised by asymmetric information in underdeveloped financial markets, most developing countries have a bank-centred financial system. Banks have served as the primary source of financing for development projects in these countries (Sheppard, 2003). Moreover, their assets have grown significantly, in relative and absolute terms over the last decade shown in Table 1-1.

Table 1-1 Deposit money bank assets/GDP by income groups (mean averages)

Country income groups	Deposit money bank assets/GDP	
	2000	2009
High income	88%	129%
Upper middle income	45%	63%
Lower middle income	36%	48%
Low income	16%	25%

Source: World Bank

Between 2000 and 2009, bank assets to GDP ratio had a dramatic increase in high income countries (41%) whereas this growth was lower following the income group ranking (9%-18%). Although all income groups have experienced the growth in their assets, their short-term deposits limit in their ability to provide LTF. To avoid this maturity mismatch, banks are not able to provide loans with maturity of more than five years (Bond, Platz, & Magnusson, 2012). Therefore, this situation revealed the danger of overreliance on short-term borrowings from banks during recent financial crises (Batten & Kim, 2001) and urged to diversify the source of LTF.

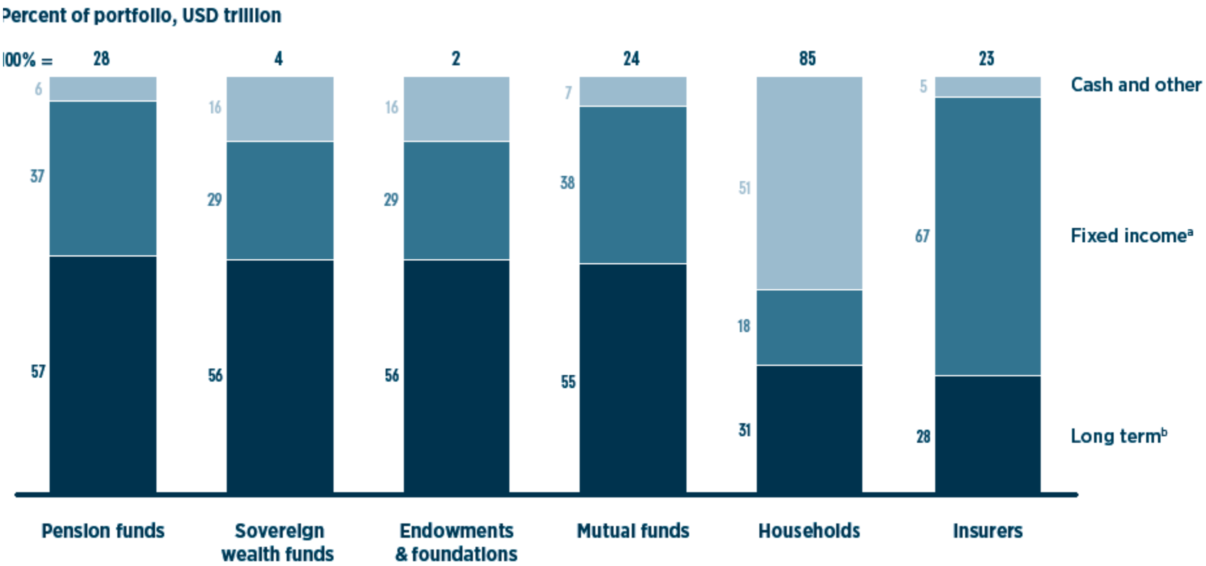
Large stock and bond markets provide diversification opportunities for businesses. In countries with developed stock markets there has an incentive for firms to substitute their funding from long-term debt to equity. However, these markets are often underdeveloped in developing countries due to ineffective legislative and institutional environments. In recent years, particularly after the Asian and world financial crises, international development institutions and governments of many countries have encouraged to deepen financial markets and develop national bond markets to diversify LTF sources. Numbers of recommendations and initiatives have taken to facilitate this development (IMF, 2011; Korea Institute of Finance, 2008; NEPAD-OECD, 2009; World Bank & IMF, 2001).

Given their regulatory power and ability to generate and facilitate LTF sources, governments play important roles in deepening financial markets and promoting LTF. Government bond are used as one of common sources for LTF. In government-regulated LTF increase, small and medium enterprises (SMEs) and infrastructure projects attract special care given that SMEs comprise the majority of business entities and infrastructure projects provide necessary conditions for development. To address this need, governments often adopt policies that direct or subsidize LTF in favour of private sectors, particularly SMEs and infrastructure projects. Directed credit policies include preferential discount lines from the central bank, portfolio restrictions on private commercial banks, guaranteed credit for public enterprises (and SMEs), and varying degrees of credit lines provided through development banks (Carpio & Demirgüç-Kunt, 1997).

Among institutional investors that provide or invest LTF, pre-funded pension plans have rapidly grown in many developing countries in recent years. Pension funds in developing countries have risen from an estimated US$422 billion in 2001 to US$1.4 trillion at the end of 2010 (J.P. Morgan, 2010). Following the advice of international financial institutions, particularly the World Bank, many developing countries have established such pension systems. Since highly predictable payments of these funds accumulated over the long-term, these pension funds should be invested in long-term assets. Thus, it is suggested that pension funds are an appropriate source for funding for infrastructure and other sectors, which can provide stable long-term returns (Bond, et al., 2012).

A research on global LTF (McKinsey Global Institute, 2011) reported that 55 to 57 percent of institutional investors' assets are allocated in LTF, while households prefer to hold their majority of assets in cash (Figure 1-2).

Figure 1-2 Institutional investors' asset allocation by 2010

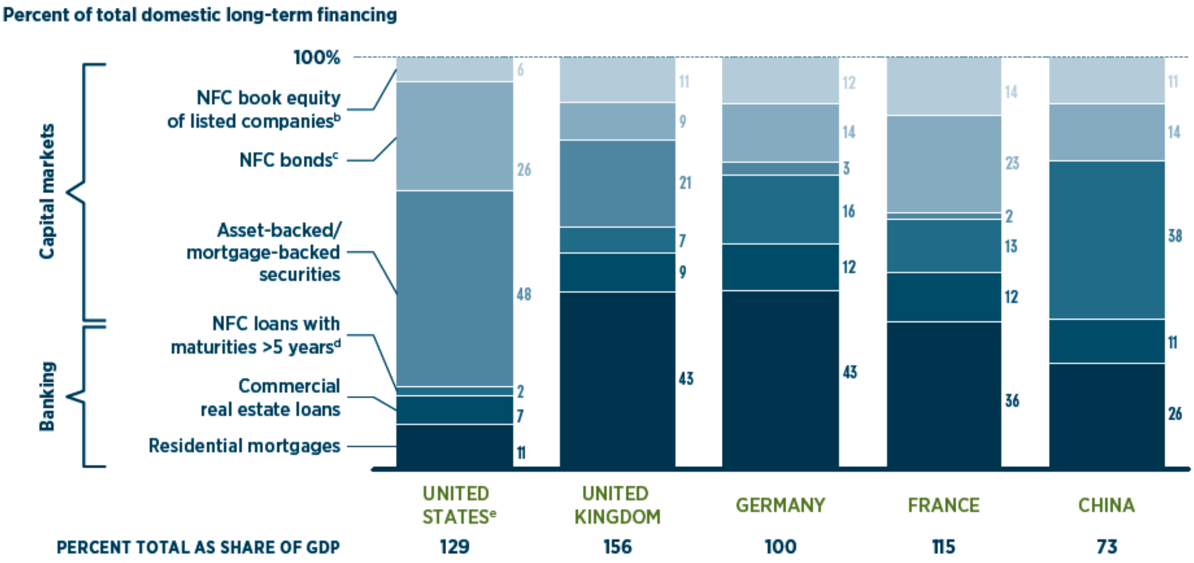


a - Fixed income includes some risky long-term investment, such as corporate bonds, but the data are unavailable for a further breakdown.
b - Long-term investment defined as equities and 80% of alternative assets; cash and other includes cash and 20% of alternative assets.

Source: McKinsey Global Institute, "The Emerging Equity Gap: Growth and Stability in the New Investor Landscape" (December 2011)

There are differing types of LTF depending on their facilitating financial institutions. Banks provide loans with maturities more than 5 years, residential mortgage and commercial real estate loans. Long-term securities, such as equity, bonds and asset-backed securities are issued at the capital market. The composition of LTF types varies significantly depending on economic and financial market development of countries.

Figure 1-3 Types of domestic LTF outstanding, 2011



a. External long-term financing here includes nonfinancial corporations' (NFCs') book equity, NFC bonds, asset-backed/mortgage-backed securities, longer maturity NFC loans, commercial real estate loans, and residential mortgages. Part of book equity is changes in retained earnings, which could be classified as internal.
b. Calculated by dividing total market capitalization by the average price-to-book ratio for NFC for each economy, and therefore covers only public (listed) companies. Due to data unavailability, the equity of private companies is not included.
c. Used Bank for International Settlements' data for bonds outstanding to be consistent with corporate bonds data.
d. We estimate the portion of 5-year maturities using a broader set of loans.
e. US bank lending includes loans to domestic and foreign entities. The other countries include only domestic entities as counterparties.

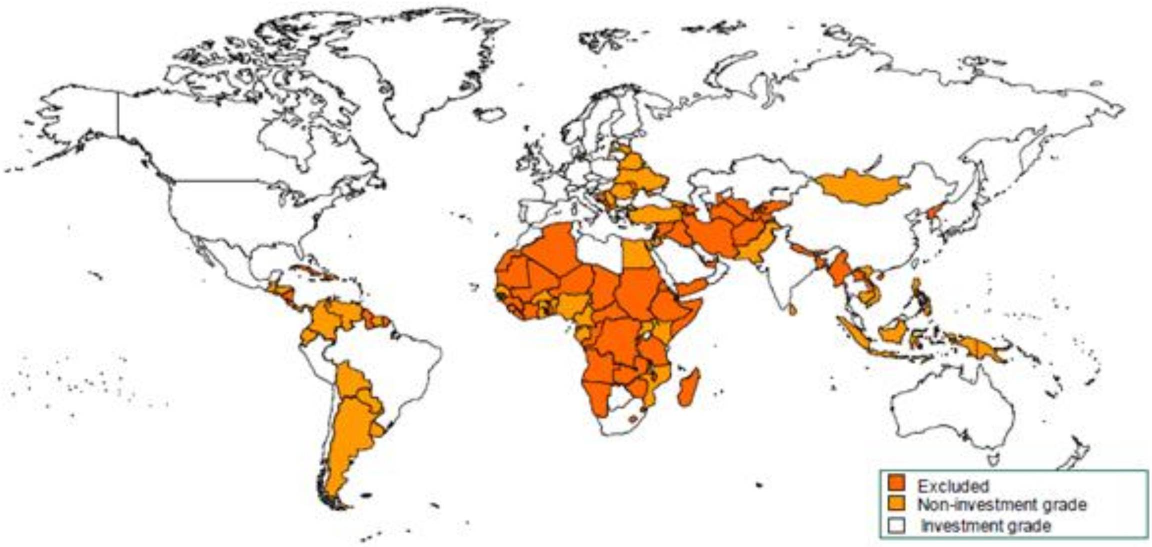
Source: McKinsey Global Institute.

The figure above shows that the USA largely utilizes bonds and asset-backed securities because of its highly developed capital market accounting for 80 percent of total domestic LTF whereas this portion is only 25 percent in China. This illustrates that there are some problems that should be challenged in developing countries.

1.2 CHALLENGES OF LONG-TERM FINANCING

There is large literature discussing that finance plays a positive role in promoting economic development (Levine, 2005). Being an engine of the economic growth, private sector faces several obstacles. A business needs money and capital to grow. It is estimated that over three billion people in developing countries lack effective access to loan and deposit services (IFC, 2010). This is particularly relevant to countries that are either rated non-investment grade or not rated at all. Low or non-existent credit ratings make it difficult for private financial institutions to invest in these countries (Dalberg Global Development Advisors, 2011). The following figure illustrates non-investment grade and unrated developing countries.

Figure 1-4 Non-investment grade and unrated developing countries



Source: S&P (2010) Sovereigns ratings: Standard & Poor's.

An ideal market for LTF would hold four key principles: (1) the financial system should channel savings from households and corporations into an adequate supply of financing with long maturities to meet the growing investment needs of the real economy; (2) LTF should be supplied by entities with committed long-term horizons; (3) a broad spectrum of financial instruments should be available to support long-term investment; and (4) an efficient global financial system should promote economic growth through stable cross-border flows of long-term finance, supported by appropriate global regulation.

Unfortunately, the current systems overseen and designed by policy makers and market actors fail to adhere such best practice principles and therefore fall short in supplying LTF from diverse providers to lenders spread across sectors and countries. Main reasons of these regulatory and market failures are:

- Potential long-term investors, such as Pension funds, sovereign wealth funds, insurance companies and foundations are increasingly constrained in their ability to provide financing due to regulatory requirements for their liquidity.

- LTF in many countries rests on a narrow range of instruments with underdeveloped bond, securitization and equity markets.

- Cross-border capital flows have been driven by short-term and volatile lending (Group of Thirty, 2013).

These failures are common in all developing countries with varying degrees of impacts. A lack of LTF became one of main barriers in developing countries to promote their development. In these countries, financial markets are highly imperfect and not able to provide LTF to meet their investment and growth needs. Main reasons for the absence of LTF are high inflation and real interest rates, unstable macro policies and institutional factors, such as underdeveloped information systems, accounting and auditing that makes financing costly and risky (Carpio & Demirgüç-Kunt, 1997).

In government-regulated LTF increase, SMEs and infrastructure projects attract special care given that SMEs comprise majority of business entities and infrastructure projects providing necessary conditions for development require large investment sums with long term returns.

1.3 SME DEVELOPMENT AND FINANCING

Definition of SMEs varies across countries depending on their development, population size and other factors. Although there is no consensus on SME definition, the most common classification is based on employee numbers. Normally, registered business entities with less than 250 employees are regarded as SMEs. For more clarification, micro enterprises with less than 10 employees are distinguished from SMEs as they became targets of microfinance institutions for delivering micro lending, saving and insurance services. According to the World Bank definition, micro, small and medium sized enterprises are defined as follows:

Table 1-2 World Bank definition of SMEs

Firm size	Employees	Assets	Annual sales
Micro	< 50	< $100,000	< $100,000
Small	< 30	< $3 million	< $3 million
Medium	< 100	< $15 million	< $15 million

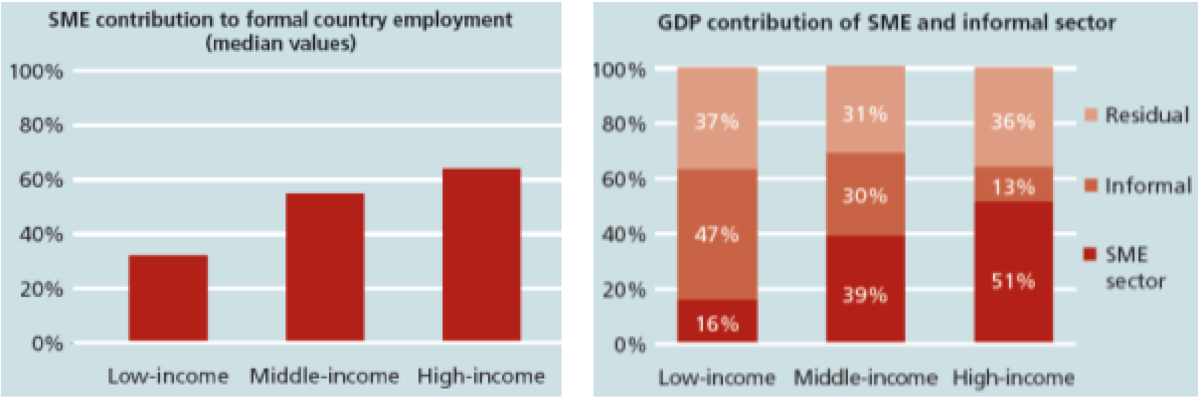
Source: Ayyagari, Beck, and Demirgüç-Kunt (2003)

Based on this definition, almost 95 percent of all entities in the world fall into this category. This percentage is higher in the European Union and developing countries as SMEs (including micro enterprises) account for nearly 99 percent of all registered entities (European Central Bank, 2012; IFC, 2009b). Although SMEs have been ignored for decades from the mainstream economic policies and development schemes in many countries, their importance in employment and role in stabilization of economies after 1997 and 2008 economic crises has started to be widely acknowledged among academics, multilateral donor organizations and policymakers.

Despite many benefits of SMEs, their contributions to countries can be easily seen from employment that SME generates and contribution they make to the GDP. Job creation of the SME sector accounts for 30 to 65 percent depending on structure of national economies compositing from formal and informal sectors. In 30 high-income countries of the Organization of Economic Development and Cooperation (OECD), SMEs generates nearly two third of formal employment, whereas this statistics is lower in low-income countries. Due to dominant informal sector in low-income countries, official employment created by SMEs is relatively low averaging about 30 percent. Figure 1.2-1 shows SMEs' job creation using the median contribution in sample of low, middle and high-income countries. As informal sector is mostly constituted from micro and small entities and individuals, it is evident that SMEs' contribution to job creation in these countries is significant if we sum up employment of both formal and informal sectors.

In terms of GDP contribution, the SME sector generates almost half of GDP in high-income countries and in some middle-income countries. However, SMEs creates about 20 percent of GDP in low-income countries due to the existence of the informal sector. Figure 1.2-1 illustrates that the median contributions of SMEs to GDP are different in low, middle and high-income countries. This figure also shows the reverse correlation of SME and informal sectors' contribution to GDP. Bigger portion of SME contribution to GDP demonstrates the existence of lower level of informal sector as in high-income countries a half of GDP is generated by SMEs and only 13 percent is created by the informal sector. However, the informal sector in low-income countries constitutes a half of the economy and less than 20 percent of GDP is generated by registered SMEs. Thus, transformation of the informal sector to registered SMEs can significantly contribute to economic development of low-income countries as they become eligible for bank loans and their employment and outcomes will be recorded in national statistics.

Figure 1-5 SME contribution to formal country employment vs. GDP contribution of SMEs



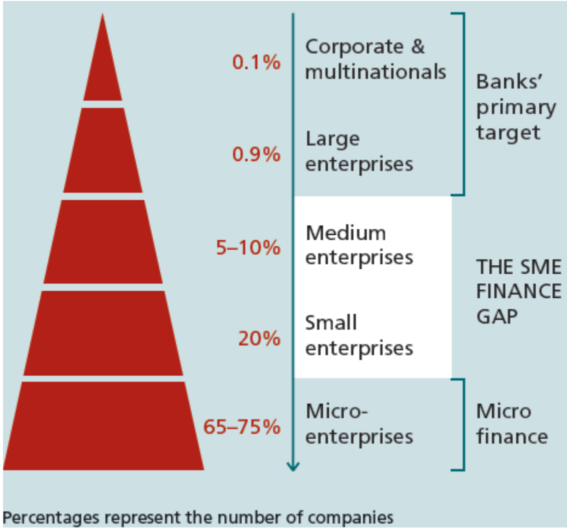
Source: Ayyagari, Beck, and Demirgüç-Kunt (2003), "Residual" includes sources such as large enterprises and public sector

Despite their size and contribution to employment and GDP, development of SMEs in most countries is weak. There are a number of factors limiting SME development, namely a lack of LTF financing, inaccessibility of bank loans due to a big portion of informal sector, and poor human and technical capacity. For the purpose of this report, the necessity of SME financing is discussed in more detail.

Depending on their development stages, SMEs utilize various financing sources. Most SMEs satisfy their primary financial needs either by their own resources or short-term bank loans. In absence of LTF, however, trade credits and short-term loans provided by banks can only meet working capital needs, but not capital investment that they needs most for their business growth.

Compared with large and micro businesses that have good access to banks, capital markets and microfinance loan providers, SMEs have a lack of access to finance (Ayyagari, et al., 2003). The following figure illustrates a financing gap evidencing that SMEs are often excluded from the formal banking sector.

Figure 1-6 Business landscape and financing



Source: IFC (2009b), p.11

SMEs are often too large for microfinance loans and too small and risky for commercial banks and financial institutions (IFC, 2009b). Thus, SMEs are often referred as the "missing middle" in financing and this gap started to attract more attention (Angelkort & Stuwe, 2011; Dalberg Global Development Advisors, 2011; European Central Bank, 2012; Hassan, 2012).

Studies on SME financing demonstrate that there is a gap between demand- and supply-side of SME financing. Main supply-side constraints of SME financing are tight regulations of central banks discouraging commercial banks to provide appropriate loans for SMEs and encouraging to accept only fixed-assets as collateral for loans; high unit costs of small loans; a lack of long-term funding and underdevelopment of capital markets (IFC, 2009b; OECD, 2006; Rabbani, 2011). In terms of demand-side problems, there are weak financial reporting systems, poor credit track records, inability to meet bank and capital market requirements, absence of proper business plans for their development, weak capacity building and a lack of understanding of SMEs to manage their cash flows, financial management and attract long-term resources from money and capital markets (Beck & Demirgüç-Kunt, 2006; European Central Bank, 2012; Kyaw, 2008).

SMEs need financing depending on characteristics of every stage of their development. During their start-up stage, the main source of financing is owners' savings, property, loans from friends/relatives, venture capital, and development finance schemes from SME promotion institutions. When they reach the growth stage, SMEs require greater amount of financing for expansion and this can be obtained through commercial bank loans, factoring and leasing, venture capital and trade credit. Once in their stable stage, SMEs expansion can be furthered with equity investment from capital market and securitization of loans and long-term loans from banks. Without appropriate resources of financing, SMEs can only rely on internally generated retained earnings that often cannot satisfy the need for SME expansion and development. Distinction between financial institution structures and lending infrastructures[1] across countries, however, affects SME credit availability (Kyaw, 2008).

In most developing countries, above stated financial methods except bank loans are underdeveloped due to information asymmetry, lack of long-term financing sources for banks, poor lending ability and immature financial markets (Beck & Demirgüç-Kunt, 2006). LTF for SMEs remains one of key barriers of their development in most countries in particular developing countries. To address SME financing challenges, some countries, in particular developed countries, have developed various financial mechanisms, such as a credit guarantee fund (CGF), credit insurance and unified credit information system. Among them, the CGF is widely adopted in many countries.

The U.S. Small Business Administration (SBA) established in 1953 offers a wide range of services: loan guarantee in various programs, micro-loans, advice and training. The German credit guarantee institutions were founded between 1948 and 1955. The credit guarantee institutions are banks from the perspective of the Credit Institutions Act. They operate within the legal form of a limited liability company (LLC). The guarantee banks provide credit guarantees for SMEs and have a close business relationship with credit institutions. Moreover, they may carryout additional activities to support SMEs. As a rule, the bank guarantee may not exceed 80% of the credit to be granted. In East European countries, a number of credit guarantee institutions were established (e.g., Hungary, Romania, Estonia, and Lithuania) within the last 10 years. Credit Guarantee Schemes in these countries show stronger government engagement, but also includes the private sector participation.

In Japan, the credit guarantee system is considered as one of main pillars of the SME development. The Japanese Credit Guarantee System (JCGS) was established in 1937. It consists of 52 Credit Guarantee Corporations (CGC), each of which guarantees bank loans allocated to SMEs. The public status of CGCs was conferred in 1953 by the Law on Credit Guarantee Corporation and they are supported by the central government. Three parties are involved in credit guarantee transactions in Japan: a small business borrower, a financial institution, and the credit guarantee corporation, which is financially backed by the government.

By 2005, about 40% of bank loans provided to SMEs were covered by the CGSs. The Figure below summarizes Japanese SME financing and credit guarantee schemes.

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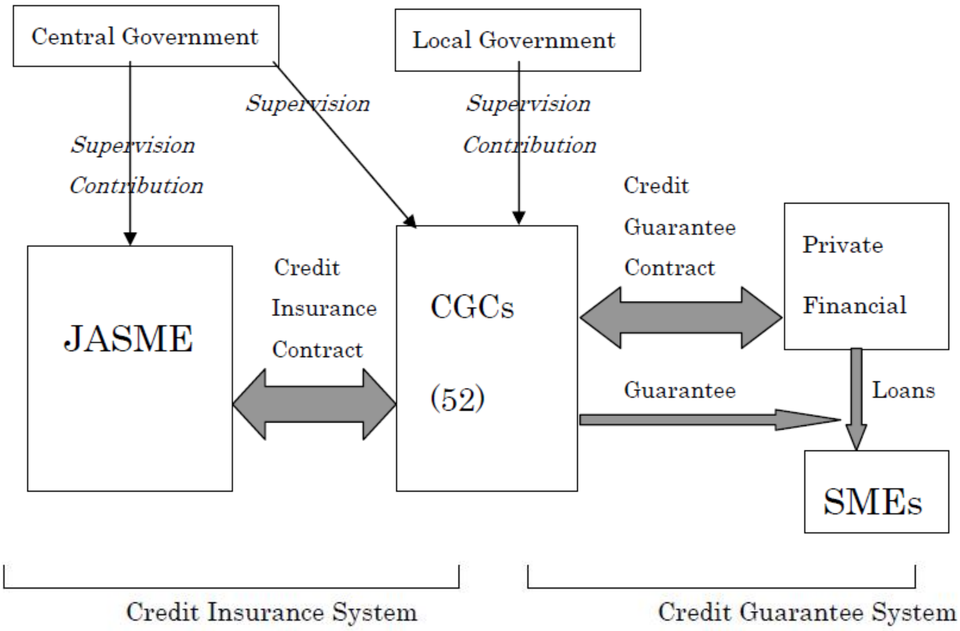
[1] As defined in Berger and Udell (2004), financial institution structure means "the market presence of different types of financial institutions that provide credit, as well as the competition among these institutions", whereas lending infrastructure refers to "the rules and conditions set up mostly by governments that affect financial institutions and their abilities to lend to different potential borrowers" (Berger & Udell, 2004, p. 2).

Figure 1-7 Japanese credit guarantee schemes



Source: Tsukahara.O (2005)

In addition, the Japanese CGS is unique, in that its loan guarantees cover 100% of the losses (to banks) caused by loan defaults. Therefore, banks bear none of the credit risks associated with the guaranteed loans that they provided to SMEs.

Credit guarantees are an important instrument in the development of SMEs and start-ups in the economy. Furthermore, in all cases it needs activite engagement of the private sector and support from the government.

In sum, SMEs are central to economic development, particularly in emerging markets. This started to be widely acknowledged among governments, international organizations and financial institutions. SMEs significantly contribute to employment and GDP though later contribution is relatively low in low- and middle income countries. Despite their importance in the economy, financing constraints, in particular shortage of LTF, limit SME development. Most emerging economies are not in a good position to promote SMEs through various financial instruments, such as LTF loans, trade credit, venture capital, leasing and factoring. However, these challenges have been addressed in countries with varying degrees of success through some financial mechanisms namely credit guarantee funds and SME banking.

To address LTF challenges, there are various initiatives and measurements taken by international donor organizations, financial institutions and governments of developing countries. The success depends on how enabling legal and regulatory environment is established, how effective financial markets and infrastructure are, how diversified and developed financial instruments are used and how well capacity and awareness building is improved. Therefore, it is worthwhile to determine the necessity of LTF in Mongolia – a rapidly growing Asian country with many developmental potentials and challenges. In order to do so, the following chapter provides background of the Mongolian economy and long-term investment needs.

2. ECONOMIC GROWTH IN MONGOLIA

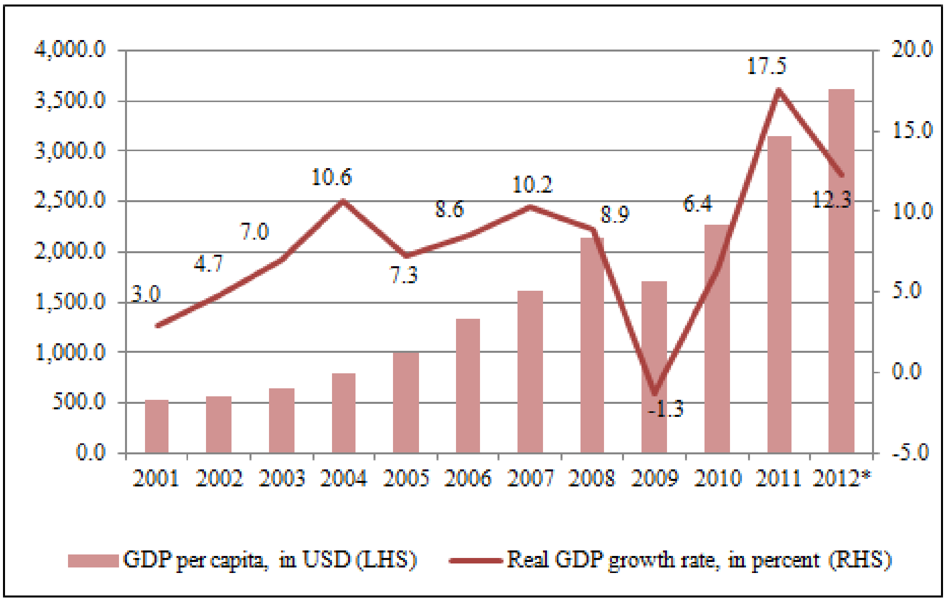
This section provides an overview of the Mongolian economy for 2008-2012 and examines key fiscal and monetary policies and external sector developments during this period. It also reviews the need for long-term investment to support the sustained economic growth.

2.1 ECONOMIC GROWTH AND EMPLOYMENT

In the early 1990s, Mongolia began its comprehensive reforms to transform its economy from a centrally planned to a market-oriented economy. The economic transformation has been marked by removal of price control, privatization of state-owned enterprises, liberalization of foreign trade, adoption of a floating exchange rate system, tight monetary and fiscal policies, and the development of a legal framework for conducting economic activities in the new context of the market economy. The impact of these reforms has led to a quick recovery of the economy, which experienced a sharp decline in output in the early stages of transition period (1990-1993). The economy successfully returned to a positive growth rate in 1994 and grew by 3.3 percent on average during 1994-2000.

The Mongolian economy has been recording a double digit growth of 12-18 percent in 2011 and 2012 supported by the expansion of the mining sector. With mineral revenues from the mining sector accounting for a third of fiscal revenues and almost 80 percent of exports, Mongolia was hit hard by the global economic and financial crisis of 2008/2009. Collapsing global commodity prices and demand led to a sharp deterioration in fiscal and current account balances. As a result, the economy, that had registered growth of 7.5 percent on average during 2001-2008, contracted by -1.3 percent in 2009. The growth was restored relatively fast as copper prices began to increase in the latter half of 2009 and robust growth was resumed in 2010. In 2011, the economy recorded a record high growth of 17.5 percent, which made Mongolia one of the fastest growing economies in the world. The growth has decelerated to 12.3 percent in 2012 owing to weakening of foreign direct investment flows and sluggish mineral exports to China. However, the GDP per capita increased sevenfold from USD522 in 2001 to USD 3,620 in 2012 (Figure 2-1).

Figure 2-1 Mongolia's GDP growth and Per Capita GDP, 2001-2012*



Source: Statistical Yearbook of Mongolia, NSO (various editions)

Economic growth is expected to increase to record high levels in the coming years as two large mines are opened up. As the development of the Oyu Tolgoi (OT) copper-gold mine – one of the five largest in the world[2]– started to operate and as output from other deposits is scaled up, GDP is expected to increase more than triple in the coming few years.

Mongolia is vulnerable to external shocks caused by fluctuations in mineral prices. The economy has a relatively narrow structure with the dominating mining sector (Table 2-1). The share of agriculture sector has declined steadily from 27.4 percent in 2000 to 14.8 percent in 2012, which in part can be attributed to a substantial loss of livestock due to *dzud*[3] experienced during the winter of 2000/2001 and 2010/2011. The mining sector expanded quite rapidly during the mid 2000s reaching 28.4 percent in 2006; but its portion had gradually dropped back to 18.6 percent at end-2012. Such a rapid expansion of the sector is attributed to a heavy FDI inflow into the mining sector aided by favourable world market conditions. The contribution of the manufacturing sector in the economy has been fluctuating around 6 percent over the last eight years.

Table 2-1 Industrial Composition of GDP, in percent (at current prices)

	2000	2005	2006	2007	2008	2009	2010	2011	2012*
Gross Domestic Product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	27.4	19.8	17.6	18.4	19.2	17.9	14.3	12.3	14.8

[2] The OT mine is one of the largest copper-gold mine complexes in the world. Once commercial production begins in mid 2013, it is expected to produce 0.5 million tons of copper, 0.65 million ounces of gold, and 3 million ounces of silver a year, on average during its first 10 years.

[3] *Dzud* is a Mongolian term for an extremely snowy winter in which livestock are unable to find fodder through the snow cover, and large numbers of animals die due to starvation and the cold.

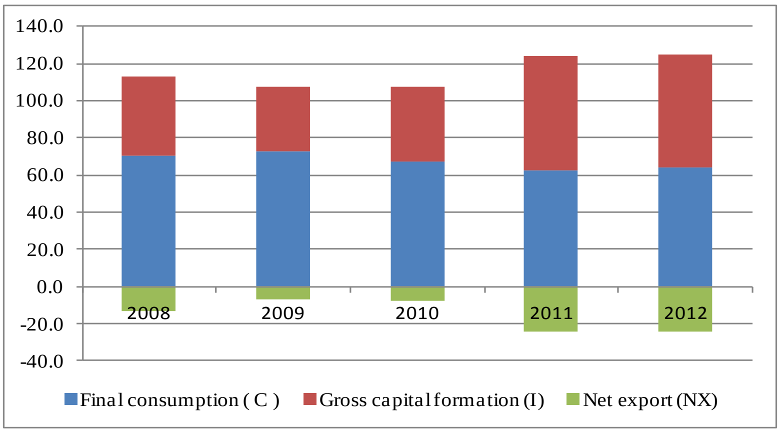
Mining and quarrying	10.8	21.1	28.4	27.1	20.2	19.5	22.7	21.0	18.6
Manufacturing	6.7	5.8	5.4	6.2	6.6	6.4	6.4	6.0	6.2
Utilities	2.5	2.9	2.7	2.3	2.2	2.8	2.6	2.3	2.0
Construction	2.2	2.7	2.2	2.1	1.9	1.3	1.3	1.6	1.6
Wholesale, retail trade, repair of motor vehicle, motorcycle, personal and household goods	9.5	7.5	6.7	6.3	7.2	6.6	8.3	9.2	9.3
Transportation and storage	7.6	8.4	7.1	6.5	6.4	8.3	7.7	7.1	6.5
Information and communication	2.8	3.2	2.5	3.4	3.4	3.3	2.9	2.7	2.6
Other services	19.3	18.4	17.2	17.7	22.7	25.0	21.9	22.9	24.8
Net taxes on products	11.2	10.2	10.1	9.9	10.3	9.0	11.9	15.0	13.3

Source: Statistical Yearbook of Mongolia, NSO (various editions)

The economy needs long-term investment to support sustained growth of the economy. For the last 12 years, all sectors except the mining sector and other services have shown no growth or decline. To shield the economy from external shocks, it is important to diversify the economy, which in turn requires long-term investment into sectors other than mining. Productive investment provides a strong basis for both economic growth and job creation. Moreover, underdeveloped infrastructure is a key obstacle to support the economic growth.

However, saving and investment as key sources of domestic long-term investment have been in shortage, which can be seen on the GDP by expenditure (Figure 2-2). Final consumption remained relatively stable over the period of 2008-2012, whereas net exports and gross capital formation increased significantly. Although investment level is picking up, its amount is still not sufficient to meet the financing needs of the economy.

Figure 2-2 Gross Domestic Product, by expenditure approach

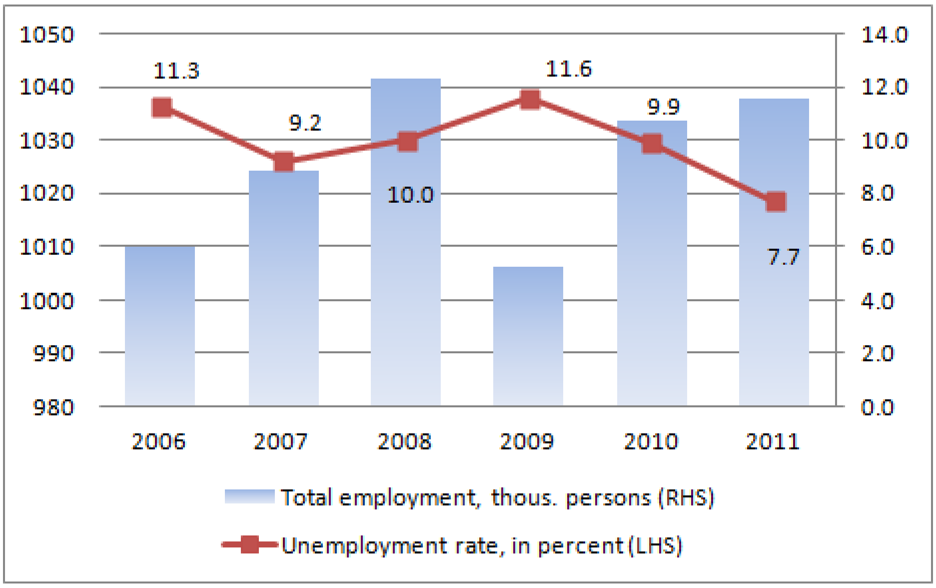


Source: Statistical Yearbook of Mongolia, NSO (various editions)

Also, long-term investment is needed to create jobs. The unemployment rate has been declined gradually from 11.3 percent in 2006 to 7.7 percent in 2011, with exception for 2009

- the crisis year, when it shot up to 11.6 percent (Figure 2-3). Labour force participation rate fluctuated around 62 percent over the period of 2006-2011.

Figure 2-3 Employment and Unemployment Rate



Source: Statistical Yearbook of Mongolia, NSO (various editions)

The agriculture and trade sectors continue to employ the majority of the labor force. At the end of 2011, the agriculture sector employed 1/3 of total labor force, while trade sector accounted for 17.2 percent of total labor force. The growth of labor force in the manufacturing sector has been very moderate. The number of employed in the mining sector remained almost unchanged during 2005-2011. The current unemployment level is still high and more financing is needed to create more jobs.

Table 2-2 Sector Distribution of Employment

	2005	2006	2007	2008	2009	2010	2011
Agriculture	39.9	38.8	37.6	36.2	34.7	33.5	33.0
Mining and quarrying	4.1	4.1	4.3	4.5	3.5	3.3	4.3
Manufacturing	4.7	4.7	4.7	4.6	6.2	6.3	6.3
Utilities	2.9	3.0	3.0	2.9	1.6	2.0	1.6
Construction	5.1	5.6	5.9	6.4	4.9	4.7	5.0
Trade and restaurants	17.7	19.0	19.0	19.6	18.2	16.8	17.2
Transport and communications	4.4	4.1	4.3	4.4	7.8	8.8	8.4
Other sectors	21.2	20.8	21.2	21.4	23.1	24.6	24.0
Total employment	100.0	100.0	100.0	100.0	100.0	100.0	100.0

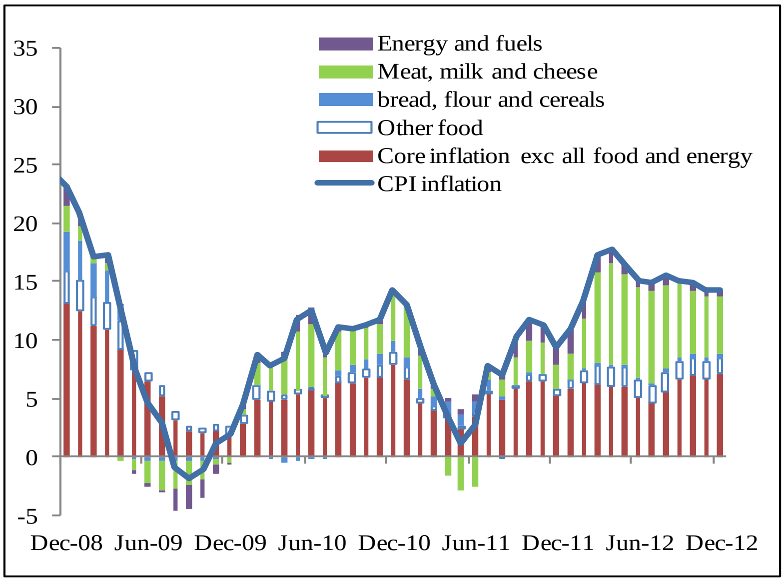
Source: Statistical Yearbook of Mongolia, NSO (various editions)

The mining sector dominated economic growth has not been supportive to create jobs in other sectors due to poor diversification of the economy. The primary sector-oriented economy is challenged to be diversified into more value added economy, which in turn creates more jobs and values to the economy. Diversification itself requires long-term commitments to be financed by LTF.

Monetary policy

Despite efforts by the Bank of Mongolia (BoM) to curb inflation, stubbornly high inflation still remains one of the challenges to the Mongolian economy. Inflation has remained highly volatile. The commodity boom and pro-cyclical fiscal policy contributed to acceleration in inflation.

Figure 2-4 Consumer Price Inflation



Source: Bank of Mongolia

Monetary tightening has not been sufficient to rein in the inflationary pressures fuelled by an overly expansionary fiscal policy. Inflation has stayed very high at 14 percent at end-2012, despite the BoM's move to increase its policy rate two times from 12.25 percent to 13.25 percent by 100 basis points. The Monetary Policy Guidelines for 2013 approved by Parliament in November 2012 envisages an inflation target of below 8 percent in 2013 and 5-7 percent in 2014-2015.

Besides high inflation, however, the liquidity of economy is improving for the last 5 years which can be seen from money market indicators below.

Table 2-3 Money market indicators

	2008	2009	2010	2011	2012
GDP (current prices)	6,555.6	6,590.6	8,414.5	11,087.7	13,944.2
growth in percent	32.3	0.5	27.7	31.8	25.8
Inflation (eop)	22.1	4.2	13	8.9	14
M1 (1)	647.3	651.2	1157.6	1741.1	1835.4
growth in percent	9.6	0.6	77.8	50.4	5.4
Quasi money (2)	1,622.7	2,228.8	3,522.4	4,671.2	5,781.9
growth in percent	-10.4	37.4	58.0	32.6	23.8
LC deposit	898.7	1,234.3	2,001.6	2,912.4	3,488.0
growth in percent	-19.3	37.3	62.2	45.5	19.8
FC deposit	724.0	994.5	1,520.8	1,758.8	2,293.8
growth in percent	3.9	37.4	52.9	15.6	30.4
M2 (1)+(2)	2,270.0	2,880.0	4,680.0	6,412.3	7,617.3
growth in percent	-5.5	26.9	62.5	37.0	18.8
M2/GDP	34.6	43.7	55.6	57.8	54.6
FC circulation ratio/M2	31.9	34.5	32.5	27.4	30.1

Source: Bank of Mongolia

Growth of broad money supply M2 (1)+(2) was relatively significant in the post crises years reaching 39 percent on average during 2010-2012. However, the trend is declining due to BoM's tight monetary policy. Financial deepening measured by the broad money to GDP ratio shows improvement as it posts 54.6 percent at the end of 2012 compared to 34.6 percent in 2008.

Fiscal policy

The expansionary and pro-cyclical fiscal policy has resulted in widening of a budget deficit to 9 percent of GDP in 2012. The Mongolian public finance is heavily dependent on mineral revenues, thus very much exposed to external shocks. Revenues from copper, coal and gold make up almost a third of total revenues. The fiscal position has been deteriorating since 2008, with exception in 2010, when the country recorded a surplus of 0.5 percent of GDP.

Table 2-4 General budget developments, 2008-2013

	2008 Actual	2009 Actual	2010 Actual	2011 Actual	2012 Prelim	2013 Plan
(in billion Tog)						
TOTAL REVENUES AND GRANTS	**2,170.4**	**1,994.0**	**3,122.5**	**4,468.2**	**4,952.2**	**7,258.1**
STABILIZATION FUND	0.0	0.0	0.0	241.0	87.4	169.8
STRUCTURAL REVENUES AND GRANTS	2,170.4	1,994.0	3,122.5	4,227.2	4,864.8	7,088.3
A. CURRENT REVENUES	2,151.0	1,972.6	3,078.3	4,213.7	4,824.7	7,087.5
1. Tax revenues	1,890.9	1,620.5	2,688.2	3,668.3	4,203.4	6,461.5
2. Non tax revenues	260.2	352.1	390.1	545.4	621.3	626.0
B. CAPITAL REVENUE	3.2	2.3	5.7	12.0	15.4	0.8
C. GRANTS	16.1	19.1	38.5	1.5	24.7	0.0
TOTAL EXPENDITURES AND NET LENDING	**2,466.8**	**2,336.6**	**3,080.7**	**4,997.0**	**6,116.7**	**7,444.6**
A. CURRENT EXPENDITURES	1,761.2	1,788.2	2,256.7	3,236.4	4,452.1	4,906.1
1. Purchase of goods and services	1,054.9	970.1	1,166.7	1,504.5	2,072.8	2,479.9
2. Interest payments	19.9	29.6	42.3	37.3	126.4	397.8
3. Subsidy and transfers	686.3	788.4	1,047.6	1,694.6	2,252.9	2,028.4
B. CAPITAL EXPENDITURES	624.4	460.6	590.7	1,280.9	1,575.3	2,488.9
C. NET LENDING	81.2	87.9	233.4	479.7	89.3	49.6
CURRENT BALANCE	**389.9**	**184.5**	**821.6**	**977.3**	**372.6**	**2,181.4**
TOTAL BALANCE	**-296.4**	**-342.6**	**41.8**	**-528.8**	**-1,164.5**	**-186.5**
(in percent of GDP)						
TOTAL REVENUES AND GRANTS	**33.1**	**30.3**	**37.1**	**40.3**	**35.5**	**41.1**
STABILIZATION FUND	0.0	0.0	0.0	2.2	0.6	1.0
STRUCTURAL REVENUES AND GRANTS	33.1	30.3	37.1	38.1	34.9	40.2
A. CURRENT REVENUES	32.8	29.9	36.6	38.0	34.6	40.2
1. Tax revenues	28.8	24.6	31.9	33.1	30.1	36.6
2. Non tax revenues	4.0	5.3	4.6	4.9	4.5	3.5
B. CAPITAL REVENUE	0.0	0.0	0.1	0.1	0.1	0.0
C. GRANTS	0.2	0.3	0.5	0.0	0.2	0.0
TOTAL EXPENDITURES AND NET LENDING	**37.6**	**35.5**	**36.6**	**45.1**	**43.9**	**42.2**
A. CURRENT EXPENDITURES	26.9	27.1	26.8	29.2	31.9	27.8
1. Purchase of goods and services	16.1	14.7	13.9	13.6	14.9	14.1
2. Interest payments	0.3	0.4	0.5	0.3	0.9	2.3
3. Subsidy and transfers	10.5	12.0	12.5	15.3	16.2	11.5
B. CAPITAL EXPENDITURES	9.5	7.0	7.0	11.6	11.3	14.1
C. NET LENDING	1.2	1.3	2.8	4.3	0.6	0.3
CURRENT BALANCE (STRUCTURAL)	**5.9**	**2.8**	**9.8**	**8.8**	**2.7**	**12.4**
TOTAL BALANCE (STRUCTURAL)	**-4.5**	**-5.2**	**0.5**	**-6.9**	**-8.4**	**-1.1**

Source: Ministry of Finance

General budget revenues grew on average of 50 percent in the post-crisis years of 2010-2011. Budget expenditure surged at a commensurate pace of 47 percent during this period. The main drivers were the politically motivated cash handouts, outlays on wages and salaries, and capital spending. To improve fiscal discipline and lay foundation for counter-cyclical fiscal policy, the Parliament passed the Fiscal Stability Law in 2010. The law caps the structural deficit at 2 percent of GDP starting from 2013, and imposes ceilings on the net present value of public debt (40 per cent of GDP from 2014) and growth of expenditure. It also allows for accumulation of fiscal savings in a fiscal stabilization fund.

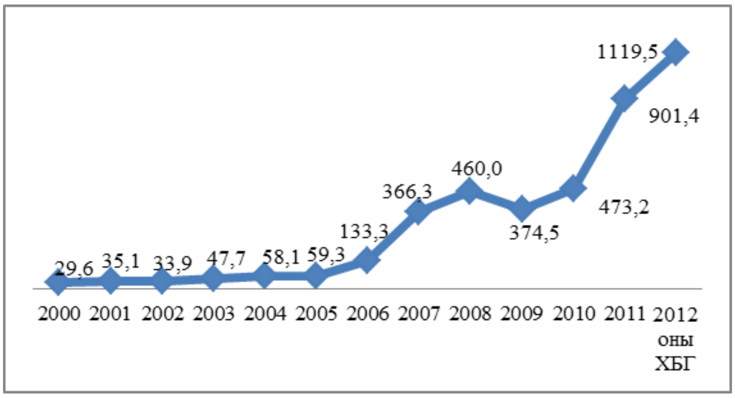
The growth of budget revenues was modest at 11 percent (y-o-y) in 2012. Tax revenue contributed 88 percent of total revenues. VAT revenues were the largest source of revenues, which more than doubled in 2012 from its 2010 level. Corporate and personal income taxes accounted for 26 percent of total revenues and increased around 22 percent in 2012. Collection of VAT and customs duties has been particularly weak, in part owing to base effects related to the deceleration of capital goods imports for the OT mining project.

Budget expenditure grew by 19 percent in 2012. Subsidies and social transfers were the largest expense and accounted for 27 percent of total budget expenditure. Subsidies and social transfers were the largest expense and accounted for 27 percent of total budget expenditure. Subsidies increased by 33 percent in 2012, while capital spending grew at 23 percent in contrast to 117 percent growth in 2011. Capital spending accounts for 25.8 percent of total spending.

Budget deficit averaged at 5.5 percent in 2008, 2009 and 2011; and it turned to surplus 0.5 percent of GDP. However, the deficit skyrocketed at 8.4 percent of GDP in 2012 resulted by 22 percent in expenditure whereas revenue increased only by 11 percent compared to 2011.

The budget spending on capital projects increased substantially during the last decade, from MNT 92.9 billion during 1990-2000 to MNT 4.1 trillion over 2001-2012. Below chart illustrates the amount of public investment undertaken in the last 13 years.

Figure 2-5 Public investment



Source: Ministry of Finance

With a surge in mineral revenues, the budget was able to scale up its investment. However, the amount and extent of the public investment is still not sufficient for the further expansion of the economy and improve its competitiveness.

In sum, the budget has no capacity to provide LTF in near future due to the long lasting deficit.

External trade

The external sector imbalance reached record levels in 2012 with the current account deficit widening to USD 3.2 billion or 31.3 percent of GDP.

The trade deficit has repeatedly hit new highs over the past several years as imports have surged. In 2012, the trade deficit widened to USD 2.4 billion up from USD 0.3 billion in 2010. Imports—mostly mineral products, machinery and equipment, vehicles imports—reached USD 4.5 billion in 2012 doubling the level in 2010.

Table 2-5 External trade, in million USD

	2008	2009	2010	2011	2012
Total turnover	5,779.0	4,023.1	6,108.6	11,415.9	11,123.5
growth in percent	44.1	-30.4	51.8	86.9	-2.6
Export	2,534.5	1,885.4	2,908.5	4,817.5	4,384.6
growth in percent	30.1	-25.6	54.3	65.6	-9.0
Import	3,244.5	2,137.7	3,200.1	6,598.4	6,738.9
growth in percent	57.4	-34.1	49.7	106.2	2.1
Trade balance	-710.0	-252.3	-291.6	-1,780.9	-2,354.3

Source: National Statistical Office

Exports also grew strongly, reaching USD 4.4 billion in 2012, up from USD 2.9 billion in 2010 supported by large coal and copper shipments to China from coal mines in Southern Mongolia. Coal is the largest export earner for Mongolia currently, constituting 43 percent of the value of total exports. In 2012 coal exports amounted to USD 1.9 billion or more than double their total export value in 2010 (USD 0.9 billion). Earnings from copper exports rose by 8.8 percent during 2012 in dollar terms, although volumes were mostly unchanged. The volume of gold exports fell from 5 tons in 2010 to 2.8 tons in 2012, which resulted in decline of overall export earnings by 31.4 percent.

The current account deficit widened to 31.3 percent of GDP in 2012 from 15 percent in 2010, but was financed mainly by FDI inflows of USD 3.8 billion or 37.4 percent of GDP. Mongolia successfully issued USD 1.5 billion sovereign bonds in 2012, which positively affected the accumulation of net reserves. Net remittances declined sharply from USD 129.4 million in 2010 to USD 42.6 million in 2012.

Large twin deficits, a sign of external and domestic sector imbalance, indicate that the economy lacks domestic saving needed to finance long-term investment projects.

2.2 OVERVIEW OF TERM FINANCING

With the high GDP growth rate mainly resulted from booming mining activities, Mongolia faces the development challenge to avoid from so called "Dutch disease" and "resource curse". The government acknowledges a need for economic diversification and infrastructure construction as ways to address this challenge. A number of strategies and programs have been set by the government and advised and funded by international donor organizations.

Development needs financing, in particular LTF which is generated through national and international funding sources. At the national level, gross savings[4] and domestic savings indicate investment capacity of a country to satisfy its development. According to the World Bank report, the Mongolian gross savings average 27% between 2008 and 2011, which is similar to Kazakhstan but much lower than China (averaged 52.5%). In terms of domestic savings to GDP ratio, statistics show that Mongolian domestic saving has been diminishing and contributing to the lack of domestic funding resources for investment (Table 2-6).

Table 2-6 Net saving to GDP ratio (2005-2011)

	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
GDP (billion MNT)	3.04	4.03	5.0	6.56	6.59	8.42	11.1
Saving, net (billion MNT)	1.2	1.85	2.03	1.97	1.8	2.18	2.77
Domestics saving to GDP (%)	**39.5%**	**45.9%**	**40.6%**	**30%**	**27.3%**	**25.9%**	**24.9%**

Source: National Statistical Office

Domestic saving has decreased dramatically between 2006 and 2011 due to impacts of global financial crisis on the economy. Thus, savings equalled 24.9 percent of GDP is incapable to fulfil LTF demand for a growing need of development.

Key providers of LTF can be classified as aids and loans from other countries and international donor organizations, lending from the banking sector, equity and bond financing from the capital market and others. In general, Mongolia is in a shortage of LTF due to a lack of sustainable and well managed foreign funding sources, deposit and loan maturity mismatch of commercial banks, availability of funding sources for banks and non-banking financial institutions, underdevelopment of equity and bond markets and the absence of adequate financial instruments.

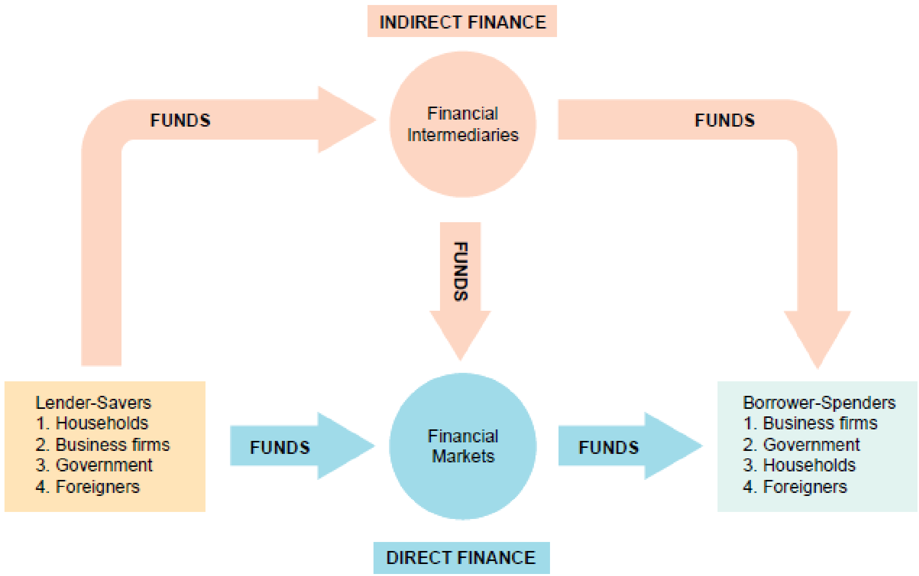
The following chapters will discuss the sources of LTF in detail with a purpose of identifying challenges and providing solutions to overcome.

[4] Gross savings are calculated as gross national income less total consumption, plus net transfers.

3. PRIVATE FINANCING IN MONGOLIA

Generally, financing is classified as direct and indirect. Direct financing refers to capital market (equity and bond market) where borrowers issue securities (initial public offering, bond etc.) directly on the market in order to finance their activities. Indirect finance is where borrowers borrow funds from the financial market through financial intermediaries such as banks and non-banking financial institutions. This procedure can be illustrated as follows:

Figure 3-1 Indirect and direct financing



Source: Mishkin, F.S (2004, p. 24)

With growing economic development, Mongolia faces an increasing demand for LTF. In order to examine a supply side of LTF, the section below discusses direct and indirect financing as a mean of LTF in Mongolia. The structure of this section is: firstly, the financial sector of Mongolia is introduced and followed by indirect financing as banks are key providers of financing in the country. Lastly, equity and bond markets as ways of direct financing is discussed with analysis of foreign direct investment.

3.1 FINANCIAL SECTOR

The financial sector comprises of commercial banks and nonbank financial institutions (NBFIs). As of December 2012, there were 14 commercial banks, 18 insurance companies, 151 saving and credit cooperatives, 205 finance companies and 78 securities and/or brokerage firms. Most financial services are concentrated in Ulaanbaatar, where over 80 percent of total assets of the financial sector are allocated. At the end of 2012, financial sector assets stood at MNT 11.9 trillion or 86 percent of GDP.

The banking sector, accounting for 96 percent of total assets, dominates the financial system and it is highly concentrated with three largest banks holding 70 percent of total banking assets. There are no subsidiaries or branches of foreign banks, as the regulation virtually restrict foreign participation in this sector[5]. Although the number of non-bank financial institutions has increased over the years, their role in the financial sector is still minimal.

Table 3-1 Structure of the Financial Sector, 2009-2012 Q3

	2009			2010			2011			2012 Q3		
	Number	Assets (bln Tog)	Percent of total assets	Number	Assets (bln Tog)	Percent of total assets	Number	Assets (bln Tog)	Percent of total assets	Number	Assets (bln Tog)	Percent of total assets
Commercial Banks	15	4,421.8	95.8%	14	6,245.6	95.9%	14	9,371.6	95.7%	14	10,968.9	95.6%
Private	14	4,283.8	92.8%	13	6,065.4	93.2%	13	9,140.0	93.4%	13	10,664.2	92.9%
State-owned	1	138.0	3.0%	1	180.2	2.8%	1	231.6	2.4%	1	304.7	2.7%
Nonbank Financial Institutions	455	195.5	4.2%	430	265.6	4.1%	472	416.1	4.3%	452	507.7	4.4%
Insurance companies	18	41.1	0.9%	17	55.4	0.9%	17	81.2	0.8%	18	100.8	0.9%
Savings and Credit Cooperatives	212	45.0	1.0%	179	49.0	0.8%	162	61.9	0.6%	151	65.5	0.6%
Finance companies/NBFIs	177	96.5	2.1%	182	128.6	2.0%	195	205.4	2.1%	205	245.4	2.1%
Securities firms/broker firms	48	13.0	0.3%	52	32.6	0.5%	98	67.6	0.7%	78	96.1	0.8%
Total Financial System	470	4,617.3	100.0%	444	6,511.2	100.0%	486	9,787.8	100.0%	466	11,476.7	100.0%

Source: Bank of Mongolia and Financial Regulatory Commission

Under the current legislation, the supervisory responsibilities for commercial banks fall within the ambit of the Bank of Mongolia (BoM) and NBFIs are regulated by the Financial Regulatory Commission (FRC) of Mongolia.

According to the Global Competitiveness Index Report (2012), the Mongolian financial market development was ranked at 112 out of 144 countries. This indicates that financial markets as one of key pillars for country efficiency enhancers[6] are still underdeveloped.

Table 3-2 Mongolian financial market development

(In the Global Competitiveness Index 2012-2013)

No	Financial market development indicators	Value	Rank/144
1	Availability of financial services	3.8	111
2	Affordability of financial services	3.5	115
3	Financing through local equity market	2.8	107
4	Ease of access to loans	1.8	135
5	Venture capital availability	1.7	139
6	Soundness of banks	4.3	121
7	Regulation of securities exchanges	2.8	132
8	Legal right index, 0-10 (best)	6	65

Source: The Global Competitiveness Index (2012)

[5] However, Bank of China, Standard Chartered and ING have their representative offices in Ulaanbaatar.

[6] As grouped in the Global Competitiveness Index, there are six sub-indexes of efficiency enhancers, such as financial market sophistication, higher education and training, goods market efficiency, labour market efficiency, technological readiness, market size.

Compared to other countries with similar domestic income, the Mongolian banking sector development is moderate in terms of availability of financial services, number of bank branches per capita and legal right index. However, Mongolia has an underdeveloped capital market with poor regulation on the security exchange, absence of venture capital investment and institutional investors, and unease of access to loans, in particular long-term loans.

3.2 Indirect financing

BANK AS A KEY FINANCING INSTITUTION

A. OVERVIEW OF THE BANKING SECTOR

Total asset of the banking system grew from 67.1 percent of GDP in 2009 to 86 percent of GDP at the end of 2012. Bank credit increased on average by 48 percent annually in 2007 and 2008, although banks virtually stopped lending in the late 2008 due to the world financial crisis. Credit growth resumed in the late 2009 as the economy rebounded strongly, and in 2011 credit grew substantially by more than 70 percent (y/y). Deposits have also grown rapidly after the crisis, by an average of 43 percent annually during 2009-2011. Strong deposit growth has been supported by robust economic growth and capital inflows.

The growth of both deposits and credits slowed markedly in 2012. Tight monetary policy pursued by the BoM has contributed to the slowdown of credit expansion. By the end of 2012, credit growth moderated to 24 percent (y/y), and deposit growth slowed to 23.8 percent (y/y). Deposits continue to be the main source of funding for most commercial banks. Most bank deposits and loans are short-term with maturities of less than one year.

Table 3-3 Banking Sector Development, 2007-2012 (in billion MNT)

	2007	2008	2009	2010	2011	2012
GDP (current prices)	4,956.6	6,555.6	6,590.6	8,414.5	11,087.7	13,944.2
growth (%)	23.1	32.3	0.5	27.7	31.8	25.8
real GDP growth (%)	10.2	8.9	-1.3	6.4	17.5	12.3
Bank assets	3,385.9	3,650.0	4,421.8	6,245.6	9,371.6	11,992.2
growth (%)	46.3	7.8	21.1	41.2	50.1	28.0
bank assets/GDP (%)	68.3	55.7	67.1	74.2	84.5	86.0
Bank loans	2,055.3	2,635.1	2,655.0	3,228.2	5,597.7	6,941.1
growth (%)	68.0	28.2	0.8	21.6	73.4	24.0
bank loans/GDP (%)	41.5	40.2	40.3	38.4	50.5	49.8
Bank deposits	1,810.8	1,622.7	2,228.8	3,522.4	4,671.2	5,781.9
growth (%)	50.3	-10.4	37.4	58.0	32.6	23.8
bank deposits/GDP (%)	36.5	24.8	33.8	41.9	42.1	41.5

Source: Bank of Mongolia

Banks' capital position has improved over the years. The capital adequacy ratio reached 16.1 percent in 2012 compared to 5.5 percent in the crisis year. The asset quality has also improved as the non-performing loan ratio declined to 4.2 percent in 2012 from 17.4 percent in 2009. Asset quality, however, might be masked by the excessive credit growth, loose credit environment, connected lending and large single borrower concentrations. Particularly, Mongolian banks are exposed to large sector concentrations such as the construction, mining, and trading sectors, and banks are vulnerable to sector-specific shocks that could arise from a sharp decline in commodity prices or trade.

Table 3-4 Mongolia: Commercial Banks' Financial Stability Indicators, 2007-2012

	2007	2009	2011	2012
Capital adequacy				
Regulatory capital to risk-weighted assets	14	5.5	15	16.1
Asset quality				
Non-performing loans (NPL) to gross loans	3.3	17.4	5.8	4.2
Earning and profitability				
Return on assets (before tax)	2.5	-5.6	2.9	2.3
Return on equity (before tax)	21.2	-131.9	18.6	15.2
Interest margin to gross income	42.3	-42.1	28	12.2
Spread between reference loan and deposit rates	6.5	7.9	5	6.5
Liquidity				
Liquid assets to total assets	28.1	36.9	32.1	29.2
Liquid assets to short-term liabilities	27.4	31.8	37.6	34.2
Foreign currency deposits to total deposits	25.4	34.4	27.1	29.3
Loans to deposits	113.5	119.1	119.8	120.1

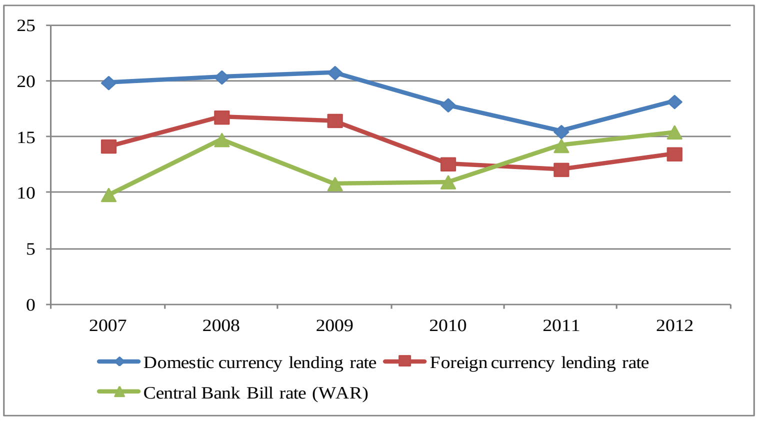
Source: Bank of Mongolia and IMF

Banks remain profitable, but their interest margins continue to shrink amid growing competition. The return on asset (ROA) posted 2.3 percent and the return on equity (ROE) logged 15.2 percent at the end of 2012, both of which improved compared to the levels at the end of 2010 where the ROA stood at 1.8 percent and the ROE recorded 11.2 percent. Increasing competition among banks, meanwhile, appears to reduce banks' interest margins. Their interest margins posted 12.2 percent in December 2012, which substantially decreased compared to 28 percent at the end of 2011.

System-wide liquidity is under pressure as deposits are not growing quick enough to catch up with loan growth. The loans to deposits ratio of the banking system has gradually increased since 2007 and reached 120 percent at the end of 2012.

Annual interest rates for both domestic and foreign currency loans have been declining since 2009, however rates have picked up slightly in 2012. Central Bank Bill (CBBs) rates have been on the rise since 2010 to reduce the credit boom experienced in the post crisis years.

Figure 3-2 Lending Rate and Central Bank Bill Rate



Source: Bank of Mongolia

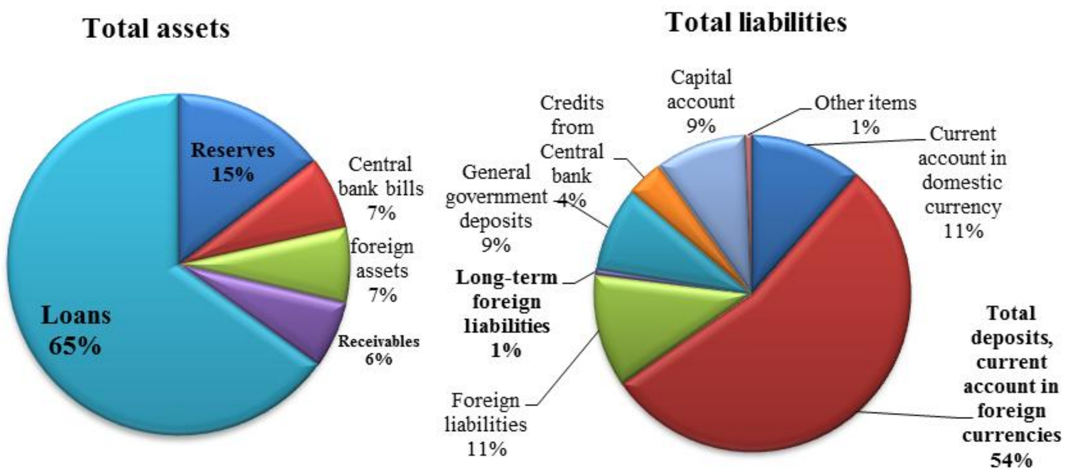
As degrees of interest rates determine lending availability and lending demand, the above figure shows that interest rates are relatively high reaching about 18 percent.

B. BANK LOANS AS THE MAIN SOURCE OF FINANCING

As the banking sector constitutes 96 percent of the total financial markets, loans provided by 14 banks are the most important source for business financing. However, these loans are often with short-terms and high interest rates as a result of various factors, such as maturity mismatch of deposits and loans, regulatory barriers of the banking sector and a lack of LTF resources for banks.

In terms of financing resources, banks are allowed to take deposits, borrow term loans and issue stocks and bonds in the capital market. However, the statistics of the BoM shows that commercial banks mostly rely on deposits as a key source of financing (Figure 3-3).

Figure 3-3 Composition of banking sector total assets and liabilities



Source: Statistical Bulletin of Bank of Mongolia

Currently, the composition of banking sector liabilities is mainly generated from deposit (54%), current account in MNT (11%), government deposit (9%), ownership capital (9%), and only 1% of total liabilities are constituted from long-term foreign loans. These sources of financing are mostly allocated into loans (65%), reserves[7] (15%) and others. Thus, it is important to pay special attention to the structure, maturity and interest rate of deposits in order to analyze capacity of the banking sector providing LTF into the economy.

Basically, there are four types of deposits: corporate deposits, individual deposits, state funds and others. Individual deposits constitute 54 percent of total deposits, while corporate deposits compose 25 percent in 2011. These two deposits generate 80 percent (MNT 5,400 billion) of total deposits. Table below shows the structure of deposits, in particular composition of time deposits, which determines term-loan lending capacity of banks.

[7] According to the BoM regulation, all commercial banks must deposit 12 percent of risk-weighted assets as the capital adequacy ratio compliance in the BoM account.

Table 3-5 Deposit structure of the banking sector (2011, in billion MNT)

Types of deposits	Demand deposits	Share of demand deposit	Time deposits	Share of time deposit	Total deposit
Corporate Deposits	1300,0	76%	400,0	24%	1700,0
Individual deposits	1600,0	43%	2100,0	57%	3700,0
State funds	400,0	80%	100,0	20%	500,0
Other deposits	300,0	33%	600,0	67%	900,0
Total deposits	3600,0	53%	3200,0	47%	6800,0

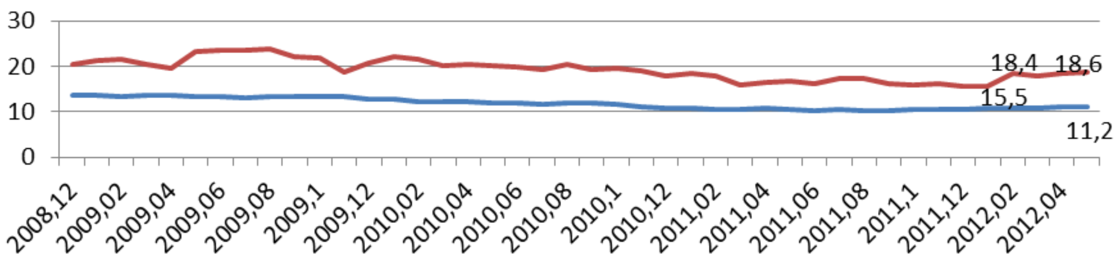
Source: Statistical Bulletin of Bank of Mongolia

Short-term financing: From the deposit structure, it is evident that majority of deposits are demand deposits. Cash equivalents of businesses and individuals generate demand deposits and current accounts aimed to cash out on immediate demand of customers. Thus, 76 percent of total corporate deposits and 43 percent of total individual deposits are not able to be used for LTF.

Long-term financing: Among other deposits, 57 percent of individual deposits and 67 percent of other deposits are eligible funds for LTF. But, shares of these sources account for 40 percent. In sum, 47 percent of total deposits can be a source for LTF depending on their maturities. Banks do not have sufficient funding sources other than time deposit given that banks do not raise much financing from equity and bond markets, and only 1 percent of long-term foreign lending goes into the total liabilities of the banking sector.

In terms of deposit maturity, most banks have time deposits with maturity of up to 18-months. In order to match with funding sources, deposits with high rates and short-term result in short-term loan with high interest rates. Deposit rates have slightly decreased since 2008 and averaged 11.2 percent. Interest rates of loans reached 24 percent in 2009 when banks virtually stopped to provide loans. Margins of deposits and loans are about 7 percent (Figure 3-4).

Figure 3-4 Changes in deposit and loan interest rates, by percentage (2008.12-2012.05)



Source: Statistical Bulletin of Bank of Mongolia

High inflation rates, banks' competition over deposits and a lack of saving tradition of Mongolians led to high deposit rates among banks. In spite of strict monetary policies of the central bank, the inflation rate has remained within two-digit. The situation results in high deposit rates among 14 banks to attract more deposits. With volatile inflation, individuals are cautious to deposit in longer term and thus, most deposits are demand deposit or time deposits up to one year.

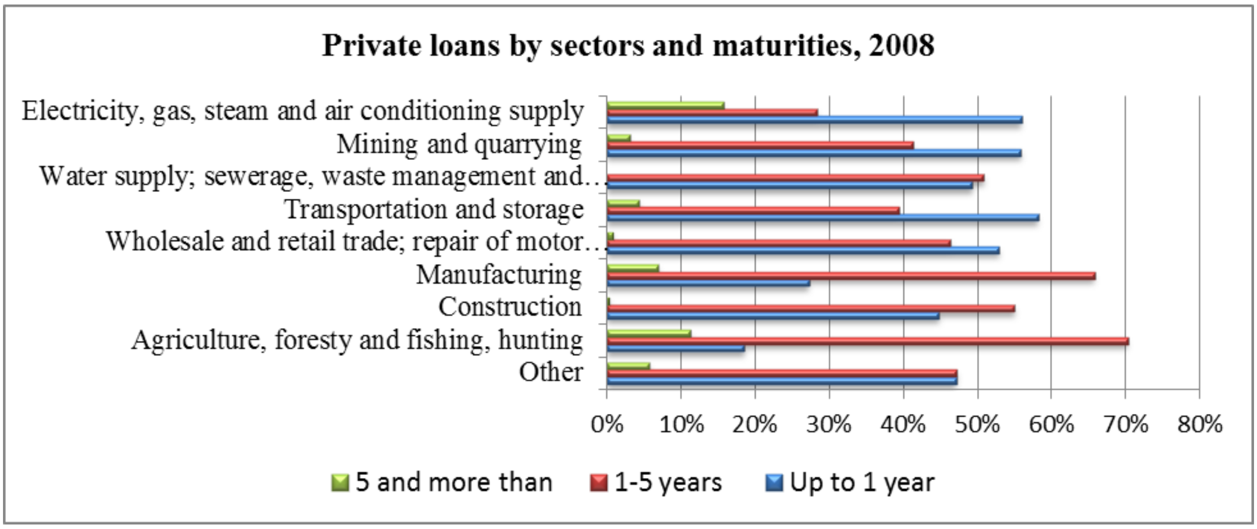
Table 3-6 Statistics of outstanding loan to the private sector

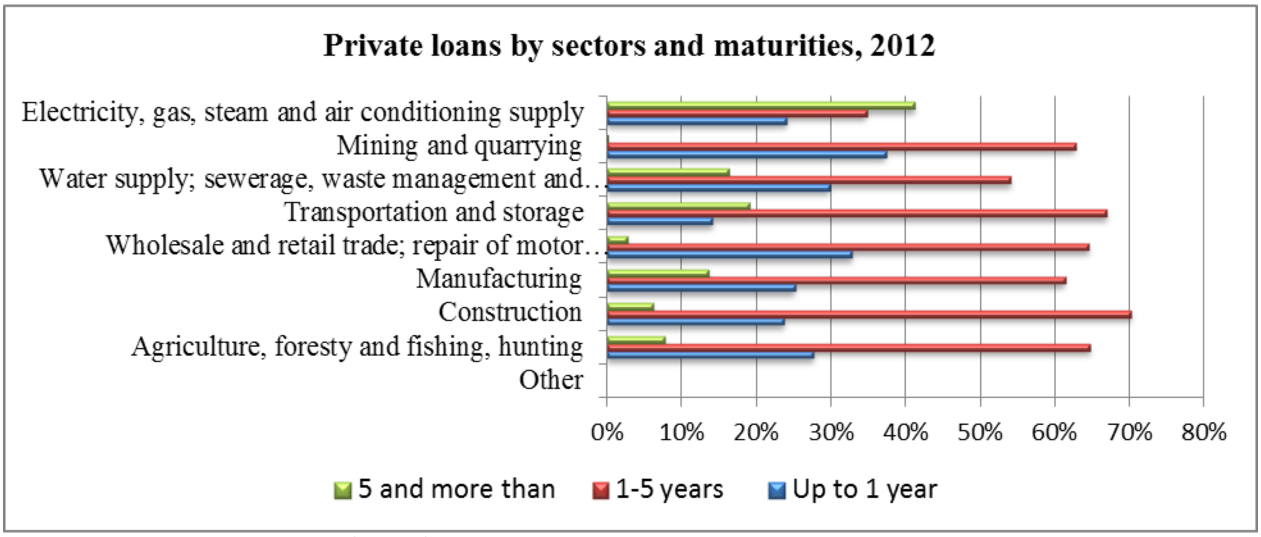
	2008		**2009**		**2010**		**2011**		**2012**	
	Amount in	**(%)**	**Amount in**	**(%)**	**Amount in**	**(%)**	**Amount in**	**(%)**	**Amount in**	**(%)**
Loan outstanding to private sector	1,555,982.5	*59.0%*	1,699,083.2	*64.0%*	1,854,627.9	*57.5%*	3,072,444.0	*54.9%*	3,819,211.7	*55.0%*
Normal	1,336,125.3	*50.7%*	1,225,613.3	*46.2%*	1,472,570.1	*45.6%*	2,752,844.3	*49.2%*	3,494,785.6	*50.3%*
up to 1 year	584,573.7	*22.2%*	439,816.8	*16.6%*	414,195.0	*12.8%*	604,490.6	*10.8%*	965,401.2	*13.9%*
1-5 years	703,650.8	*26.7%*	662,392.4	*24.9%*	975,254.6	*30.2%*	1,967,896.5	*35.2%*	2,259,874.0	*32.6%*
5 and more than	47,900.7	*1.8%*	123,404.1	*4.6%*	83,120.5	*2.6%*	180,457.3	*3.2%*	269,510.4	*3.9%*
Total loan outstanding	2,635,127.8	100%	2,655,000.3	100%	3,228,171.1	100%	5,597,743.6	100%	6,941,135.2	100%

Source: Bank of Mongolia (2012b)

Using short-term deposits with high rates, banks are incapable of providing long-term loans to businesses to grow. However, the situation is improving by the comparison between 2008 and 2012. The figure below shows private loans by sectors and maturities.

Figure 3-5 Comparison between private sector loans and maturities



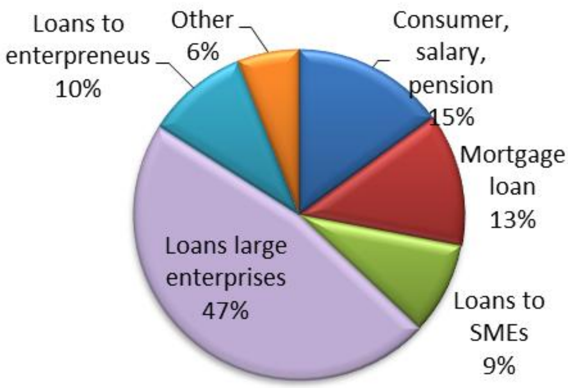


Source: Statistical Bulletin of Bank of Mongolia

Since 2008, the structure of loan maturity has had a significant change. Short-term dominated loans have been changed to mid- and longer-term loans with doubled increase in energy and transportation sectors. Mining, water supply and wholesale sectors also had up to 20 percent increase in term loans. However, term loans had not increased significantly for manufacturing and agricultural sectors which are mostly constituted from SMEs. In sum, nearly 80 percent of total loans are mid (1-5 years) and longer-term (more than 5 years) loans whereas loans up to 1 year constitutes 22 percent.

In terms of structure of loans by sectors (Figure 3-6), 28 percent of total loans are provided for individuals' loans (consumer, salary and mortgage), 47 percent to large enterprises, and only 19 percent to SMEs and entrepreneurs.

Figure 3-6 Bank loan composition in 2011



Source: Statistical Bulletin of Bank of Mongolia

Banks do not provide much term-loan to SMEs, which account for about 96 percent of total registered entities. Up to 1 year and mid-term loans are allocated to trade, manufacturing and agriculture sectors which are mostly operated by SMEs. Only about 5-8 percent of total loans to these sectors are longer term loans. Therefore, businesses mostly borrow working capital loans and trade credits rather than investment and reconstruction loans that take longer time horizons.

Another indicator for the deposit and loan match is structure of deposit and credit growth shown in the Table below.

Table 3-7 Structure of deposit and credit growth (2006-2011)

Structure of deposit and credit		2006	2007	2008	2009	2010	2011
Household	Deposits growth	43%	57%	-13%	36%	43%	40%
	Credit growth	58%	66%	20%	-11%	43%	80%
Corporate	deposits growth	17%	97%	-3%	40%	53%	96%
	Credit growth	34%	79%	36%	-10%	9%	65%
Household	Deposits growth/GDP	4%	2%	6%	5%	6%	13%
	Credit/GDP	8%	10%	13%	15%	11%	12%
Corporate	Deposits growth/GDP	18%	20%	23%	20%	22%	24%
	Credit/GDP	12%	13%	17%	24%	21%	16%

Source: Statistical Bulletin of Bank of Mongolia

Statistics show that both deposit and credit supply of banks declined in 2008 and 2009 due to the Lehman shock. However, the situation eased from 2010 and fully recovered by 2011. From the table above, household credit growth doubled household deposit growth which indicated sources from deposit were not able to satisfy credit needs, in particular long-term loans. This situation was even worse for corporate loans as corporate deposit growth was three times lower than corporate credit growth by 2011.

In sum, most bank loans have high-interest rates with short-term period (repayment period of 1-2 years and average interest rate of 18.2% per annum). This situation is caused by high deposit rates due to intensified competition over deposits, insufficient supply of LTF funds and poor capacity of businesses to have adequate business plans and credible financial information and reporting systems to meet banks' loan requirements.

C. ISSUES FOR CONSIDERATION

Main issues of the banking sector are maturity mismatch, a lack of foreign LTF sources, the absence of modern collateral registry system and credit guarantee scheme and poor saving habit of Mongolians.

Banks mostly rely on deposits mostly with short maturities (more than 50% are on-demand deposits). Financing of long-term loans by the short maturity deposits creates maturity mismatch. Therefore, deposits are used to finance short maturity loans only. Due to the lack of available long term sources, commercial banks have no incentive to risk their assets for LTF specially the gaining deposits from domestic customers is very competitive. Therefore, banks need to have available sources for long term lending which is a very difficult purpose if it is only based on domestic deposits. In addition, the absence of collateral registry system and credit guarantee scheme[8] restrict banks to provide long-term capital investment loans to businesses, in particular SMEs which account for 96 percent of total registered entities and often have difficulties with banks' collateral requirements.

As deposit is short matured and saving capacity and tradition of the public is weak, the amount of deposits falls short of being a source for LTF. Entitlement of banks to mobilize savings, therefore, appears to be not used to its full extent indicating that LTF is still in high demand for businesses to sustain and grow. Thus, external borrowing, the state regulated LTF provider – the Development Bank and equity financing remain the major funding sources.

3.3 DIRECT FINANCING

3.3.1 EQUITY AND BOND MARKETS

Equity and bond markets are parts of the capital market where companies and governments generate long-term financing. These markets, or simply the capital market, comprise about 28 percent of total outstanding domestic long-term financing in developed and developing countries. Compared to bank loans with maturities average only 2.8 years in emerging economies compared to 4.2 years in developed economies, investment-grade or high-yield bond maturities in developed countries are 8.0 years and 7.7 years, respectively, and in emerging markets they are 6.0 years and 6.9 years (Group of Thirty, 2013, p. 30). Unlike these countries, the share of the Mongolian capital market, however, constitutes only 3 percent of the domestic financial market and the bond market is dominated by government bonds. There are no high-yield bonds in Mongolia.

A. THE MARKET DEVELOPMENT

The Mongolian Stock Exchange (MSE) was established in 1991 with a duty to implement privatization of state-owned enterprises at the early stage of transition. With enactment of the Securities and Exchange Law in 1994 and the Corporate Law in 1995, the secondary market was created and brokerage firms operated and financed by the MSE were privatized.

Equity investment is not a common long-term financial instrument given declining number of listed companies at the MSE. There were 475 listed companies in 1995 and have reduced to 329 listed companies by 2012. These 329 companies account only 4.7% of 70,000 total registered business entities. Out of these listed companies, 29 companies are state-owned. However, majority of the listed companies has inactive stock trade. The FRC provides financial supervision to the MSE, listed companies and brokerage firms. The base of institutional investors, including insurance companies, pension firms and investment management companies is absent.

[8] Although there is a government established Loan Guarantee Fund in 2012, it is not fully operational yet. A private credit guarantee fund is under discussion.

The stock market capitalization has risen dramatically from 1.8 percent of GDP in 2005 to 18 percent of GDP in 2012 due to rapid growth and expected growth potential of the economy. The trading value, indicating companies' interest to raise capital in the domestic market, also soared from MNT 2.5 billion in 2005 to MNT 145.1 billion in 2012.

Being another source of financing of the capital market, bond trade has been increasing mainly resulted by the government bond issuance. Total trade value of bonds in 2011 amounted to 241.1 billion, of which government bonds accounted for 98 percent. In October 2012, the Regulation on Issuing and Trading of Government Securities was passed. The regulation authorizes the BoM to manage trading of government securities. As a result, the value of government bonds traded in the 2012 significantly declined to MNT 525,000 in 2012.

Table 3-8 Mongolian Stock Market Indicators

	2000	2005	2010	2011	2012
Listed companies	410	392	336	332	329
o/w: actively traded	125	108	69	102	96
Market capitalization					
in billion Tog	40.5	55.7	1,373.9	2,168.6	1,799.9
in million USD	36.9	45.6	1,092.9	1,553.0	1,292.9
in percent of GDP	3.3	1.8	16.3	19.6	18.0
Trading value					
in billion Tog	3.0	2.5	92.9	350.2	145.1
in million USD	2.7	2.1	73.9	250.8	104.2
in percent of GDP	0.2	0.1	1.1	3.2	1.5
Bond trading value (in billion Tog)					
Government	11.1	6.8	30.0	236.7	0.0005
Corporate	0.0	2.7	0.0	4.4	0.3
Top 20 index					
High	506.3	1,053.0	14,759.8	21,687.6	17,714.5
Low	459.6	955.9	14,006.0	18,515.0	15,449.8
Average	489.0	995.3	14,331.3	19,846.7	16,839.1
Close	469.9	1,019.2	14,759.8	21,687.6	17,714.5

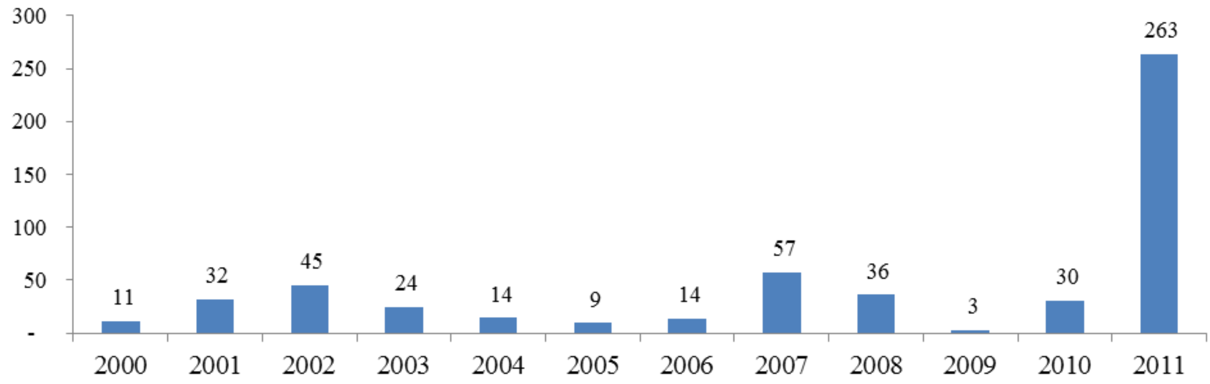
Source: Statistical Bulletin of Bank of Mongolia

In terms of market valuation, listed companies account for USD 1.3 billion. Market price to book value ratio is averaged 3.5 implying that shares of companies are 3.5 times overvalued than their book values. Average P/E ratio of listed companies is 17.5 indicating relatively overvalued trend of the capital market.

Outside the MSE, 25 Mongolian companies, mostly mining companies, have been listed on foreign exchanges because of their much greater ability to raise capital and high liquidity. Among them, 28% of companies are listed on the Hong Kong stock exchange, another 28% on the Australian stock exchange, 12% on the London stock exchange, 28% on the Canadian stock exchange and 4% in USA. Total market valuation of these companies equals to USD 14.1 billion by the end of 2011.

In terms of the market intensity, the stock exchange has relatively inactive trading and amount of capital flows is low when it is compared to the banking sector.

Figure 3-7 Primary market trade activation between 1995 and 2011 (in billion MNT)



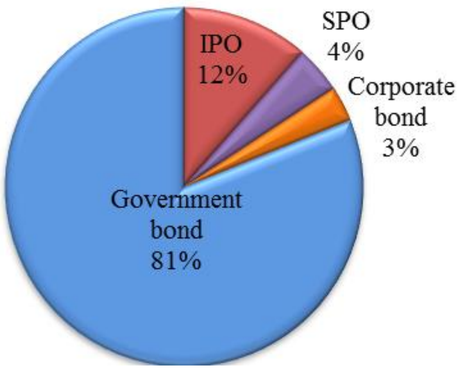
Source: Mongolian Stock Exchange

The above Figure shows that 2007 and 2011 were the most active years in terms of equity and bond trading. In 2011, the government raised MNT 236.7 billion from its bonds, two listed companies issued second public offering valued MNT 21.9 billion and one company generated MNT 4.36 billion from its corporate bond.

In terms of bond market, short maturity instruments (240 days or less) characterize the Mongolia bond market. These are sold at a discount that reflects the interest rate: the interest rate is the difference between the purchase price of the bond and the face value. Most bonds are held by commercial banks, which typically keep them until maturity – there is no real secondary bond market. The Bank of Mongolia issues its own short-term bills to manage liquidity.

As the primary market plays the most important role in LTF, the government and business entities can issue bonds and stocks at this market for project and program investments and reconstruction purposes. The figure below illustrates the structure of primary market instruments.

Figure 3-8 Composition of primary market trade between 1995 and 2011

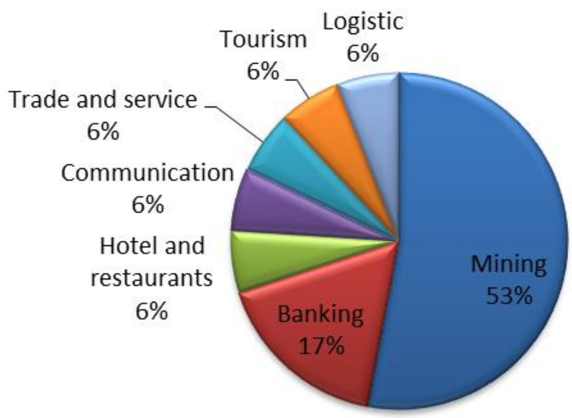


Source: Mongolian Stock Exchange

Majority (81%) of financial instruments is government bonds for financing government programs. Theoretically, corporate bond is similar to bank loans as it has low cost of capital compared to shares, but with longer-term maturity than bank loans. There are only 5 companies issued their bonds to finance big projects. These bonds account for only 3% or MNT 17 billion indicating that companies do not use this LTF instrument well enough.

Issuing shares to the public is also not commonly used in Mongolia as initial public offering (IPO) constitute 12% (MNT 67 billion), whereas second public offering accounts for only 4% (MNT 23 billion) of all trading in the primary market. Between 2005 and 2012, the FRC provided permissions to seventeen companies, comprising 9 mining companies, to issue their IPOs. Their stock trading accounts for 23.4% of total equity trade.

Figure 3-9 Companies issued IPOs (by sectors)



Source: Mongolian Stock Exchange

The above Figure shows that companies, in particular, mining companies have started to generate capital from the stock exchange to add values to their output. There is a trend that previously limited liability companies choose to become public companies in order to expand their businesses and invest big projects that cannot be financed through short-term bank loans.

Despite its rapid growth in market capitalization, trading volume and Top 20 index, the security or capital market is still underdeveloped in terms of its role in the total financial market and a number of listed companies compared to the total registered companies. In April 2011, the government signed the “Master Service Agreement” with the London Stock Exchange aiming to launch the modern trading system in Mongolia, to improve legislative environment, financial infrastructure, and technology and to help capacity building of trading staff. Within the scope of this cooperation, the “Millennium IT” operating system introduced to the MSE in 2012. The system is the fastest cash trading platform in the world and will enable the stock exchange to provide substantially lower latency, significantly higher capacity and improved scalability to meet investors and brokers and dealers’ needs.

B. ISSUES FOR CONSIDERATION

The capital market, including equity and bond markets, is still underdeveloped in Mongolia. Equity of most listed companies are not traded, or traded only sporadically. Of the companies that are actively traded, 80% of the shares are held by a small number of shareholders indicating high equity concentration. Main reasons of passive trading are a lack of liquidity of equity, high stock concentration of listed companies, absence of institutional investors, such as mutual funds, insurance companies and pension fund, and poor capacity and skills of capital market specialists.

There is not much opportunity for SMEs given strengthening entry requirements of the MSE and a lack of proper knowledge among SMEs and capital market participants regarding benefits of capital market financial instruments and potentials of SMEs penetration into the capital market.

In sum, the financial intermediation is growing fast in Mongolia. Currently, the banking sector plays a key role in providing financial services to the economy.

3.4 FOREIGN DIRECT INVESTMENT

Foreign direct investment (FDI) to the private sector makes a significant contribution to the economy. A big portion of FDI goes to the mining and petroleum sector resulting in both causes and consequences of the booming mining development.

Table 3-9 Foreign direct investment in last three years, by sectors

№	Sectors	2010		2011		2012	
		million USD	%	million USD	%	million USD	%
1	Geology, mining and petroleum	819,762.15	79.90	4,083,218.51	81.89	2,217,906.92	69.34
2	Trade and catering	162,560.01	15.84	620,567.90	12.45	694,336.18	21.71
3	Other	14,012.70	1.37	207,216.65	4.16	38,728.09	1.21
4	Bank and financial activities	12,979.37	1.27	24,124.58	0.48	27,893.87	0.87
5	Light industry	153.75	0.01	99.24	0.00	365.17	0.01
6	Construction	980.10	0.10	5,177.47	0.10	47,615.15	1.49
7	Animal raw materials processing	236.89	0.02	656.60	0.01	49.97	0.00
8	Tourism	371.40	0.04	22,152.15	0.44	12,458.16	0.39
9	Communication	125.00	0.01	8,971.86	0.18	502.37	0.02
10	Transport	2,892.00	0.28	7,374.49	0.15	135,062.51	4.22
11	Food processing	3,850.00	0.38	4,586.98	0.09	21,428.30	0.67
12	Agriculture and animal husbandry	403.36	0.04	554.00	0.01	431.12	0.01
13	Education, culture, science	60.48	0.01	415.65	0.01	833.64	0.03

	and printing						
14	Health and cosmetics	7,492.00	0.73	905.55	0.02	1,074.84	0.03
15	Woodenware	33.60	0.00	12.48	0.00	45.00	0.00
16	Energy		-		-		-
17	Service	83.07	0.01		-		-
18	Jewellery, souvenir		-		-		-
19	Appliance production		-		-		-
20	Household goods		-		-		-
	Total FDI	**1,025,995.88**	**100.00**	**4,986,034.12**	**100.00**	**3,198,731.30**	**100.00**

This table illustrates that about 70 percent of FDI go to mining and petroleum investment and thus FDI has significantly contributed to the structure of the economy and export industries. Only 1 percent of FDI has been used as LTF to banks and financial institutions.

For last five years, the size of FDI has increased 3.8 times and percentage in GDP reached 23 percent compared with 13 percent in 2008. The highest increase occurred in 2011 with 4.9 times increase accounting for 45 percent of GDP (Table 3-10).

Table 3-10 Foreign direct investment

	2008	2009	2010	2011	2012
FDI (million USD)	836.0	496.0	1,026.0	4,986.03	3,198.73
in percent of GDP	12.8%	7.5%	12.2%	45%	22.9%

Source: Bank of Mongolia

The slowdown of the FDI inflows is becoming a significant downside risk to the economy. In 2012, the net FDI inflow declined by 35.8 percent to USD 3.2 billion, from USD 4.9 billion of the previous year. In the first few months of 2013, the net FDI inflow slowed down rapidly: it amounts to only 42 percent compared with the level during the same period in 2012. The sharp deterioration of the FDI inflow reflects the expected unwinding of capital expenditure by the Oyu Tolgoi project, but also signals the growing wariness of foreign investors over the investment climate in Mongolia as Mongolia adopted Strategic Entities Foreign Investment Law (SEFIL)[9] in June 2012 and has called into question some investment agreements and contracts. With no well-functioning domestic capital markets and limited access to international capital markets, the sharp drop of the FDI inflow has a significant economic implication as it has been one of main sources for private investment.

[9] To date, the Government proposed some amendments to the SEFIL to ease the tight regulation on foreign investment.

In terms of investor countries, Chinese companies have played a key role in FDI to Mongolia. The following table illustrates countries of main investors and their share in total FDI.

Table 3-11 FDI /top ten countries/

№	Top investment countries 1990-2012.06.30	Share in total FDI	Amount /billion USD/
1	China	31.71	3.65
2	Holland	23.16	2.67
3	Luxemburg	9.01	1.04
4	Virgin islands	7.48	0.86
5	Singapore	5.45	0.63
6	Canada	4.23	0.49
7	South Korea	2.93	0.34
8	USA	2.54	0.29
9	Hong Kong /China/	1.80	0.21
10	Japan	1.60	0.18

Source: Bank of Mongolia

In terms of the regulatory environment, Mongolia is ranked a little bit above average of the Organization of Economic Cooperation and Development (OECD) countries in FDI regulatory restrictiveness index[10].

Figure 3-10 FDI Regulatory Restrictiveness Index, OECD, 2012

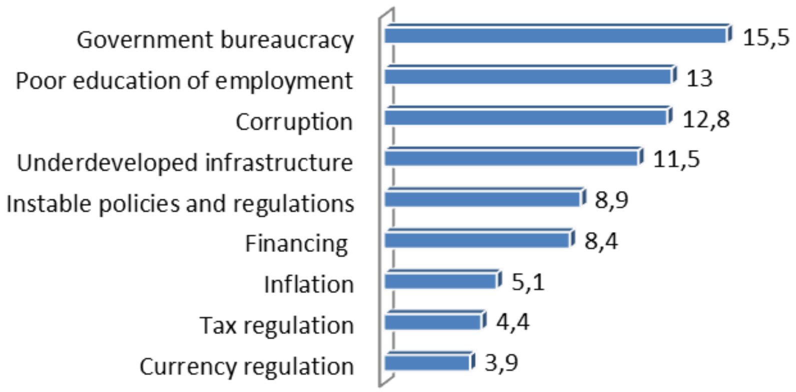
[10] FDI Regulatory Restrictiveness Index measures statutory restrictions on foreign direct investment in 55 countries, including all OECD and G20 countries, and covers 22 sectors.

Although Mongolia opened up its market to foreign residents and business entities since 1990 and the Parliament passed a number of laws and regulations on tax rate, custom threshold, trade restriction and FDI, the Mongolian regulatory environment is still not soft for foreign investment. Again, investors' disappointment resulted from the SEFIL was one of main factor for the lowered ranking in 2012.

With collaboration of the United Nations Trade and Development Forum, the Ministry of Economic Development conducted a survey among foreign investors to evaluate economic competitiveness and foreign investment environment of Mongolia. According to the Global Competitiveness Index Report (2012), Mongolia ranked in 93 out of 144 countries.

The survey results show that government bureaucracy, poor education of employees, corruption and underdeveloped infrastructure are the main barriers for foreign investors (Figure 3-11).

Figure 3-11 Most problematic factors for doing business



Source: Global competitiveness report (2012)

Mongolian ranking as a frontier market with a high market risk and lower investment rating limits long term FDI into the economy. Overreliance on the mining sector increases the risk exposure to Dutch disease and resource curse. Thus, there is a need for economic diversification which can be promoted and realized through increased FDI flows. To do that, Mongolia should have a comprehensive policy framework with differing incentive systems depending on priority development sectors and local regions.

4. GOVERNMENT FINANCING IN MONGOLIA

Majority of big projects, in particular, in infrastructure, social development and sectors with special national interests raise their necessary LTF through government financing. Thus, this section focuses on government financing with the special attention given to the Development Bank of Mongolia, bond financing and government saving funds, and discusses the status quo of this financing.

4.1 DEVELOPMENT BANK

Although the bank loan is used as a key financing method for private companies, it is not able to satisfy financial needs of businesses to prosper, in particular for investment in large-scale projects with long-term maturity. Thus, one of key domestic institutions financing these projects is a development bank. Many countries have established and successfully utilized capacity of this institution in order to generate LTF to finance their development needs.

The Mongolian Parliament passed Law on Development Bank in February 2011 and the Development Bank of Mongolia (DBM) was established and started its operation in May 2011. The DBM aims finance large scale priority projects to accelerate economic growth. Thus, primary functions of the DBM are to cooperate with commercial banks in financing large industries, infrastructure projects through loan syndication, to assist in raising funds at international markets and to provide new financial services like guarantees to the private sector. Based on the parliamentary approval in February 2011, the DBM planned to invest the following projects between 2011 and 2016.

Table 4-1 Proposed project financing of DBM

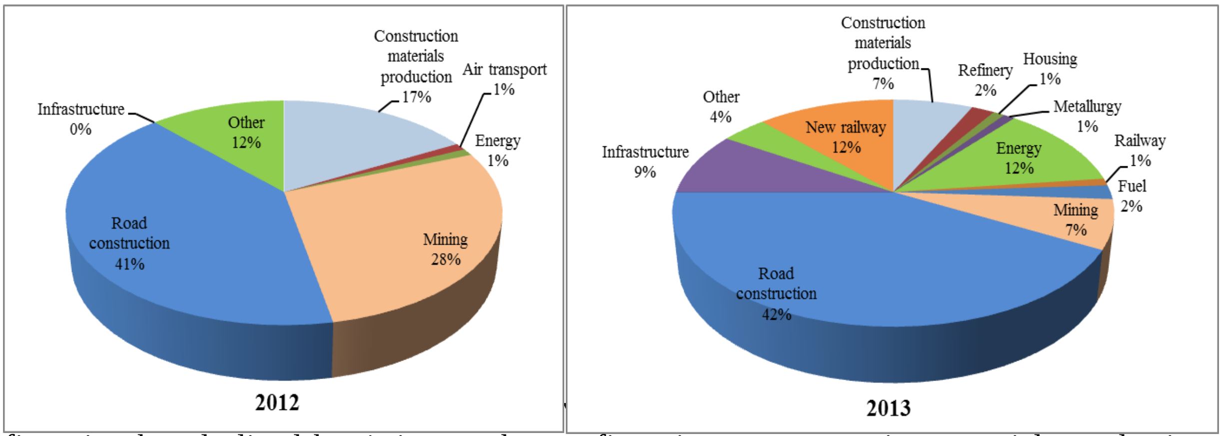
Projects	Budget /billion MNT/	Duration
1. “New building” medium term program		
- Housing building	147	2011-2016
- Road construction	5,077	
- Road drawing	14	
- Fresh water supply and sewage	265	
- Heating system	163	
- Energy power grids	482	
- Construction material production	287	
2. Government policy on railway	6,760	2011-2016

3. Sainshand industrial park		
- Infrastructure	51	2012-2015
Total amount /billion MNT/	**13,246**	

Source: DBM

In more detail, the DBM has planned to finance 236 projects amounted MNT 3.7 trillion and by May 2013 and it has provided MNT 882.1 billion. The comparison of project structures financed by DBM in last two years is shown in the following figure.

Figure 4-1 Composition of the DBM financing



financing has declined by 4 times, whereas financing to construction materials production reduced 2.4 times. Railway construction and new railway projects accounting for 13 percent of total financing which diversifies the DBM financed projects. Almost a half of total financing goes to the road construction (42 percent) which indicates that the infrastructure sector is the priority for the government.

The DBM is planning to fund 138 projects with amount of MNT 1.7 trillion by utilizing both its own sources and Chinggis Bond. The proposed financing from the DBM is as follows:

Table 4-2 Allocated and proposed financing from the DBM (by billion MNT)

No	Project name	Amount /billion MNT/	Allocated	Proposed financing in 2013		
				Financed amount	of which, proposed financing by DBM	by Chinggis Bond
	Projects with social benefits					
1	Road	1,737.8	222.3	966.7	115.7	850.9
2	Infrastructure	201.3	0.4	200.9	2.2	198.7
3	Mortgage loan	200.0	80.0	-	-	-

4	SME promotion fund	50.0	2.1	47.9	47.9	-
5	Sainshand industrial park	14.2	-	14.2	14.2	-
6	Power station	222.5	33.1	144.7	72.9	71.8
7	Railway	366.1	32.3	287.1	-	287.1
	Section sum	**2,793.7**	**370.3**	**1,661.6**	**253.0**	**1,408.5**
	Recoverable by project income					
8	Housing	141.2	-	-	-	-
9	Mining	18.4	16.4	-	-	-
10	Erdenes TT	430.7	287.1	-	-	-
12	Financing technology and equipment modernization	247.5	-	247.5	-	247.5
13	Air transport	164.3	120.4	-	-	-
14	Construction materials production	-	88.0	-	-	-
	Section sum	**1,002.1**	**511.9**	**247.5**	**-**	**247.5**
	Total amount	**3,795.8**	**882.1**	**1,909.1**	**253.0**	**1,656.0**

Source: DBM

Despite its increased roles, the DBM has not yet become a key player in providing LTF in Mongolia because of its relatively short history and high level of political influences. However, it has potentials to raise funds from international capital markets and provide guarantees and investment to large infrastructure projects and export-oriented industries given the expected high economic growth generated from mining development in next twenty years and allocation of a portion of mining revenues into government investment funds, namely the DBM and sovereign wealth fund[11].

4.2 BOND FINANCING

One of key government financing is bond financing. The government has issued bonds at both domestic and international financial markets. These bonds have had differing purposes and maturities.

[11] The Parliament is planning to establish sovereign wealth funds (SWFs) to effectively utilize mining generated excess revenue in economic diversification and saving for future. Currently, public consultation and proposals on potential types of SWFs are in progress.

4.2.1 Domestic government bonds

In terms of domestic bonds, the government started to utilize bond financing since 2010. In total, bonds with par value of MNT 1.33 trillion were issued in order to finance development programs and filling seasonal shortfalls of the budget.

Table 4-3 Government bond between 2010 and 2013

Purpose of issued bonds	Bond amount /bil. MNT/	%
Bank structural reform	33.0	2,50
Housing for Public Servants	73.99	5,58
Wool, Cashmere and SME	189.4	14,28
For filling seasonal shortfalls of the budget	1030.3	77,7

Source: Ministry of Finance

The table above illustrates that 78 percent of government bond is used for filling seasonal shortfalls of the state budget and sold through banks. After the Regulation on Issuing and Trading of Government Securities, government bonds for filling budgetary shortfall have been only sold to the Bank of Mongolia amounting MNT 445 billion (33.5 percent). The remained bonds are issued to finance the banking sector structural reform and government programs on housing for public servants and promoting wool/cashmere industry and SME development.

In detail, medium term bonds 1-3 years and 4-6 years valued MNT 100 billion with 10 percent interest rate and MNT 33 billion with 0.1 percent interest rate were issued to restructure Zoos bank and protect its customers' deposits. By the end of 2012, MNT 40 billion was paid. With the purpose to provide housing for public servants, bonds matured 1-7 years with par value of MNT 80 billion in 2010 and MNT 72 billion in 2011 were issued and allocated through the BoM, the General Office of Social Welfare Service and the Mongolian Stock Exchange. The raised fund from these bonds was used as mortgage loan sources for public servants' housing. Moreover, bonds valued MNT 300 billion (MNT 286.3 billion in 2011 and MNT 13.7 billion in 2012) with maturity of 1-5 years were also issued in order to promote wool, cashmere production sectors and SMEs. The biggest raised funding sources from domestic government bonds have been mostly used to finance seasonal shortfalls of the budget. However, there was no bond issued in 2010 and 2011 with that purpose. In 2012, the government issued bonds par valued at MNT 554.9 billion for filling seasonal shortfalls. MNT 194.1 billion of total issued bond payment was paid at the same year. In addition, MNT 313.1 billion was raised through the government bond to finance deficit of the Human Development Fund in 2012.

Key features of domestic government bonds are mostly with short term: bonds with special purpose to fill budgetary shortfall mature up to 52 week, whereas bonds financing government programs are with maturity up to 5 years. Bonds are mostly sold to the BoM and commercial banks. There is no secondary bond market yet which results in inactive bond market for most investors other than banks.

4.2.2 CHINGGIS BOND

On October 20, 2012, the Parliament approved the Government bond issuance at the international financial markets. According to this regulation, the Government raised USD 1.5 billion from the international financial markets by issuing Chinggis Bond. Two types of Chinggis Bond were successfully sold and raised USD 500 million through a 5-year bond at coupon rate of 4.125, and USD 1 billion through a 10-year bond at the rate of 5.125. Bond repayment will be finished by 2018 and 2023 respectively.

The issuance of Chinggis Bond at relatively low rates indicates that Mongolia is well-positioned in terms of foreign investment and has a growth prospective in near future with its vast mineral deposits and recently launched big mining operations of Oyu Tolgoi and Tavan Tolgoi. These medium- and long-term bonds with relatively competitive interest rates provided opportunities to attract LTF by the government itself. Thus, the raised USD 1.5 billion is planned to be used to finance key infrastructure projects and economic diversification-oriented projects.

Table 4-4 Proposed projects to be financed by Chinggis Bond

	Project name	Project details	Amount financed by Chinggis Bond (million USD)
1	Tavantolgoi power station project	Based on the Tavantolgoi coal deposit, a power station with capacity of 450 MB will be built	50
2	Street project	To rebuild 33 road sections of Ulaanbaatar city as intersections and build a highway along Tuul and Selbe rivers' dams	200
3	New railway project		200
4	Paved road projects to connect all aimag centers with Ulaanbaatar	To build 1400 km paved road	404.2
5	City infrastructure project		141.8
6	Project to modernize technology and equipment of cashmere production industry	To renew cashmere processing and production technology and equipment of the cashmere industry	68.8
7	Diary production	To establish 15 diary-farms, 4 factories (meeting international diary product standards and with	27.7

		capacity of 20 tonnes diary production), and 86 diary production manufactories near Ulaanbaatar	
8	Winter green-houses	Within the scope of this project, it is planned to build 32 hector winter green-houses, which is build as 20 hectares in Ulaanbaatar, 1.5 hectare in Darkhan city, 1 hectare in Erdenet city and 0.5 hectare each in aimag centers. As a result, 500 people will be employed, increase food supply to the cities, and thereby can limit import for vegetables.	17.4
9	Wool products		45
10	Clothing industry		13.5
	Total amount		**1168.4**

Source: Ministry of Finance

In near future, the Government has a plan to issue another up to USD 5 billion Chinggis Bonds. As the Government is entitled to repay principal and interest payments, the main concern of the government bond issuance is the effective management of bond money in promoting economic diversification to get higher returns and economic benefits rather than investing public social welfare projects.

4.3 GOVERNMENT SAVING FUNDS

4.3.1 FISCAL STABILIZATION FUND

The Fiscal Stability Law (FSL) was approved by Parliament in June 2010 and Fiscal Stability Fund (FSF) was formed at the same time. The FSF was designed to serve as a stabilization tool, with inflows to the fund occurring on a contingent basis when prices for major minerals exceed a structural benchmark. Inflows to the FSF began in 2011. No withdrawals have yet been made from the FSF.

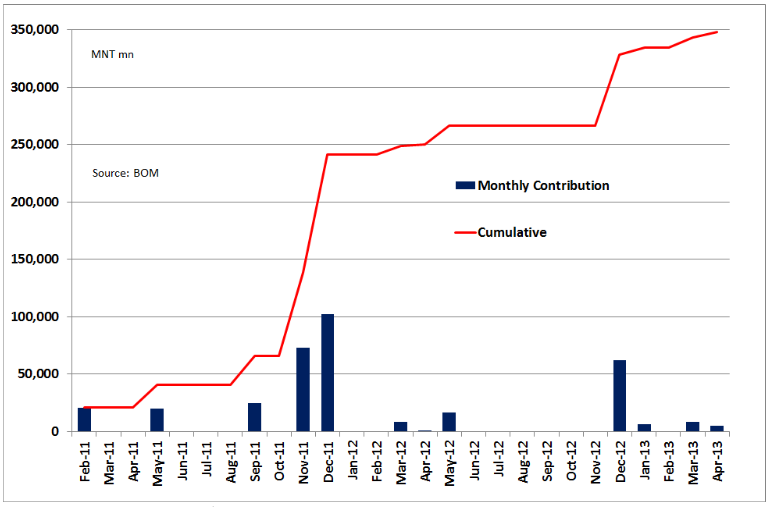
Three complementary fiscal rules in the FSL function together to ensure the disciplined implementation of fiscal policy:

- A ceiling on the ‘structural deficit’ of 2 percent of GDP, effective in 2013.
- A ceiling on expenditure growth constrained by the growth rate of non-mineral GDP, effective from 2013.

- A public debt ceiling of 40 percent of GDP, which is to become effective in 2014 with mitigated ceilings during a transition period.[12]

Contributions to the FSF have built up steadily over the last two years. The FSF balance stood at MNT 360 billion in mid-June 2013, which is a little over two percent of GDP (Figure 4-2). The FSF is deposited in the BoM, in accordance with the Law on Government Special Funds. No interest is paid on that account, which is outside the Treasury Single Account (TSA). The BoM is asked by the same Law to manage the FSF in order to ensure liquidity of the resources in the event of a withdrawal request, to mitigate risks and to invest the balances efficiently at the international financial market. The FSL (Article 17.1) stipulates that no active management of FSF balances should occur until the balance reaches 10 percent of GDP.

Figure 4-2 Accumulation of Assets in the FSF



Source: Ministry of Finance

4.3.2 HUMAN DEVELOPMENT FUND

The Human Development Fund (HDF) was established in November 2009 according to the law on HDF. The implementation of the activities on distribution from the HDF benefiting the Mongolian citizens started in 2010. The HDF's objective is to accumulate the permanent and steadily increasing sources from the mining revenues and to ensure the equal distribution among the citizens.

According to the law, the revenues from the following sources shall be channeled to the HDF:

- Dividends on the state shares from the strategic mines license holders and proceeds from the sales of the shares belonging to the state;

[12] Mitigated ceilings are 50 percent of GDP in 2011, 60 percent in 2012 and 50 percent in 2013. Public debt for these purposes is defined in NPV terms and includes guarantees.

- Part of the royalties going to the state budget;
- Net return on investment;
- The advance payment and the certain part of the loans related to the use of the strategic mines.

According to the law on HDF, the withdrawals from the HDF can be made for the following types of benefits for the citizens:

- Payment of the pension and health insurance fees;
- Payments for mortgages;
- Cash;
- Payments for the health and education services.

The HDF budget has been prepared to have the revenues of MNT 621.3 billion and expenses of MNT 284.2 bln, and the payment of paybales for MNT 95.3 billlion as well as the repayment of the Governemnt domestic loans of MNT 192.1 billion.

The distribution of cash and non-cash benefits from the HDF was made in accordance with the provision 1.4.3 of the Governemnt Action Plan for 2008-2012 on "creation of the legal environment and accumulation of the sources for and the distribution of MNT 1.5 million to every citizen".

Table 4-5 Number of people benefited from the HDF

Distributed benefits	Number of people covered, thousand			
	2010	2011	2012 Estimate	Total
2010 benefits				
MNT 70K, in cash	2,618.0	96.4	37.1	2,751.5
MNT 50K, in cash	2,435.8	113.6	24.7	2,574.2
2011 benefits				
MNT 252K, in cash	-	2,781.4	16.6	2,798.0
Health insurance fee	-	624.9	-	624.9
Herders	-	233.9	-	233.9
Students	-	139.4	-	139.4
Unemployed people	-	251.6	-	251.6
Tuition fees for the students –	-	133.6		133.6

MNT 500K				
Mortgage payment	-	-	-	-
2012 benefits				
MNT 128K, in cash	-	-	2,800.0	2,800.0
Elders and disabled people (MNT1.0 mln)	-	-	326.8	326.8
Tuition fees for the students (MNT500K)	-	-	140.6	140.6
Child money			894.1	894.1
According to the Health insurance law:				
Health insurance fee for the citizens payable by the State	1,356.5	1,356.5	1,505.0	-

Source: Social wealth department (old name)

The revenues of the HDF in 2010-2012 accounted for MNT 921.9 bln and distributed 1,968.7 bln in order to meet the objective of the Government Action Plan for 2008-2012 on distribution of MNT 1.5 mln to every citizen; this led to a Fund deficit of MNT 1,047 bln. The total spending in cash has accounted for 89.4% of the total Fund's expenses.

Table 4-6 2010-2012 HDF budget execution

	2010	2011	2012*	2010-2012	%
1. Total revenues	158.1	314.2	449.5	921.9	100.0%
Royalties	117.2	101.7	204.1	423.1	45.9%
Progressive royalties	-	166.8	166.8	302.2	32. 7%
Dividends	40.9	45.0	110.0	196.0	21.2%
Interest gain	-	0.6	0.16	0.6	0.1%
2. Total expenses	315.9	786.8	866.0	1 968.9	100.0%
Cash handouts	350.0	704.2	751.3	1 760.7	89.4%
Tuition fees for students	-	66.8	83.6	150.4	7.6%
Health insurance fees payable by the State	10.9	15.7	12.1	38.8	2.0%
Interest on loans	-	-	-	19.0	1.0%
3. Balance	-157.8	-472.6	-416.5	-1 047	
4. Sources of Financing	157.8	472.6	416.5	1 047	100.0%

Advance payment	212.5	461.5	80.0	754.0**	72.0%
Government Bonds	-	-	313.1	313.1	28.0%

*2012 amended budget

**The advance payment (currency conversion is based on the exchange rate of the day of booking in the budget)

The sources of the HDF revenues are specified in the article 3 of the law on the HDF, therefore, the HDF would have the following revenues in 2013:

- Royalties – MNT 257.1 billion;
- Progressive Royalties –MNT 294,2 billion;
- Dividends –MNT 70.0 billion;

A section 17.2, Article 17 of the Law on the HDF specifies that the Mongolian citizen can benefit from the Fund in cash or using it for the payment of the pension and health insurance fees, mortgage payment, and payment for the health and education services. Therefore, the following payments will be made from the HDF in 2013:

- Payment fo the health insurance fees payable by the State – MNT 12.2 billion,
- Payment of the outstanding balance of the cash handouts of 2010-2012 to those citizens who has not received them –MNT 32.0 billion;
- Child money –240.0 billion.

The HDF is targeted to provide social benefits to the citizens by utilizing mining generated revenues. The fund money is often highly politicized and spent to keep political promises of political parties after elections. Therefore, it has no direct contribution to businesses and providing LTF into the economy.

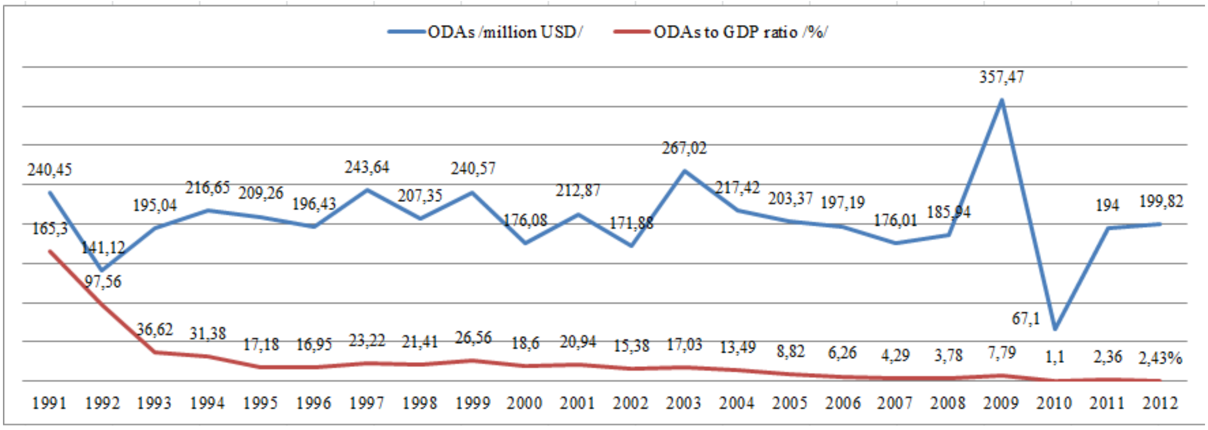
4.3.3 SOVEREIGN WEALTH FUND

The government has been actively considering forming a sovereign wealth fund and is drafting a law to create a sovereign wealth fund. Two task groups were formed after the March 2013 conference to draft a law, one in the Office of the President and another in the Ministry of Finance. The draft law, representing the work of both task groups, has been prepared and presented at the Citizens Hall of the Government Palace. The task groups are working to get other researchers' and economists' opinions on the draft and researching on the investment corporation who will manage the asset allocation. It will be subject to further revision until approved by the Cabinet.

4.4 OFFICIAL DEVELOPMENT ASSISTANCES

Official development assistances (ODA) and low-interest rate loans from donor countries and international organizations constitute another key source of LTF for the government. As ODAs are directly pooled and allocated through the general budget, ODAs can be considered as a financial instrument of the government used to invest priority public projects. Between 1991 and 2012, the Government of Mongolia received and spent foreign aids and ODAs equalled to USD 4.5 billion (Figure 4-3).

Figure 4-3 Total amount of ODAs (in million USD)

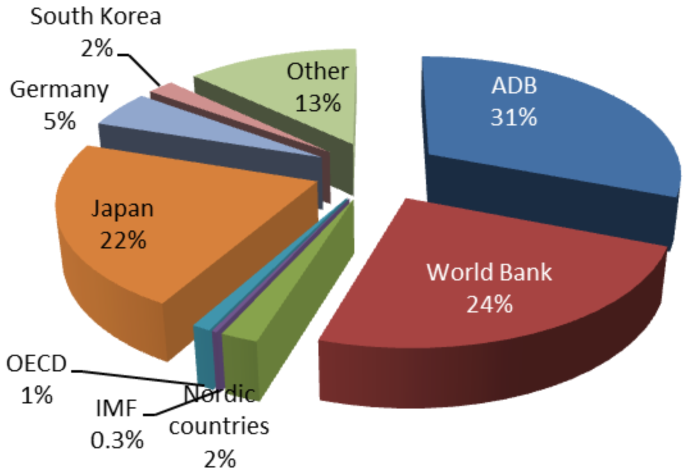


Source: Ministry of Finance

After the democratic revolution, ODAs accounted for 165% of GDP, largely contributed to economic and social structural changes, institutional capacity building and monetary and budgetary stabilities in 1990s. Although the size of ODAs remained similar to 1990s, their portion to GDP decreased to 2.3% because of the dramatic increase in GDP (USD 8.2 billion in 2011 compared to USD 2 billion). By the end of 2012, a remainder of the ODA debt was USD 2.1 billion.

Most ODAs are provided through multilateral donor organizations and directed to accelerate structural reforms, improve capacity building and to develop infrastructure and financial systems. The following figure illustrates the composition of donor organizations and countries.

Figure 4-4 Structure of ODAs, by donor organizations and countries

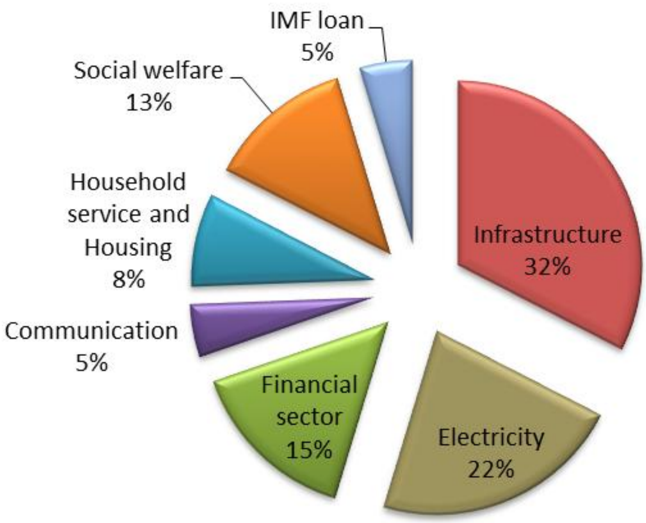


Source: Ministry of Finance

Biggest donors of the Mongolian Government are the Asian Development Bank (ADB), the World Bank and Japan together accounting for 77 percent of total ODAs among 23 countries and international organizations. By 2012, ODAs from multilateral donor organizations and international financial institutions accounted for 55 percent and loans from bilateral donors comprised 45 percent of total ODAs.

Allocated through the general budget, ODAs are used as LTF for various sectors and projects. From 1990 to 2012, about 44 percent of ODAs was disbursed to domestic companies and contractors.

Figure 4-5 Utilization of ODAs, by sectors



Source: Ministry of Finance

Figure 4-5 shows that three quarters of projects (75 percent) financed by ODAs are disbursed to infrastructure, energy, housing and social welfare to provide the foundation to economic growth and social development. By the end of 2012, ODA allocation was as followed: MNT

432.2 billion or 32.9 percent to energy sector; MNT 212.8 billion or 16.2 percent to road and transportation; MNT 162.6 billion or 12.4 percent to household service; MNT 86.6 billion or 6.6 percent to communication; MNT 97.7 billion or 7.4 percent to SMEs; and MNT 105.4 billion or 8 percent to other sectors. The loan amount distributed with collaboration of NGOs accounted for MNT 217.1 billion or 16.5 percent.

Almost 45 percent of ODAs had 40-50 years of maturity with 0.5-1.5 percent of interest rates and first 10-years remission of principal payments. In recent years, loan conditions have been tightened because of the improved credit rating and GDP per capita of Mongolia. For instance, the ADB loan maturity averages 25 years with 2 percent interest rate and first 5-year remission of principal payments.

Mongolia needs to have a new approach as ODAs are expected to reduce with improved country ranking from a low income to a medium income country in 2012. Thus, the role and size of ODAs will be diminished and it cannot be the main source of LTF in near future.

In sum, the Mongolian government has used ODAs, bond financing and other financial mechanisms, such as stabilization fund, HDF and development bank in financing LTF. However, effectiveness of fund usage and promotion of LTF through these facilities are questionable, which in turn leaves an arena for further improvements.

5. SME DEVELOPMENT

Comprising more than 95 percent of total registered business entities, SMEs are the crucial part of the economy and LTF related issues. Thus, this part discusses the Mongolian SME development and their financing needs. Firstly, the SME definition is provided with in depth examination of legal environment, government policies and strategies focused on SMEs and SME related government institutional structure. Then, it examines SME development by discussing their contribution to employment, GDP and export, and sectors that SMEs operate and barriers limiting their development. Lastly, SME financing are analysed through key providers, international projects and demand side issues.

5.1 CURRENT DEVELOPMENT OF SMES

5.1.1 NUMBER OF SME'S

As of 2011, 67.4 thousand business units are registered, of which 48 thousand business units are active which constitute 71.3 percent of total entities. Among them 96.5 percent are entities with up to fifty employees. In 2011, there was an increase of 11.6 thousand business entities or 31.7 percent compared to 2008.

TABLE 5-1 **NUMBER OF ENTITIES**

	2008		2009		2010		2011	
	Total number	Share	Total number	Share	Total number	Share	Total number	Share
Number of registered establishments	60,535		64,574		73,822		67,409	
Number of active entities	36,498	100%	36,877	100%	40,921	100%	48,086	100%
1-9	29,879	81,9%	30,272	82,1%	34,827	85,1%	38,797	80,7%
10-19	3,123	8,6%	3,156	8,6%	2,738	6,7%	4,363	9,1%
20-49	2,286	6,3%	2,253	6,1%	2,180	5,3%	3,256	6,8%
Sub-total (below 50)	35,288	96,7%	35,681	96,8%	39,745	97,1%	46,416	96,5%
50+	1,210	3,3%	1,196	3,2%	1,176	2,9%	1,670	3,5%

Source: National Statistics Office (2011)

There are 15.8 (39.8 percent) thousand business units in wholesale and retail sector. In 2011, the number of entities in manufacturing sector has increased by 60 percent compared to the previous year. This increase is attributed to the government's efforts to support the SMEs.

Business units in retail and trade sector reduced from 41.2 percent to 33.1 percent compared 2008 to 2011. But business units in processing sector increased from 6.1 percent to 8.6 percent. Business units in agriculture were 1584 which is 4.3 percent in 2008 increased to 2507 which increased by 58 percent in 2011.

Table 5-2 Number of active establishments by divisions of economic activity

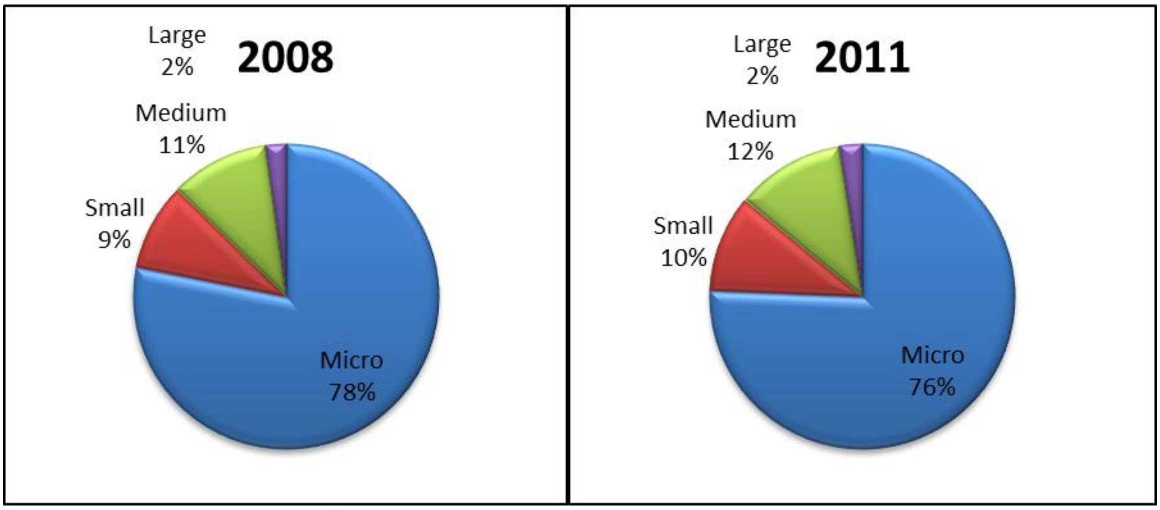
	2008		2009		2010		2011		
	Total	**Share**	**Total**	**Share**	**Total**	**Share**	**Total**	**Share**	**Below 50**
Total	**36,498**	**100%**	**36,877**	**100%**	**40,921**	**100%**	**48,086**	**100%**	**46,419**
Agriculture, forestry and fishery	1,584	4.3%	1,762	4.8%	1,804	4.4%	2,507	5.2%	2,491
Mining and quarrying	347	1.0%	323	0.9%	367	0.9%	383	0.8%	330
Manufacturing	2,243	6.1%	2,364	6.4%	2,574	6.3%	4,143	8.6%	3,987
Electricity, gas and water supply	214	0.6%	209	0.6%	197	0.5%	219	0.5%	164
Construction	1,313	3.6%	1,064	2.9%	1,452	3.5%	2,831	5.9%	2,675
Wholesale and retail trade, repair	15,031	41.2%	14,691	39.8%	19,749	48.3%	15,897	33.1%	15,770
Hotels and restaurants	1,376	3.8%	1,371	3.7%	1,320	3.2%	1,899	3.9%	1,863
Transport, storage and communications	1,025	2.8%	1,045	2.8%	1,056	2.6%	1,895	3.9%	1,823
Financial service	774	2.1%	1,069	2.9%	834	2.0%	1,564	3.3%	1,544
Real estate, renting and other business activities	2,728	7.5%	2,895	7.9%	2,518	6.2%	5,092	10.6%	4,949
Public administration and defence, social security	1,514	4.1%	1,536	4.2%	1,586	3.9%	1,407	2.9%	1,179
Education	2,005	5.5%	2,047	5.6%	2,141	5.2%	2,790	5.8%	2,322
Health and social work	2,216	6.1%	2,275	6.2%	2,283	5.6%	2,569	5.3%	2,492
Other community, social and personal services	4,126	11.3%	4,224	11.5%	3,036	7.4%	4,873	10.1%	4,813

Other	2	0.0%	2	0.0%	4	0.0%	17	0.0%	17

Source: National Statistics Office (2011)

There are 76 percent of micro business units, 10 percent small business units, 12 percent medium business units, and 2 percent large business units. These figures have not changed significantly over the last few years.

FIGURE 5-1 **NUMBER OF ESTABLISHMENTS BY SIZE**



Source: National Statistics Office (2011)

In terms of geographical distribution, 70 percent or 35.8 thousand business units are located in Ulaanbaatar, and 30 percent are located in rural areas. The majority of large entities are concentrated in urban area, such as Ulaanbaatar, Darkhan, and Erdenet, while the smaller businesses are spread nationwide (Ganbold, 2008).

Table 5-3 Number of establishments by region

	2008					2011				
	Micro	Small	Medium	Large	Total	Micro	Small	Medium	Large	Total
Western	4.7%	10.2%	12.1%	8.7%	6.0%	5.5%	9.7%	11.8%	9.8%	6.8%
Khangai	7.2%	12.9%	14.5%	11.7%	8.6%	7.8%	12.4%	14.2%	11.7%	9.1%
Eastern	9.8%	15.2%	17.1%	12.6%	11.1%	9.7%	12.7%	15.5%	12.2%	10.7%
Central	2.6%	5.1%	5.9%	5.2%	3.2%	3.0%	3.8%	5.4%	4.6%	3.4%
Ulaanbaatar	75.7%	56.6%	50.4%	61.9%	71.0%	74.0%	61.4%	53.1%	61.8%	70.0%
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Statistics Office (2011)

In local areas agriculture/animal husbandry, wholesale and retail are dominating sectors. There are 200.0 thousand members in 2446 cooperatives in 21 aimags.

5.1.2 EMPLOYMENT OF SMES

As of 2011, in Mongolia there are 1,124.0 thousand people are eligible for the employment, and of whom 92.2 percent or 1,037.0 thousand people are actually employed. Of these employed 342 thousand or 33 percent work in agricultural sector, and 152.5 thousand people or 17.7 percent are engaged in trading activities. Another 65.8 thousand people or 6.3 percent work in manufacturing sector. There was decrease of 17.2 thousand people in trade sector and increase of 18.3 thousand people in manufacturing sector over the last 4years.

Table 5-4 Employees, by divisions, at the end of the year (by thousand persons)

Divisions	2008	2009	2010	2011	share
Economically active population	**1 071.5**	**1 137.9**	**1 147.1**	**1 124.7**	
Employees, by divisions	**1,041.7**	**1,006.3**	**1,033.7**	**1,037.7**	**100%**
of which:					
Agriculture, forestry, fishing and hunting	377.6	348.8	346.6	342.8	33.0%
Mining and quarrying	46.5	34.8	34.1	45.1	4.3%
Manufacturing	47.5	62.7	64.8	65.8	6.3%
Electricity, gas, steam and air conditioning supply	30.1	9.5	12.4	11.9	1.1%
Water supply, sewerage, waste management and remediation activities	-	6.1	7.8	5.1	0.5%
Construction	66.8	49.6	48.8	52.0	5.0%
Wholesale and retail trade, repair of motor vehicles and motorcycles	169.7	160.3	146.2	152.5	14.7%
Transportation and storage	35.8	68.7	76.5	75.8	7.3%
Accommodation and food service activities	34.5	23.3	27.7	26.4	2.5%
Information, communication	10.5	10.2	14.5	11.5	1.1%
Financial and insurance	19.8	12.3	15.2	16.6	1.6%
Real estate activities	12.0	0.2	0.5	0.3	0.0%
Other service activities	190.9	219.8	238.6	231.9	22%

Source: National Statistics Office (2011)

5.1.3 CONTRIBUTION OF SMES TO ECONOMIC DEVELOPMENT

SMEs together with micro enterprises constitute 98.1 percent of total business entities, and they generate 36.3 percent of sales revenue, and 22.2 percent of export with over 50 percent of total employment.

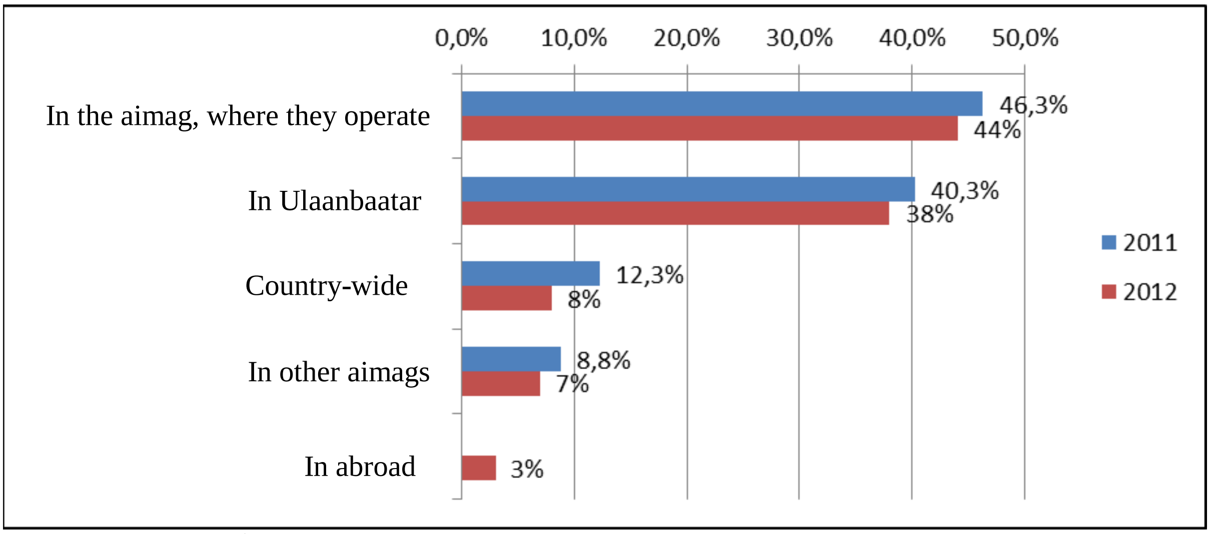
Table 5-5 Sales, export by 2010

Firms	Companies		Sales		Export		Employment	
	Number	**%**	**Amount in Mln.MNT**	**%**	**Amount in Mln.$**	**%**	**000's people**	**%**
Micro	60 317	81.7	2,226,399.6	11.5	370.0	13.5	87.9	18.2
Small	5 772	7.8	876,371.5	4.5	22.2	0.8	36.9	7.6
Medium	6 384	8.6	3,908,847.6	20.3	218.4	7.9	126.1	26.1
Large	1 349	1.8	12,277,562.2	63.6	2137.4	77.8	231.5	48.0
Total	**73 822**	**100.0**	**19,289,181.0**	**100.0**	**2748.0**	**100.0**	**482.3**	**100.0**

Source: National Statistics Office

SME activities are mainly focused on the domestic market demand. The wool, cashmere factories export final products whereas others export skin, hides, raw wool, cashmere and other raw materials of animal husbandry. According to the BoM survey, over 80 percent of SMEs sold their products in Ulaanbaatar and local areas. Only 3 percent of SMEs exported their products to foreign countries in 2012.

Figure 5-2 Sale location of commodity and service



Source: (Bank of Mongolia, 2012a)

SMEs contribute 25 percent of GDP and employ half of the workforce in Mongolia. However, they are in shortage of favorable financing conditions that would enable them to expand their operations and contribute to the further growth. Although banks provide loans to SMEs, these loans have relatively high interest rates, short-term maturities and small sizes with predominantly immoveable collateral-based lending requirements. This is related to the supply side as banks are constrained with the short-matured deposits and limitation of other funding sources with longer maturities.

Table 5-6 Contributions of business entities to GDP

Types of entities	2008	(%)	2009	(%)	2010	(%)
Micro	308,376.8	4.7%	349,670.9	5.3%	583,143.3	6.9%
Small & Medium	1,054,364.0	16.1%	1,063,159.8	16.1%	1,267,260.6	15.1%
Large	2,269,071.2	34.6%	2,265,444.7	34.4%	3,046,578.8	36.2%
GDP at market prices	**6,555,569.4**		**6,590,637.1**		**8,414,504.6**	

Source: National Statistics Office (2011)

With the booming mining sector and stable world commodity price, the foreign trade and budget deficit has been declined steadily. The GDP grew by 17.5 percent in 2011 and 12.3 percent in 2012. In 2012, the value added products of agriculture in comparative price increased by 21.3 percent, while manufacture and construction grew by 9.7 percent and 25.6 percent respectively. However, over 90 percent of export is generated by the mining sector, which makes Mongolia vulnerable to the commodity price fluctuations. Therefore, the economy needs to be diversified and the private sectors shall be developed, especially the SME sector which accounts the majority of total registered entities and employs over 50 percent of total workforce. One of effective support mechanisms is to improve an access to financing.

5.2 GOVERNMENT POLICY AND LEGAL FRAMEWORK FOR SME DEVELOPMENT

To avoid the overdependence on the booming mining sector, the government has aimed to diversify the economy and taken some initiatives to support the domestic private sector businesses, in particular SMEs. In 2008, the Parliament identified the long-term development priorities which were summarized and endorsed in the policy document named "The Millennium Development Goals-based Comprehensive National Development Strategy". The Law on Small and Medium Size Enterprises was adopted by the Parliament in 2007 and the Law on Credit Guarantee Fund was adopted in 2012. The following section introduces some key policy documents and laws related to SME development.

1) *Policy documents*

The Millennium Development Goals-based Comprehensive National Development Strategy (NDS) was adopted on the 31st January, 2008 by the Parliament Resolution No. 112.

The policy document identifies the country's long term development policy and priorities, and their implementation strategy which were aligned with the specific targets to achieve The Millennium Development Goals in 2007-2015 with a focus on acceleration of economic growth. The second, which covers in the period of 2016-2021, is aimed at implementing the policies to create the knowledge based economy.

The NDS refers specifically to the priority number two (item 5.2.1) which focuses on industrial sector policy, including heavy industry, manufacturing and SME support.

TABLE 5-7 **SME DEVELOPMENT POLICY**

Directions	Implementation strategy
Favourable conditions shall be created for developing vigorously small and medium-size enterprises and services, for substantially reducing unemployment and poverty	**The first phase (2007-2015)**
Strategic goal 1. Favourable legal environment shall be created to support the development of small and medium size enterprises	Adopt and implement respective legislation, including laws on provision of financial aid to small and medium-size enterprises, on credit collateral fund.
	Support export-oriented small and medium-size enterprises through customs duties and VAT policies
	Enrol small and medium-size entrepreneurs in credit insurance services
	Create legal environment to protect rights of small stakeholders.
	Expand the provision of small-size equipment leasing services to support small and medium-size entrepreneurs
Strategic goal 2. Make services provided by the State for small and medium-size entrepreneurs more efficient and prompt	In aimags, cities, soums and districts establish centers to provide citizens wishing to run small and medium-size enterprises with necessary data and information, assistance in choosing appropriate equipment and machinery, consultancy and services in preparing projects and their selection.
	Provide support to small and medium-size enterprises in accordance with the concept of regional development, create and operate the business incubators.
	Transfer fully into online modality the services of issuing special permits that are provided in conformity with the law on special permits for economic activities.

Second phase /2016-2021/:

Strategic goal 1. Development of some service sectors shall be accelerated to a greater extent and their share in the economy shall be increased	Increase production of information and communication technologies including software applications.
	Specialize in manufacturing some products of world known large producers
	Develop inter-sectoral services such as transit transportation and financial intermediations

The Government Action Program for 2008-2012 envisages several key objectives for creating a favourable business environment for development of the private sector and SMEs.

- Introduce a loan guarantee, loan insurance and collateral provision mechanisms to support SMEs access to financing;
- Set up SME advisory service centers, incubators and eliminate government bureaucracy;
- Formulate a government policy on industrialization;
- Promote processing industries, in particular a production of final cashmere, wool and leather products capable to compete in international markets;
- Allocate at least MNT 150 billion from the state budget, the Development Fund, donor funding for supporting SME operations and employment generation.

Under these objectives, the Credit Guarantee Fund Law has been successfully passed by Parliament in 2012. Moreover, 32 centers providing advisory services to SMEs have been established during 2009-2011. To streamline provision of public services, the government has established "one stop service" points at every aimag and district of Ulaanbaatar.

In 2009, Parliament adopted a Law on providing customs duty and VAT exemption on SME imported equipment, subsequently a detailed list of such equipment and spare parts were approved by the government (Cabinet Resolutions No. 316 of 2009 and No. 100 of 2011). Under this initiative, the government has provided MNT 16.2 billion tax exemptions to SMEs during 2009-2011.

Key policy documents formulated by the government to support SME development are:

- Industrialization program for 2009-2016 was formulated to develop industry which is based on domestic resources, able to compete at in world market, and apply the advances of the technological innovations (by the resolution no. 178 on 10 June, 2009. This program includes the goals. Moreover, the program focuses on economic diversification and upgrading the country's competiveness

- "Measures to support national industry" were enacted by the resolution no. 104 on 6 April, 2011. These measures aimed at intensifying implementation of industrial policy, increase competitiveness of processing industry, support production and expand employment. It includes also List of priority products and services to be procured domestically.

- "Ratification of template of contract for soum development fund accumulation, its spending, and monitoring procedure" which was enacted by the Resolution no. 134 on 17 April, 2011. 'Soum development fund regulates relations to support SME in soums, expand job opportunities and fund management, selection of proposals for funding and disbursement of loan from fund and its repayment.

- Social program on Cooperative Development was enacted by the Resolution no. 173 on 10 June, 2009. This program is being implemented in 2009-2017, and the main objectives are to improve cooperation of government, cooperative, cooperative mentoring organizations, increase role of cooperative in a society by creating favourable environment in legal and economic framework. Also it aims to increase competitiveness, intensify development of SME and create new jobs.

The Action plan of GOM in 2012-2016 was approved by the parliament resolution no.37 on September 18 of 2012. The Action Plan included specific measures to support industrialization, processing the agricultural raw materials, and assisting the SME development, namely:

- Support SMEs through the loan guarantee fund;

- Develop the national program to support export of non-mining industry with participation and leadership of the private sector. Certain revenue from the mining export should be directed to establishment of non-mining export fund;

- Support domestic construction material production, and implement policies to supply demand of cement, steel, glass, insulation material by domestic production

- To establish soum development fund with initial capital of least MNT 150 million, and SME fund of aimag, district - at least MNT 3 billion The SME production support fund should be established with at least MNT 500 billion.

2) *SME law*

Based on the above SME related policy documents the Parliament approved the Law on Small and Medium Size Enterprises Development in 2007. This law defines the scope of SMEs and provides policies, guidelines and activities to support them.

Table 5-8 SME category

Category	Sector	Number of employees	Sales revenue / billion MNT/
Medium	Production	≤ 199	< 1.5
	Wholesale	≤ 149	< 1.5
	Retail	≤ 199	< 1.5

	Services	≤	49	< 1.0
Small	Production	≤	19	< 0.250
	Trade	≤	9	< 0.250
	Services	≤	9	< 0.250

Source: SME law (2007)

With high economic growth and inflation rate was 10-14 percent since 2008, the maximum level of sales revenue specified in the Law does not capture the current circumstances of SMEs. Thus, the amendments to this law are submitted to the Parliament.

Despite the legal definition of SMEs, banks use their own definitions in providing SME loans. For example, XAC bank defines small businesses as entities with annual sales of MNT 60-500 million, whereas medium sized businesses - with annual sales ranging between MNT 501-1500 million. Golomt bank identifies businesses with assets worth of MNT 150.0 million – 3.0 billon, sales of MNT 300.0 million – 5.0 billion and employees number ranging 10-150 as SMEs.

3) *Other related laws*

The special fund law of government was adopted in 2006. It determines types of special fund and regulates establishment, spending, reporting, monitoring.

This law regulates SME development fund, livestock protection fund, crop production support fund which moderates generation of capital, spending, monitoring.

Company law, partnership law, cooperative laws determine ownership types and scope of activities.

Partnership is first defined in 11 may, 1995 partnership law. It is vaguely defined meaning:

Some people can join capital to make profit and be established in one of two forms which is legal subject running activities of production, service.

Forms: all members are fully responsible or some members are fully responsible

Company is amended in company law on 6 oct, 2011. It is defined in paragraph 3.1 of article 2:

Invested capital is from shareholders and legal subject whose purpose is profit making

Cooperative is defined in cooperative law on paragraph 3.1, article 1 which was amended on 4 July, 2002

Some people who joined voluntarily to meet their economic, social, cultural needs. It has democratic management, control and capital is common. That kind of legal subject is cooperative.

Saving and credit cooperative is defined in paragraph 3.1.1 of article 1. It is legal subject whose members joined to meet their economic, social, cultural needs. It can provide service of saving, credit to their members based on special license. It has democratic management, common monitoring and activity is not for profit

5.3 PUBLIC INSTITUTIONS TO SUPPORT SME DEVELOPMENT

In 2012, the New Government for Changes was established introducing structural changes. Currently there are 16 ministries. The related ministries and government initiatives are as follows:

1/ Ministry of Labor

The Government transferred the functions of the SME development, SME agency and SME fund under the Ministry of Food, Agriculture and Light industry (MOFALI) to the Ministry of Labor. The SME promotion division is established under the SME support department of the Ministry of Labor. The department's strategic goals are to facilitate implementation of SME policy, formulate policy, program, and project which enhance development of SME. Also develop SME, cooperative, utilities, household production, micro business, increase jobs, formulate loan, financial assistance policy and facilitate implementation. It provides support to SME and Business incubator system, conduct research on SMEs, facilitate database and provide information.

2/ SME fund

The government set up a SME fund in 2009 and now it operates under the Ministry of Labor. It is responsible for provision of financial sources for the SMEs to increase the role of SMEs in the economy and create more jobs. Objectives are as follows:

- Provide long-term concessional loans to SMEs;
- Provide financial support to the employers who create new jobs;
- Support leasing of equipment for SMEs;
- Monitor project implementation;
- Formulate policy, facilitate financing and cooperation with domestic and international counterparts;
- Provide advisory services to SMEs;
- Provide Loan guarantee services.

3/ Ministry of Industry and Agriculture

The Ministry of Industry and Agriculture is in charge of heavy industry, light industry, food industry and animal crop production. It formulates policy and ensures its implementation which results in acceleration of economic growth, industrial development and supply safe food to the population.

4/ SME incubator centers

SME incubator centers have been established in 4 districts (Songino-Khairkhan, Bayanzurkh, Chingeltei, Sukhbaatar) of Ulaanbaatar city and 3 aimags (Gobi-Altai, Darkhan-Uul and Zavkhan). As of today, the number of incubator centers has reached to twelve centers. These centers provide consulting services and training to SMEs, and incubate them to grow and expand.

5/ Soum development fund (SDF)

The SME agency under the Labour Ministry provides soum governors with coordination and guideline for selecting SME projects for financing. SDF procedures have been approved by Cabinet Resolution No. 134 of 2011. The SDF aims to provide financing to newly established SMEs or existing SMEs for expanding their businesses. A task force led by the aimag governor manages the SDF, monitors the fund disbursement and loan repayment and has a responsibility to select projects to be funded by the SDF.

6/ Credit Guarantee Fund (CGF)

Currently, there are two loan guarantee funds: one was already established by the Government, whereas another private fund is under the progress. The Mongolian Loan Guarantee Fund (LGF) is a public non-profit financial institution established in November 2012 under the provisions of the Law of Credit Guarantee Fund. The co-founders of the LGF are the Government of Mongolia, the Mongolian Employer's Federation and the Mongolian National Chamber of Commerce and Industry.

The LGF aims to support the balanced development of the national economy by extending credit guarantees for the liabilities of promising SMEs which lack tangible collateral to secure their financing. As the fund is the government initiated, its main funding source comes from the central budget and necessary fund injection will be provided from the budget every year based on the Law of Credit Guarantee Fund.

The credit guarantee scheme involves three parties: a loan applicant (SME), bank and the LGF. Based on the bank's credit analysis of a loan application, the SME can apply for the loan guarantee up to MNT 250 million (or no more than 60 percent of applied loan amount) to the LGF. The credit guarantee department analyzes the application and sends the application to the Credit Guarantee Committee if it sees the project as feasible. The Committee makes the final decision and a tripartite agreement is signed once approved. The bank provides the loan to the SME if it agrees to pay the LGF commission for the credit guarantee. Then the bank subtracts the commission amount from the loan and transfers to the LGF account.

Currently, the LGF has made cooperation agreements with 6 commercial banks (Golomt Bank, Khan Bank, State Bank, Capital Bank, Xac Bank and Chinggis Khaan Bank) and the Government SME Fund. According to the law, the SME Fund shall re-guarantee up to 60 percent of total planned guarantee amount of the LGF. Therefore, every year the SME Fund, which is financed by the central budget, should hold cash equals to 10 percent of the LGF guaranteed amount in its current account as re-guarantee fund.

Since its establishment, the LGF has provided 14 loan guarantees amounting MNT 1 billion (equals to 20 percent of its current fund). Besides its enthusiastic start-up, there are some issues, such as a lack of human capacity, credibility of the LGF and dependence on the central budget as the key funding source that might limit the LGF to become fully operational in near future.

Besides the LGF, there is an initiative of a Credit Guarantee Fund (CGF) funded by the Mongolian Banks' Association. Establishment of this private CGF is still under the progress as founders are searching for the most appropriate scheme for the CGF in order to become operationally and managerially effective enough to self-sustain in the long-run. Additionally, the current law on guarantee fund leaves a little room for private funds to operate in this guarantee space and therefore the CGF has some challenges to handle. Once it starts the member banks can make monetary contribution and appoint the management team to operate.

5.4 FINANCING FOR SMES

SMEs need financing at every stage of their development—from start-up to developing stages, and ultimately, when they go public. By recognizing the role of SMEs in the economy, governments in both developed and developing nations have established and facilitated various funding schemes and institutions to enable SMEs to easily access to financing at each stage of their development. In Mongolia, SME financing is mainly characterized by bank lending with addition of government funding and international organizations-initiated financing programs.

5.4.1 BANK LENDING

According to the BoM survey on SME development and finance (hereafter, the SME study) which was conducted among 2285 business entities, 32 percent of respondents replied that banks are very supportive for SMEs. Only 10 percent of respondents cited that the government is very supportive for SMEs. Another 10 percent of respondents favoured the local administration as one of supporters for SMEs (Bank of Mongolia, 2012a). In 2012, 17.4 percent of total loan outstanding was allocated to SMEs.

Among 13 commercial banks, Khan and XAC banks are the key providers of SME loan as 46 percent of the loan portfolio is allocated to the SMEs. Golomt and Capital banks have recently opened their rural branches targeting the SME market.

Out of total lending, 55 percent is allocated for the private sector, of which 13.9 percent are with under one-year maturity up to one year, 32.6 percent with 1-5 years and 3.9 percent have more than 5-years maturity. Due to short matured deposits and a lack of seed fund, the banks are incapable to provide long-term loans. Despite the relatively big share of lending with 1-5 years maturity, most banks disburse loans with up to 2-years maturity designed for working capital financing only. Depending on banks 30-40 percent of the loan outstanding matured less than one year and 30-50 percent of loan outstanding has 1-3 years maturity. However, this maturity period is insufficient to meet the SMEs requirements of capital investment.

Table 5-9 Loan outstanding

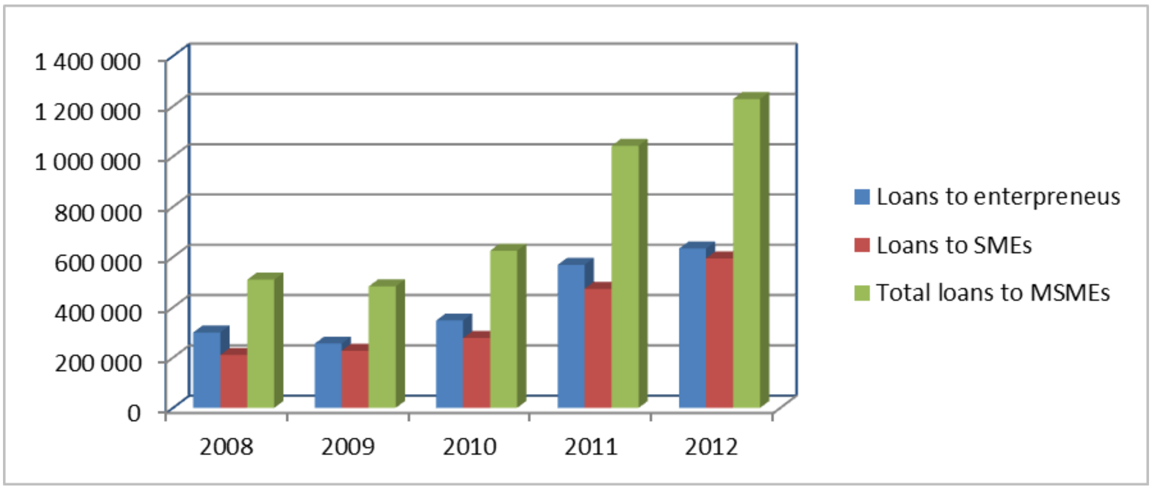
	2008		**2009**		**2010**		**2011**		**2012**	
	Amount in	**(%)**	**Amount in**	**(%)**	**Amount in**	**(%)**	**Amount in**	**(%)**	**Amount in**	**(%)**
Loan outstanding to private sector	1,555,982.5	*59.0%*	1,699,083.2	*64.0%*	1,854,627.9	*57.5%*	3,072,444.0	*54.9%*	3,819,211.7	*55.0%*
Normal		*50.7%*		*46.2%*		*45.6%*	2,752,844.3	*49.2%*	3,494,785.6	*50.3%*

	1,336,125.3		1,225,613.3		1,472,570.1					
up to 1 year	584,573.7	*22.2%*	439,816.8	*16.6%*	414,195.0	*12.8%*	604,490.6	*10.8%*	965,401.2	*13.9%*
1-5 years	703,650.8	*26.7%*	662,392.4	*24.9%*	975,254.6	*30.2%*	1,967,896.5	*35.2%*	2,259,874.0	*32.6%*
5 and more than	47,900.7	*1.8%*	123,404.1	*4.6%*	83,120.5	*2.6%*	180,457.3	*3.2%*	269,510.4	*3.9%*
Total loan outstanding	2,635,127.8	100%	2,655,000.3	100%	3,228,171.1	100%	5,597,743.6	100%	6,941,135.2	100%

Source: Bank of Mongolia (2012b)

Loan disbursement to SMEs reached 1.2 trillion in 2012, which is 2.4 times increase compared to 2008. This increase accounts for 17.4 percent of total loans. In 2008-2012 banks disbursed MNT 633.7 billion to 55,474 micro business units, MNT 594.0 billion to 3566 business units. The SME study shows that 70 percent of total SME borrowing generated from banks, 11 percent from concessional loan, 8 percent from friends, 4 percent from NBFI, 3 percent from suppliers. In terms of loan usage, 36 percent of loan was used for working capital, 19 percent for extending business, 17 percent were for equipment and 18 percent of loan was spent on building extension of premise or buying new building (Bank of Mongolia, 2012a).

Figure 5-3 Loans to SME (in million MNT)



Source: Bank of Mongolia, SME study (2012a)

The SME study respondents stated that high interest rate, short maturity, undervalued collateral are the major impediments to SME development. Concessional loans from the government and international institutions are limited and difficult to access (Bank of Mongolia, 2012a). On the one hand, banks cannot satisfy all capital needs of SMEs due to their limited amount of deposits and capital. On the other hand, SMEs are often not eligible to meet collateral requirements of banks, to prepare feasible business plans and to have good management and accounting practices to satisfy loan application requirements of banks.

5.4.2 GOVERNMENT SME FINANCING

The government has disbursed MNT 60.4 billion for SME development and industrialization, and generated MNT 27.4 billion from the loan revolving fund. In addition, the government disbursed MNT 276.5 billion to SMEs from government bond financing. The soum development fund issued loans worth MNT 24 billion. According to the Cooperation Agreement with banks, another 30 percent line of credit or MNT 12.2 billion were allocated as SME financing.

Table 5-10 Government financing for SMEs

Sources	2009	2010	2011	Total
Government budget	30,850.0	29,550.0	-	60,400.0
Repayment	1,000.0	2862.9	25,355.0	27,418.4
Bank participation	9,343.2	11,004.1	3,413.94	12,256.4
Local participation	896.0	-	-	896.0
Government bond	-	-	276,480	276,480.0
Total source	**42,089.2**	**43,417.0**	**305,248.94**	**390,755.1**

Source: MOFALI

The government generated MNT 276.5 billion from bond financing. From that MNT 150.0 billion was provided to support SMEs and MNT 126.5 billion to wool, cashmere sector. The annual interest rate of the loan was 7% with maturity up to 5 years and grace period of 1 year. The amount of loans varied according to the market size of aimags. In total, 329 soums depending on their population size have received SME support loans valued at MNT 50-265 million and totalling MNT 149.2 billion.

In 2012, the financial leasing cooperation procedure of SME fund was approved by A/184 resolution of the Minister of the MOFALI. According to the procedure, the SME fund disbursed MNT 2 billion for leasing purposes. Additional MNT 1.4 billion was contributed from various service providers and in total MNT 3.4 billion were disbursed on leasing. Condition of leasing was up to MNT 100 million with 3 years leasing period and annual interest rate of 10.8%. There were 113 SME leasing applications for MNT 5.2 billion and 60 applications for MNT 2.6 billion leasing equipment were approved.

The central and local governments have inititated a number of programs and schemes to support SMEs and industralization through their various organizations and facilities. However, the effectiveness and efficiency of these efforts are questionable as there is no clear evidence showing steady growth of SMEs. This urges effective and well-coordinated mechanisms of SME financing and less political intervention and bureaucracy from the government that leaving more rooms and favourable environments for financial institutions to engage in SME financing more in depth.

5.4.3 FINANCING BY INTERNATIONAL ORGANIZATIONS

There are some programs and projects initiated and funded by international donor organizations to support SME development and job creation. This section briefly introduces some of main projects.

1) *Promotion of SMEs and strengthening of financial sector*

The German Reconstruction Loan Bank signed a loan agreement on 'Promotion of SMEs and Strengthening of Financial sector' on 24 April, 2002. It had 3.6 million euro loan and 0.8 million euro grant package. The Parliament ratified the loan agreement on 21 June, 2002. The Ministry of Finance, representing Mongolia, and the German bank were signatories. The BOM was responsible for management of line of credit allocation for Trade Development Bank and Post Bank.

Out of USD 12 million, USD 10 million was disbursed to SMEs through the two step loan arrangements through the local banks. Additional USD 2 million was used for technical assistances, such as international and domestic training of staff of the project financing institutes, mentoring, equipment procurement and project management. Repayments of loan were allocated to the State Fund.

2) *Private sector Development Credit II (PSDC-II)*

'Private sector Development Credit II' of the World Bank was commenced in 2006 and completed on 30 August, 2011. The project cost was 6.9 million special loanable units which is equal to USD 10.3 million. Trade Development Bank disbursed to 20 sub-projects, State bank 7, Khan bank 6, Golomt bank 3 in total 36 sub-projects. USD 8.29 million was allocated by the World Bank and USD 2.83 million by the government. Details of credit requirements, participating financial institutions and project components are indicated below:

Project component 1	**Line of credit = sub-loan (USD 14.6 million)**
Eligibility of sub-borrower	No sector or market-limits except negative list, with the followings; i) Established and operating in Mongolia, ii) Privately owned, iii) Having a debt service coverage ratio of >1.3:1 throughout the life of the sub-loan; and, iv) No previous loan default
Eligibility of sub-project	i) Technical, commercial and financial viability with due regard to local laws and regulations, ii) A loan to project value ratio of<80 percent, and, iii) FIRR of >13%
Terms & conditions	*Sub-loan:* may finance the cost of equipment, civil works, services, leasing arrangements, and incremental permanent working capital, either in US$ or MNT. - Single borrower exposure : USD 600,000 - Maximum loan size : USD 600,000 - Final maturity: 2 to 7 years - Grace period for principal repayment: 1 year (2-3 years maturity) and 2 years (3-7 years maturity) - Interest payments: market-based *On-lending loan* - US$ lending: LIBOR for six-month US$ deposits + 1 percent - MNT lending: average rate for MNT demand deposits
PFIs	Trade and Development Bank, Zoos Bank (original); Khan Bank, Golomt Bank (added)
Project component 2	**TA Programs**
	To strengthen institutional capacity of PFIs and BOM, covering; *For PFIs* i) Credit analysis, risk assessment, loan monitoring and structuring, ii) Human resources management iii) Advanced cost accounting system iv) Procedures and technique for risk-based internal audits, and, v) System customization of treasury operations and internal audit *For BOM's Supervision Department* i) Financial and consolidated supervision, ii) Credit, market, operational and inherent risk assessment iii) Policy analysis, and, iv) Anti-Money Laundering activity
Project component 3	**Project Implementation Support**

Progress was deemed rather slow during the early stage. Therefore, two new banks were added as PFIs. However, relatively longer time required for loan processing and higher interest rate (compared to JICA-TSL), and the project specific issues continued to cause delays in project implementation despite of the addition of two new banks.

3) Agricultural and Rural Development Project (ARDP)

In August 2008, the ADB approved a new financial assistance project collaborating with commercial banks to support agribusiness enterprises. The project is to develop value chains to deliver uniquely valued products to niche markets through the components: i) value-chain development of major agribusiness sub-sectors under which the ADB establishes a deposit account to guarantee 50 percent of total amount of loans made by the commercial bank to investment plans of agribusiness enterprises, and ii) grant for infrastructure development to develop rural infrastructure and veterinary services.

The targeted agribusiness sub-sector includes wool/cashmere, leather, meat, dairy, and herbal and fruit/vegetable processing. During the preparation period of this project, the ADB screened almost 150 business plans of agribusiness enterprises (usually large companies according to the ADB definition) and endorsed 23 investment proposals as eligible to receive project funds. Project funds for each investment proposal are to be fully financed by the commercial banks (Khan Bank, as of now), but 50% of the loan amount guaranteed by the funds deposited by the ADB (with no deposit rate, which enabled commercial banks to utilize this funds to lower interest rates offered to the end-borrowers). Project, through directing long-term loans to large agribusiness enterprises, aims to develop or improve a delivery/information system of agro-raw materials, adopt technologies to improve the quality of raw materials, and to develop unique products to niche markets, thus expecting positive spillover impacts on rural agriculture/animal husbandry sector (i.e., suppliers of agro raw materials).

The project works with other donors. The International Fund for Agricultural Development (IFAD) conducts the “Market Access for the Poor Project”, aiming to increase added-value of agriculture products, improve the quality of raw materials and access to finance. An agreement was made with the IFAD that it would assist the raw material suppliers in agriculture/animal husbandry sector and to be parts of value-chain development plans assisted by the ADB. A component of the Sustainable Livelihood Project funded by the World Bank also agreed to help herder groups and to be parts of value-chain development plans. The project was implemented over 4 years until 2012.

4) CGF Guarantee Fund (LGF)

The GTZ provides a CGF in three pilot regions (Zavkhan, Darkhan and Erdenet provinces) in order to increase the access to loans and broaden financial services provided by commercial banks to SMEs and cooperatives (fallen under the category of manufacturing/processing industry) with the production purpose. The CGF commenced since October 2007 with a size of MNT 500 million and has the following conditions:

Coverage of guarantee	- Up to 50% of loan risk per project - Maximum guarantee amount of MNT 30 million per project
Eligibility	1) Officially registered SMEs at the State Registry and Tax office, 2) Located and operated in the project area 3) Engaged in production activities 4) A start-up or new business that has a sound business plan with sustainable and profitable activities for a time starting from a date of loan application to at least two years after the loan repayment 5) An existing business that has a good record of business proven by audited financial statements 6) A start-up and/or existing business that provide at least 50% of collateral required by the banks 7) A start-up and/or existing business that has no delinquent loan in any other financial institutions
Others	- Interest rate and term for loans shall be negotiated between the lending bank and borrower. - Chamber of Commerce & Industry, Employers' Federation, Cooperative Training and Information Center shall assist SMEs and Cooperatives on business planning.
PFIs	Five (5) banks including Trade and Development Bank, Zoos Bank, Khan Bank, Khan Bank and Post Bank

In this scheme, SMEs shall submit a business plan to the GTZ (project office) asking the guarantee support. The GTZ shall assess the application and issue a recommendation letter to PFIs confirming the provision of additional collateral if the SME client has insufficient collateral. The application with recommendation letter shall be sent back to SMEs, so that they can choose a lending PFI based on the best terms and conditions of loan, following review of business risk and collateral assessment. Once the lending PFI decides to grant a loan, PFI would discuss to agree on the amount of collateral to be guaranteed by the GTZ and sign a collateral agreement. No charge or fee is imposed on the guarantee arrangement.

By 2008, committed guarantee amounted to about MNT 370 million and realized loan issuance of about MNT 950 million with some 60 projects of processing industries such as wool, leather, hide and skin, fruit and vegetable, wood, milk and construction materials. The GTZ currently works out for an expansionary proposal of the CGF to extend the project area with an additional budget of MNT 1 billion and intends to closely collaborate with the SME loan program like JICA-TSL. Although there are two or three projects which were financed by the JICA-TSL and guaranteed by the CGF, critical points in further cooperation are left including limited location of the CGF, size of maximum guarantee amount and the number of PFIs.

5) Two-Step-Loan Project Phase II

The Loan Agreement (L/A) concerning the TSL Project for SME Development and Environmental Protection Phase II (TSL Phase II), between Japan International Cooperation Agency (JICA) and the GOM was signed on November 19, 2010 and became effective on June 6, 2011. TSL Phase II aims to promote sustainable growth and poverty reduction in Mongolia through the provision of long-term financing to SMEs and technical assistance to the PFIs and SMEs, thereby contributing to the private sector development and environmental protection. Two components of scope of the TSL Phase II are SMEs Development Loan and Environmental Protection Loan.

The borrower is the Ministry of Finance (MOF), and the executing unit includes the Counterpart Steering Committee (CSC), composed of representatives of MOF, Ministry of Nature, Environment and Tourism (MONET), MOFALI and BoM. Currently, MONET was divided into 2 ministries: Ministry of Environment and Green Development and Ministry of Culture, Sports and Tourism. Also MOFALI became Ministry of Industry and Agriculture.

The six PFIs include Capital Bank, Golomt Bank, Khan Bank, XacBank, Trade Development Bank, and Ulaanbaatar City Bank. Khan Bank, XacBank and Trade Development Bank were the first 3 PFIs to join and Capital, Golomt and Ulaanbaatar city banks were added after the project commenced.

Term loans have been provided to SMEs (sub-borrowers) through selected PFIs under the following conditions. PFIs receive the necessary funds from the MOF in accordance with the On-lending Loan Agreement made between the MOF and PFIs. Both sub-loans for SMEs development and environmental protection share almost same scope, terms and conditions with a difference for Environment protection loans have no upper limit for sub-loan size.

1) Eligible sub-loan borrowers : All the sectors excluding loans listed below:

- Loans for trade (wholesale and retail)
- Loans for entertainment business that is harmful to the society (e.g. prostitution, gambling)
- Loans for real estate, including for individual housing
- Loans for environmentally-damaging projects
- Loans for refinancing
- Loans for military activities
- Loans for consumers
- Loans for mining extraction
- Loans for individuals
- Loans for alcohol and tobacco/cigarette

Preconditions to application manufacturing

: SMEs which are defined in the SME Law, enacted in 2007, and are domestically private (i.e. majority private-owned), number of employees < 200 (for manufacturing) and <50 (for service sector), loan-to-value ratio < 80 percent, debt-service coverage ratio > 1.3, financial internal rate of return of loan project > 13 percent, and no previous default

2) Type of financing : Fixed asset financing;

: Factory premise financing; and,

: Working capital financing (up to 20% of the loan)

3) Region : Nationwide

4) Currency : Either USD or MNT

5) Interest rate (on-lending) : Market-based (6-month USD LIBOR + 1% for USD lending)

: Average demand deposit rate for MNT lending

6) Interest rate (sub-loan) : Market-based, spread defined by each PFI will be set on top of the on-lending rate. Spread will reflect PFI's aspect of the sub-loan project such as credit risk and profit

7) Size : Within the range between USD 10,000 – USD 600,000 per sub-project, or MNT equivalent (with no upper limit for EPLs, every EPL exceeding USD 600,000 needs JICA's concurrence)

8) Repayment period From 3 up to 10 years (including up to 3 years of grace period)

The total cost of TSL Phase II is estimated JPY 5,092 million, out of which JPY 5,000 million has been financed by Yen Loan from the Government of Japan through the JICA. The GOM provides the rest of JPY 92 million equivalents for administration and other costs.

In sum, international organizations have initiated some projects targeted SMEs and have made some contribution to the sectorial development. However, most of them terminated due to the project implementation time. Therefore, sustainability of the projects to accomplish their objectives in the long-run is dependent on donors' funding availability and their long-term commitment.

5.5 DEMAND FOR LONG-TERM LOANS

The research team also examined the "demand side" for medium and long term borrowing of SMEs in Mongolia. As there is not much data available on the SME demand for financing, it was difficult to estimate a gap between demand and supply sides of SME financing.

For the purpose of this research, primary data on SME financing demand and barriers facing SMEs was collected from interviews with government officials from the Ministry of Labor and representatives of 7 participating financial institutions of TSL project. The analysis of this research also draws on conclusions of the Bank of Mongolia SME study conducted in 2011 and 2012. Based on the interviews and secondary data, the key constraints to SME financing were identified as follows:

(1) There is a poor access to finance for SMEs.

The IFC Enterprise survey (2009a) shows that access to finance is the most critical constraint amongst the top 10 constraints reported by firms in Mongolia. The ratio of private sector credit to GDP is a widely recognized measurement of financial market development. Typically, this ratio in high-income countries is well above 100 percent. In Mongolia, lending to the private sector reached only 28 percent of GDP indicating that the current financial market is unable to meet the growing demand for loans (Bank of Mongolia, 2012b).

According to statistics, 45,000 micro entrepreneurs out of 60,317 micro entrepreneurs and 2,500 SMEs out of 12,100 SMEs (or nearly 20 percent) have received bank loans which constitute 19.4 percent of total commercial lending in 2010. In terms of location, SMEs in rural areas are less capable to access to loans as 80 percent of total loan outstanding is disbursed in Ulaanbaatar.

As interviewees of PFIs stated "Demand is strong. But we refuse almost half of applications because there is not sufficient fund for long-term lending on the bank's side, on the SME side, there's a lack of collateral and other issues". SME fund officials noted that only 18-20 percent of SME applicants approved by the SME fund are accepted by banks, the rest are declined due to their inability to meet banks' requirements. This argument is also supported by the BoM SME study (2012) that 80 percent respondents out of 2,285 SMEs expressed their urgent need for financing and consequently the financing environment received the lowest rank (-0.64) from respondents.

In 2012, the SME fund received MNT 596 billion funding request from 816 SMEs. Out of total requested amount, only 4 percent (98 projects worth MNT 19.8 billion) was financed by the SME fund. Such a low level of financing is mainly caused by the shortage of funding.

(2) Most financing comes from banks loans.

According to the BoM SME study (2012), 72 percent of respondents financed their operations through banks loans; 12 percent were funded concessional loans provided by IFIs and from the SME Fund; 5 percent borrowed from their friends and relatives; and the rest used other sources. Although there are various funding of international financial institutions and the Government, they are still insufficient to meet SME financing demand.

Capital markets are underdeveloped in Mongolia and SMEs have limited understanding of raising capital from financial markets. Financial institutions providing leasing and factoring is almost absent.

Funding obtained by SMEs are spent on financing of working capital (36%), expansion of business activities (19%), purchase of machinery and equipment (17%) and factory extension and purchase of real estates (18%) (Bank of Mongolia, 2012b).

(3) Major constraints to SME financing

- *High interest rate, short term lending and insufficient loan amount*

SMEs need medium and long term financing. However, most financial institutions, including banks, provide short term lending at high interest rates, which discourage SMEs to apply for loans. The weighted average loan rate at the national level accounts for 17.9 percent. According to the BoM SME study, most SMEs preferred to receive loans with over 5-year maturity at annual interest rate of 8.8 percent.

- *SMEs do not meet banks' minimum lending criteria*

  - *Lack of collateral and undervalued assets*

When processing loan applications, banks put more weight on collateral instead of the project's estimated future inflows. Land and real estate are considered to be the main collateral. Other assets, such as machinery, equipment, vehicles and other movable assets are valued much lower than its real value (about 40-50 percent). Absence of unified real estate registration system and banks' tendency to undervalue collateral assets create difficulties for SMEs to obtain loans. Although the Parliament recently passed the Law on Loan Guarantee Fund and the LGF started to operate, it has not yet become fully operational.

  - *Poor accounting and reporting practice of SMEs*

Inadequate financial record keeping, the lack of ability to use accounting information and neglecting the role of accounting and financial information in business decision making are some of negative features of SMEs in Mongolia. Some business owners deliberately hide or fail to keep proper accounting records with a purpose to avoid tax. This leads to higher information asymmetry and increase risks for banks. In Mongolia, almost 20 percent of SMEs cannot obtain loan due to poor bookkeeping proving their income inflows.

  - *Inability to prepare proper business plan*

Although a well-conceived business plan is a roadmap for business, most SMEs do not have the capacity to prepare business plans. About 10 percent of SMEs loan applications have been rejected by banks for this reason. Banks mostly rely on collaterals, whereas government and international financial institutions funded institutions use a project financing approach in providing their medium and long term loans. A well-conceived business plan is important for project financing approval.

- *Too costly to obtain loans*

According to the BoM SME study, 14 percent of SMEs stated that complicated and time consuming procedures were the main reasons for not choosing bank loans. SMEs criticized bureaucracy and backdoor lending of the SME Fund, especially in rural areas. In terms of timing, there's a mismatch between SME loan demand and supply of the SME Fund. Most businesses become active in spring and fuels more demand for loans. However, banks' capacity to process large amount of loan applications at once is limited and also they do not have sufficient funding resources to satisfy the loan demand.

In summary, major barriers for SME financing are not only related to capacity of SMEs, but also affected by other factors, namely development of financial markets, bureaucracy and unrealistic bank loan requirements. Despite many initiatives by the government targeted to SME development, coordination and efficiency of these initiatives are weak. Ambiguity of legal environment for SMEs, lending infrastructure and development of financial markets hinders the SME development.

6 CONCLUSION AND RECOMMENDATIONS

6.1 CONCLUSION

Booming mining development brings both benefits and challenges to the Mongolian economy. Although the country has enjoyed rapid economic growth primarily induced by the mining sector, there is an increasing demand for infrastructure development, economic diversification, especially value-added economic activities in order to prevent so called Dutch disease and to promote sustainable economic development.

The Mongolian economy has been recording a double digit growth of 12-18 percent in the last three years. The growth has been supported largely by the expansion of the mining sector, aided by foreign direct investment into the sector, and a high demand for minerals in the global commodity market. The heavy dependence on mining poses risks to the economy and makes it vulnerable to fluctuations of global mineral prices. The diversified economy would help to shield the economy from these changes.

The economy needs long term investment to support sustained growth of the economy. Productive investment would provide a strong basis for both economic growth and job creation. Even though investment level is picking up along with the economic growth, it is still not sufficient to meet the financing needs of the country. There are numbers of reasons that limit resources to be allocated toward to LTF.

A high risk of instability in the current balance discourages the growth of the domestic saving. The current balance instability caused by followings: export revenue largely based on natural resources depends on external demand, in particular Chinese demand; export for non-mineral products has no growth; manufacturing of import substitutes is sluggish; and transition from the consumption based to industrial based economy is slow. Although FDI is a key source for LTF, inferior diversification of the economy and the lack of incentive policies to retain FDIs in non-mineral sectors resulted 75 percent of FDI goes to the mining sector for the last three years.

Despite its rapid progress, the financial intermediation is incapable of meeting growing demand of LTF. Compared to 2007 and 2012, the banking sector asset increased 3.5 times reaching USD 8.5 billion; outstanding loan growth 3.4 times accounting for USD 5 billion; and bank deposit reaching USD 4.1 billion. Yet, the booming mining sector alone will require more than USD 10 billion over the next decade which gives no room for the investment into other sectors.

LTF in Mongolia rests on a narrow range of instruments, such as bank loans, bonds and equity. Overreliance of the banking sector in the financial system and underdeveloped capital market cannot satisfy the rapid growth of the economy. The banking sector accounts for 96 percent of total financial market assets whereas non-banking financial institutions including insurance, non-banking financial institutions, saving cooperatives and brokerage firms comprise only 4.4 percent. In the banking sector, three largest banks hold 70 percent of the banking market which indicates high concentration of the banking sector.

Given this financial sector structure, commercial banks provide primary source of financing for businesses. However, a closer look at their balance sheets reveals that much of their activities are not the provision of long-term financing and thus they do not help to build the solid foundation for sustainable development. Banks mostly rely on deposits and current accounts (constitute 74 percent of debt, excluding own capital) and most of them have short-matured (mostly demand deposits). The financing of long-term loans by short maturity deposits creates maturity mismatch. Therefore, deposits are used to finance short-term loans only. Due to scarcity of domestic funding sources and limited availabilities of raising capital at the international market, the banks search opportunities from the international financial institutions, donors' capital and lately special projects financed by the general budget. Therefore, it can be said that Mongolia does not have sufficient domestic savings to fund its growth.

Being a potential domestic investor for big infrastructure projects and economic diversification, the DBM should play a leading role in LTF. Nevertheless, insufficient asset, high political influence, poor governance, exchange rate risk and a possible high rate of loan default limit the DBM to be fully functional. The DBM obtains initial funding in USD, but it lends loans in MNT which is exposed to the exchange rate risk when the initial funding is paid back in USD. The DBM has played as a funder on social projects and programs that should be financed by the general budget which in turn increases its default risk. Additionally, the Fiscal Stability Fund was designed to serve as a budget stabilization tool, with inflows to the fund occurring on a contingent basis when prices for major minerals exceed a structural benchmark. However, unclear spending procedure of the FSF limits the FSF to be a potential source for LTF.

Comprising over 90 percent of total registered entities, SMEs contribute 25 percent of GDP and employ a half of the workforce in Mongolia. Notwithstanding its contribution to the economy, the SME sector development is still in infancy. There's a tendency of increasing number of SMEs in the manufacturing sector, which indicates shift towards more value-added production. However, SMEs still fall short in human capacity, managerial skills and financial literacy.

While financial intermediation in Mongolia has been growing fast, access to finance remains the main constraint for enterprises, especially for SMEs. They lack favourable financing conditions that would enable them to expand operations and contribute to the further growth.

On the supply side, banks and the government and international organizations are key providers of SME loans. SME loans are characterized by relatively high interest rates, short-term maturities, small loan sizes and predominantly immoveable collateral-based lending requirements. Although banks supply most of SME financing, they do not have sufficient long-term funding to meet the growing needs of SME demand. Banks are constrained with the short-term deposits, high inflation and deposit rates, and the shortage of other funding sources with longer maturities.

Bank lending is particularly limited in rural areas evidenced by 80 percent of total loan outstanding provided to SMEs in Ulaanbaatar. Bank lending in rural areas is limited due to several reasons, including: (i) the low population density that makes it unprofitable to service isolated areas using traditional banking methods; (ii) the riskiness of agricultural loans; (iii) lack of financial information on micro-firms/herders; and (iv) lack of real estate collaterals in rural areas.

Recognizing importance of the SME sector, the government has undertaken various measures to support SMEs. These measures range from (i) reforming existing legal and regulatory framework, (ii) creating institutions providing financing to SMEs, such as the SME fund and Soum development funds and (iii) supporting through sector specific targeted programs (wool and cashmere sector) financed from the government bond proceeds. However, SME funding of the government is unsustainable as it only relies on budget revenue that is heavily dependent on the world commodity price fluctuation of mineral resources. Between 2009 and 2010, the government allocated MNT 60.4 billion to the SME fund. But, there was no budgetary allocation to the Fund in 2011 and 2012. In terms of Soum development funds, MNT 24 billion was distributed by soum governing officials, but not through commercial banks. The government is planning to establish a sovereign wealth fund (SWF) generated from future mining income of major mining projects, namely Oyu Tolgoi copper mining and Tavan Tolgoi coal mining. However, a possibility of sudden collapse of the mineral market puts the SWF at risk as mining revenue is highly volatile and unpredictable. Also, it is uncertain how to effectively manage mining revenue to avoid the Dutch disease. In sum, the government financing mechanism is not so efficient and fund resource is unsustainable.

International organizations, such as the World Bank, ADB, GIZ and JICA, have some projects to promote private sector development. Compared with others, the TSL project of JICA is more targeted to SMEs and it had covered more than 400 SMEs since 2007. Phase II of the TSL continues to be implemented until 2015. Due to high loan demands of SMEs, JPY 5 billion of total loan funding has been disbursed within first two years. In addition, revolving fund is being used for SME loans. This again confirms an insatiable demand for SME financing.

Opportunity to raise financing from the capital market and use of financial resources, such as leasing and factoring is practically absent in Mongolia. Non-banking financial institutions and saving and credit cooperatives play minimal role in SME financing and still in its early stages of development. A loan amount provided by these institutions is small with short-term maturity and high interest rates.

On the demand side, SMEs demand for financing is growing constantly. There are many constraints that limit SMEs to obtain financing. SMEs often cannot meet banks' lending requirements due to a lack of collateral assets, weak management skills and poor financial reporting.

Unfavourable bank lending terms discourage SMEs to approach banks for financing. Loan size is deemed to be insufficient for SME growth needs, and short-matured loans make SMEs to use the funds for working capital financing only rather than long-term capital investment. High interest rate leads SMEs to fall into interest rate burden. Current collateral requirements of banks are too rigid as only immovable assets are qualified for collateral. Not many SMEs own immovable assets and if they do, assets are often valued below their real market value.

The presence of institutional and legal obstacles compounds difficulties for SME financing. Currently, a quarter of 30 government special funds are directed towards supporting SME activities. However, operations of these funds are not well coordinated. In addition, government issued bonds to support specific industries. Scattered allocation of funds to support SMEs, weak internal coordination of government programs, a lack professional skills of government officials to manage the funds, select potentially viable projects and monitor results leads to inefficient allocation and use of government funds.

The passage of the SME Law by the Parliament in 2007 was a remarkable step towards SME development. For the first time, the Law provided a SME definition and provided a clear framework for government policy and strategies and scope for government of activities in promoting SMEs. Yet, there are significant weaknesses in the legal framework. The definition of SMEs needs to be revised by increasing the sales threshold for SMEs, the definition also needs to be streamlined among financial institutions, as number of banks use own definitions in providing loans to SMEs. Overlapping and conflicting legal provisions serve as impediments to implementation of the SME Law. In terms of SME financing, it is unclear how the SME law interrelates with recently passed the Credit Guarantee Fund Law. Enforcement of laws is weak as regulations and implementation mechanisms are poor.

A reliable legal system and judiciary are necessary for lenders to enforce contracts and foreclose collateral on loans. Inefficient legal processes and court proceedings increase the risk for lenders and make the foreclosure processes time-consuming and expensive. Similarly, inadequate creditor rights can diminish the incentives for borrowers to meet their financial obligations. In turn, these factors translate into a higher cost of financing for borrowers. Bankruptcy procedures are rarely used and the capacity of courts to handle insolvency issues is another bottleneck. The ongoing reform of the insolvency regime should be completed as soon as possible, bringing the law in line with international standards.

6.2 RECOMMENDATIONS

Shortage of LTF in Mongolia is caused by the supply factors rather than demand for it. It is obvious that the country needs LTF for all economic sectors. Based on the current macroeconomic conditions, strength of domestic financial institutions, development of financial sectors and household saving, the country has limited domestic potential sources for LTF. Promising ways to get capital for LTF is to retain international sources and involvement.

With consideration of four key principles in order to have an ideal market for LTF stated in Chapter 1, some improvements need be done as follows:

(1) To address first principle "The financial system should channel savings from households and corporations into an adequate supply of financing with long maturities to meet the growing investment needs of the real economy":

A number of changes in particular in legislation and consumer protection areas need to be done to promote household savings. These are as follows:

- To provide public awareness-building on investing financial instruments and take initiatives to promote saving habits of individuals and households
- To define an institutional framework for financial consumer (individual investors and savers) protection in order to: protect consumers from unfair or deceptive practices; improve transparency through disclosure and understandable language requirements for financial instruments and pricing, in a way that allows consumers to easily compare offers of financial products; and establish an efficient and fair mechanism for resolving customer complaints and disputes.

(2) Second principle "LTF should be supplied by entities with committed long-term horizons":

As banks mostly rely on their deposit and own resources, the size of long-term loans are not sufficient to meet growing LTF needs. Thus, banks need to find and raise more LTF sources from international financial institutions, and international and domestic capital markets.

The current collateral-based traditional approach in providing loans needs to be shifted towards a project-based financing to promote good proposals with potential growth rather than immoveable collateral-based "safe" loans which are often not enough to meet investment needs of businesses to expand. This shift requires improved capacity of banks and their staff knowledge and skills to evaluate efficiency of proposed business projects. Therefore, a special attention should be given to train bank staffs on the project financing scheme.

In order to promote financial intermediaries with committed long-term horizons, the legal environment, capacity building and financial infrastructure needs some improvements, such as:

- Improve the legal and regulatory framework for secured transactions
- Establish a modern moveable collateral registry,
- Amend the insolvency legislation to make it consistent with international standards
- Provide training and awareness-building to stakeholders on compliance with a new legal and regulatory framework, and on the use of the registry
- Strengthen court capacity to handle commercial matters and consider the creation of commercial courts
- Issue licenses and regulations to enable operations of a private credit information bureau
- Enhance operations of loan guarantee funds

- A training program for clients is needed to improve understanding of credit information sharing
- Create a national platform to improve inter-connectivity and service delivery, reduce the cost of maintaining and using mobile banking services, and improve customer security
- Consider less costly, market-based mechanisms, that may involve risk-sharing with financial institutions, and which promote efficient credit allocation.

(3) *To enable third principle "A broad spectrum of financial instruments should be available to support long-term investment":*

The current few financial instruments should be challenged by creating more new instruments, such as leasing, factoring and venture capital that can raise LTF sources for businesses. Amendments to the leasing law by considering preferential tax treatment for leasing transactions, and increase business awareness on the benefits of leasing as a financial instrument is crucial in order to promote the usage of this instrument among enterprises (specially SMEs). Similarly, factoring can be developed through the establishment of better legal environment and awareness building. Additionally, SME banking and venture capital fund that will be discussed below in more detail can be developed to satisfy LTF needs of SMEs.

(4) *"To promote economic growth through stable cross-border flows of long-term finance, supported by appropriate global regulation":*

This principle is quite challenging as it involves not only domestic financial intermediation and infrastructure, but also international financial markets and participants. Thus, a number of measurements need to be done. The main areas of improvement in the legal, regulatory and supervisory framework include: (i) establishing foreign lenders friendly environment in terms of legal and collateral protection; (ii) creating legal and regulatory procedures for international sources to finance domestic financial investments; (iii) having credit reporting and guarantee systems for lenders; and (iv) strengthening the institutional, legal and regulatory frameworks for consumer protection and financial literacy.

In terms of the capital market, IT systems, databases, interconnectivity and software tools of the MSE are needed to improve in order to effectively perform its capital market functions both domestically and internationally. For the banking sector, there is a need for encouragement of foreign bank entry into the financial market in order to attract LTF sources and increase competition to improve borrowers' financing needs.

In particular for SMEs, more efforts need to be taken from both supply and demand sides. These are discussed in details below.

Supply side

<u>*Commercial banks*</u>

As banks mostly rely on their deposit and own resources, size of long-term loans are not sufficient to meet growing LTF needs of SMEs. Thus, banks need to find and raise more LTF sources from IFIs and international and domestic capital markets.

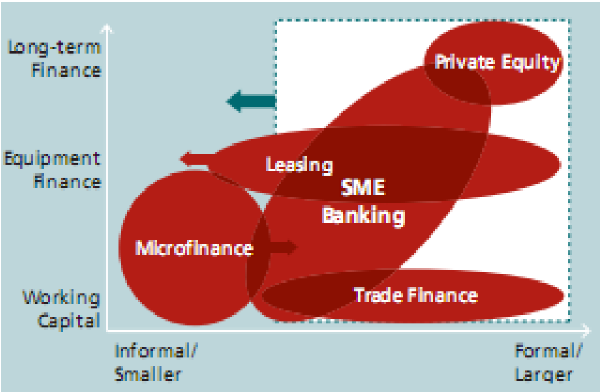
The current collateral-based traditional approach of banks in providing SME loans needs to be shifted towards a project-based financing to promote SME development. However, bank staffs do not have adequate long-term lending knowledge and skills to evaluate efficiency of proposed business projects of SMEs which do not possess immoveable collateral assets they require, but have good proposals with potential growth. Therefore, a special attention should be given to train bank staffs to handle with project financing.

<u>*SME banking*</u>

Although there are many government and donor initiatives supporting SMEs, sources are limited and funding allocated through several institutions leads to poor coordination and inefficient use of resources. Drawing from the international experiences of SME banks, to address above challenges we suggest *setting up a SME bank*, which includes participation of the government, international and domestic financial institutions. One potential source for LTF resource of the SME bank in near future can be the sovereign wealth fund generating fund resources from mining-induced income.

The SME bank will provide full financial services to SMEs ranging from SME loans, leasing, trade credit and equity finance by closely coordinated with other banks, the Financial Regulation Committee on equity finance and the Credit Guarantee Fund. The Bank also needs to effectively utilize financial infrastructure, such as the payment system, unified credit information system and collateral registries.

Figure 6-1 Types of SME financing and coverage of SME banking

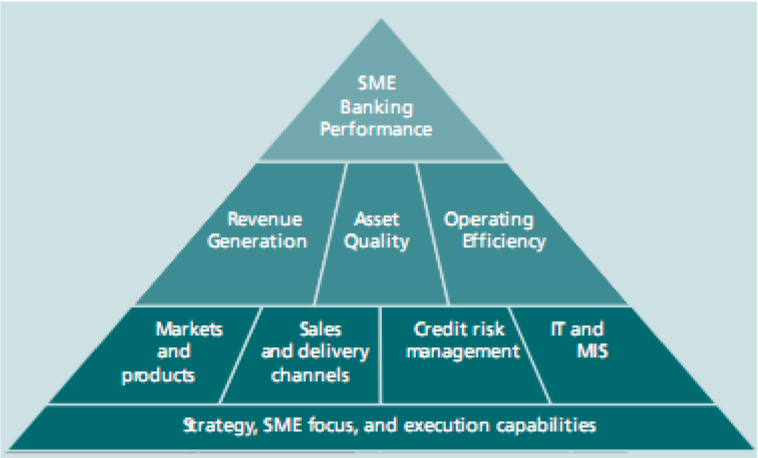


Source: IFC (2009b)

While there is no single formula for the successful SME bank, there are lessons and good practices that apply to five strategic areas: (1) strategy, SME focus and execution capabilities; (2) market segmentation, products and services; (3) sales culture and delivery channels; (4)

credit risk management; and (5) information technology (IT) and management information system (MIS). These are illustrated in the figure below.

Figure 6-2 Five strategic areas form the foundation for SME banking performance



Source: IFC SME Banking CHECK Diagnostic Toolkit

In order to set up the SME bank, a legislative framework should be developed in consistency with the SME Law, the Credit Guarantee Fund and other related laws and regulations.

Commonly used financing in other countries, such as factoring, leasing, project financing and trade credit can be developed with active engagement of commercial banks, the SME bank and other financial institutions.

Capital market

In terms of capital market development, the entry threshold and requirements need to become SME friendly with close coordination with the Credit Guarantee Fund. Independent credit rating financial institutions should be developed to assess credit rating of SMEs that is necessary for issuing bond and common stocks in the capital market. A separate Stock Exchange board, similar to AIM[13] in the UK and Japan, can be established to help smaller and growing companies raise the capital that they need for expansion.

In particular, strategically important, high growth SMEs can raise equity financing from the capital market through development of venture capitals in Mongolia. The government can engage in venture capital development in two ways: to provide the necessary legal environment for venture capital formation and invest directly in funds. While, the first step is crucial, governments, particularly in developed countries namely Canada, UK and Europe[14],

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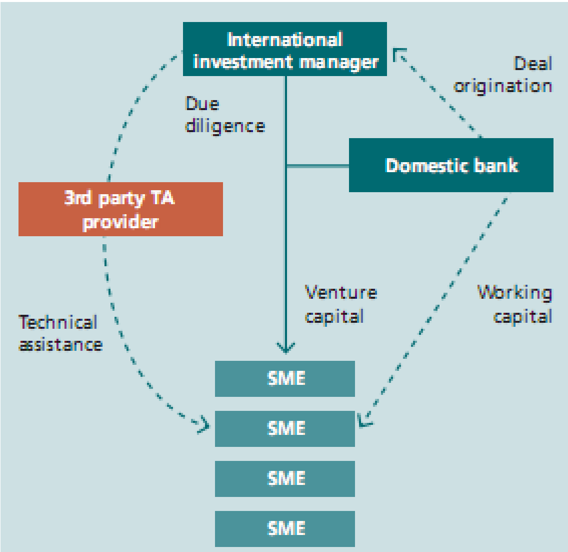
[13] The AIM is the London Stock Exchange's international market for smaller growing companies. A wide range of businesses including early stage, venture capital backed as well as more established companies join AIM seeking to growth capital. Similarly, the Tokyo Stock Exchange established Tokyo AIM, Inc. in 2009.

[14] The Canadian government invests directly in venture funds. Some other governments have followed that model whilst others achieve the same result via manipulation of the tax code. The Venture Capital Trust and Enterprise Capital Fund schemes in the UK, the French closed-end investment schemes in France, and the European Investment Fund supporting the whole of Europe are other good examples.

take initiatives that put government cash into venture capital funds alongside private money to make it more attractive for private investors.

One of widely used LTF source for enterprises is a venture capital fund that manages money from investors seeking private equity stakes in businesses with strong growth potential. Benefits of the venture capital are that it not only helps them raising LTF from the capital market, but also brings managerial and technical expertise. Most venture capital comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships. Venture capital has not been developed in Mongolia due to the asymmetric information, and uncertain legal and political conditions. Effective engagement of international investment managers, domestic banks, third party technical assistance providers and beneficiaries (in particular SMEs) is the key to success of the venture capital financing. The following figure illustrates potential cooperation between these parties.

Figure 6-3 Framework of venture capital



Source: IFC (2009b)

In Mongolia, this framework can work well if necessary legislation, financial infrastructure and capacity building is satisfied with supervision of international benchmark venture capital funds and managers.

Demand side

<u>Improving legal environment</u>

The government has made special efforts to put in place fundamental laws supporting SME development over the last several years. However, the enforcement of these laws has not been always satisfactory. Clear regulations and implementation mechanisms are either absent or poorly defined. Reviewing key legislation is recommended to address problems related to enforcement of laws.

Tax regime for SMEs needs to be streamlined to lessen the tax burden on SMEs. Although the government has provided a generous tax exemption to SMEs since 2009, there's a need to review certain tax legislations. For instance, the current the VAT threshold (MNT 10 million) needs to be increased. Currently, average sales value of SMEs well exceeds MNT 10 million making SMEs subject to VAT. Under the law, VAT taxpayers are required to report on their VAT return statement on a monthly basis. This adds excessive burden on SMEs especially on those SMEs that lack with qualified personnel.

SME capacity building

It is reported that SMEs lack necessary skills and capacity to prepare business plans with analysis of their markets, financial and technical feasibility and risk assessment. In certain cases, access to necessary information and data hinders the ability of SMEs to develop proper business proposals. Training or assistance to SMEs on financial bookkeeping and maintenance of company records and accounts will also help SMEs to better present themselves to banks as credible borrowers.

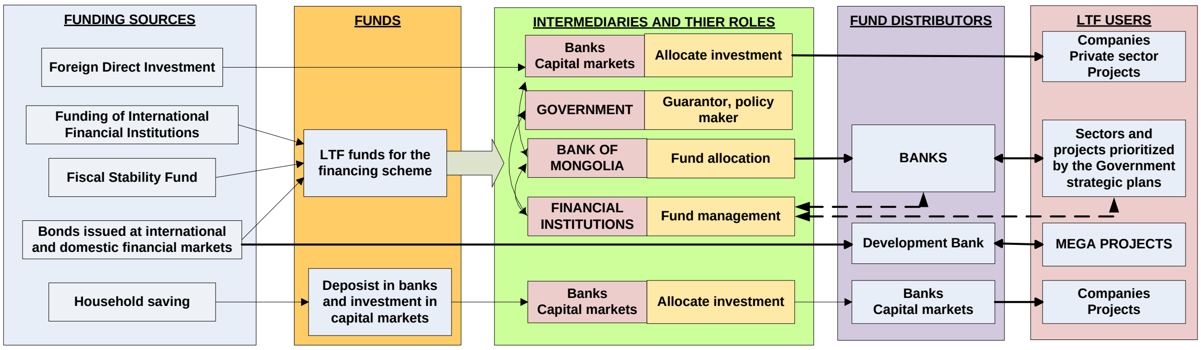
Although there are many SME training programs offered by various institutions, the quality, content and practical applicability of training programs is questionable. It is recommended to organize seminars and trainings together with international organizations which have extensive experience in this field, including project financing. The proposed SME bank can also conduct SME training and research.

Public-private partnership initiative in LTF

Due to the lack of available long term sources, commercial banks have no incentive to risk their assets for LTF especially when the deposits obtained from domestic customers is very competitive. The domestic capital market is underdeveloped and is not capable of raising much LTF to satisfy development needs. Thus, the government can fill this gap through effectively managed public-private partnership (PPP) initiatives. Schemes of the existing SME Fund and some international organizations' funding project like the Two-Step-Loan of the MoF and JICA can be more sophisticated and used as an exemplar PPP initiative in LTF.

Instead of having deep administrative and political involvement in allocating and administering LTF, the government should hand its duty over professional financial institutions to ensure effectiveness and outreach of LTF to promote economic development. The government responsibilities will be to determine priority development sectors with introduction of incentives to attract LTF; to be a guarantor for the loans and funds financed by international financial institutions, investors and venture capitals; and to provide necessary legal environment ensuring information availability, and reduce political influence and uncertainty. Financial institutions will have special roles in managing funds: to develop effective policies and project financing systems and improve capacity building of banks and NBFIs to utilize them; to monitor effectiveness of the fund allocation by assessing end users' satisfaction; to have a neat cooperation and coordination with fund providers, banks and the government; and to continuously enhance their funding management by engaging and including stakeholders' views. Banks will distribute the LTF fund to the private sector (specified in the Government strategic plans) based on policies developed by financial institutions and their own market requirements (See Figure 6-4).

FIGURE 6-4 **LTF FUND SCHEME**



Source: Authors

As FDIs directly invest their investors' target sectors and projects, foreign and domestic banks and capital markets transfer capital flows. Similarly, household savings are either placed in banks as deposits or equity and bond investment in capital markets.

Government facilities, such as the DBM and FSF have different intermediations depending on their objectives. In terms of the FSF, the regulation on the usage of the fund should be clarified and allow using the fund source exceeded more than 5 percent of average GDP of the last three years can be utilized as a LTF source. For the DBM, bonds issued at international and domestic financial markets can raise LTF sources and be distributed to national priority mega projects without much political interventions.

In this LTF scheme, financial infrastructure, such as the credit guarantee scheme, collateral registry system, inter-connected database and project financing facilities, should be developed and trained properly among all participants.

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