



Progress Report on Tranche Release

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Loan Number: 3297
April 2016

Mongolia: Social Welfare Support Program (Second Tranche)

CURRENCY EQUIVALENTS

(as of 1 March 2016)

Currency Unit	–	togrog (MNT)
MNT1.00	=	\$0.000493
\$1.00	=	MNT2,033.0

ABBREVIATIONS

ADB	–	Asian Development Bank
DBM	–	Development Bank of Mongolia
GDP	–	gross domestic product
MPDSP	–	Ministry of Population Development and Social Protection

NOTE

In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. In a letter dated 15 April 2015, the Government of Mongolia requested financial assistance from the Asian Development Bank (ADB) to help it overcome severe fiscal revenue shortages. The government asked for a policy-based loan (PBL) to ensure that social welfare programs can be sustained during the implementation of the government's macroeconomic adjustment and fiscal consolidation program.

2. On 29 September 2015, ADB approved a policy-based loan to Mongolia in the amount of \$150 million from ADB's ordinary capital resources. The loan was to be disbursed in two tranches. The first tranche of \$100 million was disbursed upon loan effectiveness on 20 November 2015, as the first tranche policy actions were satisfactorily completed. The policy actions pursued improved fiscal policy management to maintain social welfare funding. The second tranche of \$50 million, focusing on policies and regulations to support targeting and consolidation of social welfare programs, is to be disbursed upon achievement of the second tranche policy actions. The program covers the period from 1 December 2014 to 31 December 2016.

3. The program funds short-term revenue shortages which, if unaddressed, would result in significant cuts in welfare programs. These cuts would disproportionately affect the existing poor, as many depend heavily on benefits for daily subsistence, and push more Mongolians into poverty. The program supports reforms under the country's economic adjustment plan to (i) improve fiscal policy management, and (ii) develop policies and regulations to improve targeting and consolidate social welfare programs. Through these reforms, the program mitigates the adverse effects of fiscal consolidation on the poor, and sustains financing for social welfare programs.

4. This progress report provides details of achievements that substantiate compliance with the conditions for the release of the second tranche of \$50 million. The International Monetary Fund has been consulted on the PBL and has no objections to the tranche release.

II. MACROECONOMIC AND POLITICAL DEVELOPMENTS

A. Macroeconomic Developments

5. Gross domestic product (GDP) growth decelerated sharply to 2.3% in 2015 from 7.9% in 2014, as monetary and fiscal policies became less expansionary, falling mineral prices eroded exports, and foreign direct investment declined by 33.8%. Growth slowed in all sectors but remained robust in the industry sector, which contributed 2.0 percentage points to growth, and the agriculture sector, which contributed 0.9 percentage points. As trade shrunk, services growth fell to 1.1% from 7.8% in 2014, dragging GDP.

6. On the demand side, a fall of 27.7% in investment in 2015 on top of a 30.1% decline in 2014 continued depressing growth. Consumption growth slowed to 4.6% from 7.5% in 2014—despite robust growth in private consumption—as government consumption declined in the context of its fiscal consolidation plan. As a result of a substantial contraction of imports, net exports turned positive contributing 9.1 percentage points to growth.

7. Exports declined by 19.2% as increased quantities of copper concentrate, oil, and gold exports failed to compensate for an overall decline in commodity prices and the reduced volume of coal and iron ore shipments. Since imports fell by 28.1%, the merchandise trade surplus increased, and the current account deficit narrowed from 11.5% of GDP to 4.8% of GDP. Together with rapidly increasing external borrowing, this further reduced the balance of payments deficit to \$268.1 million from \$471.1 million in 2014, but at the cost of higher external debt.

8. Several factors caused average inflation to moderate to 6.6% in 2015 from 12.8% in 2014. Preemptive slaughtering of livestock in anticipation of a harsh winter sharply reduced meat prices, which have a large weight in the consumer price index basket. Other factors include subdued domestic demand and a tight monetary policy in response to balance of payment pressures.

9. Government commitment to fiscal consolidation resulted in a budget deficit stabilized at 3.1% of GDP in 2015. The consolidated deficit—including the expenditures of the Development Bank of Mongolia¹ (DBM)—fell to 7.9% of GDP in 2015 from 11.4% in 2014. Monetary policy was tightened as the central bank raised its policy rate in August 2014 and January 2015 by 2.5 percentage points in total, and off-budget public spending was curtailed.

10. GDP growth will continue falling and reach 0.1% in 2016 and 0.5% in 2017 as mining production declines, and rising debt repayments and continued balance of payments pressures force tighter macroeconomic policy. Agriculture remains the main driver of growth, but services are flat as domestic demand falters. Industry will benefit from the midyear start of underground mine construction at Oyu Tolgoi, which will be ramping up in 2017 and is reportedly set to generate \$2.5 billion in domestic capital expenditure by 2022. Average inflation will continue to moderate in 2016 and stabilize at around 3.0% by the end of the year, with meat prices normalizing in the second half of the year. Inflation will pick up to 7.0% in 2017 reflecting the impact of currency depreciation on imports.

11. Risks to the outlook include a delay in development of the second phase of the Oyu Tolgoi mine that would affect economic prospects and raise risk perceptions, thereby constraining options for refinancing debt. Although a delay is unlikely because project financing is secured, the scenario highlights the need to maintain policy buffers and prudent macroeconomic policy. Other external risks include lower commodity prices and tightened external financing conditions. Further, risks to the fiscal and external accounts would accumulate if Mongolia were to raise substantial external debt at high interest rates.

12. Against this background, policy responses should include further reducing consolidated deficits, strengthening debt management, and urgently resolving looming external debt repayments. Gradual currency depreciation in line with market fundamentals would restore competitiveness and contain balance of payments pressures while safeguarding foreign exchange reserves, but its adverse impact on the finance sector and the public debt ratio cannot be ignored. Lax monetary policy should be avoided, as it could aggravate balance of payments pressures.

¹ The DBM was established as a state-owned entity in 2011 with the mandate to support the financing of major projects and programs for the country's development. However, the DBM's lending activities have generated large additional fiscal deficits that were kept off-budget to circumvent the requirements of the Fiscal Sustainability Law (2010).

B. Political Developments

13. The term of the current ruling coalition is coming to an end. Parliamentary elections are scheduled on 29 June 2016. While the outcome of the polls is unknown, it is unlikely that a single party will gather a majority. This means that a new ruling coalition will have to be formed after the elections. The change in government will not affect the implementation of the reforms required under the program as all policy actions have been complied with.

III. STATUS OF SECOND TRANCHE RELEASE CONDITIONS

A. Summary of Compliance with Second Tranche Policy Actions

14. The second tranche comprises seven policy actions focusing on two output areas: (i) improved fiscal policy management (to maintain social welfare during the fiscal consolidation progress), and (ii) improved policies and regulations (to support targeting and consolidation of social welfare programs). Compliance was required before 31 December 2016. The government has complied with all policy actions in March 2016, and submitted all the verification documents. The policy matrix is in Appendix 1.

B. Compliance with Second Tranche Policy Actions

Output 1: Improved Fiscal Policy Management

15. **Policy Action 2.1 (complied with).** The government will submit to parliament a second 2015 budget amendment to adjust fiscal expenditure to ensure that funding for social welfare programs is maintained.

16. The government submitted to parliament a second budget amendment reflecting further expenditure cuts in compliance with the government action plan for fiscal consolidation. However, the amended budget maintains the allocation for social welfare programs intact at MNT285 billion. The budget amendment was approved by parliament in October 2015.

17. **Policy Action 2.2 (complied with).** The government will submit to parliament a revised DBM Law to improve the bank's transparency and accountability, including (i) subjecting the bank to central bank supervision, (ii) ensuring independent investment decision making, and (iii) ensuring regular disclosure of financial statements.

18. In June 2015 the government submitted to parliament a revised law for the DBM. The revised law reflects the three points specified in the policy action. Article 27 of the law subjects the DBM to the supervision of the central bank. The DBM's independent investment decision making is established in Articles 6 and 25 of the law. Article 31 ensures that the DBM's financial statements will be regularly disclosed.

Output 2: Improved Policies and Regulations to Support Targeting and Consolidation of Social Welfare Programs

19. **Policy Action 2.3 (complied with).** The government, through the Ministry of Population Development and Social Protection (MPDSP), will issue a ministerial order requiring the Health Insurance Organization to provide health insurance coverage for household members in need of social welfare services.

20. On 20 January 2016, the MPDSP issued a ministerial order in accordance with the Social Welfare Law. Under the ministerial order, the Health Insurance Organization fully covers the cost of health care services for those households that are recipients of social welfare services and who were not covered before and would otherwise be unable to afford health care. In addition, the order establishes that the MPDSP's Regulatory Office of the Social Protection Policy Implementation is tasked with monitoring the implementation of the ministerial order.

21. **Policy Action 2.4 (complied with).** The government will prepare a draft regulation to require at least two ministries to use proxy means testing in selected programs.

22. At present, the food stamp program is the only welfare program in Mongolia using proxy means testing². It relies on the use of the poverty-targeted integrated household information database to allocate the benefits among the poorest 8% of the population. The data base was established in 2008 with ADB financing³ and has succeeded accurately targeting the recipients in most need. The PBL seeks to expand the use of the database for the provision of other welfare programs. It will thus strengthen the social welfare system by supporting the prioritization of available resources and assistance based on demonstrated need. Against this background a draft government resolution was prepared on 22 March 2016 establishing that the Ministry of Justice and the Ministry of Education will adopt proxy means testing to targeting for the provision of free legal services and secondary school textbooks to the poorest households, respectively.

23. **Policy Action 2.5 (complied with).** The government will include a budget line under the MPDSP's 2016 budget for maintaining and updating the poverty-targeted Integrated Household Information Database in 2016.

24. The 2016 budget, approved in November 2015, allocated MNT471 million for maintaining and upgrading the Integrated Household Information Database. The database is the only one in the country that is poverty targeted. This allocation is essential to update the entitlements of the recipients of welfare benefits, and, in particular, to identify the new poor resulting from the economic stabilization and adjustment process, so they can be added to the database and access welfare benefits and social assistance.

25. **Policy Action 2.6 (complied with).** The government will establish an interministerial working group to analyze options and impacts (including gender analysis) to prepare a plan to further consolidate social welfare programs of the MPDSP.

26. On 29 February 2016 the Ministry of Finance established the interministerial working group through Ministerial Order No. 78 to analyze options for welfare benefits consolidation. The working group has representatives from the Ministry of Finance and the MPDSP. ADB has participated in the various meetings of the working group. Given the technical complexity of the subject, ADB has supported the deliberations of the working group with specialized consulting services.

27. Welfare programs in Mongolia focus on the provision of social pensions, allowances, and services to citizens with special needs who are in poor health, lack family, and are not

² Proxy means testing is a targeting methodology that estimates household income by associating indicators or proxies with household expenditure or consumption. The test assesses eligibility for government assistance, based upon whether the individual or household possesses the means for critical expenditures without that help.

³ ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Asian Development Fund Grants to Mongolia for the Food and Nutrition Social Welfare Program and Project*. Manila.

capable of living independently. Programs also support individual household members who require care or social welfare assistance to meet their minimum needs. The MPDSP administers 71 social welfare programs. Given the large amount of programs, consolidation and improved targeting will reduce administrative and implementation costs, as well as the duplication of benefits.

28. Consolidation of 71 programs is a long-term target which requires an in-depth analysis of the impact of consolidation on the recipients of welfare benefits. The working group has taken the first steps in this process by identifying proposals for consolidations that would be achieved at zero cost (i.e., reform does not involve extra budget but will maintain the current level of spending and, in some cases, generate savings). The following proposals have been discussed in the working group: the introduction of a poverty benefit, the reform of benefits for honored mothers, and the role of a disability allowance through which both cash and services could be provided. The working group also discussed steps to refine the scope of the proposed reforms, including due consideration of gender aspects in the consolidation process.

29. **Policy Action 2.7 (complied with).** The government will strengthen monitoring and evaluation of social welfare programs by ensuring budget allocations for the quarterly preparation of the Household Socioeconomic Survey are maintained in 2016.

30. The 2016 budget, approved in November 2015, allocated MNT1.1 billion for the quarterly preparation of the Household Socioeconomic Survey. This is critical to the strengthening of monitoring and evaluation of social welfare programs to ensure the effectiveness of the program.

IV. PROGRAM ASSURANCES

31. Appendix 2 details the status of the program assurances and shows that all assurances provided by Mongolia in the Loan Agreement remain valid.

V. CONCLUSION

32. Mongolia has complied with the required policy actions for the release of the second tranche before 31 December 2016.

VI. THE PRESIDENT'S DECISION

33. In view of the progress made in the implementation of the Social Welfare Support Program, as evidenced by full compliance with the seven second tranche policy actions, the President is satisfied with the overall implementation of the Social Welfare Support Program, and that the necessary conditions for the release of the second tranche have been fulfilled. In accordance with the established procedure, the President will authorize the release of the second tranche in the amount of \$50 million. The authorization shall be effective no less than 10 working days after the date of circulation of this progress report to ADB's Board of Directors.

Takehiko Nakao
President

12 April 2016

POLICY MATRIX

TRANCHE 1 (by Q3 2015)		TRANCHE 2 (before December 2016)	
Policy Actions	Implementation Status	Policy Actions	Implementation Status
Output 1. Fiscal policy management improved			
1. The parliament approved the Comprehensive Macroeconomic Adjustment Program.	Complied with (Required document: copy of Parliament approval of the Program)		
2. The government made the Budget Transparency Law effective.	Complied with (Required document: copy of published Law)		
3. The parliament approved the amended 2015 budget that reflected (i) a 7.3% reduction in expenditures, and (ii) a MNT228 billion increase in fuel tax revenue.	Complied with (Required document: copy of Budget Amendment)	1. The government will submit to parliament a second 2015 budget amendment to adjust fiscal expenditure ensuring that funding for social welfare programs is maintained.	Complied with (Required document: copy of the page showing the budget allocation)
4. The parliament approved the amended Fiscal Stability Law to (i) include budgetary expenditures financed by the Development Bank of Mongolia under the state budget, and (ii) to reflect a gradual reduction of fiscal deficit and debt levels to the original targets of the law (fiscal deficit level of 2% and debt level of 40% of GDP) by 2018.	Complied with (Required document: copy of Amended Fiscal Stability Law)	2. The government will submit to parliament a revised Development Bank of Mongolia Law to improve the bank's transparency and accountability, including (i) subjecting the bank to the central bank's supervision, (ii) ensuring independent investment decision making, and (iii) ensuring regular disclosure of financial statements.	Complied with (Required document: copy of Development Bank of Mongolia Law)
5. The president submitted the Future Heritage Law to parliament (Sovereign Wealth Fund).	Complied with (Required document: copy of the submission to parliament)		
6. The parliament approved the midterm debt management strategy, 2016–2018.	Complied with (Required document: copy of parliament's decree)		
7. The government terminated the Price Stabilization Program, and transferred the outstanding loans from the central bank to the state budget to be subject to the Fiscal Stability Law.	Complied with (Required document: cabinet resolution)		

TRANCHE 1 (by Q3 2015)		TRANCHE 2 (before December 2016)	
Policy Actions	Implementation Status	Policy Actions	Implementation Status
Output 2. Policies and regulations to support targeting and consolidation of social welfare programs improved			
8. The government increased funding for the Food Stamp Program by 80%, expanding both the benefit and coverage of the program.	Complied with (Required document: copy of the budget page stating the increase)		
9. The parliament approved the Revised Citizens' Health Insurance Law to subsidize health insurance contributions for household members in need of social welfare services.	Complied with (Required document: copy of revised Law)	3. The government, through the MPDSP, will issue a ministerial order requiring the Health Insurance Organization to ensure health insurance coverage for household members in need of social welfare services.	Complied with (Required document: copy of ministerial order)
10. The cabinet issued a decree to use the poverty-targeted Integrated Household Information Database across government programs.	Complied with (Required document: copy of cabinet decree)	4. The government will prepare a draft regulation for at least two ministries to use proxy means testing in selected programs.	Complied with (Required document: copy of draft government regulation)
11. The government allocated funding under the MPDSP budget to maintain and update the poverty-targeted Integrated Household Information Database in 2015.	Complied with (Required document: copy of the page showing the budget allocation in 2015)	5. The government will include a budget line under the MPDSP's 2016 budget for maintaining and updating the poverty-targeted Integrated Household Information Database in 2016.	Complied with (Required document: copy of the page showing the budget line)
		6. The government, through the prime minister, will establish an interministerial working group to analyze options and impacts (including gender analysis) to prepare a plan to further consolidate social welfare programs of the MPDSP.	Complied with (Required document: prime ministerial order for the establishment of the working group)
		7. The government will strengthen monitoring and evaluation of social welfare programs by ensuring budget allocations for the quarterly preparation of the HSES are maintained in 2016.	Complied with (Required document: copy of the page showing the budget allocation in 2016)

GDP = gross domestic product, HSES = household socio-economic survey, MPDSP = Ministry of Population Development and Social Protection.

Source: ADB

STATUS OF PROGRAM ASSURANCES

Assurances	Status
The Borrower shall cause the Program to be carried out with due diligence and efficiency and in conformity with sound applicable technical, financial, business and development practices. In the carrying out of the Program, the Borrower shall perform, or cause to be performed, all obligations set forth in Schedule 4 to the Loan Agreement.	Complied with
The Borrower shall make available, promptly as needed and on terms and conditions acceptable to ADB, the funds, facilities, services, as required, in addition to the proceeds of the Loan, for the carrying out of the Program and for the operation and maintenance of the Program facilities.	Complied with
The Borrower shall ensure that the activities of its departments and agencies with respect to the carrying out of the Program are conducted and coordinated in accordance with sound administrative policies and procedures.	Complied with
The Borrower shall maintain, or cause to be maintained, records and documents adequate to identify the Eligible Items financed out of the proceeds of the Loan and to indicate the progress of the Program. The Borrower shall enable ADB's representatives to inspect any relevant records and documents.	Complied with
As part of the reports and information referred to in Section 7.04 of the Loan Regulations, the Borrower shall furnish, or cause to be furnished, to ADB all such reports and information as ADB shall reasonably request concerning [(i) the Counterpart Funds and the use thereof; and (ii)] the implementation of the Program, including the accomplishment of the targets and carrying out of the actions set out in the Policy Letter. Without limiting the generality of the foregoing or Section 7.04 of the Loan Regulations, the Borrower shall furnish, or cause to be furnished, to ADB [quarterly] reports on the carrying out of the Program and on the accomplishment of the targets and carrying out of the actions set out in the Policy Letter.	Complied with