1 BRIEF REVIEW OF THE WORLD ECONOMY

1.1 Economic prospects and policy issues

After a series of adverse shocks in the first half of 2003, the green shoots of recovery are now increasingly evident and the balance of risks, in April tilted well to the downside, has improved significantly. However with the pace and robustness of recovery still unclear, and with continued low inflationary pressures, monetary policies should remain accommodating for the time being. Fiscal policies need to focus increasingly on medium-term consolidation, especially given the background of approaching demographic pressures. Widening global imbalances, and the continued dependence of global economic growth on the United States, underscore the need for accelerated structural reforms in many countries, along with measures to rein in the U.S. budget deficit over the medium term and, in some cases, a gradual move to greater exchange rate flexibility.

The war in Iraq was short, hence the resumed global recovery in the second half of the year, global growth picking up to 3.2 percent in 2003. After months of uncertainty, major hostilities in Iraq ended quickly and forward-looking indicators generally took an upturn with equity markets strengthening markedly accompanied by some pickup in business and consumer confidence in particular. Concurrent data initially remained weak with industrial production and trade growth slowing markedly in the second quarter, reflecting continued geopolitical uncertainties, the continued aftereffect of the equity price bubble burst and, particularly in Asia, the impact of Severe Acute Respiratory Syndrome (SARS). More recently, however, there have been growing signs of a pickup in activity, including investment, particularly in the United States, Japan and some emerging market countries, notably in Asia. With inflationary pressures subdued, macroeconomic policies have eased further across the globe. Interest rates have been reduced in Europe and the United States as well as in a number of other industrial and emerging market countries. Fiscal policy has also been further relaxed in the United States and in a number of Asian countries.

In mature financial markets, the combination of ample liquidity, monetary easing and the expectation that low interest rate policies would be maintained for longer than earlier anticipated drove long-run interest rates down to 40-year lows by mid-June. Since that time long-run interest rates have rebounded, most sharply in the United States, apparently reflecting growing expectations of recovery, higher inflation and the continued strong supply of government paper. In the currency market, the US dollar continued to depreciate through

Table 1. Overview of the World economic outlook (annual percent change)

	2000	2001	2002	2003 *
World output	4.7	2.4	3.0	3.2
Advanced economies	3.8	1.0	1.8	1.8
Major advanced economies	3.5	0.8	1.6	1.8
Other advanced economies	5.3	1.6	2.7	1.7
Euro area	3.5	1.5	0.9	0.5
Newly industrialized Asian economies	8.5	0.8	4.8	2.3
Developing countries	4.1	4.1	4.6	5
Countries in transition	6.6	5.1	4.2	4.9
World trade volume (goods, service)	12.6	0.1	3.2	2.9
Import				
Advanced economies	11.8	-1.0	2.2	2.8
Developing countries	15.9	1.6	6.0	5.1
Countries in transition	13.4	11.9	6.3	6.6
Exports				
Advanced economies	12.0	-0.8	2.2	1.6
Developing countries	15.0	2.7	6.5	4.3
Countries in transition	14.7	6.0	6.3	5.8
Commodity prices (U.S. dollars)				
Oil	57.0	-14.0	2.8	14.2
Nonfuel	1.8	-4.0	0.6	5
Consumer prices				
Advanced economies	2.3	2.2	1.5	1.8
Developing countries	6.1	5.8	5.3	5.9
Countries in transition	20.2	16.2	11.1	9.7
Six-month London interbank offered rate (LIBOR, percent)				
On U.S. dollar deposits	6.6	3.7	1.9	1.3
On Japanese yen deposits	0.3	0.2	0.1	0.1
On euro deposits	4.6	4.2	3.3	2.2

* Projections

mid-May, reflecting a combination of relatively low interest rates and continued investor concern over the large U.S. current account deficit. Since then the US dollar has strengthened somewhat but overall, since its peak in early 2002, it has fallen by some 12 percent in nominal effective terms, matched by the substantial appreciation of the euro, the Canadian dollar and some other industrial country currencies.

In emerging markets, financing conditions eased significantly through June aided by low industrial country interest rates and improved sentiment toward a number of key markets, most notably Brazil. Financing costs have risen since then, but spreads have continued to decline. With capital outflows from many countries slowing, net private capital inflows to emerging markets are projected to rise to over USD 110 billion in 2003, the highest level since the mid-1990s. Emerging market currencies have in general been little affected by the fall in the US dollar though most have depreciated in nominal effective terms since the dollar peak. In Asia, where large surpluses on both the current and capital accounts have continued to run, this has been accompanied by a substantial increase in reserves.

Commodity markets have continued to be heavily influenced by geopolitical developments, cyclicity and supply-side shocks. After peaking at over USD 34 a barrel before the war, oil prices fell back sharply in April before recovering somewhat to USD 30 by late August. This reflected a slower-than-expected recovery in Iraqi oil production, persistent tight industrial country inventories and concerns about the sustainability of production levels in Nigeria and Venezuela.

North America

After a year of solid recovery, GDP growth in the United States slowed markedly from mid-2002 onward due to rising geopolitical uncertainties in the run-up to war and the continued aftereffects of the equity price bubble burst. Amid weak demand and continued substantial excess capacity, inflation has fallen considerably with core CPI inflation still well below 2 percent. With the substantial depreciation of the US dollar over the past year only just beginning to show its effects, the external current account deficit has continued to break new records. In contrast to previous years it has been financed primarily by sales of government agency and corporate paper, including to a number of Asian central banks, rather than by equity inflows.

The end of war in Iraq was a fillip to a faltering global economic recovery that then regained some momentum. Second quarter GDP data proved stronger than expected, aided by a sharp rise in government expenditures, and there were increasing signs of a pickup in consumption (albeit due in part to very strong automobile sales) and private investment. Fiscal policy has since become even more stimulative with the passage of further tax cuts and higher defense expenditures and equity prices have risen markedly. The dollar has fallen significantly since its peak in early 2002 and long-term interest rates, despite experiencing a strong rebound since mid-June, are still low by historical standards. GDP growth in the United States is projected to be 2.6 percent in 2003.

Following impressive growth in the first three quarters of 2002, GDP growth in Canada has slowed considerably in recent months, reflecting the rapid and sizable appreciation of the Canadian dollar, weakened foreign demand and a slowed pace of inventory accumulation coupled with the temporary impacts of SARS and mad cow disease. Reflecting these factors, as well as the drop in core inflation to well within its 1-3 percent target range, the Bank of Canada acted in July and September to partially reverse earlier interest rate hikes. Reflecting the projected strengthening of U.S. activity, improving confidence and the fading impact of recent adverse shocks, growth is expected to pick up to 1.9 percent by the end of this year.

Western Europe

The Euro zone slowdown has been deeper and more prolonged than was widely expected and there are still relatively few signs of a broad pickup in real activity. GDP declined in the Euro zone as a whole in the second quarter of 2003 as well as in Germany, France and Italy

in particular. Despite some recent strengthening in expectations, household and business confidence indicators continue to reflect a general economic malaise. Unemployment continues to edge up and industrial production has yet to show sustained upward movement. The German economy remains weak for the third year in a row, adding to the below par performance of the Euro zone as a whole and threatening to hold back the region's prospects for recovery. Reflecting these developments, growth projections for the Euro zone have again been marked down by about 0.5 percent for 2003.

Looking at the main components of demand, investment spending has been a key weakness in recent years. Exacerbating this downturn has been low business confidence and, in Germany, the continued unwinding of the post-reunification construction boom. While still uneven across the area, consumption has picked up slowly over the past year and should be bolstered further by rising real incomes as inflation declines. Household balance sheets appear to be in generally good shape, with lower levels of debt and a higher savings rating than those in the United States. However low consumer confidence, reflecting concerns about rising unemployment, has so far offset these fundamental strengths.

External trading conditions have also been unfavorable to growth. While exports have been suppressed mainly by weak demand among the major economies, the substantial appreciation of the euro over the past two years weakens prospects for an export-led recovery as strong as those in past regional upturns. To date, euro appreciation has largely been offset through lower interest rates.

Turning to countries outside the Euro zone, growth in the United Kingdom weakened through the first half of 2003 reflecting a slowing of investment and private consumption as well as deteriorating external demand. However recent indicators, including business surveys and retail sales, point to an improving outlook. The labor market has been resilient with continued low unemployment and relatively stable growth in earnings. In July 2003 the Bank of England cut the basic rate of interest by 0.25 percent to 3.5 percent in response to weakening economic prospects, even though inflation remained above its target rate of 2.5 percent owing to temporary factors.

Fiscal policy has provided important support for activity during the current slowdown. These supportive macroeconomic policies, together with relatively favorable domestic conditions and a gradual improvement in external trade, should support stronger growth in the period ahead. Projected GDP growth in the United Kingdom for 2003 is 1.7 percent, down on 1.9 percent in 2002.

Elsewhere, the 2003 growth projections for Denmark, Norway and Sweden have been marked down to reflect weak domestic confidence, rising unemployment and a more challenging international climate. The central banks in all three countries have reduced interest rates since early June and with inflation still declining, further reductions could be considered if weak activity persists. However policy support already in the pipeline, together

Figure 1. Growth of World Real GDP

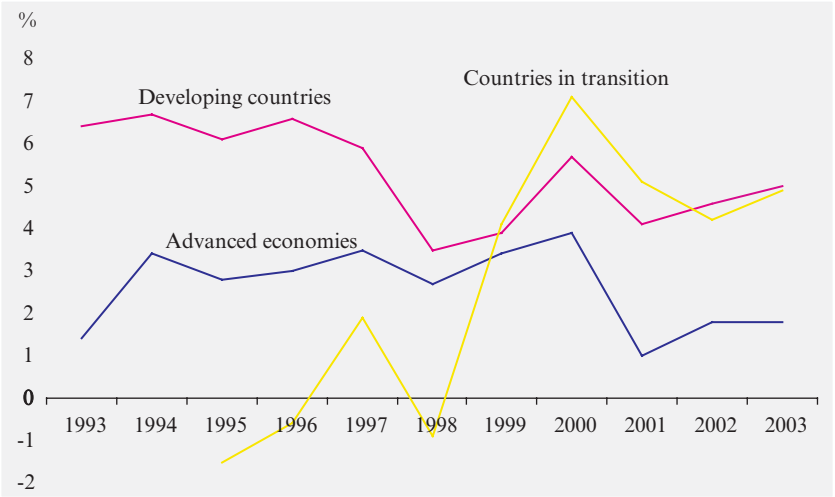


Figure 2. World Inflation rate

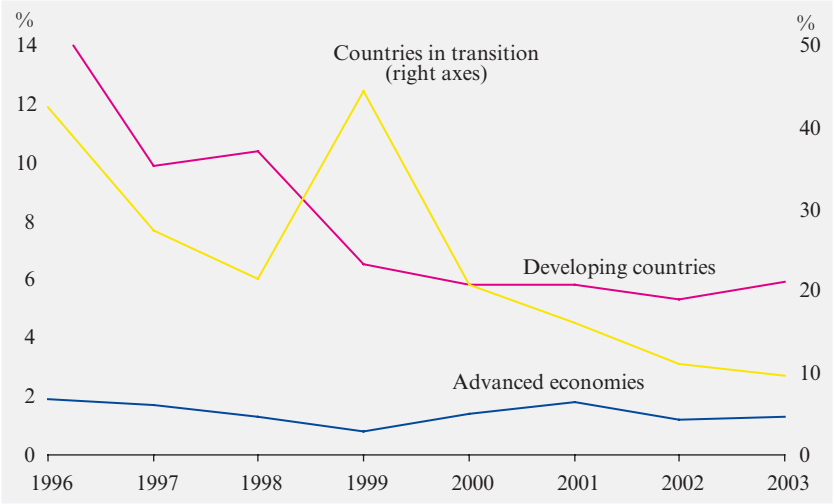
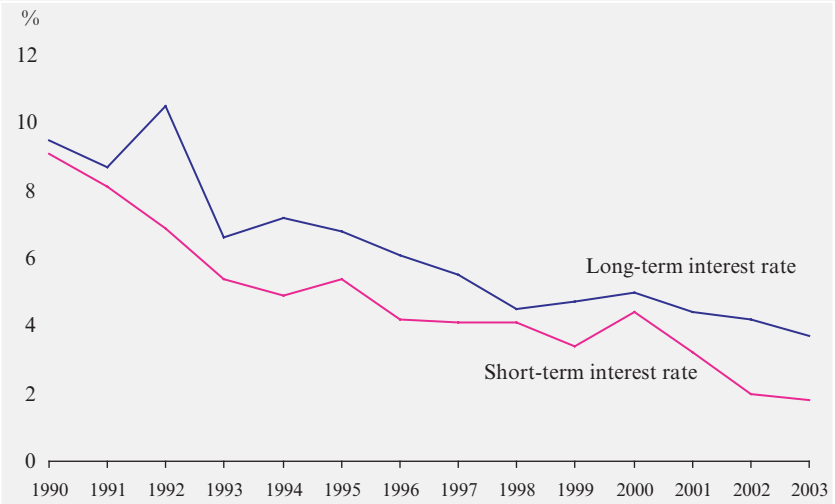


Figure 3. World long-term and short-term interest rate



with an improvement in external conditions, is expected to lead to a slow upturn in growth in the second half of 2003. Despite strengthening trade and supportive macroeconomic policies, activity in Switzerland is expected to show only modest improvement in 2003.

Japan

The initial estimation of actual second quarter growth in Japan significantly exceeded expectations and this, coupled with a further upward revision to the first quarter GDP outturn, an improved external environment and an upswing in stock prices has led to sizable increases (around 2 percent) in growth projections for 2003. Export growth has been strong and industrial production picked up from July, but retail sales continue to fall and the apparent strength of business fixed investment in national accounts data appears at odds with weaker trends in the shipment of capital goods and construction materials. Financial conditions are providing uneven support for recovery: while recent increases in equity prices are encouraging, bond yields have rebounded substantially from their all-time lows reached earlier this year.

Although risks have become more balanced, the outlook remains clouded by entrenched deflation and by persistent weaknesses in corporate, financial and public sector balance sheets. While a stronger global recovery could provide some upside for activity in the remainder of 2003 and into 2004, the economy remains vulnerable to a range of domestic and external shocks. Given the limited progress achieved in bank and corporate restructuring, falls in equity or bond prices could weaken corporate and financial balance sheets triggering a rapid cutback in bank lending and dampening investment. Other risks include the impact of sustained appreciation of the yen on corporate profits, investment, deflation and net exports. There is also a risk of a potential upsurge in household saving rates if uncertainty about the future outlook and the possibility that rising public debt could trigger sharply higher real interest rates increases.

To contain these risks, a bold strategy is needed that tackles the underlying weaknesses in the economy. Such a strategy would include: rapid and forceful measures to accelerate the disposal of non-performing loans; address the poor quality of capital in the banking sector; actions to promote more rapid corporate restructuring including the effective use of the newly established Industrial Revitalization Corporation of Japan (IRCJ), and a public commitment by the Bank of Japan to end deflation, backed by more aggressive quantitative easing and a detailed and ambitious plan to restore sustainability to Japan's public finances.

Latin America

A tentative recovery appears to be emerging in much of Latin America, although growth is highly differentiated across the region and political uncertainty continues to weigh heavily in some cases. The recovery reflects a number of factors, including swelling exports, helped

by stronger global growth and substantial real exchange rate depreciation. An improvement in the appetite for risk, which has underpinned a rally in emerging bond markets, pushed secondary market spreads to near all-time lows and produced expectations of improved policy fundamentals.

The recovery nevertheless remains fragile, even below the baseline of 1.1 percent growth for the region in 2003. A key risk is that the rally in emerging bond markets will not be sustained, undercutting growth prospects and macroeconomic stability. A fallback to greater risk aversion, rising industrial country interest rates or better prospects for mature-market investments are potential triggers for this. Sentiments could also be affected by policy slippages in the region or by further sovereign rating downgrades of heavily dollarized economies. Finally, political instability in some countries could undermine a gradually improving economic situation as well as progress with structural reforms.

Turning to individual countries, economic activity (including industrial production and construction) is recovering from a very low base in Argentina. Monthly inflation remains low and the trade balance has posted large surpluses. In Brazil, progress on the policy front has helped strengthen confidence as seen in the further appreciation of the Brazilian real. Nevertheless, growth remains weak due to large external borrowing requirements and the slowing of foreign direct investment inflows. In Venezuela, despite the recovery of oil production following the conclusion of industrial action in February, real GDP is expected to decline by 17 percent this year, bringing the cumulative decline to 26 percent over the past two years.

Asia-Pacific Region

Despite the slowdown since early 2003, the Asia-Pacific countries are again set to be the world's fastest growing region this year. Economic growth across the region is expected to be 5.9 percent in 2003 and then 6.2 percent in 2004. A notable feature of the region's recent performance has been the support to output growth provided by net exports. While domestic demand is clearly playing a greater role in the region than in the period immediately following the economic crisis, the global cycle remains a key determinant of cyclical development in the region. In the present climate, with the US dollar's decline necessitating a rebalance of global demand, the need to boost the domestic component of growth in Asia is ever more pressing. While accelerating structural reforms should be the centerpiece of a strategy to achieve this goal, greater exchange rate flexibility in some countries would also help.

The regional slowdown since early 2003 was due to uncertainties surrounding the situation in Iraq, surging oil prices and, subsequently, the impact of SARS. The drop in household credit growth in Korea, due to a tightening of prudential regulations, slower house price rises and rising credit card delinquencies, was also a factor. Notwithstanding the rapid expansion of interregional trade, export growth slowed in the early months of the year in several countries

BOX 1. SHADOW ECONOMIES: SIZE, GROWTH AND CONSEQUENCES

Underground, or shadow, economy activities, both legal and illegal, around the world are worth trillions of dollars a year of "off the book" activities, beyond the gaze of the taxman and government statisticians. Due to the sheer size of the shadow economy, it is important to understand what it is; how large it is (size and labor force); how much it is growing and has grown; why it is growing; how it affects the official economy, and how best to measure it.

Also known as the underground, informal, or parallel economy, the shadow economy includes not only illegal activities but also unreported income from the production of legal goods and services, either through monetary or barter transactions.

Table 1. Types of Underground Economic Activities

Type of activity	Monetary transactions		Nonmonetary transactions	
Illegal activities	- Trade in stolen goods, - Drag dealing and manufacturing, - Proctitution, - Gambling, - Smuggling, - Fraud, - Money loundering, - Corruption.		- Barter of drugs, stolen or smuggled goods. - Producing or growing drugs for own use. - Theft for own use.	
	Tax evasion	Tax avoidence	Tax evasion	Tax avoidence
Legal activities	- Unrepoted income from self-employment, - Wages, salaries, and assets from unreported work related to legal services and goods.	- Employee discounts, fringe, benefits.	- Barter of legal services and goods.	- All do-it-youself work and neihbor help.

Structure of table from Lippert and Walker, *The Underground Economy: Global Evidence of its Size and Impact*. Vancouver, B.C., The Frazer Institute, 1997.

How Large is the Shadow Economy?

Estimating the size of the shadow economy is difficult. After all, people engaged in underground activities do their best to avoid detection. But policymakers and government administrators need information on how many people are active in the shadow economy, how often underground activities occur and the scale of these activities, in order to make appropriate resource allocation decisions. To estimate the size of the shadow economy, researchers have focused on a sample of 84 countries, using a variety of estimation methods. The results show that for all 84 countries investigated, value added in the shadow economy has reached a remarkably large value.

Table 2. Shadow Economy as Percent of Official GDP, 1988–2000

Country group	*Percent of GDP
Developing	35-44
Transition	21-30
OECD	14-16

*The ranges reflect the different estimation methods used by different sources. Common estimation methods are described later in this booklet.

According to a survey conducted in 1998-99 in Africa, Nigeria and Egypt had the largest shadow economies: equivalent to 77 percent and 69 percent of GDP, respectively. South Africa, by contrast, had a shadow economy of only 11 percent of GDP. In Asia in the same period, Thailand ranked highest with a shadow economy worth 70 percent of GDP; Hong Kong SAR and Singapore had the smallest shadow economies, both at around 14 percent of GDP. In Latin America in 1998-99, the biggest shadow economy was in Bolivia where it was worth 67 percent of GDP, and the smallest was in Chile, at 19 percent.

Among the states of the former Soviet Union in 1998-99, Georgia's shadow economy was the largest at 64 percent of GDP; Russia's was 44 percent of GDP, and Uzbekistan's was the smallest at 9 percent. Among the transition countries of Central and Eastern Europe during the same period, Bulgaria's was largest at 34 percent of GDP and Slovakia's smallest at 11 percent.

Among the 21 OECD countries in 1999-2001, Greece and Italy had the largest shadow economies, at 30 percent and 27 percent of GDP, respectively. In the middle group were the Scandinavian countries and at the lower end were the United States and Austria, both at 10 percent of GDP, and Switzerland at 9 percent.

Shadow Growth and Labor Force

In most transition and all investigated OECD countries, the shadow economy has been growing rapidly (the trend in developing countries as a group cannot be judged accurately for lack of data). Shadow economies grew between 1990 and 1998 in the states of the former Soviet Union, from about a quarter to more than a third of GDP, while in central and eastern European states shadow economies remained relatively stable at about a fifth of GDP.

Among the 21 OECD countries surveyed the shadow economy has been growing for 30 years - doubling from less than 10 percent of GDP in most of these countries in 1970 to 20 percent of GDP or more by 2000 in Belgium,

Denmark, Italy, Norway, Spain and Sweden. Growth has also occurred in countries with smaller shadow economies: in the United States, for example, the shadow economy doubled from 4 percent of GDP in 1970 to 9 percent in 2000.

Participation in the shadow labor market has also been rising. The shadow labor market includes all cases where employees, employers or both hold a shadow economy position - regardless of whether they also have officially recorded positions. Some workers in the shadow economy take on second jobs after or even during their regular hours in official employment. Others work entirely within the shadow economy, either because they find it more profitable to do so or because they are barred from the official economy as is the case for illegal immigrants, for example.

In the European Union in the late 1990s, 20 million people engaged in shadow economy activities. In all European OECD countries combined, about 35 million people did so. In some individual countries, the shadow economy labor force was very large: in Italy, it accounted for 30-48 percent of the total labor force (1997); Spain, 12-32 percent (1997-98), and Sweden 20 percent (1997-98). In many countries, these high shares coexisted with high official rates of unemployment.

Taxes and social security contributions add to the cost of labor in the official economy and hence are key factors driving the growth of the shadow economy. The bigger the difference between the total cost of labor in the official economy and the after-tax earnings from work, the greater the incentive for employers and employees to avoid this difference and participate in the shadow economy.

Few studies empirically investigate the relationship between corruption and the shadow economy, but those that do so observe that countries with more corruption have relatively larger shadow economies. Corruption is essentially the abuse of public power for private benefit.

Effects on the Official Economy

A change in the size of the shadow economy may be reflected in a change in:

- Monetary indicators: shadow economy transactions tend to be in cash. Rising activity in the shadow economy is likely to push up the demand for currency.
- Labor market participation rates and working hours: as growing numbers of people work in the hidden sector, participation rates in the official economy may fall. Similarly, as people work more hours in the hidden sector, hours worked in the official economy may fall.
- Output statistics: as the shadow economy grows production inputs, especially labor, move at least partly out of the official economy. This displacement may depress the official growth rate of the economy.

Measuring the Shadow Economy

Analysts and policymakers need to know that estimates of the shadow economy can vary widely depending on the estimation method used. There is no "best" estimation method; each approach has strengths and weaknesses, and yields its own insights and results. Table 3 describes common methods of which the *currency demand* and *latent variable* approaches are the most widely used.

Table 3. Ways of Measuring the Shadow Economy: Different Methods[1]

Method	Main features
Direct approaches	
• Sample survey	Estimates size of shadow economy from survey data.
• Tax audit	Estimates size of shadow economy from audit measurements of undeclered taxable income.
Indirect approaches	
• National accounting statistics	Estimates size of shadow economy on basis of the discrepancy between income and expenditure statistics in national accounting or in individual data.
• Labor force statistics	Estimates growth in shadow economy on basis of decline in labor participation in the official economy, assuming the labor force has a constant participation rate overall.
• Transactions	Uses data on the overall volume of monetary transactions in the economy to calculate total nominal (unofficial plus official) GDP, then estimates size of shadow economy by subtracting official GDP from total nominal GDP.
• Currency demand	Estimates size of shadow economy from the demand for cash, assuming shadow transactions are undertaken in cash and that an increase in the shadow economy will raise demand for cash.
• Physical inputs (electricity onsumption)	Estimates growth of shadow economy from electricity consumption, assuming that electricity consumption is the single best physical indicator of overall economic activity. Subtracts the growth rate of official GDP from the growth rate of total electricity consumption and attributes the difference to the growth of the shadow economy.
Models	
• Latent variable approach	Estimates the size of the shadow economy as a function of observed variables that are assumed to influence the shadow economy-for example, the burden of taxation, the burden of government regulation-and of variables where shadow economic activities leave traces, like cash, official working time, unemployment, etc. Advantageous method because it considers multiple causes and effects simultaneously.

[1]For a detailed description of the different methods, see Friedrich Schneider and Dominik Enste, "Shadow Economies: Size, Causes, and Consequences," *The Journal of Economic Literature*, 2000, 38/1, pp 77–114.

The Shadow (Informal) Economy in Mongolia

Shadow economic activities are a fact of life around the world and almost all societies engage in attempts to control these activities. Size, causes and consequences vary in different countries, but there are some comparisons that can be made that might be of interest to parties who deal with the phenomenon.

In this case, we tried to approximate the size of the shadow (informal) economy in Mongolia resulting in the estimation above (Table 2.). If we use estimation methods used in developing countries, it is worth 35-44 percent of GDP, or USD 383.1 to 481.6 million, while according to estimation methods used for transition countries, it is worth 21-30 percent of GDP, or USD 229.8 to 328.4 million. The average between the two estimations is 32.5 percent of GDP, or USD 355.7 million. This is based on 2002 figures.

Several studies have been made into the informal sector in Mongolia: Anderson, James H. (1998), "The size, origins, and character of Mongolia's informal sector during the transition"; Bikales, B., Khurelbaatar, Ch., Schelzig, K. (1999), "The Mongolian informal sector: survey results and analysis"; Morris, E. (2001), "The informal sector in Mongolia". They all describe the size, type, activity, growth and labor force involved in Mongolia's informal sector. Due to lack of data, these studies are limited to using survey, questionnaire and interview methodologies, or in other words, to direct approaches. According to one study (Anderson, 1998) the size of the Mongolian informal sector fluctuates between 30-38 percent of GDP, which is approximately the same as the previous estimation. In future, it is recommended that data of this area be compiled and processed and that indirect and model approaches be used together in examinations of the shadow (informal) economy.

Implications for Action

As mentioned earlier, an increase in the size of the shadow economy is likely to result in reduced state revenues, which in turn reduces the quality and quantity of publicly provided goods and services. Ultimately this can lead to an increase in tax rates for firms and individuals, quite often combined with deterioration in the quality and administration of public goods such as roads and hospitals provided by the government.

On the other hand, two thirds of the income earned in the shadow economy is immediately spent in the official economy. This can be a boost for the official economy and may lead to additional overall economic growth. The growth of the shadow economy therefore affects everyone but it is difficult to evaluate whether the shadow economy ultimately has a positive or negative effect on the official economy.

The major driving forces behind the size and growth of the shadow economy appear to be an increasing burden of taxation and social security payments combined with more pervasive state regulatory activities. Weak and arbitrary enforcement of laws and regulations encourages shadow economic activity. These findings emphasize the importance of the rule of law in curbing both corruption and associated shadow economic activity.

The findings contain some useful implications for policymakers:

- Even major reductions in tax rates will not substantially reduce the shadow economy, but they may stabilize it.
- Marginal tax rates are more relevant to people's shadow-economy work decisions than are average tax rates; replacing direct taxes with indirect taxes is unlikely to improve tax compliance.
- More frequent tax audits and heavier penalties for tax evasion may reduce the size of the shadow economy.
- Governments should put more emphasis on legalizing certain shadow economy activities, for example by liberalizing the labor market.
- Reforms that liberalize regulations and make the economy more competitive reduce incentives for corruption and encourage firms to move from the shadow economy into the official one.
- Governments should put emphasis on the rule of law and on the strict enforcement of a minimum necessary set of regulations, rather than on increasing the number of regulations.

Source: www.mongolbank.mn

including Korea and Philippines – largely a reflection of weakness in the electronics sector. In China GDP growth, led by exports and strong investments, hit 10 percent in the first quarter before slowing in the second quarter, mainly due to the impact of the SARS virus. The epidemic's impact has been most visible in tourist arrival and retail sales figures, especially in Hong Kong and Singapore.

For the most part, the policy response to weaker growth has been appropriate. With inflation contained, monetary policy has been eased in a number of countries, though the continued buildup of official reserves suggests that reforms to increase exchange rate flexibility remained largely on hold. Fiscal stimulus has also been provided in a number of countries to offset the impact of SARS on hard-hit sectors. The scope for easing fiscal policies, however, is much more constrained in countries with chronically high public debt levels, such as India and the Philippines, or where there are significant weaknesses in the banking sector. Beyond macroeconomic policies, the key issues remain: to resolve issues surrounding non-performing loans (China, Indonesia, the Philippines, Thailand); to strengthen insolvency laws to facilitate loan workout and corporate restructuring (India, Korea, the Philippines, Thailand); to implement further corporate governance reforms including strengthening accounting and auditing practices (Korea), and to return banks to private ownership to ensure market-based intermediation practices (Indonesia, Korea).

European Union Candidates

Among European Union (EU) accession countries, growth is picking up and the short-term outlook is generally favorable. GDP growth for these counties is expected to be 3.9 percent in 2003 and to reach 4.3 percent in 2004. Of late, growth has generally been supported by both exports and private consumption. Export-driven GDP growth is expected to further accelerate which, along with strengthening corporate profits, is also projected to stimulate investment spending. While exports have thus far been strong, growth prospects in the EU accession countries are heavily dependent on the pace of recovery in the Euro zone, as merchandise exports to the Euro zone account for 10-35 percent of GPD in most of these countries. Another threat to growth is the euro's appreciation since February 2002, which has led to some real effective appreciation in those countries whose currencies are closely tied to it. Countries with a greater balance of exports going to the Euro zone and larger real effective appreciation have seen more strongly negative contributions of net exports to growth.

While structural reforms and EU accession will underpin growth over the medium term, there are a number of risks around this broadly favorable baseline. Fiscal positions are already difficult in many countries and an aging population will exacerbate this along with spending pressures arising from compliance with EU environmental standards. The banking systems appear mostly sound, but private credit has recently experienced rapid growth and EU entry will likely stiffen bank competition and put pressure on margins. External current account deficits are generally large and, in some countries, are already in unwelcome territory. Finally,

there is the risk of sudden capital outflows, as some recent inflows appear to have been driven largely by short-term considerations.

In light of these risks, it is essential to make early and substantial progress on fiscal consolidation, to enhance the monitoring of banking systems and to aggressively pursue growth-enhancing structural reforms. The still-favorable economic environment in the accession countries is conducive to such reforms being undertaken. With EU membership slated for mid-2004 in most countries, the EU candidates' goal of adopting the euro could be an important disciplining force for delivering policies that promote macroeconomic stability.

Commonwealth of Independent States

Commonwealth of Independent States (CIS) countries have continued to weather the growth slowdown in advanced countries, and the ensuing uneven recovery, better than expected. Over1999-2002 GDP growth averaged about 7.5 percent. This was aided initially by Russia's rebound from financial crisis in 1998, and then by rising oil prices and - linked to this rise – higher government expenditures and energy sector investment. Current indicators suggest that economic activity in 2003 has remained robust and GDP growth in the region is projected at 5.8 percent for the year as a whole: 1.4 percentage points higher than expected at the same time last year. This is largely due to continued strong growth among the net energy exporters, most notably Russia. With a few exceptions, GDP growth elsewhere is expected to moderate slightly, reflecting a weakening of consumption growth.

The external current account surplus of the region is expected to weaken over 2003-2004, reflecting continued robust demand growth, the recent fall in oil prices and increased import demand related to foreign direct investment (Azerbaijan, Georgia and Kazakhstan). Within this general picture, Russia is expected to remain in continued, if declining, surplus. With strengthened net capital inflows in a number of countries, reserves have risen for some, particularly Russia and Kazakhstan. By contrast, net energy importers are projected to register rising, and in some cases sizable, deficits: this is a particular concern for poor and highly indebted CIS countries (Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan). While these countries need to maintain appropriately tight fiscal policies, a number also require additional international assistance to ensure progress toward sustainable external debt positions.

Inflation rates across the region have continued their decline, but remain relatively high compared with other developing countries. Among most of the advanced reformers, inflation is comfortably into single digits while in Russia it remains relatively high. Inflation in less advanced reformers, while declining, continues to be stubbornly high, particularly in Belarus and Uzbekistan. In most CIS countries the process of remonetization has continued to pose important challenges. With the pace of remonetization difficult to predict, policymakers face unusual difficulty in judging underlying money demand in managing banking system risk, underscoring the need for further improvements in prudential regulation and supervision.

Figure 4. World market price of gold

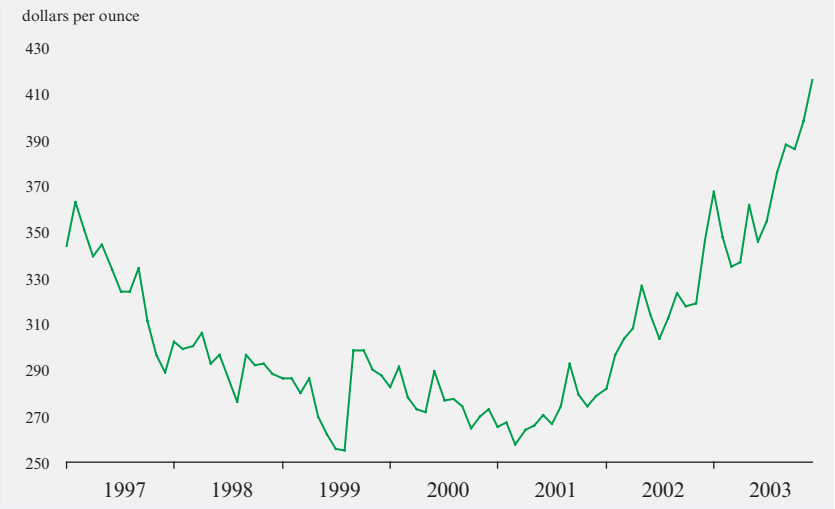


Figure 5. World market price of copper

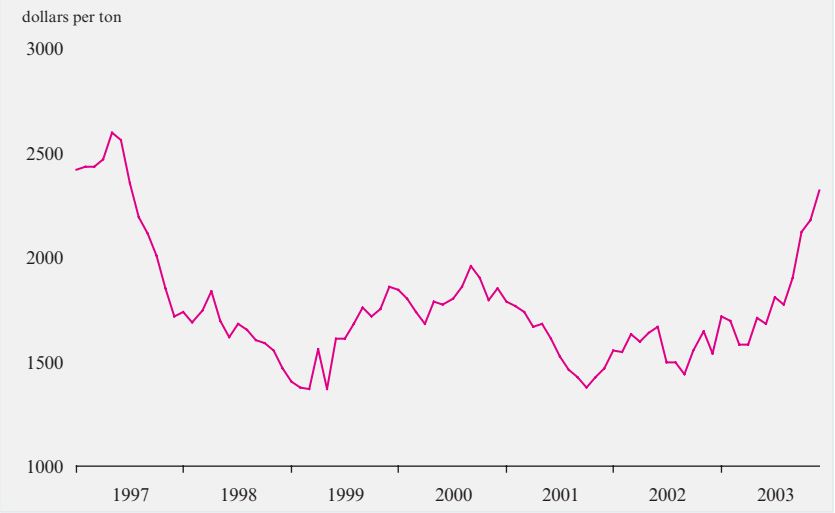
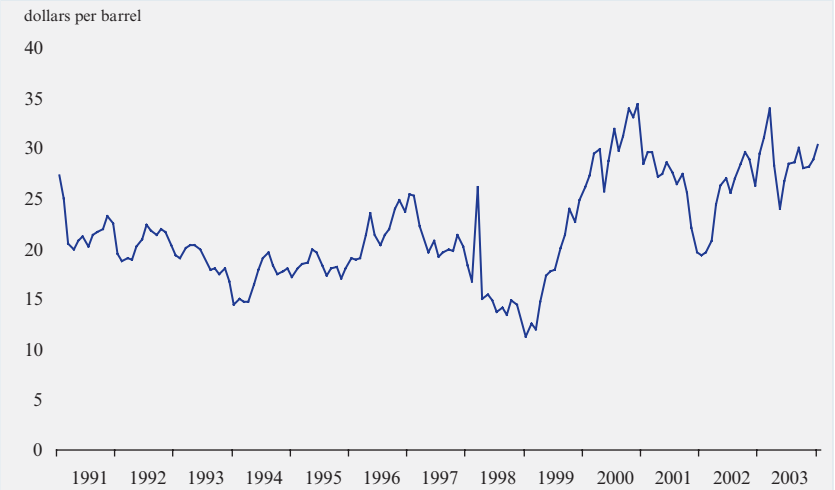


Figure 6. World market price of crude oil



1.2 World market prices and interest rates

Exchange rates among the industrialized countries have been substantially realigned since the peak of the US dollar in February 2002. Most significant has been the dollar's depreciation against the euro – a fall of 20 percent from early 2002 to the end of the August 2003. But also noteworthy has been the dollar's weakening against the yen, the pound sterling and the Canadian dollar (down 10 to 12 percent in each case) and against the Australian dollar (down 20 percent). Trade-weighted currency movements have been less dramatic than bilateral changes. The US dollar has fallen by 11 percent in nominal effective terms, partly reflecting the fact that about half U.S. trade is with developing countries whose currencies have remained stable or depreciated against the dollar over recent years. China and Mexico are the largest suppliers of U.S. imports after Canada, with China maintaining a de facto fixed exchange rate against the dollar and the Mexican peso depreciating about 17 percent against it. Individual Euro zone economies have also faced much smaller effective exchange rate appreciation than is suggested by the euro/dollar change – reflecting the significance of intra-European trade together with the increasing volume of trade with Central and Eastern Europe. For instance, Germany and France have experienced nominal effective exchange rate appreciation of only 5 to 6 percent since early 2002.

In most regions, monetary policy changes have reinforced, or helped to offset, the impact of recent exchange rate developments on overall monetary conditions. In the United States and United Kingdom, monetary conditions have eased significantly since early 2002 as a result of both lower interest rates and weaker currencies. In the Euro zone, monetary conditions have been broadly stable over this period with interest rate reductions offsetting the impact of the euro's appreciation. In Japan even with massive foreign exchange market intervention, the authorities have only managed to stem the appreciation of the yen, rather than engineer a desirable easing of monetary conditions to tackle entrenched deflation.

1.3 World market commodity prices

In March 2003, world oil prices fell from over USD 34 a barrel to USD 25.50 a barrel as military action against Iraq became a certainty. War-related disruptions to oil supply were limited to Iraq, with increases in ouptut by other OPEC members broadly offsetting the loss of Iraqi crude oil exports, though there was also a partial loss in Nigerian output in March and April due to civil unrest. The post-strike recovery of Venuzuelan production proceeded more quickly than had been anticipated, but questions remain about the extent and sustainability of its recovery. Production in Saudi Arabia also expanded markedly during the period March to May. A seasonal decline in oil consumption, which followed a surge in demand due to colder-than-expected winter weather in North America, also exerted downward pressure on oil prices. Nevertheless, industry oil inventories, which had fallen in early 2003 to their lowest level in decades, remained low and - together with increased demand from U.S. electricity generation plants, the announcement of a cut in OPEC's production target, and setbacks in the recovery of Iraq's oil production – this has caused oil prices to rise again

since May. Since then, world oil prices have been fluctuating about a general upward trend.

Non-energy commodity prices were dampened in the first half of 2003 by weak demand due to war-related uncertainties, SARS-related concerns, and the slower than anticipated pace of economic activity. As a result, the non-energy commodity price index fell by 3.8 percent in SDR terms in the first half of 2003. Owing to the depreciation of the US dollar against other major currencies however, non-energy commodity prices rose in dollar terms by 1.6 percent during the first half of the year.

Recent developments in industrial metals prices highlight their relationship with global industrial activity. Metal prices eased in SDR terms during the second and third quarters of 2002 as global economic prospects weakened before picking up modestly toward the end of 2002 and the start of 2003 as overall economic indicators strengthened. However, industrial metals prices softened once again in the second quarter of 2003 as the pace of global recovery proved more tepid than previously expected.

2 BRIEF REVIEW OF THE DOMESTIC ECONOMY

2.1. General overview

During the reporting period, the Government of Mongolia and the Bank of Mongolia's policies were aimed toward intensifying economic and social innovations by stabilizing the macro economy, promoting growth, improving the state budget and finance, diminishing debt burdens and supporting export-oriented private business.

As a result of the Bank of Mongolia's monetary policy, which aimed at achieving these goals, stability in the financial sector has been strengthened and financial intermediation has been intensified. Furthermore, steady prices for goods and services and stable exchange rates have contributed positively to the overall growth of the economy.

Bolstered by clement weather conditions compared with previous years, agricultural sector production has seen a recovery. Moreover, industrial production increased by 2.0 percent and, according to preliminary estimates, GDP growth for 2003 is 5.5 percent. Compared with 2002, the contribution of industrial and agricultural sector production to GDP decreased by 1.2 and 0.2 points to 25.0 and 23.3 percent respectively.

Table 2. Annual real GDP growth (percent)

	1996	1197	1998	1999	2000	2001	2002	2003
GDP	2.4	4.0	3.5	3.2	1.1	1.0	4.0	5.5
Agriculture, hunting and forestry	4.4	4.3	6.4	4.2	-14.9	-18.5	-10.7	4.5
Mining & quarrying	6.1	5.6	4.9	3.2	6.6	9.6	-6.9	-1.2
Manufacturing	-13.8	-15.0	3.2	-2.8	-3.3	31.8	22.1	2.4
Electricity, thermal energy	0.7	0.4	3.2	4.6	0.4	3.5	3.9	1.1
Construction	2.6	-2.7	-1.1	1.6	-14.6	10.8	18.5	12.6
Wholesale & retail trade	0.3	17.1	-3.1	1.3	26.1	9.8	13.3	9.6
Transport, storage & communication	11.2	5.8	7.4	6.1	25.2	14.9	16.2	16.5
Financial intermediation	42.2	-26.7	-33.0	39.9	7.0	22.4	7.3	13.5
Real estate, renting & business activities	4.2	-2.4	8.4	-4.7	12.5	7.1	25.2	1.9
Education	4.0	4.1	6.8	4.6	3.2	1.3	4.9	-4.3
Health & social security	4.4	3.0	1.4	3.1	-0.1	4.6	2.9	-4.7
Community, social & personal services	0.8	6.2	5.3	0.5	57.1	10.4	49.2	1.7
Indirect services of financial institutions	15.6	-7.5	-16.6	7.0	30.5	27.1	1.6	9.5

Although money supply (M2) increased by 49.6 percent, its effect on inflation was negligible. Therefore, the annual inflation rate, based on the consumer price index, was 4.7 percent, and so the goal specified in the State Monetary Policy Guidelines for 2003 has been met. The ratio of broad money (M2) to GDP, which represents the level of economic monetization, was 25.4 percent in 2000, 29.7 percent in 2001, 37.9 percent in 2002 and it stepped up to 51.6 percent in 2003.

During the reporting year, Chinggis Khaan non-bank financial institution (NBFI) was granted banking license and 34 NBFIs were newly established. At the same time, 5 existing NBFIs had their licenses revoked. Therefore, as of the end of 2003, 17 banks and 88 NBFIs were operating in Mongolia.

In 2003 savings and loan volumes reached MNT 363.5 billion and MNT 442.1 billion respectively. This represents a considerable jump in savings, up 66.4 percent, and in loans, up 91.0 percent on 2002. Non-performing loans soared by MNT 20.1 billion to MNT 36.7 billion, representing 8.3 percent of all loans – up 1.1 points on the previous year. Although interest rates are relatively high, they are showing a tendency toward gradual reduction. The weighted average of banks' loans in domestic and foreign currency decreased by 1.9 and 0.2 points to 31.5 and 19.6 percent respectively.

As a result of the Mongolian People's Revolution in 1921, opportunities to establish banking and credit systems first became feasible. In 1924 the first bank, the Mongolian Trade and Industrial Bank, opened its doors to customers and thereby laid the first milestone in the 80-year history of the Mongolian banking system. From 1924 to 1990 a one-tier banking system was used and the only bank, the State Bank of the Mongolian People's Republic, conducted banking activity through its branches and offices. In 1991 the Baga Khural (the Parliament of that time) approved the Banking Law and so the legal framework for a two-tier banking system was established.

During the early years of transition to a market-oriented economy (1991-1996) many banks fell into bankruptcy and the stability of the financial system was threatened due to weaknesses existent in the legal and supervisory frameworks, the inadequate skills of banks management and poor accounting practices. As a result of decisive actions to overcome these crises, the banking sector began to show signs of recovery from 1999. Today, security and robustness have been achieved in the banking and financial sector and as a result the sector is successfully performing its financial intermediation role. The 80th anniversary of the establishment of the banking system in Mongolia will be celebrated in June 2004.

As a result of the privatization of formerly state-owned banks conducted over the last few years, best practices of international banking management have percolated through, been adopted and integrated into the Mongolian banking system. Last year, the state-owned Agricultural Bank was sold to Japanese HS Securities for USD 6.8 million. The company extended management contracts, first appointed by the US DAI Group, which was working

Figure 7. Real GDP growth rate

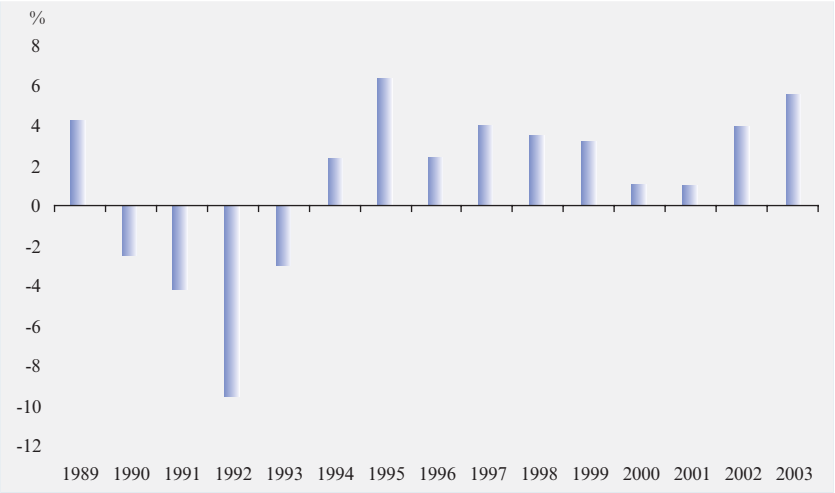


Figure 8. GDP growth by sector

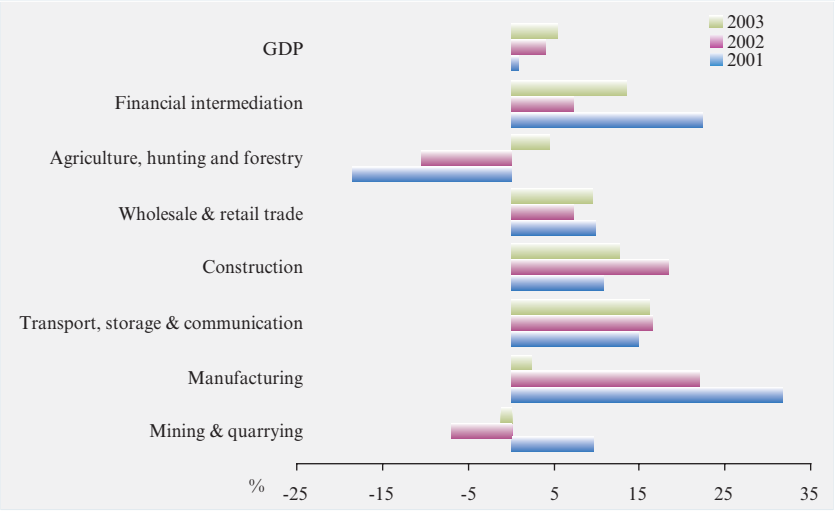
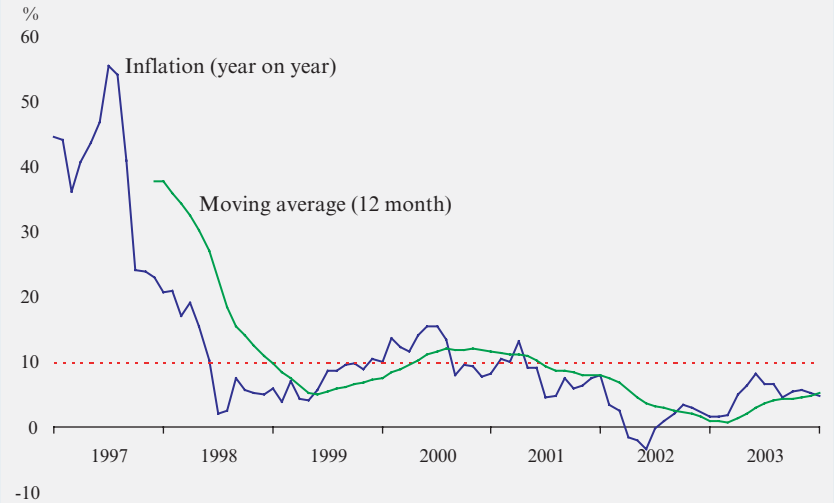


Figure 9. Inflation rate



at the bank, and it is also intending to make additional investments worth USD 13 million in the bank. In addition, Trade and Development Bank of Mongolia signed management cooperation contracts with ING Bank in 2003.

One of the major events in the Mongolian financial sector was the USD 5.8 million privatization of the Mongol Daatgal Company, which represented approximately 90 percent of the Mongolian insurance industry, to Angara-CKB - a financial conglomerate composed of the Russian Angara Insurance Company and the Chinggis Khan Bank, incorporated in Mongolia.

The Government labeled the year 'Visit Mongolia 2003', and in accordance with this announcement took numerous actions to advertise Mongolia in foreign countries and to attract foreign tourists. In the event the number of tourists that visited Mongolia increased by 3,096 people, but growth in the tourism sector as a whole was down on the previous year due to fears arising from the SARS outbreak in Asia.

The 10th convention of Mongolian Donor Countries, which ran under the slogan "Implementing Strategy to Facilitate Economic Growth and Alleviate Poverty", was successfully organized in Tokyo, Japan, in November 2003. Representatives from 16 different countries, over 10 private entities and over 10 non-government organizations participated in the convention. The participants agreed to extend further official assistance to Mongolia to a value of USD 335 million. Over the last decade, Mongolia has received grants totaling USD 1.3 billion and has borrowed USD 1.1 billion on favorable terms. Assistance rendered by the Japanese, U.S. and German governments represent 50, 11 and 9 percent respectively of the total amount of assistance.

Last year 98 percent of the credit, denominated in convertible Russian roubles and borrowed by the Mongolian Government from the Russian Federation during the Soviet era, was relieved under favorable conditions.

In 2003, Mongolian budget income reached MNT 553.9 billion, while total expenditures climbed to MNT 615.8 billion. Both figures were higher than the previous year figures, by MNT 76.9 billion and MNT 65.3 billion respectively.

The Mongolian parliament introduced amendments in legislation to reduce the tax burden; the marginal rate of taxation for organization and corporate income in the highest bracket was reduced from 40 to 30 percent.

Industry

During the reporting period, total industrial production was MNT 276.6 billion (at 1995 base price) which is MNT 5.5 billion, or 2.0 percent, up on the previous year's output. This was due to a 6.7 percent jump in the production sub-sector, and 1.0 percent increases in the

production of electricity, thermal energy and water distribution. However, mining and natural resource exploration fell by 1.0 percent.

New production such as the extraction of peat, crude oil, petroleum and natural gas, other mining and quarrying, food production, beverage, cigarette and clothing manufacture, fur dressing and dyeing, timber and wood manufacture and water purification and distribution all increased. However, the mining of metal ores, manufacture of textiles, tanning and dressing of leather, manufacture of footwear, chemicals and furniture all experienced falls.

Held against 2002, the share of trade attributable to the mining and natural resources sector went up by 3.4 percentage points while the production sub-sector share fell by 1.3 points and utilities by 2.1.

Of 208 commodities included in the statistical compilation list, the production of 92 products including electricity, crude oil, coal, molybdenum concentrate, fluorspar concentrate, metal moulds, metal foundries, lumber, carpets, wheat flour, soft drinks, bread, bakery products, milk and dairy products increased.

During the reporting year, 2.5 billion kilowatts of electricity, 5.6 million tons of coal and 6.6 million gkal of thermal energy were produced. These figures represent a 2.2 percent increase in electricity output, a 5.0 percent rise in coal exploration and a 2.1 percent fall in thermal energy production.

In 2003, MNT 793.2 billion (at current prices) of industrial products were sold on the domestic and foreign markets.

Agriculture

During the reporting year, crop yields and head of livestock increased on 2002 due to relatively clement weather conditions.

Preliminary results of the annual livestock census suggest that 25.3 million livestock were counted, 255,600 of which were camels, 2.0 million horses, 1.8 million cattle, 10.7 million sheep and 10.6 million goats. The total number of livestock increased 5.9 percent, or 1.4 million, on the previous year. If we consider livestock variations by type, it is shown that camels increased by 2,600, sheep by 69,600 and goats by 1.5 million, while the number of horses fell by 3,600 and the number of cattle by 100,000.

The preliminary results suggest that the aggregate number of livestock increased by 0.8-27.2 percent in the 15 aimags, but that the number of livestock in the central area, which experienced severe weather conditions over the last year, decreased.

The proportion of female livestock in 2003 was found to be 80.1 percent, or 8.4 million, an increase of 12.2 percent on 2002. Within this figure, goats showed the highest change with a rise of 20.5 percent, followed by camels (10.3), sheep (7.3), horses (5.8) and cattle (5.3). Of all offspring produced 93.4 percent, or 7.9 million, survived. This figure is 1.1 million higher than in 2002 and the percentage survival rate is 5.6 points higher than in 2002.

In total 1.3 million head of livestock were lost; 1.6 million less than in 2002.

During the reporting year 165,000 tons of wheat, 78,700 tons of potatoes, and 59,600 tons of other vegetables were harvested. Compared with figures from the previous year, wheat production rose by 31.1 percent, or 39,200 tons, potato production rose 51.6 percent, or 26,800 tons and production of other vegetables rose 50.1 percent, or 19,900 tons.

Of the total crop, 49.2 percent was harvested in Selenge Aimag, 13.0 percent in Bulgan Aimag and 12.2 percent in Tuv Aimag. The potato harvest broke down as 23.5, 18.0, 9.3, and 7.2 percent in Tuv, Selenge, Ulaanbaatar and Hovd aimags respectively. 22.9 percent of the total vegetable crop was harvested in Selenge Aimag, 17.5 percent in Tuv Aimag, 15.9 percent in Darkhan-Uul Aimag and 8.6 percent in Ulaanbaatar.

On average, 790kg of wheat and 9,340kg of potatoes were produced per hectare, compared with 570kg and 5,640kg, respectively, in the previous year.

830,800 tons of grass and 28,400 tons of supplementary livestock feed were prepared in 2003. This is an increase of 10.2 percent, or 77,100 tons, and 12.5 percent, or 3,200 tons, respectively on 2002.

Construction

In the reporting year, construction companies undertook construction and capital repair work valued at MNT 131.9 billion, 38.3 percent more than in the previous year. Of all work done, 69.9 percent was completed by domestic companies and 30.1 percent by foreign companies. In comparison with the previous year, domestic companies' construction and capital repair work rose by MNT 20.9 billion while the value of work undertaken by foreign companies rose by MNT 15.5 billion. Also large-scale projects including laying electrical cables, the construction of apartment complexes, road construction and repair, and the building of hospitals, schools, and trade centers were completed at a total cost of MNT 42.5 billion. This was 2.6 times higher than in 2002.

During the reporting year, corporations such as the Great Construction Company and Construction Company drew finances from the sale of bonds.

Since 2002 the Asian Development Bank has implemented a project to assist in providing apartments for the public, lending to low income households to finance their housing and

Figure 10. Consumer Price Index

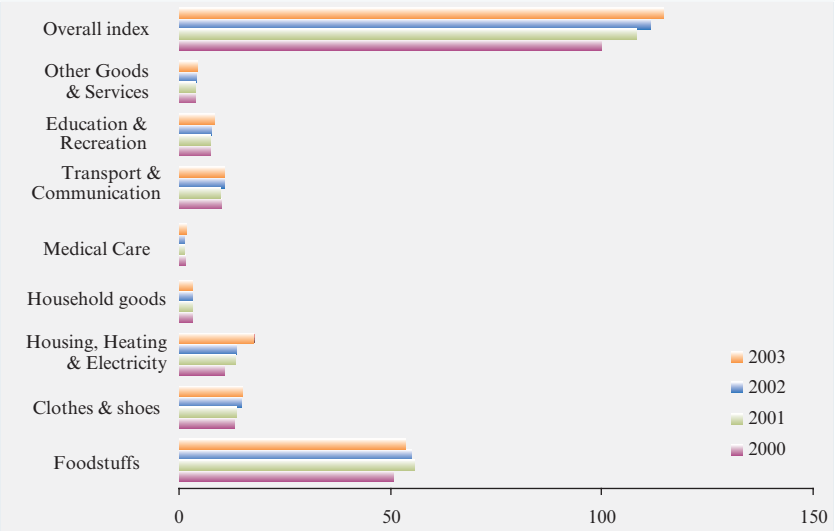
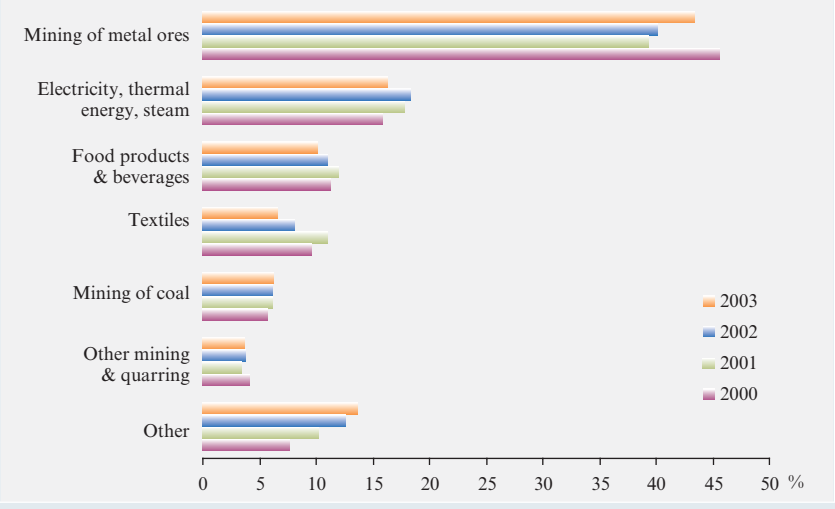


Figure 11. Gross industrial output growth (at 1995 prices)

Figure 12. Gross industrial output (by structure)



improving infrastructure in the ger districts (gers are traditional felt tents). Mortgage loans are being distributed through Golomt, Zoos, Mongol Post and Savings banks as well as through local government.

Transportation

In 2003, 17.6 million tons of goods and 167.9 million (double counted) passengers were carried by all means of transportation. This represents an increase of 30.3 percent, or 4.1 million tons, for the former and 58.8 percent, or 62.2 million passengers, for the latter.

Rail freight accounted for 69.7 percent of all goods transported, with the remaining 30.3 percent accounted for by road transport. In contrast, 97.5 percent of passengers traveled using road transport, 2.3 percent used the railway network and 0.2 percent used air travel. Compared to the previous year, the amount of goods transported using road transport was 2.8 times higher, passengers were up 61.4 percent and rail freight increased 5.6 percent. However, airfreight decreased by 6.8 percent, air travel passengers fell 6.5 percent and rail travel fell by 0.4 percent.

Total revenue in 2003 for the transportation sector rose by 26.0 percent reaching MNT 192.6 billion, of which 57.1 percent was derived from rail transportation, 26.0 percent from air and 16.9 percent from road transport.

According to the vehicular census results, 105,800 road vehicles were counted in 2003, up 1.9 percent, or 2,000 on the previous year. Of these, 74.7 percent of vehicles were private cars.

In 2003 the communication sector generated revenue equal to MNT 92.4 billion of which 67.0 percent, or MNT 61.9 billion, came from household expenditure. Telephone lines rose by 8.8 thousand or 6.9 percent to 135.5 and the number of cell phone users grew by 62.6 thousand or 24.4 percent to 319,400. During the reporting year, the Mobicom and Skytel companies provided cell phone services in all aimag centers and most urban areas.

2.2. Government Finance

In the reporting year, budget revenue reached MNT 553.9 billion (40.7 percent of GDP). Budget expenditure was MNT 615.8 billion (45.2 percent of GDP) and the current account surplus was MNT 110.4 billion (8.1 percent of GDP). On the other hand, the total budget deficit swelled to MNT 61.9 billion, or 4.5 percent of GDP, which is 0.6 points lower than in 2002. The ratio of current account surplus to GDP fully satisfies the stated objective of bringing it to 3.6 percent as stated in the “Main Guidelines of Economic and Social Development in Mongolia”, approved by Resolution 80 of the State Great Hural (SGH) in 2002.

Table 3. General government budget (in billion of Togrogs)

	2002 actual	2003 projection	2003 actual	Changes of actual
Total revenue & Grants	477.1	495.0	553.9	58.9
Current revenue	469.8	486.8	545.3	58.4
Tax revenue	359.2	373.7	421.0	47.3
Income tax	72.4	68.4	97.6	29.1
Social security contribution	54.4	56.0	65.2	9.2
Taxes on property	3.4	4.3	4.6	0.3
Taxes on goods and services	178.6	190.7	190.1	-0.5
Taxes on foreign trade	24.6	26.6	32.6	6.0
Other taxes	25.8	27.6	30.8	3.2
Non-tax revenue	110.6	113.1	124.3	11.2
Capital revenue	0.5	0.0	0.0	0.0
Grants	6.8	8.2	8.7	0.5
Total expenditure & Net lending	550.5	580.1	615.8	35.7
Current expenditure	415.3	435.1	434.8	-0.3
Expenditures on goods and services	285.8	290.3	291.8	1.5
Wages and salaries	105.0	117.1	116.9	-0.2
Other purchases of goods & services	180.8	173.2	174.9	1.6
Interest payments	19.6	20.0	17.6	-2.4
Subsidies and transfers	109.9	124.8	125.4	0.5
Subsidies	8.8	9.4	9.4	-0.1
Transfers	101.1	115.3	116.0	0.7
Capital expenditure	68.1	64.8	90.5	25.7
Lending (net)	67.1	80.2	90.5	10.3
Current balance	54.5	51.7	110.5	58.8
Overall balance	-73.4	-85.1	-61.9	23.2
Financing	73.4	85.1	61.9	-23.2
Foreign, net	81.8	99.9	-158.2	-258.1
Project loans	80.8	91.0	106.7	15.7
Financial loans	15.7	29.2	27.4	-1.8
Amortizations	-14.7	-20.2	-292.3	-272.1
Domestic, net	-8.3	-14.8	220.1	234.9

Although the major budget indicators have been showing improvements since 2001, the budget deficit is still high and it is still financed using foreign loans. Of the MNT 134.1 billion in foreign loans that were spent financing the budget deficit, 106.7 billion came from project loans and 27.4 billion from financial loans. In 2003, a total of MNT 292.3 billion in principal foreign loan repayments was made.

On June 12, 2003, the SGH approved the "Law on Regulating Foreign Loans and Grants", which has as its main objectives the regulation of: all relations associated with the Government getting loans and grants; the drawing up and approval of projects for the utilization and implementation of those loans and grants, and the centralization, registration and supervision of loan and grant income. In 2003, the "General State Budget Law" and the "Law on Pensions and Allowances to be Paid from the Social Insurance Fund" were amended. Furthermore, on November 27, 2003, the SGH made amendments to the "Personal Income Tax Law", "Corporate Income Tax Law" and the "Value Added Tax Law", all of which were to be effective starting January 1, 2004.

BOX 2. TAX ON DEPOSIT INTEREST

Tax on deposit interest should be advocated after testing it against basic tax imposition principles. Tax on deposit interest is distinguished by the low administrative cost of tax collection and it has high neutrality, minimizing market distortion. Minimal market distortion promotes efficiency and so is a desirable tax system objective for collecting deposit interest tax. The tax neutrality principle holds that the imposition of a tax should not affect taxpayers' economic decisions. Therefore, choices such as: where to save, when to save and how much to save must be unaffected by all taxes.

Many countries use withholding tax imposition on deposit interest. A withholding tax is a tax deduction at source. For example, tax deduction by employers on employees' wages or the direct deduction on interest payments of financial institutions.

The deposit interest tax is socially equitable because rich people pay more than poor people. In some countries small savers are exempted from the tax. Also, a deposit interest tax is effective in that it is difficult to evade and it has an initial advantage over other taxes as its rate is usually low; furthermore, tax authorities can identify the operations of business entities and individuals by studying their tax payments.

A withholding tax has weaknesses, however. Those who earn incomes other than on interest from deposit holdings may pay a lower proportion of income in taxes, which may result in inequality in tax payments. Second, the deposit interest tax is not applicable to newer financial instruments such as discount bonds or derivatives. Third, it impairs a country's ability to attract foreign savings.

On the attempts to introduce deposit interest tax in Mongolia

As stated in the 'Business entity and organization income tax law and Personal income tax law' of Mongolia, tax on deposit interest is to be imposed at 15 percent. The provision has been postponed and will not come into force until 2005 by a resolution of the Great State Khural. There is a fear that imposing tax on deposit interest would discourage savings and that people might make profits elsewhere by investing their assets in real estate to generate rent, or transferring their assets to areas with a lesser tax burden. Thus, if tax on deposit interest is imposed, it might lead to artificial asset price bubbles, or cause a flow of funds into credit and savings associations, which usually engage

in more risky types of lending. The fact that Government bonds are usually exempt from income tax may provide an impetus to increase demand for their purchase. Notably, the size of savings mainly depends on deposit owners' sensitivity to tax and their decisions concerning effective capital allocation. Furthermore, it might be appropriate to amend a provision to tax earnings on Government bonds to promote equitable taxation.

On the other hand, by imposing tax on deposit interest, the tax authorities would have an opportunity to obtain data on the amount and allocation of deposits (who has what value of deposits at which bank). This could give rise to resistance to the implementation of the tax so it is important to keep that data within a very restricted circle of users. Deposit information is a useful method for defining the real income of corporations and individuals. Also, it is necessary for the tax authorities if equitable taxation is to be imposed. There is also a two-sided argument over the implications of the tax for the privacy of banks. People who think that reduced privacy would have a negative effect say that it would reduce savings and confidence in banks and that it would consequently reduce financial intermediation. The other half considers privacy not to be a desirable objective saying that it erodes, rather than enhances, confidence in banks and that savings should not be promoted at the cost of equitable taxation or increasing banking privacy.

Year	Quarter	Deposit	Growth (%)	Deposit interest	Tax (estimated by 15%)	Growth (%)
1999	IV	67,983.7		9,085.5	1,362.8	
2000	I	70,989.7		2,128.3	319.2	
	II	74,263.6		4,052.8	607.9	
	III	83,720.5		5,990.3	898.5	
	IV	92,686.2	36.3	8,388.0	1,258.2	(7.7)
2001	I	104,243.5	46.8	2,425.2	363.8	13.9
	II	114,030.0	53.5	4,989.8	748.5	23.1
	III	127,370.5	52.1	7,734.4	1,160.1	29.1
	IV	134,607.4	45.2	11,239.9	1,686.0	34.0
2002	I	152,005.6	45.8	3,656.4	548.5	50.8
	II	164,230.6	44.0	7,578.5	1,136.8	51.9
	III	195,842.4	53.8	13,406.9	2,011.0	73.3
	IV	218,359.6	62.2	19,623.9	2,943.6	74.6
2003	I	260,202.0	71.2	7,459.5	1,118.9	104.0
	II	285,187.5	73.7	16,255.7	2,438.4	114.5
	III	315,896.8	61.3	25,883.1	3,882.5	93.1
	IV	363,498.2	66.5	36,819.4	5,522.9	87.6

As shown in the above table, at the end of 2000 the value of deposits had increased by 36.3 percent on the same period in the previous year. Nevertheless, a hypothetical tax on deposit interest could have fallen by 7.7% over the same period. This decline is related to the decrease in the level of deposit rates. Furthermore, it is lower than the hypothetical tax receipts in the first quarter of 2002. In the first quarter of 2002, the difference between deposit growth and estimated deposit interest tax was 5 points and it increased by approximately 20 percentage points by the end of the third quarter of 2002. This is a result of people's growing confidence in banks and their deposit of cash into banks, which is shown as a higher deposit rate. In general, new deposit inflows are mostly directed towards what are considered to be well-run banks such as the Golomt, Agricultural or Trade and Development banks.

Introducing a new tax on deposit interest, is estimated to increase annual tax receipts by around MNT 5 billion. Further development of the country and financial sector growth may create interest contradiction as the level of deposits increases and interest rates fall. In that situation it is clear that tax authorities would pay more attention to applying a tax on transactions.

Source: www.mongolbank.mn

Budget revenue

According to the preliminary budget performance report, 98.4 percent (MNT 553.9 billion) of total budget revenue is current revenue, 1.6 percent (MNT 8.7 billion) is grant. Compared with the previous year figures, the percentage of current revenue in the total budget revenue

has increased by 0.2 points, the percentage of grant revenue has fallen by 0.2 points.

A compositional breakdown of budget current revenue reveals that the percentage share to tax revenue increased by 1.5 points over 2002, reaching 76.0 percent, and the percentage of non-tax revenue decreased by 1.5 points from the previous year to 24.0 percent.

Against the budget plan, non-tax revenue performance was 109.9 percent, tax revenue performance was 112.7 percent, and revenue from the all major classifications other than tax on business activities, where precise income cannot be determined, fuel tax, tax on imported beer, cigarette, vehicles and royalty fees surpassed planned levels.

Revenues from personal income tax increased by 9.9 percent or MNT 2.6 billion, from the previous year. Tax revenues from private enterprises rose 10.9 percent, business activities, where precise income cannot be determined, by 17.2 percent and other tax revenue increased 7.2 times over.

Non-tax income was MNT 124.3 billion, MNT 11.2 billion (9.9 percent) higher than was planned. The majority of this revenue is generated by fines, navigation and private income made by public institutions. Dividend revenue was MNT 1.3 billion, MNT 4.6 billion (78.0 percent) lower than planned.

Privatization projects were aimed at fulfilling the objectives stated in the "Main Guidelines of Public Property Privatization 2001-2004" and at implementing the "Public Property Privatization Programme in 2002 and 2003", approved by the Government. During the reporting year, a total of 16 enterprises were privatized and 22 real estate properties were sold in accordance to the above. This generated revenue of MNT 19.4 billion, which was added to the state budget, is MNT 3.5 billion higher than was generated in this way in the previous year.

Budget expenditure

State budget expenditure reached MNT 616.8 billion and total financing exceeded planned expenditure by MNT 35.78 billion, or 6.2 percent. The compositional breakdown of state budget expenditure shows that expenditure on goods and services accounted for 47.4 percent of the total, loan servicing 2.9 percent, transfer and subsidy payments 20.4 percent and capital expenditures and net loans 29.4 percent. Compared to 2002, the percentage of expenditures on goods and services loan servicing fell by 4.5 points, tell by 2.7 points, capital expenditure and net loans increased by 4.8 points and transfers and subsidies increased by 0.4 points.

MNT 2.3 billion was saved on loan servicing from the planned amount, 2.6 billion was saved on fuel and heating expenditures, 0.8 billion on electricity costs, 1.0 billion on clean and waste water and 0.4 billion on uniforms and special clothes.

Figure 13. Budget deficit (percentage of GDP)

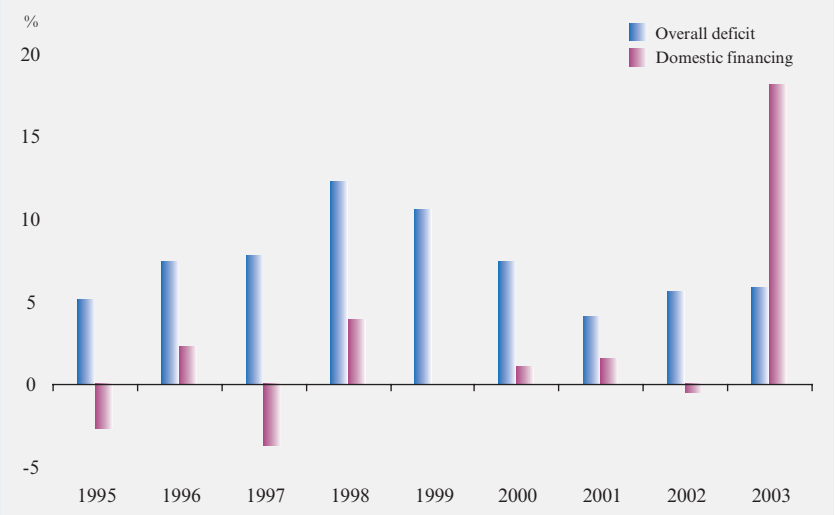


Figure 14. Budget revenue and grants

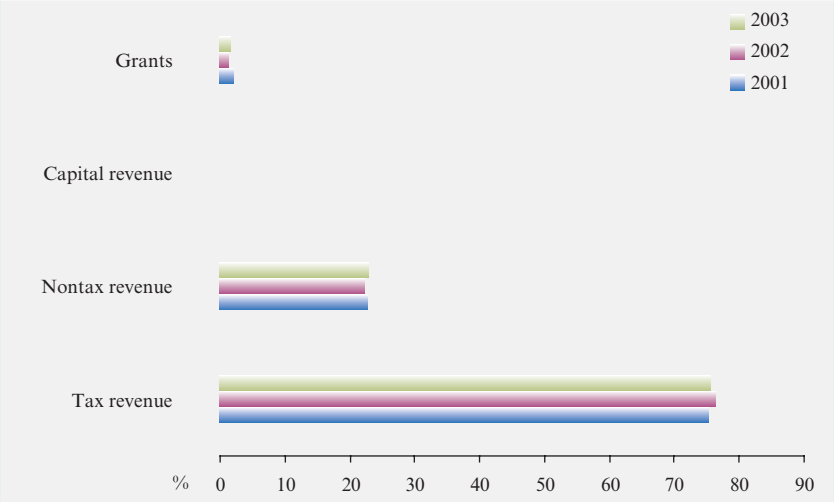
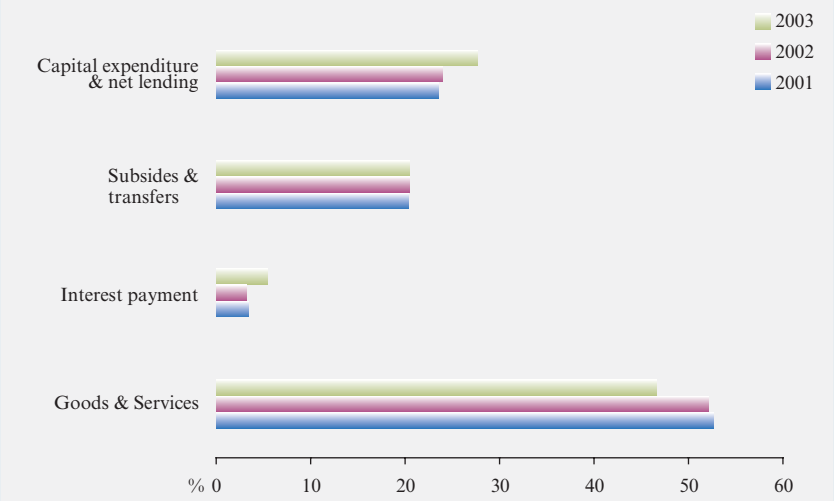


Figure 15. Budget expenditure and net lending



Capital expenditures exceeded the planned level by MNT 25.7 billion, reaching MNT 90.5 billion, MNT 22.4 billion higher than in the same period of the previous year. The majority of capital financing growth was created by an increase in domestic investments.

The level of domestic investment has reached MNT 56.9 billion, an increase of 42.6 percent on the previous year, and specifically the financing of expenditures in most major classifications except overhaul and geological exploration has exceeded the expectations of the budget plan.

2.3 Balance of Payments

Since second half of the reporting period, the price of Mongolian export commodities has risen on the world market, positively affecting the balance of trade. In the first half of the year, gold and copper price volatility was 10 percent. In the second half of the year, this rose to 15-20 percent. At the beginning of the year, the price of gold stood at around USD 343.80 per ton and copper was USD 1,554.50 per ton. By the middle of the year, the gold price had risen to USD 364.70 and copper to USD 1,692.00 and by the end of the year, prices were USD 410.00 and USD 2,321.00 respectively.

During the reporting period, Mongolia exported USD 627.3 million worth of goods to 64 countries and imported USD 826.9 million worth goods from 81 countries. Total foreign trade turnover was worth USD 1,452.2 million and was undertaken with 99 different countries.

At the end of 2003, the current account deficit was equal to 8.3 percent of GDP and stood at USD 98.7 million, shrinking 6.1 percent from its level the previous year.

In the reporting year, imports increased by 19.7 percent and exports increased by 9.8 percent from the previous year. The amount of copper exported, the core export item, increased by 15.3 percent on the previous year, reaching USD 161.7 million in value.

14.2 tons of gold, worth USD 157.3 million, were sold by the BOM to international financial institutions. This was 33.8 percent higher than in 2002 and it accounts for 25.1 percent of total exports. Export growth was comparatively higher than import growth, but the trade deficit including services nevertheless grew by 4.5 percent.

In 2003, exports of goods and services equaled 70.3 per cent of GDP and goods and services imports equaled 91.2 per cent of GDP. The high level of imports is related to the increasing number of equipment supplied by foreign investors, materials, accessories and the imported good content in domestically produced products. Of total imports, fuel and oil products accounted for 29.9 per cent; equipment, machinery, parts and electric tools 21 percent; mineral products 20.5 percent; air and road transport vehicles, and related accessories 10.8 percent; textile products 10.4 percent, and food products 9.2 percent.

Table 4. Foreign trade structure

Table 4. Trade breakdown (by countries)	2002		2003	
	Export	Import	Export	Import
G-7 countries	190.7	145.3	201.5	109.4
USA	140	22.9	165.7	23.4
Japan	8.4	62.9	6.3	42.8
European union	45.2	86.2	33.1	79.3
Euro area	18.2	71.4	15.6	48.2
Newly industrialized Asian countries	45	100.8	25.7	125.8
Hong-Kong	2.8	23.4	3.2	28.2
Singapore	35	10.2	0.1	11.2
Korea	7.2	67.1	22.5	86.3
Developing countries	283.3	195.4	219	140.7
Asia	5.2	22.7		
China	276.7	171.6	217.3	139.5
Middle east and Turkey	1.5	22.7	1.7	1.2
Countries in transition	61.7	280.1	54.3	261.4
Central and east Europe	23.9	22.6	3.3	22.6
Russia	37.5	257	48	237.6
Other	0.3	0.5	3.1	1.2

Source: Foreign Trade Statistics, Mongolian Customs General Administration

The service balance was in deficit by USD 49.1 million, 5.3 times higher than that of 2002. Service income increased 12.7 percent and service payments increased 32.6 percent. Also, overall private remittances to the current account balance increased by 14.8 percent compared with the previous year, reaching USD 128.3 million.

Private remittances from abroad to Mongolia have increased significantly over the last three years. In 2003 they were equal in value to 10.8 percent of GDP. In the reporting year foreign countries and international organizations rendered grants and aid to Mongolia worth USD 87.2 million, an increase of 19.1 percent over the previous year.

The capital and financial account showed a positive balance of USD 4.9 million, but this was 32.1 times lower than in the previous year. USD 342.6 million in loan payments were made, of which USD 250.0 million were made to the Russian Federation. The main impact of this was to cause a drop in the capital and financial account compared with 2002.

Foreign direct investment increased 69.0 percent over 2002, reaching USD 131.5 million. Canada, China, South Korea and Japan are the leading investors in Mongolia and together they account for 93.2 percent of all investment in the country.

The share of investment by sector is: 73.7 percent in mining and processing; 3.4 percent in wholesale and retail trading, hotel and restaurant; 2.3 percent in processing factories; 2.0 percent in communications, 1.2 percent in the construction industry, and the remainder is in other sectors.

Table 5. Balance of payments (in millions of US dollars)

	2002	2003 [1]				
		I	II	III	IV	Total
Trade balance	-228.8	-37.6	-104.0	-50.7	-7.3	-199.6
Exports F.O.B	524.0	129.2	90.1	182.1	225.9	627.3
Of which: Copper concentrate	140.2	34.8	29.1	52.5	45.3	161.7
Non-monetary gold	117.6	40.3	0.0	51.8	65.2	157.3
Other	266.1	54.2	61.0	77.8	115.4	308.3
Imports C.I.F	-752.8	-166.9	-194.1	-232.8	-233.1	-826.9
Of which: registered by customs	-690.7	-166.9	-194.1	-232.8	-233.1	-826.9
Service, net	-9.3	-22.0	-14.9	9.3	-21.6	-49.2
Receipts	184.5	29.8	33.2	83.2	61.7	207.9
Payments	-193.9	-51.7	-48.1	-73.9	-83.3	-257.1
Income, net	-4.5	1.2	0.1	-2.2	-10.6	-11.5
Interest payments	-10.8	-2.0	-3.4	-2.2	-4.4	-11.9
Private transfers	64.4	16.7	20.1	31.6	5.9	74.3
Current account deficit (excluding public unrequited transfers)	-178.3	-41.8	-98.7	-11.9	-33.5	-185.9
Public unrequited transfers	73.2	24.0	29.9	18.9	14.4	87.2
Official grants	53.0	14.4	20.4	9.4	5.1	49.4
Others	20.2	9.6	9.5	9.5	9.3	37.8
Current account deficit	-105.1	-17.8	-68.9	7.0	-19.0	-98.7
Capital and financial account	157.4	22.8	58.1	55.0	-131.1	4.9
Direct investment	77.8	15.5	42.8	39.6	33.6	131.5
Portfolio investment	0.0	0.0	0.0	0.0	50.0	50.0
Medium and long-term loan	102.4	23.0	6.2	15.6	-197.0	-152.1
Of which: Disbursements	185.1	40.4	28.9	41.3	79.9	190.5
Amortizations	-82.7	-17.4	-22.7	-25.6	-276.9	-342.6
Government	73.7	11.0	13.6	19.5	-188.7	-144.6
Of which: Disbursements	86.9	12.6	16.0	20.3	67.3	116.1
Amortizations	-13.2	-1.6	-2.4	-0.8	-256.0	-260.7
Business entities	28.7	12.0	-7.4	-3.8	-8.3	-7.5
Of which: Disbursements	98.2	27.9	12.9	21.0	12.6	74.4
Amortizations	-69.5	-15.8	-20.3	-24.8	-20.9	-81.9
Commercial bank, net	-9.5	-7.3	-0.2	22.0	-31.0	-16.5
Short term capital	-8.7	-8.4	9.3	-22.2	0.3	-21.0
Trade credits	-14.0	-7.3	-0.2	22.0	-18.0	-3.5
Errors and omissions	14.1	-17.9	32.5	-37.0	19.3	-3.1
Overall balance	66.4	-12.8	21.8	25.0	-130.8	-96.8
Financing	-66.4	12.8	-21.8	-25.0	130.8	96.8
Increase in net official reserves (-)	-65.7	12.8	-21.8	-25.0	130.8	96.8
Use of IMF credit	-4.3	-2.4	-0.9	8.9	1.3	7.1
Changes of offical reserves	-61.5	15.2	-20.9	-33.9	129.5	89.8
Arrears accumulations (+)/payments (-)	-0.7	0.0	0.0	0.0	0.0	0.0
Exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0

* Preliminary

Figure 16. Balance of payments (net amount)

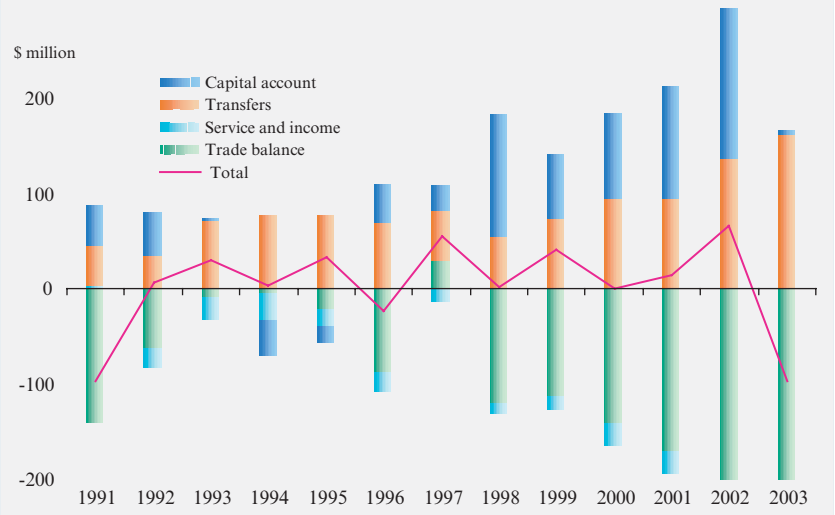


Figure 21. Current account structure in 2003

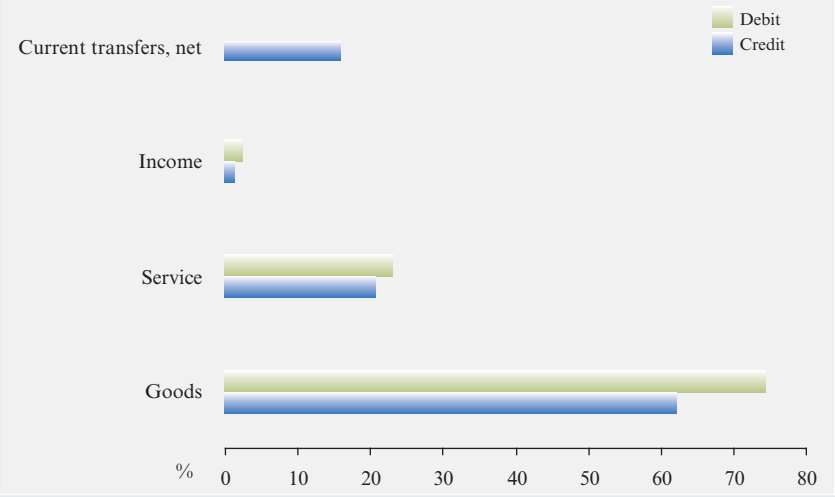
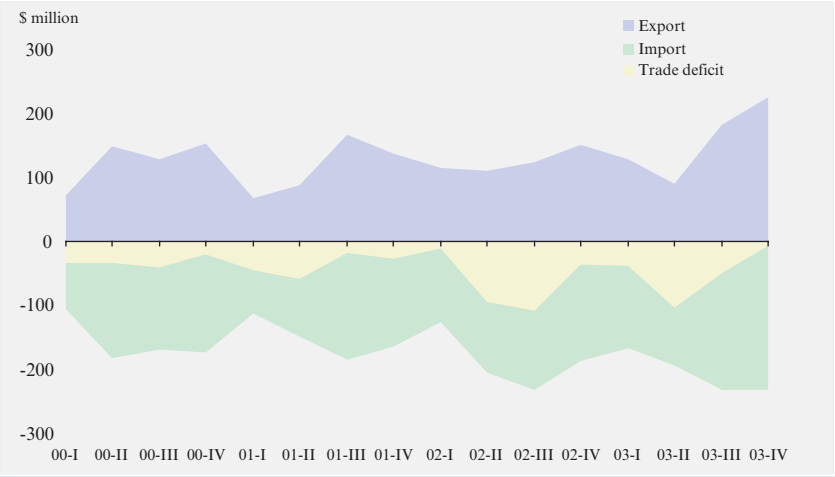


Figure 18. Trade balance



BOX 3. FOREIGN DIRECT INVESTMENT

1. The basics of Foreign Direct Investment

Foreign Direct Investment (FDI) occurs when an investor in one country acquires or expands its ownership of a business entity in another country and the equity participation is sufficiently large to give the investor management control. It is the management dimension that distinguishes FDI from portfolio investment in foreign stocks and other financial instruments. Both foreign direct and portfolio investments are favorable for a given country.

Foreign direct investors are predominantly multinational enterprises. Indeed, direct investment is the vehicle by which enterprises go multinational.

FDI has three components:

- *Equity capita:* the foreign investor's purchase of shares of an enterprise in a country other than its own;
- *Reinvested earnings*: the direct investor's share of earnings not distributed as dividends by affiliates or earnings not remitted to the direct investor;
- *Intra-company loans or intra-company debt transactions:* short- or long-term borrowing and lending of funds between direct investors and affiliate enterprises.

The concepts of stock and flow apply to FDI. FDI flows comprise capital provided directly by a foreign direct investor to the enterprise, while FDI stock is the value of the share of the capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtness of affiliates to the parent enterprise.

2. A Summary of Recent Literature on FDI

There are a substantial number of papers on or about FDI. There is a growing view in recent years that FDI is positively correlated with growth and this view has been bolstered by recent developments in growth theory, which highlight the importance of improvements in technology, efficiency and productivity in stimulating growth. In this regard, FDI's contribution to growth comes through its role as a conduit for transferring advanced technology from industrialized to developing countries.

This positive externality can lead to improvements in productivity and efficiency in local firms in several ways. First, a spillover can occur when a local firm improves its productivity by copying technology used by multinational enterprises in the local market. Another positive externality occurs when local firms are forced to use existing technology and resources more efficiently, or to search for more efficient technologies because a multinational enterprise's entry has increased competitive pressure in the local market. In addition, spillovers can occur when a multinational enterprise demonstrates new techniques to and trains local workers, who later accept employment in local firms or start their own businesses.

A determinant of the magnitude of spillovers appears to be the size of the technology gap between domestic and foreign firms, that is, spillover magnitude appears to depend on the host country's capacity to absorb the foreign technology. The smaller the technology gap the higher the magnitude of spillover. It is more difficult to identify spillover when the gap is wide.

Factors that may have a significant effect on FDI are outlined below:

- Economic distance/transport costs: to the extent that horizontal FDI will tend to replace exports if the cost of market access through exports is high, horizontal FDI will tend to increase. However vertical FDI, which is export-oriented, may be discouraged by high transport costs. The net impact of transport cost on FDI is uncertain.
- Size of the host market: to the extent that larger host markets reduce the cost of supplying the market because of economies of scale and hence lower fixed cost per unit of output, a larger host market will encourage horizontal FDI. Vertical FDI, however, is indifferent to the host's market size. The net impact of market size on FDI is likely to be positive.
- Agglomeration effects: to the extent that agglomeration effects make FDI attractive, their impact on both horizontal and vertical FDI will be positive. Factors contributing to agglomeration effects include the state of the host country's infrastructure, the degree of industrialization and the size of the existing FDI stock. The net impact of agglomeration effects on FDI is positive.
- Factor cost: production cost-minimizing vertical FDI will be stimulated directly by lower factor costs. Lower factor cost should also be viewed favorably by horizontal FDI. The net impact of lower factor cost on FDI is positive.
- Fiscal incentives: fiscal incentives in the host country can increase the country's locational advantage for both types of FDI. However, vertical FDI may be more likely to respond to fiscal incentives, since they are more sensitive to costs. Horizontal FDI tends to be more concerned about the viability of the host market and may thus tend to favor other policies (such as an increase in import tariffs, or quota-setting).
- Business/Investment climate: a friendlier business/investment climate benefits both horizontal and vertical FDI.
- Trade barriers/openness: Horizontal FDI tends to decrease with an increase in openness. Vertical FDI, which benefits from a liberal and predicable trade environment, will increase with greater openness.

Generally, as shown in many studies, market size appears to be the most robust, positive, FDI determinant. FDI also appears to like to cluster, making infrastructure and a certain level of industrialization important determinants, while political risk and economic instability hinder FDI. The statistical results of other variables are mixed so it is difficult to make distinct conclusions.

3. FDI into Mongolia[1]

Total FDI flows into Mongolia are much lower than in many transition economies. A large share of FDI inflows to transition countries are generated by the privatization process. However, there are transition countries that attract a large amount of FDI without embarking on a significant privatisation program (Azerbaijan) while the privatisation process in other countries has involved a significant amount of stock market flotation (Hungary, Poland, Russia) and therefore some privatisation-related capital inflows are reported as portfolio inflows instead of FDI. Many transition countries have also actively promoted privatisation to local investors (Czech and Slovak Republics), which was usually debt financed and thus linked either to domestic or foreign credit.

Privatisation-related FDI inflows are usually used to finance fiscal deficit in countries where this deficit is large. FDI is the preferred source of financing for the current account deficit as it does not create debt stock.

FDI inflows to Mongolia are much lower than those in Central Eastern Europe and the Baltic States (CEB) and higher than the average in the Commonwealth of Independent States (CIS).

Despite FDI inflows to Mongolia being smaller than in other transition economies, the FDI per capita is higher than in some countries of the former Soviet Union. FDI per capita in Mongolia is near the average of the CIS, half the average of the CEE, and ten times lower than in the CEB.

In view of the fact that there is insufficient data for econometric analysis of the determinants of FDI inflows to Mongolia, some explanations are given below on possible factors that could influence FDI.

The existing import tariff in Mongolia is 20[2] percent (import tax 5 percent, value added tax 15 percent), which is not high enough to attract horizontal FDI. Instead of FDI, foreign firms prefer to serve the market directly by exporting their products. A case in point is the Coca-Cola company which, instead of FDI, sold a license to a local firm. Low trade barriers and existing capacity in Mongolia's two neighboring countries contributed to this decision. Horizontal FDI, which tends to favor large market size, is unlikely to come to Mongolia. Vertical FDI, though encouraged by low trade barriers, is smaller than would otherwise be expected due to high transportation costs, the lack of successful operating firms and a scarcity of skilled workers. Mongolia removed import tariffs in 1997, but FDI inflows were inelastic to this measure, showing that vertical FDI may have refused to enter the local market due to other reasons. Also, if the business/investment climate created by other countries is better than in Mongolia, then of course FDI inflows will tend to flow to those countries. The most important things for attracting FDI are political and macroeconomic stability.

The largest investors in Mongolia are Tuu Mart (Sky shopping center), Univcom (Skytel), Amikal (Mongol amikal), Millennium Securities (Chinggis Khaan), Gerald Metals-Lugano bank consortium (Trade and Development bank) and Boroo Mongolia Mining Corporation (Boroo Gold).

The following is an analysis of possible influences of FDI on the operation of monetary policy. In this case, depending on the exchange rate regime, different policy arrangements are applied. Under a fixed exchange rate regime, the Central Bank stands ready to buy or sell domestic currency for foreign currency at a predetermined exchange rate. In such cases, the Central Bank often relinquishes control over the money supply. The effects of the Central Bank's effort to expand domestic credit lead to: an increase in aggregate spending, rises in the current account deficit and downward pressure on the exchange rate. When the Central Bank begins to intervene in the foreign exchange market to maintain the fixed rate, its international reserves are usually depleted. The way to adjust the money supply in this case is sterilization, but the basic weakness of this is that sterilization is limited by the cost of interest payments on securities should the Central Bank sell too many securities to offset a large foreign exchange inflow.

Under a floating exchange rate regime, the Central Bank does not intervene in the foreign exchange market. In this case, the Central Bank has full control over the money supply and therefore can determine the rate of inflation. In most small, open economies dependent on many critical imports like Mongolia, the exchange rate provides an additional link between the money stock and inflation. These cases are rare in the real world and most Central Banks do intervene in their economies to some extent, resulting in a managed floating exchange regime. In the real world, most countries have responded to capital inflows by undertaking a combination of actions involving (i) a partial intervention to buy some of the capital inflow; (ii) partial sterilization; and (iii) some increase in the monetary base, inflation and consequently real exchange rate appreciation.

[1] Below all data related to the FDI flows. Data for 2002 are preliminary for all countries
[2] The condition under which Mongolia entered the WTO is not impose an import tariff higher than 20 percent

Source: www.mongolbank.mn

In 2003 Mongolia's balance of payments was in deficit by USD 96.8 million, 2.5 times higher than in the previous year. The overall balance of the payment deficit was financed using foreign exchange reserves and loans.

2.4. Prices and Wages

In recent years positive changes have been observed in the banking and financial sectors that, along with price and exchange rate stability, have had a favorable influence on the business environment.

At the end of 2003, inflation was 4.7 percent, an increase of 3.1 percentage points over the same period in 2002. The jump is largely explained by growth in the foodstuff group index of 7.7 percent as this makes up 46.6 percent of the consumer basket. Moreover, fuel price increases of 17.5-19.5 percent over the same period in 2002 caused by the upward tendency of crude oil prices on the world market as a consequence of war in Iraq coupled with rises in the price charged for oil by Yukos, the Russian supplier company, have also had a negative effect on the foodstuff group and other indices.

Until 2001 the consumer price index (CPI) experienced sharp quarterly movements, but this has smoothed relatively in the last 3 years. Annual inflation stood at 4.7 percent at the end of 2003.

Fluctuations in the price of meat and meat products, which are given heavy weight in the consumer basket, showed overall falls in 2002, but rose in 2000, 2001 and 2003 with consequent influence on fluctuations in the foodstuff index. Indices of other subgroups of foodstuffs have followed stable trends.

During last 4 years the housing, heating and electricity group index has shown an overall increase. The index showed relative stability in the first six months of the year before increasing sharply in the second half.

Quarterly changes in indices for other goods and services have not been significant, remaining comparatively stable throughout the year.

By December 2003, inflation had increased by 14.9% on its end of 2000 (base period) level and by 4.7 percent over the same period in 2002. Goods and services representing 15.9 percent of the 239 items in the consumer basket increased in price, the prices of another 15.9 percent fell and the remainder showed no change. In comparison with the same period of 2002, the biggest price increases in the foodstuffs group were flour and flour products (16.4 percent) and meat and meat products (23.4 percent), whereas the price of potatoes and other vegetables tumbled by 28.7 percent and alcohol and tobacco prices showed a more modest fall of 2.9 percent. With regard to the other sub-groups, the prices of cultural and educational goods and services rose by 11.4 percent, other goods and services by 13.6 percent, and medical

care and services by 4.9 percent, while the prices of housing, heating and electricity fell by 1.7 percent and household goods by 2.8 percent. The prices of mutton and beef increased by 22.8-29.2 percent, flour prices increased 22.3-37.8 percent, and potato, turnip and carrot prices fell by 31.8-48.8 percent, milk and yogurt prices by 7.2-8.0 percent, rice prices by 0.7 percent, and firewood and coal prices by 5.8-9.8 percent.

The wages of civil servants were increased by 20 percent in 2002. Furthermore, it has been decided that starting February 2004 their wages will be raised by an additional 25 percent.

Remuneration has improved significantly since the minimum wage and minimum pension rates were established. The minimum wage was MNT 18,000 per month in 2000, MNT 24,750 in 2001 and MNT 30,000 in 2002. From March 2004 the minimum wage will be ramped up to MNT 40,000 per month. This establishes a proper proportion between the minimum wage, subsistence living requirements and pensions provided by the Social Security and Social Insurance Funds, reflecting growth in private sector salaries.

By the end of the fourth quarter of 2003, the average monthly salary of workers engaged in enterprises across different ownership and economic activity types amounted to MNT 82,800 which is MNT 7,300, or 9.7 percent, higher than in the same period of 2002.

If wages are broken out by economic sector, workers engaged in construction, mining and quarrying, manufacturing, transportation, storage, communications and financial intermediation come out on top with monthly salaries MNT 7,800 to MNT 40,700 higher than average. Meanwhile workers in education, public administration, defense, social and personal services, agriculture, hunting and forestry fare less well with monthly salaries MNT 6,500 to MNT 39,900 below average.

2.5. Labor Market

At the end of 2003, the population of Mongolia was 2,504,000. 1,488,200 of these were of working age, 959,800 persons were in the labor force and 926,500 persons were employed.

To reduce poverty and support economic growth, it is essential to implement a rational labor policy in compliance with market principles. Special emphasis has been placed on organizing professional training for persons who never been enrolled on unemployment insurance and who are long-term unemployed in order to provide them the opportunity to work.

At the end of the reporting year, the number of people registered as unemployed was 33,300, 8.0 percent or 2,500 people higher than in the previous year. While 46.5 percent of all registered unemployed had been previously employed, the residual 53.3 percent have no working experience.

In 2003, 61,900 people were newly registered at the city and municipal labor bureaus. Breaking

Figure 19. CPI group index, % (2000.12=100)

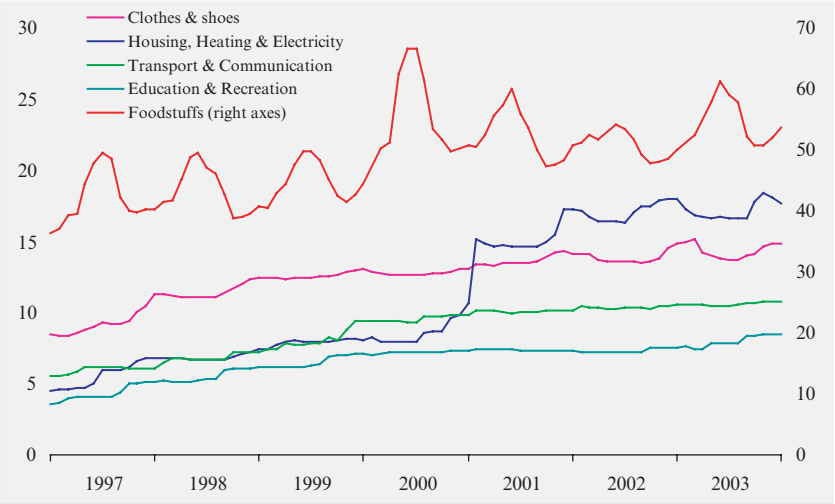
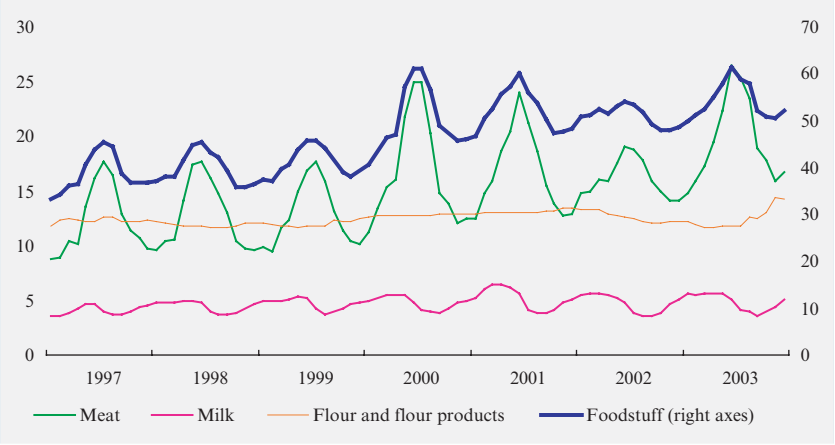


Figure 20. Consumer price index for foodstuff sub-groups, % (2000.12=100)



BOX 4. INFLATION FORECASTING

Beginning in the 1990's, the Central Bank has changed the methods by which it implements monetary policy, has set price stability as its main goal and has started making public announcements on expected inflation levels. In order to implement monetary policy in this fashion, it is important to have a robust inflation forecasting model. The purposes of this research work are to develop an inflation forecasting model of Mongolia, to evaluate it, and to demonstrate the general trend of inflation for 2003.

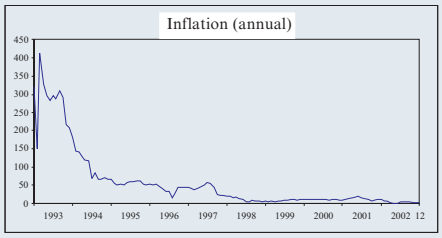
Inflation forecasting methods

Of the many methods of inflation forecasting such as the Phillips curve, markup method, indicator method, money supply function method, vector autoregression method and ARIMA method, vector autor regression and the ARIMA methods are used to forecast inflation in this research work. The Box-Jenkins ARIMA model is univariate and depends on autoregression, degree of integration and moving averages. Although this model is simple, it does result in effective forecasting. Therefore, the ARIMA model is taken as a base and other models are then compared to it.

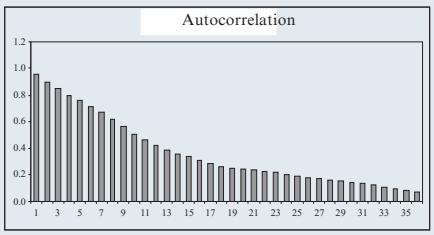
About twenty years ago (1980) Christopher Sims introduced a new macroeconometric model: vector autoregression (VAR). VAR consists of n-equations and n-variables, where each variable is explained by its own lagged value and the present and lagged values of the remaining n-1 variables. This simple model systematically shows the dynamics of many variables. The VAR model is used when making explanations, forecasts, structural deductions and policy analysis. However, although VAR is strongly reliable when making explanations and forecasting, it is more doubtful how reliably it performs structural deductions and policy analysis (K. Stock, M. Watson 2001).

In order to make inflaton forecasts, it is first of all imperative to study the time-series structure. For that purpose, graphical representations of inflation and its autocorrelation function are shown below. As shown by Graphic 1, the mean rate of inflation is non-stationary and has a decreasing trend. If we look at the autocorrelation function (Graphic 2), autocorrelation values are shown to be slowly falling with a time lag, corroborating the non-stationary inflation situation.

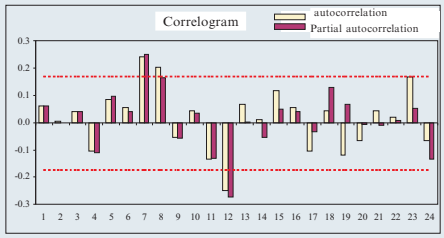
Graphic 1



Graphic 2.



Graphic 3.



Since inflation is non-stationary (tested using ADF test in previous research), the second order differential was used first to analyze the correlogram.

As shown by the correlogram graphic, when time lags are 7 and 12, partial autocorrelation is significant. Based on the root mean squared error (RMSE), the following ARIMA model is chosen from the possible versions.

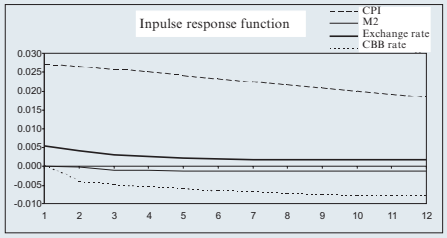
$$dlog(Inf)_t = -0.006 + e_t - 0.953e_{t-12}$$
$$(-5.53) \qquad (-58.0)$$

Where dlog(inf) is the first order differential of inflation with natural logarithm, e is the regression error and numbers in parentheses are t statistics.

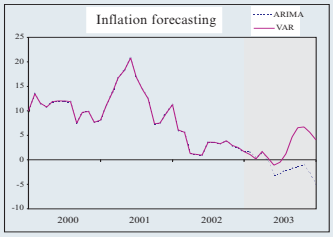
Exchange rate, money supply and CBB rates are taken as variables, all of which have an influence on inflation, in the VAR model. In order to calculate this model, however, variables are required to be stationary and the variables were tested and proven to be non-stationary using the ADF test, calculations for which are not included in this research. Some researchers (Clements, Hendry 1995) have determined that VAR calculated with non-stationary variables and differenced VAR actually result in better forecasting than does cointegrated VAR. Therefore, since our purpose here is to forecast inflation, first order differentials and non-stationary variables are taken. When determining the time lag of VAR, Akaike and Schwarz criterions were used. They determined the lag to be 2 and 1 respectively. The Akaike criterion is chosen over Schwarz; therefore, the VAR time lag is 2.

VAR takes three forms: reduced, recursive (Sims 1980) and structural (Bernanke, Blanchard, Watson, Sims, 1986). First, VAR is calculated at the reduced form and since coefficients at this level are insignificant, it does not show the result of the calculation and produces a misspecification test. However, in the next level, it transfers from the reduced form to the recursive or structural form and shows results by producing the impulse response function and variance decomposition. In this research, Cholesky decomposition was used to calculate the impulse response function.

Graphic 4.



Graphic 5.



As seen from the Graphic below, while CBBs have a strong influence on inflation, the influence of money supply is negligible.

When the RMSE is calculated by comparing the real value of inflation in December 2002 with the forecasted level of inflation, it was found to be 6.73 in the ARIMA model and 7.25 in the VAR model. Therefore in comparison with the VAR model, ARIMA produces slightly better forecasts. Based on those two models, inflation levels in 2003 were forecasted. The results of this are shown in the table below:

	2003											
	1	2	3	4	5	6	7	8	9	10	11	12
ARIMA	1.8	0.3	1.5	-0.4	-3.1	-2.8	-2.0	-1.8	-1.2	-1.1	-2.9	-5.0
VAR	1.1	0.1	1.7	0.3	-1.1	-0.5	1.2	4.7	6.6	6.7	5.6	4.0
Mean	1.4	0.2	1.6	-0.1	-2.1	-1.6	-0.4	1.5	2.7	2.8	1.4	-0.5

The dynamic forecasts of the ARIMA and VAR models diverge noticeably from the middle of the year. Therefore, we can propose to perform an inflation forecast by taking the mean average of those dynamics and general trends. However, the longer the forecasting period, the more reliable the VAR model becomes (Clements, Hendry 1995).

Conclusion

In this research, an inflation forecast has been proposed for the year 2003 using the ARIMA and VAR dynamic models. When forecasting inflation using the VAR model, it is seen from the impulse response function that exchange rates and CBB rates have a significant influence on inflation levels. Therefore, in order to maintain price stabilty, we should attatch greater concern to foreign exchange rates and CBB rates than to money supply.

When forecasting inflation for 2003 using the ARIMA and VAR models, it was found that the forecasts diverged from the middle of the year. Indeed, by the end of 2003, inflation was forecasted to be -5.0 by ARIMA and +4.0 by the VAR model. Based on careful examination of those models and trends in previous years, inflation for 2003 was forecasted to be between 2-4 percent.

Source: www.mongolbank.mn

out unemployment by age shows that 24.1 percent are between the ages of 16-24, 33.2 percent are between the ages of 25-34, 30.2 percent are between the ages of 35-44 and the remaining 12.5 percent are between the ages of 45-59.

Furthermore, breaking out the unemployment statistics by level of education reveals that 9.3 percent have higher education, 9.9 percent have specialized secondary education, 10.9 percent have technical and vocational training, 63.8 percent have upper and compulsory secondary education, 5.3 percent have primary education and that 0.8 percent have no formal education.

Within the framework of the ADB-funded Employment Generation Project, the Government of Mongolia has issued loans to 361 economic entities and 129 individuals to the value of MNT 6.2 billion through Golomt, Zoos, Erel and Transport Development banks during 2001-2003 and as a result, 3,901 jobs were created.

During the reporting year, 19 companies exported labor to Korea, the Czech Republic, Hungary and Japan and a total of 2,489 people went abroad to work.

By contrast, permission to work in Mongolia was granted to 7,532 foreigners from 67 countries, of which 65.4 percent were Chinese, 17.6 percent Russian, 2.2 percent Korean, 2.1 percent American, 2.0 percent Australian and the residual were citizens from the Ukraine, Canada and Japan. Because of the seasonable nature of works in infrastructure and several large projects implemented in sectors including road, energy, construction, mining and quarrying, labor inflow increased markedly during the spring and summer. Of all foreigners with permission to work, 42.2 percent are engaged in mining and quarrying, 12.9 percent in manufacturing, 10.5 percent in education and 6.9 percent in construction. The remainder work in other sectors.

Table 6. Labor force indicators (thousand persons)

	1996	1997	1998	1999	2000	2001	2002	2003*
Population of working age	1212.8	1229.6	1256.8	1279.3	1347.4	1402.8	1439.2	1488.2
Labor force	825	828.8	842.4	853.4	847.6	872.6	901.7	959.8
Employed	769.6	765.1	792.6	813.6	809	832.3	870.8	926.5
Registered unemployed	55.4	63.7	49.8	39.8	38.6	40.3	30.9	33.3
Unemployment rate (%)	6.7	7.7	5.9	4.7	4.6	4.6	3.4	3.5

Source: National Statistical Office

* Preliminary

3 MONETARY AND FINANCIAL SECTOR DEVELOPMENT

With regard to the monetary and financial sector, public confidence in banks has increased and the financial intermediation of the banking system deepened. Moreover, bank deposits and the issuance of new loans increased. The improvements mentioned above have contributed significantly to the growth of the real economy in 2003. Inflation, represented by the consumer price index, was reduced to single digits and was stable throughout the reporting year. By the end of 2003, inflation was 4.7 percent. The 49.6 percent increase in broad money from the beginning of the year was due to the considerable increase in foreign currency deposits by the Erdenet Corporation and Ivanhoe Mines in the Trade and Development Bank though these are likely only to be a one-time increase.

3.1 Money supply

The money supply increased by 49.6 percent, or MNT 233.2 billion, from the beginning of 2003 reaching MNT 703.3 billion. In comparison with 2002 money supply increased 67.7 percent, or MNT 94.1 billion, during the course of the reporting year.

The majority of this growth, 89.2 percent, is due to an increase in the level of togrog and foreign currency deposits (quasi money). The amount of M1, which had a significant influence on money supply growth in 2002, fell by 11.9 percent reaching 10.8 percent during the reporting period.

Foreign currency deposits increased by 85.1 percent during the course of 2003, whereas foreign currency outside banks showed the lowest increase - only 8.9 percent. During the period January to July 2003, the annual growth of M1 fell from 39.4 to 10.4 percent, whereas quasi money increased from 58.4 to 59.9 percent. However, both held stable during the

Table 7. Main ratios of the financial sector (percent)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
M2/GDP	52.4	27.6	21.9	23.7	18.6	19.9	20.4	20.5	23.8	25.4	29.7	37.9	51.6
Loan/GDP	68.0	40.4	16.2	16.3	11.4	10.0	6.0	10.5	8.4	6.6	12.1	18.7	32.5
Deposit/GDP	13.8	11.4	12.4	13.5	10.8	9.9	11.3	10.4	11.4	12.6	15.7	22.8	36.0
Currency outside banks/M2	17.1	14.1	20.5	24.4	25.1	32.5	29.3	33.7	39.6	39.0	33.0	25.7	18.7
Loans outstanding (billion of togrog)	12.9	19.1	31.6	52.8	62.7	64.8	50.4	85.6	77.5	66.8	135.1	231.4	442.1

BOX 5. MONEY AND FINANCIAL SECTOR DEVELOPMENT

Beginning in the 3rd Century B.C. the Kunnu, Sunnu, Uigar, and Kidan empires used coinage including the: 'Zuun uzuurt hutgan mungu', 'Sukhes', 'Ikh Mongol Ulsyn Mungu', 'Ulgii Mungu' and 'Ikh Khaany Nevtrekh Erdene' as media of exchange.

In 1206 Chinggis Khaan founded the Mongolian Empire and minted silver coins. Then in 1227, paper money was printed for the first time in the world. The first bank was recorded in the 13th Century.

During the period of the Mongolian United Empire, Chinggis Khaan's successors minted around 100 different coins from gold, silver, copper and bronze. In 1236 Uguudei Khaan, and in 1254 Munkh Khaan, printed paper money once more, audited the wealth of their empire and began trade with other countries.

After the collapse of the Mongolian Empire, and during the Manchu dynasty, these traditional tools and means of settlement dissappeared and the Mongolian economy relapsed into chaos for several years. Livestock, skins, hides and ceremonial "khadag" scarves fulfilled money functions. At the end of the 19th Century silver ingots and Russian, Chinese, English and American golden and silver coins and notes served as the principal means of payment. As a result, monetary circulation was destroyed without any regulation. Moreover, foreign and domestic usurers grew rich as Mongolian herders fell heavily into debt and the Mongolian economy became dependent on foreign countries.

Historically, foreign capital flows into Mongolia have been substantial and a few foreign bank subsidiaries and joint ventures were established to carry out related activities at the turn of the last century. For instance, in 1900 a Russian-Chinese bank, which opened branches in Urguu and Uliastai, operated for a short time. The Chinese Datsin Bank also opened two branches in Mongolia and was active in 1907-1912. At the request of the Autonomous Government of Mongolia, a branch of the Siberian Trade Bank (a Russian concern) operated in 1915-1919 and was named the Mongolian National Bank. The Mongolian Government also requested the Chinese Jungo Bank to open a branch in Mongolia. This is it did, operating in 1918-1919, and it was followed by a Japanese-Chinese joint bank that was also active for a short time.

In 1921 the Mongolian People's Revolution was victorious and the first measures taken by the new People's Government were to relieve the Mongolian people's debt to foreign usurers and merchants, and to eliminate the feudal budget and tax system. In 1922 the State Temporary Khural decided to establish the 'Khorshoo Saijruulah Bank' (Cooperatives Development Bank). Due to weak economic potential and lack of qualified specialists, however, it was impossible to establish bank without foreign assistance and so the Mongolian Government addressed the Russian Government (the former Soviet Union) with a request that it assist in establishing the bank. In 1923, the Mongolian regulations on the Mongolian Trade and Industrial Bank, now a Mongolian-Russian joint bank, were approved and in 1924 the joint bank began its activities.

In its first year the goals of the Trade and Industrial Bank (Bank of Mongolia) were to support the development of industry and agriculture, to expand trade and to regulate monetary circulation. Promissory notes, the settlement of transactions with promissory notes and transactions involving commodities and precious metals as collateral dominated the bank's credit transactions. Regulating monetary circulation quickly became impossible due to the broad use of Chinese currency, 'yanchan', and silver. In response to this, the Trade and Industrial Bank was directed to issue a Mongolian national currency backed with foreign currency, precious metals, short-term promissory notes and high liquidity commodities, and to organize money supply. The Trade and Industrial Bank also had the right to participate in concessions on processing minerals, trade and transport within 30 percent of its capital. In this way, the Bank of Mongolia pursued diverse activities and objectives conforming to the interests of the Mongolian people.

During its first year the Bank of Mongolia defined action forms, near and future objectives, took measures to attract customers and established the basis for conducting settlements and providing credits. The Bank of Mongolia also opened a branch in Khyagt city, Russian Federation, and developed relations with foreign banks. The Bank of Mongolia's activities essentially intensified the economic life of the country. By the end of 1924, credits accounted for 52.5 percent of total assets, and cash and securities for 31.6 percent, while attracted assets made up 56.8 percent of total liabilities and capital the remaining 43.2 percent.

In its second year the Bank of Mongolia had the objective of providing conditions for money renewal in Mongolia. Money renewal was adopted in two steps. First, the national currency, the togrog, was introduced into circulation removing the need for Chinese currency. Second, the togrog became the single legal means of payment and was backed by gold. Since 1927, in accordance with the Mongolian government's decision, all enterprises and organizations started to conduct settlements, to charge prices, pay taxes and fees in the national currency the togrog.

Source: www.mongolbank.mn

Figure 21. Monetary aggregates

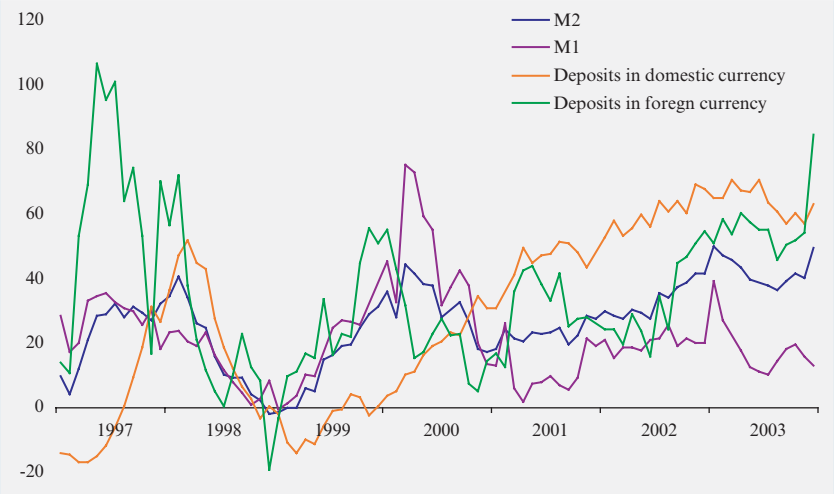


Figure 22. Composition of money supply growth

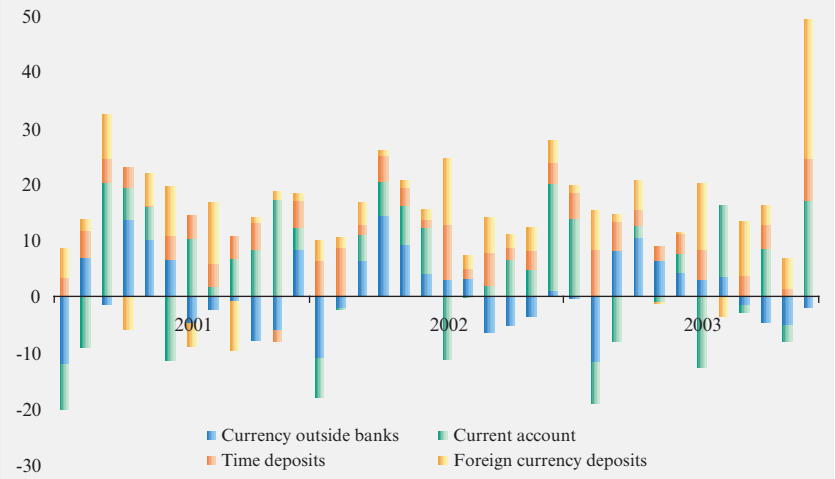
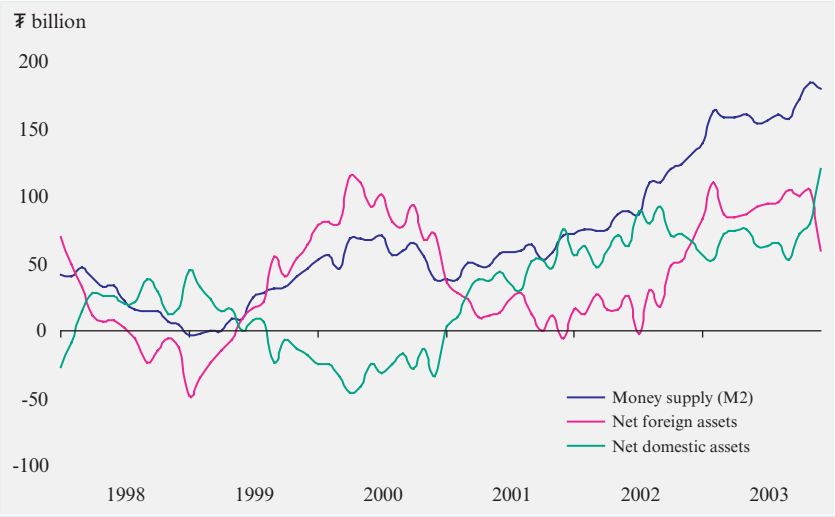


Figure 23. Annual changes in money supply, net domestic and foreign assets



period August to November before, in the last month of 2003, foreign currency deposits jumped 24.7 percent leading to a significant increase in the amount of quasi money and causing a major growth in broad money (M2) by the year's end. These trends reveal that public togrog deposits had a significant effect on money supply growth.

In the reporting year the growth of net domestic assets made the largest contribution to money supply growth. Net foreign assets went down by MNT 52.2 billion from the 2002 level. Although the trends in both the foreign and domestic net assets were relatively stable over the first 11 months of 2003 producing growth of 40 percent on average, during the last month of the year net domestic assets jumped by 78.5 percent or MNT 196.6 billion, and net foreign assets fell by 32 percent, or MNT 120.8 billion. Despite this significant change in net domestic and net foreign assets during the last month, these changes were in opposite directions and so had little net effect on the annual growth of money supply.

Net domestic credit from the banking sector increased by 57.3 percent or MNT 314.6 billion, from the beginning of the year, increasing net domestic assets by 76.6 percent or MNT 285.4 billion. The share of private sector credit and Government credit growth in the overall growth of Net Domestic Credits was 51.3 percent and 41.0 percent respectively.

In the reporting year net foreign assets fell by 24.2 percent, or USD 64.8 million, and net foreign official reserves dropped by 42.9 percent, or USD 98.9 million. The changes in net foreign official reserves were influenced by the 86.6 percent, USD 43.1 million, decrease in monetized gold and the 28.9 percent, or USD 46.0 million, fall in time deposits at foreign banks. However, starting November 2003 Other Foreign Liabilities rose and accordingly other foreign assets declined by the same amount as the new foreign resources of the Chinggis Khan Bank increased.

Narrow money M1

In 2003, currency outside banks and togrog deposits decreased on the previous year. Narrow money growth fell by 6.8 points and the share of narrow money in broad money consequently fell by 9.6 points. As the consumption of non-cash payment instruments improved, togrog deposits made up the majority share accounting for 57.4 percent of M1 growth.

In the reporting year currency outside banks rose 8.9 percent, or MNT 10.7 billion, and togrog deposits rose by 21.5 percent, or MNT 14.4 billion.

The production of sectors such as agriculture and mining, that together constitute the greatest part of GDP, is seasonal as they halt activities through winter - the first three months of the year - and resume major operations and production preparations in the second quarter. Directly related to that, demand for currency outside banks decreases during the first quarter of every year and picks up once more starting from the second quarter with a consequent increase in

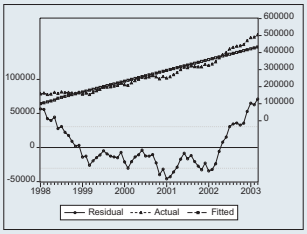
BOX 6. ANALYSING DYNAMICS OF BROAD MONEY M2

The main macroeconomic indicator, which should necessarily be analyzed and adjusted within the framework of the Central Bank's domestic price stability remit, is broader defined money M2 or in other words money supply. During the last few years broad money growth has showed a tendency to accelerate. In particular, broad money at the end of 2002 grew by 42 percent over the end of 2001. Although the money supply series trend over the last 5 years shows a precisely increasing trend, we will determine the form of the trend: whether it is linear or a high-ordered function such as polynomial, exponential and so on. In order to do that, we will build every function's line graph and compare their regression equations.

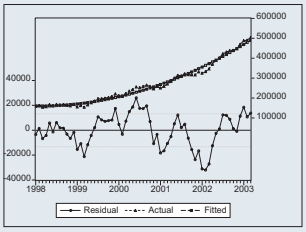
The following graph (below left) indicates the linear trend of the broad money series.

From the graph the variance of the error term proves that the dynamic of broad money in past 5 years does not follow the linear function and we examine a polynomial function in the graph on the right. This graph shows that a polynomial function is a better fit, especially when R^2 equals 0.98. However, we will study further to improve our findings.

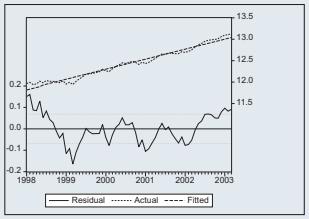
$Y_t = 95433.01 + 5274.97t$



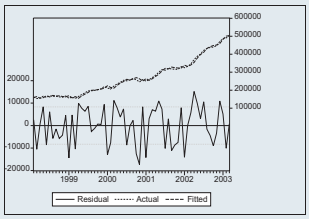
$Y_t = 161277 - 582.21t + 89.48t^2$



$y_t = 11..79\varepsilon^{0.02t}$



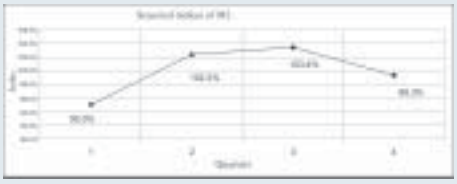
$Y_t = -3125.23 + 1.03Y_{t-1}$



The graph, above left, shows an exponential trend curve for the money supply series. But this function does not explain money supply, since the variance of its error terms is too high. In the next step, the graph on the left, we examine an autoregressive function and it is clear from the graph that the autoregressive trend is a perfect fit for money supply, as its R-squared is 99.3 and the variance of the error term is stable. Thus, our money supply series follow an autoregressive trend.

Analyzing seasonal effects of money supply

Just as Mongolia's Gross Domestic Product and Total Loans show seasonal variations, money supply may also show seasonal effects. In this section we will study the seasonality of money supply. If we test the presence of seasonality of broad money series by using the Census XII program of econometric software Eviews, the results prove that an identifiable seasonality is presented. On the basis of estimating seasonal indices for the analyzed time series we will calculate a seasonality graph in the second stage of analysis and study its dynamics. Over the last 5 years the time series of money supply slopes precisely upward. We can calculate seasonal indices by leveling out the series using a moving average.



Looking at the graph's seasonally adjusted indices, it is clear that the money supply series is below its centered moving average value (100%) during the 1st and 4th Quarters and higher in the 2nd and 3rd Quarters. Thus we can describe the general seasonality dynamics of money supply as it moves from a minimum point at the beginning of 1st Quarter following a gradual upsurge until it reaches its peak in the 3rd Quarter and then drops off steadily until reaching its seasonally adjusted value. Consequently, the seasonality of money supply shows similar results to the seasonality of GDP (The Bank of Mongolia, Research Papers 2002) and the only difference between them is that if GDP peaks in the 2nd Quarter, then M2 peaks in the 3rd. However, if we compare the seasonally adjusted series with M2's actual series, the following graph proves that seasonal effects, while real, are very weak.

Analyzing M2 series using monetary aggregates and money stocks

Monetary survey, or the consolidated balance sheet for the entire banking system, comprises the consolidated balance sheet of Deposit Money Banks and the balance sheet of the monetary authorities. One important purpose of the monetary survey is to present, in a timely fashion, data on monetary and credit developments for the entire banking system that will allow policymakers to monitor these developments and to adjust monetary policy, if necessary.

$$M1=CY+DD, \quad M2=M1+QM \quad or \quad M2 = CY+DD+TD$$

Where M2 is broad money, M1 is narrow money, QM is quasi money, CY is currency outside banks, DD is demand deposits and TD is time deposits.

From the dynamic movements of currency outside banks, narrow and quasi money for the last 5 years, quasi money shows relatively higher growth than other aggregates.

$$M2 = NFA + NDA \quad or \quad M2 = NFA + NDC + OIN$$

Where NFA is net foreign assets, NDA is net domestic assets, NDC is net domestic credit, OIN is other items net.

It is clear that the biggest portion of M2 belongs to NFA. Besides, a decreasing trend for OIN can be seen over the last 4 years. No radical changes are presented by any net items, except NDC which showed a relatively sharp increase during mid-2002 when OIN showed positive in August first time. It is clear that OIN increased dramatically during August and September 2001 and dropped sharply between September and October 2002 but in terms of the other net items, no big change is presented. Thus, in general we can state that no indicator that explains money supply growth unilaterally is identified. Consequently, we will execute data analysis for each net foreign and domestic asset in the next stage. In order to do that we will build scatter plots of money supply depending on net foreign asset, net domestic credit and other items net. Data will be used for 2 values, actual and monthly change, and will be analyzed by monthly and quarterly average and quarter end. The result was:

- A strong correlation between money supply and net foreign assets.
- Although there might be a correlation between M2 and NDC, some shift of scatter in particular periods is clearly seen in all charts. This gives us some idea of possible external effects during that period.
- A negative correlation between money supply and other items net is clearly seen in the scatter plots.

The plots prove that no correlations exist between the variables except NFA. Consequently, on the basis of the data analysis we can conclude that since monthly change values do not tell us anything, we should exclude them from our study and take only analysis based on actual data further. As already mentioned, along with a positive relationship between M2 and NDC a lower-level sloped shift was observed in the scatter plots. This occurred during the period 1998 to 1999, which may illustrate strong effects to money supply and net domestic credit. First, when we estimated a regression equation of money supply dependant on net domestic credit (actual data at the end of quarters), the correlation between the variables was very poor or as follows (R^2 = 0.28):

$$M2eq_t = 68298.87 + 1.5157*NDCeq_t$$
$$(0.9006) \qquad (2.6717)$$

Therefore, in order to clarify the shift, we will include a multiplicative dummy variable to the equation.

$$M2eq_t = b_0 + b_1*NDCeq_t + dDeq_t + u_t$$

Where, $M2eq_t$ is actual money supply at the end of t quarter,
$NDCeq_t$ is actual net domestic credit at the end of t quarter, and
Deq_t is Dummy value at t quarter

It is clear from the estimation that the output of the equation utilizing a dummy variable is much better than that without a dummy variable. This proves that a tight monetary policy during 1998 and 1999 caused a low level of money supply through net domestic credit and that since 2000 that tight policy has started to ease.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	122020.1	23772.39	5.132847	0.0001
NDCEQ	1.567295	0.161711	9.691945	0.0000
DEQ	-151272.8	13509.06	-11.19788	0.0000
R-squared	0.930058	Mean dependent var		276053.1
Adjusted R-squared	0.922287	S.D. dependent var		107456.4
S.E. of regression	29955.66	Akaike info criterion		23.58439
Sum squared resid	1.62E+10	Schwarz criterion		23.73361
Log likelihood	-244.6361	F-statistic		119.6787
Durbin-Watson stat	1.716841	Prob(F-statistic)		0.000000

Dependent Variable: M2EQ
Method: Least Squares
Date: 05/14/03 Time: 22:59
Sample: 1998:1 2003:1
Included observations: 21

Conclusion

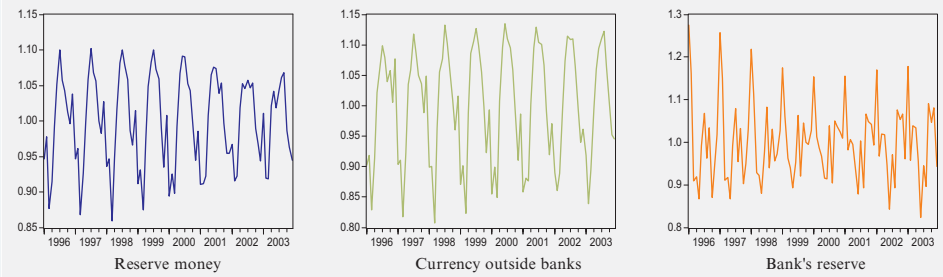
- Money supply series have followed an upward sloping autoregressive trend.
- Money supply has seasonality and the dynamics of its seasonality are similar to the seasonality of GDP but its peaks are lagged one quarter behind those of GDP.
- The seasonal variation of money supply is very weak.
- Monetary aggregates analysis reveals that money supply growth during recent years is mainly defined by quasi money exchange. Data analysis for the stocks of money (net items of monetary survey) proves that net foreign asset expansion mostly played a substantial role in money supply growth.

The expansionary monetary policy since 2000 is best represented by the equation estimation utilizing a dummy variable for net domestic credit.

Source: www.mongolbank.mn

the amount of currency outside banks. There is a tendency for cash to flow back to banks from the agricultural and mining sectors in the second half of the year, leading to a decrease in cash. Therefore, the quarterly trend in the currency outside banks is stable and has a strong influence on both M1 and M2. For the last few years, following changes in the share of M1 in broad money, there has been a tendency for the seasonality of M2 to decline.

Figure 24. Seasonally adjusted index



Quasi money

During the reporting year quasi money rose by 73.7 percent or MNT 208.1 billion, reaching MNT 490.5 billion, which is 69.7 percent of broad money.

As the MNT/USD exchange rate has been relatively stable over the last 4 years, public confidence in the togrog has risen and as a consequence, togrog time deposits make up the major component of quasi money. However, in December 2003 the balance of forex accounts of the Erdenet Corporation and Ivanhoe Mines increased sharply bringing forex deposits up by MNT 49.5 billion over the previous month. This increase was 8.3 times higher than the average growth of the first eleven months of the year. As a consequence, 51 percent of quasi money growth was accumulated in forex deposit growth.

BOX 7. ON MONEY SUPPLY DYNAMICS AND MONETISATION

Money supply has risen at a significant rate since 1999. In turn, credit growth has also been at a very high pace. Therefore there is concern that there might be growing inflationary pressure and that the high pace of money (credit) growth could overheat the economy as expansion above potential could lead to an over-accumulation of capacity. One answer to these concerns is monetisation. Monetisation gives one explanation of how money supply could expand without having a serious impact on prices. In other words, if demand for money grows rapidly then fast expansion in money supply should not be too inflationary and there will be minimal impact on interest rates.

Real money growth represents a money demand shift. The demand shift in Mongolia became possible because of widespread demonetisation due to extreme inflation and the insolvency of financial intermediaries in the 1990s. We believe that inflation was evident during the 1980s in the form of goods and service deficits and that it exploded in the early 1990s, having a large adverse impact as deflationary measures failed. Therefore, hidden inflation created by price control in the centrally planned economy produced hyperinflation with the advent of price liberalisation. Price liberalisation continued from 1990 through 1996, possibly contributing to the continued presence of hidden inflation for years. On the other hand, the failure of monetary policy to control high levels of inflation slowed the process of price liberalisation itself and may have contributed to the frequent public policy measures that supported an economy with hyperinflation.

How far can we go with high money growth without causing serious inflation? The answer comes with the explanation of the monetisation of the economy detailed in this study. Monetisation is primarily linked to agents' decisions: those who did not previously use, or stopped using, the official financial sector in their transactions. Thus an increase in real narrow money, M1, shows monetisation best because it is the principal means by which transactions are performed.

We can draw several observations from Table 1. When real money began to grow in 1999 aggregate money, that is including more payment instruments, grew instantaneously. It then fell back leaving stored money value to grow

Table 1. Selected key indicators of the financial market in recent years

Indicators	1998	1999	2000	2001	2002	2003
Real GDP growth	3.5%	3.2%	1.1%*	1%*	4%	5.5%**
CPI growth	6.09%	10.0%	8.1%	8.0%	1.6%	4.7%
Annual growth of M2	-1.7%	31.6%	17.6%	27.9%	42.0%	49.6%
Annual growth of M1	1.1%	39.0%	13.9%	21.6%	28.6%	13.4%
Annual growth of currency	33.7%	39.6%	39.0%	33.0%	25.7%	18.7%
Average annual rate of loan	48.1%	44.1%	36.8%	37.4%	35.5%	31.9%
Average rate of time deposit	35.3%	39.3%	16.8%	14.3%	13.2%	14%
CPI adjusted real loan rate	42.2%	44.6%	29.0%	29.7%	33.8%	27.2%
Depreciation of MNT	10.9%	18.9%	2.3%	0.5%	2.1%	3.8%

*According an IMF publication real GDP growth rates were estimated the same as previous years. Zud disaster was excluded from the estimation. The effect of zud disaster is included in this estimation, so the resulting GDP is different.
** Expected

faster. So, while M2 growth was accelerating, M1 growth was falling and currency growth was falling even faster. Even if money supply was growing faster, prices were not growing quickly and interest rates were changing slightly but real loan rates were not changing much and the togrog continued to depreciate. Thus, we say, money demand and supply were growing together. Another explanation for money growth through monetisation is that because of hyperinflation prior to 1995 and continued bank failure, agents were not using the togrog in their transactions or as part of their asset accumulation and official financial services were not in demand.

Enhhuyag (2002) presents an explanation for how a financial structure consistent with the market was established in Mongolia. The paper highlights mistakes in the early period such as: lack of bank management skills; serious difficulties due to the adverse selection of asymmetric information, and the inefficiency of the BOM's supervision. In addition a physical deficiency of banknotes, restrictions on non-cash payment instruments, loss of deposit in terms of moneyness (depositors could not make withdrawals from their accounts at the first request) are, in our opinion, factors that limited the functioning of the financial system. These factors led agents to decide not to make deposits at formal intermediaries. The savings deposit rate floor increased the cost of intermediation because it raised the interest expenses of banks that were already losing their deposits, as mentioned before, as well as their assets due to increasing difficulties caused by asymmetric information. More and more banks became insolvent and the banking crisis began.

Growing difficulties with solvency, exacerbated consequences of asymmetric information and insufficient ownership control over banks made the business of banking unattractive and unprofitable. Hence, public confidence in unprofitable banks was lost, resulting in the continued flight of deposits from banks. Banks in turn had to maintain high interest rates to cover their losses, in part due to lost deposits, and the volume of financial intermediation fell. In short, the monetisation of the economy stopped, even though inflation was lowered successfully, due to accumulated losses on banks' balance sheets, insufficient capitalisation and the loss of banks' credibility and solvency.

$\Psi_t = \ln(M1_t/P_t)$

Another outcome of hyperinflation and financial disintermediation was the shortening of financial contract terms. This came about because banks were trying to reduce the impact of inflation and the uncertainty due to asymmetric information. This may have solved the adverse selection problem, except in the case of some state-owned banks, but it did not help the moral hazard. The shortening of financial contracts eliminated investment in bulky medium- and long-term projects.

Bank restructuring measures, improvements in the legal environment and the elimination of financial repression had an almost revolutionary result and productivity in the banking sector is now growing. Resulting from these innovations, banks' credibility recovered and thus business entities and individuals are more often choosing formal financial services, facilitating a smooth monetisation process. However, the question "How long will money supply grow like this?" is still difficult to answer. One possible answer is to use univariate dynamic compositions of real narrow money to analyse near future forecasts. As explained earlier, if the first part of money, characterised as payment instruments, grows faster and at sufficient volume, asset accumulation in the togrog will grow. At first, money creation by the Central Bank shall boost the means of exchange and then impact banks' liabilities. So, when means of exchange growth falls and its real level approaches that of the pre-hyperinflation period, we might observe signs of sufficient monetisation in the economy. For this purpose we use the dynamic composition of M1 and decompose it for forecasting purposes. The model is:

$$\Psi_t = \alpha + \tau_t + \sum_{j=2}^{12} \delta_j D_{jt} + \varepsilon_t \qquad (1)$$

$$\phi(L)\varepsilon_t = \theta(L)\upsilon_t \qquad (2)$$

$$\upsilon_t \sim wn(0, \sigma^2)$$

Where $\Psi_t = M1_t/P_t$ or is real narrow money or its log, t_t, is time trend and e_t is a combination of the stochastic term and the variable's lagged value. Modeling the residual represents cyclicity and u_t ~ iid.

Equation (1) is the model for real narrow money and equation (2) is the cyclical model. The forecast, using estimated results of the model, shows that real M1 in 2004 will be very close to its level in mid-1992. In short, narrow money growth will be less intensive and its level will approach that just prior to the period of Mongolia's highest inflation. Thus, monetisation could be at a high enough level. Hence, in 2004 monetisation may reach a high enough level that it exhausts opportunities to expand money without putting serious pressure on prices. In other words, further increases in the proportional growth rate of money may be translated into inflation. Then, with inflation, the purchasing power of the togrog will weaken causing an outflow of funds from Mongolia. Furthermore, if nominal exchange rates do not depreciate further it could lead to real appreciation damaging the economy's competitiveness and closing options to finance the domestic economy.

Source: www.mongolbank.mn

3.2. Money market

The result of monetary policy is assessed by inflation. As the inflation rate changes according to current circumstances on the financial market, it plays a signaling role to the market. The following factors influence inflation:

1. Circumstances of the financial market
2. Activities of financial intermediaries
3. Risks in the financial sector
4. Competitiveness of the real sector

The first two factors demonstrate the current conditions of the financial market whereas the latter two determine perspectives in the nearest future. Proper regulation of these market factors ensures togrog stability and improves the public's purchasing power.

During the last few years the inflation rate has been stable. The stability of inflation is extremely important in the promotion of productivity in the economy. If we compare the stability of inflation in 2003 with that of the previous year, the inflation rate expressed by CPI shows most stable. Furthermore, it signals some progress that there was no deflation. Deflation discourages consumption and furthermore its continuation has a negative effect on the sale of goods and services leading to crisis.

As a result of stabilized inflation, prices became more predictable and the potential negative impacts of price changes on financial negotiations reduced significantly. Moreover banks, as the main distributors of resources in the financial market, can mobilize and deliver resources within a shorter period of time. The banking crisis and long-time deterioration of banks' payment ability had previously resulted in weak mutual trust between banks and made the inter-bank market impossible to operate. Now banks have successfully restructured and the activities of the inter-bank market have consequently enhanced. Although the money market is not yet fully developed, the inter-bank togrog and forex market have begun to operate much more smoothly. The repurchase financing instrument introduced by the BOM in mid-2002 has played a significant role in the development of the market for togrogs. The inter-bank market started to publicly state forex rates and this has strengthened activities in the forex market.

Table 8. Changes in reserve money, M2, CPI and exchange rate (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Reserve money	157.1	168.6	104.1	28.7	36.5	23.1	18.7	49.9	18.6	8.2	21.9	14.5
Broad money (M2)	31.6	227.6	79.5	32.9	25.8	32.5	-1.7	31.6	17.6	27.9	42.0	49.6
CPI	325.5	183.0	66.3	53.1	44.6	20.5	6.0	10.0	8.1	8.0	1.6	4.7
Exchange rate	0.0	891.3	4.4	14.4	46.4	17.3	10.9	18.9	2.3	0.5	2.1	3.8

Figure 25. Inflation, in comparison with the previous year

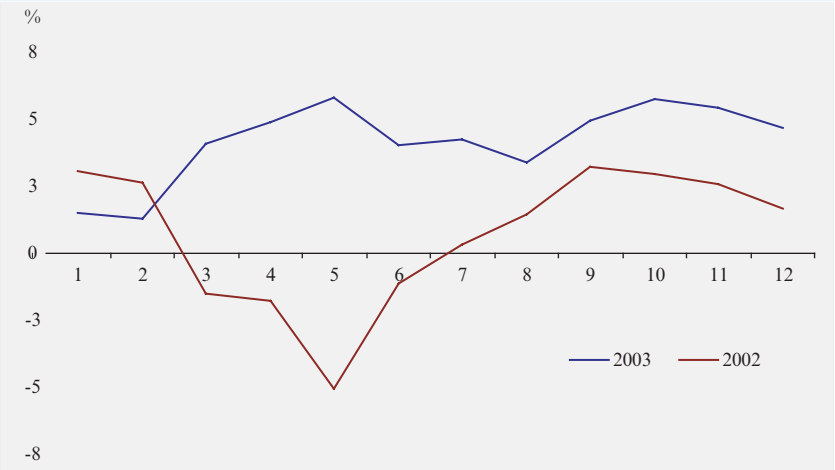


Figure 26. Tradings of togrog and foreign currency at the interbank market in 2003

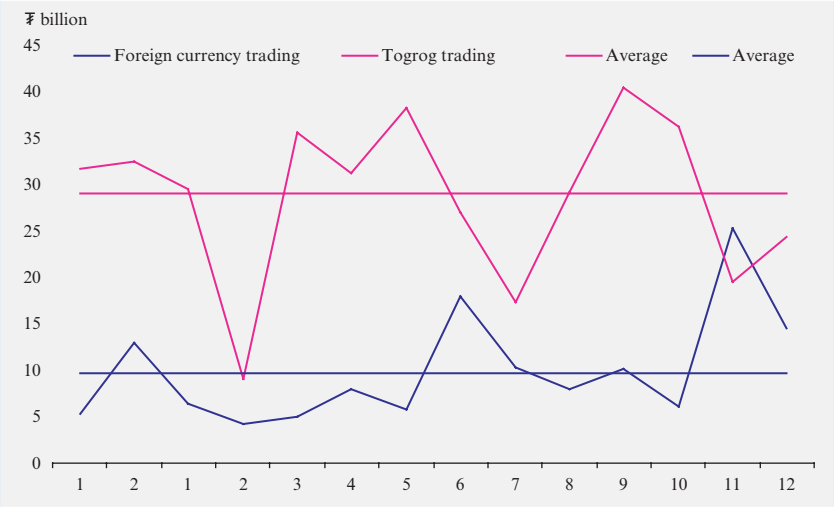
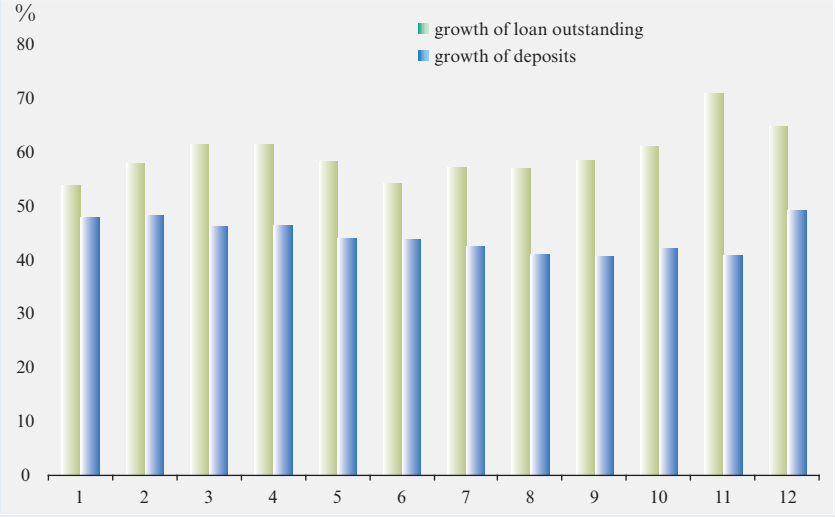


Figure 27. 12 month growth of loan outstanding and deposits



In the reporting year togrog transactions worth MNT 29.0 billion and forex transactions worth some MNT 10 billion were made on the inter-bank market. In total, MNT 337.9 billion were traded on the inter-bank market. Out of the total, MNT 5.9 billion were traded by inter-bank credit, MNT 205.5 billion by repurchase agreement, MNT 78.8 billion by CBBs, MNT 46.3 billion in overnight loans and MNT 1.4 billion by government bonds. The weighted average interest rate of these trades was 10.16 percent. The interest rate on the inter-bank market is considered to be the prime rate of the financial sector.

The development of the inter-bank market provides banks with the opportunity to position their excess reserves and to mobilize monetary resources within a short period of time. The core requirement for efficient distribution of excess resources is the possibility of passing it on to intermediaries within a short time period. As such activities become more intense the wholesale price of short-term credit lowers, providing the possibility of reducing the expenses arising from both the resources and financial intermediation. The BOM needs to be innovative and make efforts to enhance the structure of the inter-bank market and to ensure the disclosure of information as well as to improve independent operations of participants in the future. The BOM introduced advanced payment forms as a result of which banks were provided with the opportunity to control their payments and to manage their short-term resources more efficiently.

During the last few years economic monetization was undertaken within a short timeframe, producing significant progress. The liquidity of banks has improved and monetary resources have concentrated in the financial sector. These advancements have deepened financial intermediation; resources have started to be allocated through the private-ownership dominated banking sector, and there is opportunity in the market to support creativity in the real sector. Since the financial sector recovered and competitiveness increased, the difficulties of financial intermediation that previously put the brakes on economic growth have been lifted. Further productivity growth, tax support and the development of the capital and labor markets are extremely important in the intensification of further economic growth. Banking credit to the real sector and the growth of banks' deposits demonstrate the performance of the financial sector.

Outstanding loans increased by 81.8 percent on average through the year and deposits increased by 56.1 percent over the same period. The rapid monetization of the economy is reaching its final stages and, related to this, the growth of bank deposits is likely to slow down. However, it is possible that credit growth will remain stable for a certain period of time depending on bank reserves and asset management.

The increase of public confidence in the banking system is due in large part to the improved risk management of banks. The operations of banks and non-bank financial institutions contain risks in themselves but banks are more capable of managing the risks and recovering from losses that may result from them. As a result of proper delivery of information the public has become more interested in depositing their money with banks. The minimum requirement of

banks' paid up capital should be MNT 4.0 billion in the first quarter of 2004. This means that every profitable bank will be capable of covering a loss of some MNT 4.0 billion under any circumstances. On the other hand, banks should have well-organised staff that are able to manage any risks and the BOM should pay more attention to this area. Banks should get rid of characterizations such as 'accounting was made improperly', 'information delivered was misleading' or 'the managing staff are not competent' as this will increase public confidence in the banking sector. Moreover, the creativity of Mongolian banks has improved attracting the attention of both domestic and foreign investors. The equity of the banking sector has grown and investors' shares have increased.

Although the assets to finance the real economy through banks have risen constantly and the economy was monetized within a short time period, loan terms are still too short and the loan interest remains at its previously high rates. The terms of only 8.3 percent of outstanding credit in 2002 was longer than a year, though by the end of 2003 this figure had reached 22.1 percent. It is impossible to lower interest rates by an administrative method, but one way of reducing repayment pressure would be to lengthen loan terms while the interest rate is still high. On the other hand, long-term loans establish a long-term relationship between the bank and the borrower. The advantages of this relationship are that it reduces the expense of granting loans and it also increases the possibility of providing properties as collateral. The introduction of mortgages is a crucial step in increasing long-term loans. New products similar to this were introduced to the market by ADB projects and currently banks are able to grant tenant-owned hypothecary loans with their own resources. Banks have been provided favorable conditions to learn about granting business loans, especially long-term project loans, in the future.

3.3. Capital Market

In 2003, the Mongolian Stock Exchange held 250 overlapping sales totaling 8.1 million shares in 281 companies, 232,700 government treasury bills and 222,300 bonds issued by 4 companies. The total value of trade in the year reached MNT 25.4 billion. Trade in government bonds accounted for 85.7% of the total value of transactions, while trade in corporate bonds was worth 10.8% of the total and the remaining 3.5% of trade was in shares.

The value of trade in bonds increased by MNT 250.9 million due to the trade of 25,100 New Century bonds on the secondary market.

Table 9. Capital market transactions (mln togrogs)

	Transaction amount		Change (increase, decrease)	
	In 2002	In 2003	of value	of percentage
Government bonds	41,690.60	21,722.50	-19,968.10	-47.90
Corporate bonds	2,958.00	2,988.30	30.3	1.02
Shares	13,745	895.8	-478.7	-34.80

In the reporting year, an average 32,300 shares worth MNT 3.6 million were traded daily. The most popular corporates, by trade volume, were: Mongol Savkhi, Shipping Company #22, State Department Store, Shivee Ovoo Coal Mine, Baga Nuur Coal Mine, AgroTechImpEx, Contsruction Material, Bilgeh Bayanburd, Bohog and Gonir. Also actively traded on the market were: Bayangol Hotel, Ulaanbaatar Hotel, Mongol Savkhi, Ulbaa, Altain Zam, Baganuur Coal Mine, Telecom Mongolia, MakhImpEx, Shivee Ovoo Coal Mine, Ulaanbaatar.

According to a decision made by the State Property Commitee, the Government sold 28.6 percent of its stake in Altain Zam and 55.3 percent of its holdings in Ulbaa in 2003. However, Government also offered a 4.9 percent stake in the Gobi Corporation and a 12.5 percent stake in Avtozam Arhangai but neither sale was concluded successfully.

The Top 20 index averaged 768.4 points in 2003, down 352.9 points from the previous year. The fall was mainly due to losses at Barilga Corporation, Mongol EEG, Bayangol Hotel, Gobi Corporation, APU, Takhi Company and Tavan Tolgoi Coal Mine.

In 2003, there were 9 rounds of trade in Government bonds, at which 232,700 bonds were traded at a total value of MNT 21.7 billion. Of these, the lion's share of trade occurred in 5 rounds which between them accounted for 222,700 bonds worth MNT 21.6 billion, all of which were bought by banks and corporations. 10,000 bonds worth MNT 96.8 million went to individuals at the remaining 4 rounds.

An additional MNT 74.5 million over the nominal level was raised from the sale of Government discounted bonds.

In reporting year, 222,300 corporate bonds were sold in 63 sessions to a total value of MNT 2.7 billion. In April 2003 the Ih Barilga Project issued 16,000 new bonds at nominal MNT 50,000 each.

In 2003, 232,700 Government discounted bonds worth MNT 22.3 billion were registered as well as 200,000 Barilga Corporation bonds worth MNT 2 billion and 16,000 Ih Barilga Project bonds worth MNT 0.8 billion.

In 2003, 402 limited liability companies were registered, of which the state had a stake in the ownership of 68 and 334 were fully part of the private sector. A total of 1,224.6 million stock

Table 10. Trading information of company bond (In millions of togrog)

Bonds	Volume of trade	As a share of total
Shine zuun	1809.69	66.1
Niislel orgoo	125.7	4.6
Ikh barilga	1.99	0.1
Ikh barilga project	800	29.2
Total	2737.38	100

Table 11.Changes in security registration (as of December 31, 2003)

	2002	2003	Changes
Number of registered companies	403	402	-1
- Partly state owned	61	68	7
- Privatised	342	334	-8
Number of registered shares	657 268 298	1 224 637 137	567 368 839
- State owned (pieces)	475 076 606	988 947 572	513 870 966
- Owned by investors (pieces)	182 191 692	235 689 565	53 497 873
Newly registered:			
- Number of state owned companies	8	12	4
- Number of state owned shares	384 906 535	569 865 749	184 959 214
Excluded from official register:			
Number of stock companies	6	13	7
- Number of shares	207 978	14 366 932	14 158 954

Figure 28. TOP-75 Index

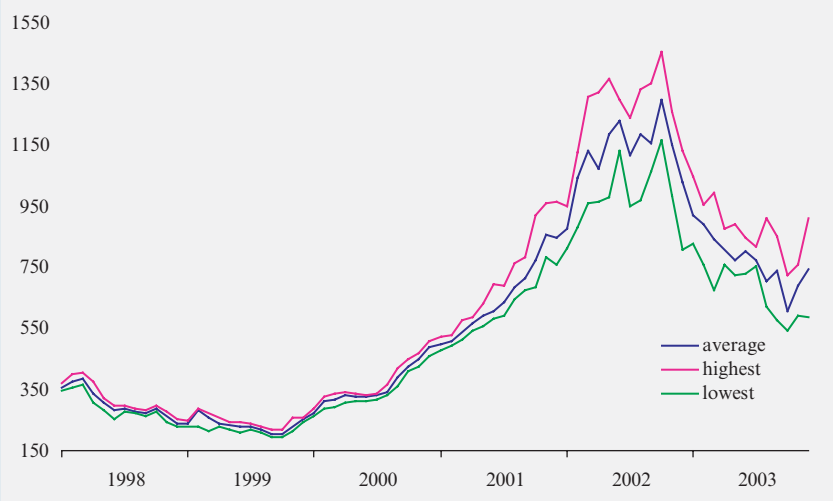
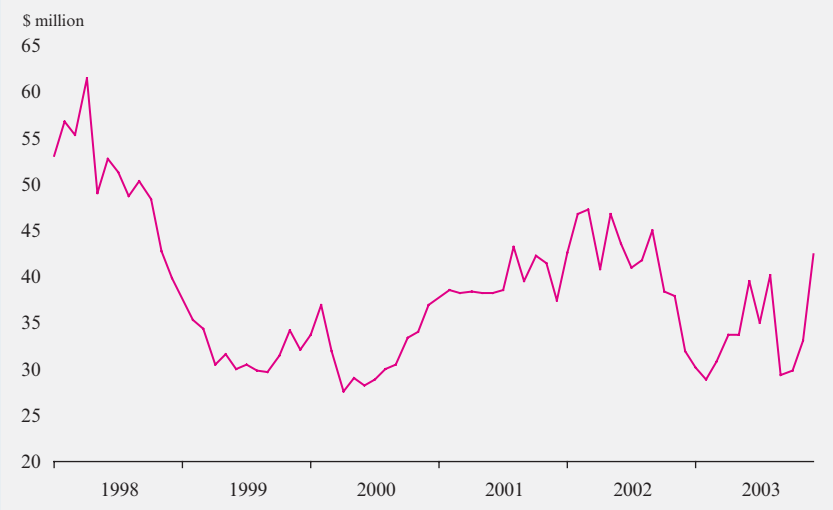


Figure 29. Market capitalization



shares were registered of which 989.0 million, or 80.7 percent, belonged to the state. The number of state-owned companies declined, but the number of shares held by the state increased 8.5% on the previous year. The State Property Committee explained this paradox as being a result of the deregistration of 569.9 million shares in 11 companies.

Non-trade shares transaction

After 6 years of accepting non-trade transactions, transactions were made amounting to MNT 1.4 billion involving 9.2 million shares; 78 percent of the 374 companies initially registered. The number of non-trade transactions made in 2003 increased in terms of share volume by 95.2 percent on the previous year. 2.2 million shares were traded in this way, though this represented a decline in trade value of 41.4 percent from the previous year: transactions worth MNT 137.7 million were made.

According to the above research, non-trade transactions accounted for 0.3 percent of all transactions in 1997, 11 percent in 2002 and 22 percent in 2003. In 2002, 94 percent of transactions were non-trade portfolio transactions and this increased slightly in 2003 to 96 percent.

In reporting year, 26 Brokerage companies were conducting operations, 25 of whom had received an approval.

Privatization

In the reporting year the State Property Committee conducted activities focused on the Great State Khural's Guidelines for the privatization of State property in 2001-2004, as it had since 2001, and on the Government's Program on Privatization of State Property, which it began in 2002.

In 2003, 16 companies part-owned by the state and 22 fully state-owned companies were privatized. Privatized properties and companies were from the:

- Banking and financial sector
- Mining and quarrying sector
- Energy sector
- Roadway sector
- Food sector
- Social sector
- Other sectors

In 2003, the Agricultural Bank and Mongol Insurance Company were privatized from the banking and insurance sector by international tender and Tushig Insurance Company was sold separately using a competitive selection method.

From the mining and quarrying sector, 80 percent of state shares in “Shariin Gol” Company were privatized by competitive tender and the state-owned company “Gan” was sold by closed auction.

In the energy sector, state-owned shareholding companies, such as the “Darkhan, Selenge Energy Supply Sector Network” and “Baganuur Gas, Energy Station” were privatized by competitive tender and those in “Nalaikh Gas Station” were sold by contract.

From the roadways sector, state participation in shareholding companies such as, “Zavkhan Ulbaa” in Zavkhan Aimag were privatized through the Mongolian Stock Exchange, while “Altain Zam” in Khovd Aimag and the fixed assets of its branches were privatized by public auction.

In the food sector, state-owned Shareholding Company “Khuns Trade” was privatized by public auction and “Mercury” food market was by superior renting right.

In the social sector, the state-owned shareholding companies “Emiin Uildver” and “Monemzim” were privatized by competitive tender and 49 percent of state shares in “Mongolemimpex” were sold at public auction, Humanitarian and Ulaanbaatar universities were privatized based on work result of the management team.

In 2003, the State Property Committee brought MNT 19.4 billion to the State budget as a result of its privatization operations.

4 BANK AND FINANCIAL SECTOR DEVELOPMENT

As of the end of 2003, 17 banks, 88 non-bank financial institutions (henceforth referred as NBFIs) were providing banking services to their customers through 635 offices, including 92 branches, 523 payment and settlement centers and 20 savings and cash units. Around 478 offices of 15 banks were operating in rural areas, aimags and soums, which represent 75.3% of all bank offices. This figure has increased by 20 offices from the previous year.

As of the end of 2002, 16 banks were operated, of which 2 were state-owned, 2 had state participation and 12 were privately owned (of which 1 was a private foreign bank). As of 2003, 1 bank remained state-owned, 2 banks retained state participation in their equity funds and the number of private banks increased to 14. As of the end of 2002, state-owned and state-participated banks held almost 28 percent of all household savings and time deposits and 10 percent of current accounts, but as a result of privatization of the state-owned banks, state involvement in the banking sector has decreased steadily.

Table 12. Banks' branches and units **(end of 2003)**

	Ulaanbaatar city		Countryside		Total	
	Number of branches & units	Changes*	Number of branches & units	Changes*	Number of branches & units	Changes*
1 Agriculture	31	20	343	3	374	23
2 Trade and development	8	0	10	0	18	0
3 Savings	31	-1	9	0	40	-1
4 Golomt	9	-1	2	0	11	-1
5 Post	6	-3	67	5	73	2
6 Erel	3	0	1	0	4	0
7 Ulaanbaatar city	14	-2	2	0	16	-2
8 Capital	6	1	3	2	9	3
9 Transport and development	3	0	0	0	3	0
10 Credit	6	2	2	1	8	3
11 Zoos	8	4	9	3	17	7
12 Anod	13	6	5	2	18	8
13 Inter	2	0	2	1	4	1
14 Capitron	5	2	1	1	6	3
15 XAS	10	3	22	2	32	5
16 Menatep	1	0	0	0	1	0
17 Chinggis khaan	1	1	0	0	1	1
Total	157	32	478	20	635	52

* Annual changes

Despite the negative impact of the SARS virus, evidenced mainly in the South East Asian countries, on the expected growth of tourism, GDP growth was higher than forecast due to steady growth in the industrial sector and the recovery of the agricultural sector. Therefore, it can be concluded that these developments have added momentum to the further expansion of the banking and financial sector. As a result, the growth of bank and NFBI assets were higher relative to previous year figures; total banking sector assets, current account, saving and time deposits and capital accounts grew by 67.5, 59.0, 66.5, and 80.1 percent respectively.

The prima facie evidence suggests that the expansion of economic activity among households, companies and other institutions has created demand for comprehensive financial services. Taking into account these developments, banks have been broadening the scope of services they provide and trying to boost their incomes through fees and commissions from these services. During the last few years, several banks have issued their own debit and credit cards, which is one form of non-cash payment and settlement, and within the last year the number of cardholders has increased by 33,671 to 55,074.

In addition, the Golomt and Capitron banks have introduced Internet Banking Services, while other banks have started to provide telephone-banking. These activities not only save time for their customers, but also simplify access to financial services.

In 2002, banks concentrated on the introduction of new services while in 2003 they were more focused on improving the forms and quality of those services. On one hand, these changes have been beneficial to customers, but, on the other hand, it has become necessary for banks to give special attention to improvements in technology and related software as, due to internal and external factors, these new services carry with them new risks.

The ‘State Monetary Policy Guidelines’, approved during the banking system crisis (1996-1999), were focused on ensuring the stability of the financial sector and deepening the bank restructuring process rather than promoting competition. As a result of these actions the banking sector has been stabilizing and of late it has become necessary for the financial sector to improve profitability, to increase its ability to withstand different types of risks, to enhance competition to make access to financial services easier for relatively small/non-sophisticated customers, and therefore to encourage the establishment of financial intermediaries other than banks. Relevant policy measures to boost the operations of NBFIs and to establish a pertinent legal framework were included in the Monetary Policy Guidelines, and consequently within the last 4 years, 97 NBFIs have been licensed by the BOM, of which 34 were licensed within the last year. The number of NBFIs licensed over the last few years demonstrates enhanced competition, deepened financial intermediation and also the intention of individuals and institutions to conduct banking operations.

There was no specific law regarding NBFIs during the first years of their establishment, and therefore they were following provisions from the Banking Law and some special regulations

Figure 30. Money supply, currency outside banks (percentage of GDP)

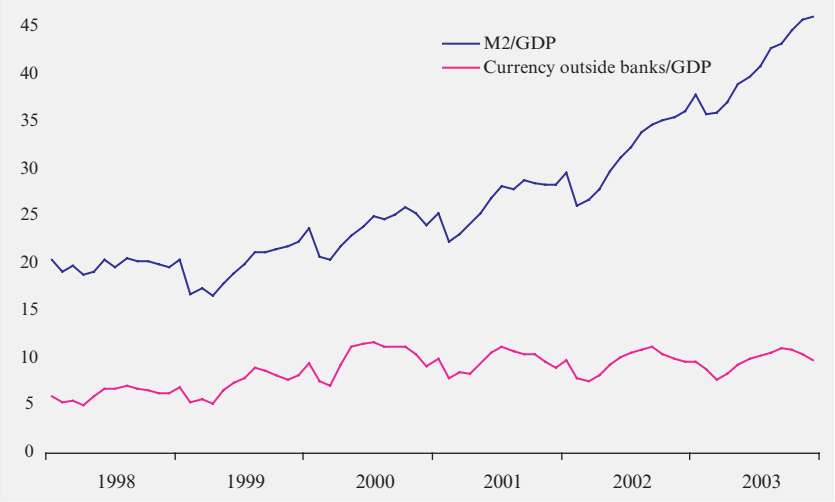


Figure 31. Non-performing loans

Figure 32. Return on equity and assets

BOX 8. FINANCIAL INTERMEDIATION

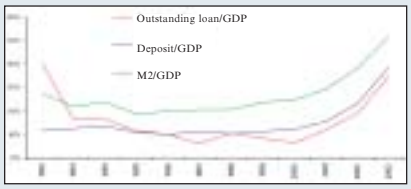
Financial intermediation is the service of channeling funds from savers to borrowers promptly and efficiently. Individuals and institutions that provide this type of service are called financial intermediaries, and examples of these are: commercial banks, non bank financial institutions, investment companies, saving and loan associations and insurance companies. In Mongolia, financial intermediation started developing in a real sense when the two-tier banking system was established in the 1990's.

In the beginning, irregularities in financial intermediation due to economic structural reform resulted in an unfavorable economic environment, or specifically: hyperinflation, a weak legal framework to regulate financial sector activities, inefficient loan policies and a lack of knowledge and practical experience to work in the new system among banking staff. This caused a financial sector crisis and in 1998-1999, policies and reforms were put in place to normalize activities in the banking and financial sector. For some banks, the lack of management rewards or a bonus system was also a factor.

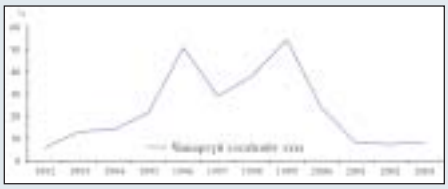
The list of reasons for the financial crisis could go on; however, taken as a whole the reason is simple: some banks could not take advantage of their position as financial intermediaries and provide their services with a high level of professionalism. In other words, a large number of loans became bad loans as financial intermediaries failed to collect and analyze sufficient information on borrowers, did not pay adequate attention to loan use and could not estimate or diversify the risks associated with investments.

Movements in the main indicators of financial intermediation are shown by the following graphs:

Graph 1. Ratio of outstanding loan, deposit and M2 to GDP



Graph 2. Percentage of non-performing loans to total loans



As shown by the graphs, the main indicators of financial intermediation began to improve from 2000. The main reasons for this improvements in loan issuance and loan quality are that banks learned their lessons and gained experience of working under the new system enabling them to apply more efficient loan policies, and the BOM strengthened its supervision of commercial banks. In addition, from 1999, the financial sector became more stable, public confidence improved and therefore banks began to attract more funds.

When household income levels are relatively low, and barely sufficient to cover basic needs, households might be more interested in keeping their money as cash since it is easier to make payments. One way to reduce the amount of cash in people's pockets is to promote the usage of non-cash payment, credit and debit cards, which have been gaining in popularity over recent years. However, there are several difficulties: card use is relatively expensive; household real incomes are low, and the network, between banks as well as between banks and service institutions, is not fully developed.

Another important financial intermediary is the Stock Exchange. Unfortunately, in Mongolia's case, Stock Exchange activity is very passive, almost dead, and as shown by several surveys public knowledge about the Stock Exchange does not often extend beyond its name. If the Stock Exchange could reach a level at which it could perform its activities efficiently, companies wouldn't have to limit their financing options to bank loans as it would be possible for them to obtain funds by issuing bonds or shares. At the same time, not only would interest rates fall in the financial market, but also among financial institutions, contributing to the development of the sector. Moreover, Mongolia usually has to depend on foreign grants and direct investment when it comes to financing where large investments are required as it would be too risky and beyond the power of a single bank to undertake such financing independently. Therefore, in those cases, several banks could jointly grant loans based on accurate estimation of the risks involved.

Source: www.mongolbank.mn

issued by the BOM. Therefore, the BOM was actively involved in drafting the Law on NBFIs that was approved last year. These actions created solid foundations for the further development of NBFIs and the BOM has amended its rules and regulations accordingly.

Growth of banking sector assets in 2003 was higher than in previous years and the main indicator measuring the level of financial intermediation, the ratio of Broad Money (M2) to GDP, increased by 21.9 percent (from its 2001 level) and 13.7 percent (from its 2002 level) to 51.6 percent.

4.1. Banking sector

In 2003, banking sector assets sky-rocketed by MNT 333.1 billion (67.5 percent), representing 60.6 percent of nominal GDP. Asset growth was driven by a rapid increase in current accounts, time deposits, funds attracted from foreign banks and capital accounts, which soared by MNT 77.3 billion (59 percent), MNT 145.1 billion (66.5 percent), MNT 34.9 billion (tripled) and MNT 49.1 billion (80.1 percent) respectively.

Total banking sector assets were structured as follows: net outstanding loans made up 51.8 percent, foreign assets 19 percent, Central Bank Bills 9.3 percent and Claims on the Government 5.7 percent. Compared to figures from the previous year, the share of loans and foreign assets increased by 6.6 and 4.7 percent respectively, while the share of other assets fell. As for changes in the levels of particular assets, primary reserves soared by 27.4 percent, claims on other banks and BOM bills rose by 37.1 percent, net outstanding loans by 80.9 percent, other securities by 90.7 percent, fixed assets by 38.8 percent, OREO by 60.1 percent and other assets by 30.1 percent.

During 2003, total bank liabilities escalated by 65.8 percent, or MNT 284 billion, caused by an increase in savings and time deposits of 51.1 percent, current accounts of 27.2 percent and funds attracted from foreign banks of 12.3 percent. As for the structure of banking sector liabilities, during the last year there was a shift from Government deposits toward household and private entity deposits, funds attracted from foreign banks and other liabilities. As a result total liabilities were structured as: savings and time deposits 50.8 percent, current accounts 29.1 percent, funds attracted from domestic banks 7.2 percent and other liabilities 3.8 percent.

Table 13. Main ratios of the banking sector (percent)

	1996	1997	1998	1999	2000	2001	2002	2003
1 M2/GDP	19.9	20.4	20.5	23.8	25.4	29.7	37.9	51.6
2 Loan/GDP	10.0	6.0	10.5	8.4	6.6	12.1	18.7	32.5
4 Capital/GDP	-2.1	2.0	0.9	2.2	3.1	4.2	5.0	8.1
6 Total assets/GDP	21.3	23.6	22.0	19.7	22.1	29.8	39.7	60.6
7 Currency outside banks/GDP	6.5	6.0	6.9	9.4	10.0	9.8	9.7	9.7
8 Deposit/GDP	13.4	14.4	13.6	13.7	15.5	19.9	28.2	42.0

BOX 9. LENDING

As profit seeking organizations that carry out activities as financial intermediaries, banks earn profits by withdrawing capital from business entities and individuals and allocating it efficiently. In other words, banks make profits equal to the difference between interest income on loans given and interest expenditure paid to withdraw capital.

As a consequence of the victory of the People's Revolution in 1921, the Mongolian banking and credit system was established and in 1924 the Mongolian-Russian joint bank, the 'Mongolian Trade and Industrial Bank', was founded. Thereafter, for over 70 years, the activity of issuing loans was handled solely by the National Bank (The Bank of Mongolia) under the resolution of the Board of Ministers. However, from 1991, when a two-tier banking system (Central Bank and commercial banks) was introduced, commercial banks began to provide credit to the economic and social sectors along market economic principles.

Let's glance into the history of credit development in Mongolia.

1. 1924-1991

In Mongolia the agricultural sector was the largest contributor to GDP and it is also considered to have been one of the largest credit-receiving sectors. After the 'Mongolian Trade and Industrial Bank' was founded in 1924, Government began to give even greater attention to the agricultural sector, taking measures to develop agriculture and industrialization, broadening trade and forming a National Credit System. Until 1933, the National Bank's credit policy hadn't been shaped and mechanisms and principles for issuing credit had not yet been determined, so bank credits were mostly aimed towards trade reservation, private trade, financing the provision of goods and regulating prices. During that time, due to the broad credit granted to newly established collective farms, credit principles such as back payment and loan guarantees were not yet in place. Besides this, organizations and individuals were providing credit to each other directly, not always going through the bank. Considering these circumstances, in 1933 the Board of Ministers issued a second resolution, which stated that the National Bank would be the only credit provider and that it would perform transactions and transfers between organizations. The principles of credit provision were also established.

In comparison with 1930, in 1933 credit granted to the trade sector increased 5-fold, to the transportation sector 15.5-fold and to the agricultural sector 18.5-fold. In the framework of actions taken to withdraw and manage capital, banking capital increased, producing an opportunity for credit to small manufacturers to be increased. In 1934, loans issued to small manufacturers and craftsmen increased 30-fold and loans to private farms increased 8-fold over those issued in 1932.

The 8th Great Khural, held in 1944, established further economic development goals and under this framework changes in loan regulations were made. As a result, issued loans grew by 40 percent in 1948-1952 and by 1952 short-term loans reached MNT 360.1 million in value and long-term loans MNT 10.9 million.

Table 1. Total Loan: Total Assets as 10-year averages (in millions of MNT)

Years	Total Loans	Total Assets	Percentage Ratio of Total Loans to Total Assets
1924-1934	22,580.1	43,361.5	52.1
1935-1944	117,153.7	229,239.9	51.1
1945-1954	251,661.1	454,297.3	55.4
1955-1964	1,162,588.0	2,417,009.6	48.1
1965-1974	2,016,261.5	17,641,364.7	11.4
1975-1984	4,872,048.0	48,539,116.5	10.0
1985-1990	7,825,533.7	93,642,587.3	8.4

In 1956, loan and current account interest were set by the Government resolution "The Role of the National Bank in Further Development of the National Economy", strengthening banking supervision. In 1963, Government issued a resolution to further strengthen banking supervision that allowed the National Bank to credit, encourage or forfeit industries and farms depending on their activities and profit ratios. Consequent to transferring the administration of farms to the new system, in 1971 arrangements were made on banking services and supervision. Thereafter, organizations working in the new administrative and planned regime began to follow a new credit regime under which credit was made available for the purpose of fulfilling planned production or activities.

By the end of 1980, actions were taken to improve economic profitability and to manage money transactions according to normative results. In 1990, new techniques and technologies were introduced to banking operations. Considering the credit process through the planned economy, from the establishment of the banking and financial system in 1924 to 1990, and taking 10 year averages, the highest ratio of loans to total assets was in 1924-1933, when it ran at 52.1 percent. This was largely due to post revolution reconstruction activities.

2. 1991-1999

In 1991, the Mongolian Parliament approved a brand new 'Banking Law of Mongolia', which positively influenced the legal environment for establishing a two-tier banking system. Thereafter, the establishment of a two-tier banking system has played a major role in the transition from a planned economy to a market economy.

During the transition period, newly organized banks suffered major setbacks due to lack of experience, poor legislation and an undeveloped legal environment, forcing many banks into facing bankruptcy. Furthermore, Government still influenced the state-owned bank's loan decisions and weakened liquidity by means of its shareholdings due to weak legislation on commercial banking activities under market economic principles. The fundamental difficulty of liquidity was related to the loan process, and lack of information and difficulties in determining debtor's operations caused insecurity in the loan portfolio. The first signs of crisis appeared in 1994 with the acquisitions of the Mongolian Cooperative Bank by Ardyn and the Selenge Bank by ITI Bank. Due to lack of studies prior to credit issuance, the credit chain led to consequences such as the Reconstruction Bank's nonperforming loan ratio reaching 100 percent and the ITI Bank's nonperforming loan ratio reaching 96.4 percent, leading to the bankruptcy of the Ardyn and Insurance banks in 1994 and of the ITI and Reconstruction banks in 1999.

3. 2000-2003

The banking system overcame the crisis of 1994-1999, the legal environment has since been better formed, the Central Bank's degree of supervisory authority has been increased, the Bank' s accounting system has been renewed, new recruits have been trained and other mechanisms of internal auditing have been established, all of which have played a major role in the recovery of banking operations. An improving trend in the banking system has emerged since 2000 and the confidence of entrepreneurs and the public towards banks has greatly increased, bringing an influx of funds to banks in the form of current accounts and time deposits that has allowed banks to significantly increase their lending operations.

In 2001, in order to oblige debtors to repay loans and to upgrade the legal environment, significant changes to the regulation of loans and loan collateral were made in Civil Law that had a positive influence on the situation. Also, in order to help banks reduce their credit risk and to bring an end to the issue of loans to debtors with a poor credit record, the BOM took action to promote stability and to create a Loan Database System (established in 1996) with support from donor countries. The Loan Database System demonstrated a notable decline in the issue of new loans to debtors with financial constraints or existing outstanding loans that had exceeded their terms. As a result of actions taken by the BOM, banks' ability to grant loans has progressed. For example, by the end of 2003, total outstanding loans reached MNT 442.1 billion, 7 times higher than in the same period in 2000, 3.5 times higher than the same period in 2001 and 1.9 times higher than the same period in 2002.

As of the end of 2003, net lending to the non-industrial sector increased 90.9 percent over the same period in 2002, while net lending to the industrial sector grew by 62.2 percent. Comparing the growth rates of the industrial and non-industrial sectors by juxtaposing data from December 31, 2002, to the same data from the previous year, the highest growth rate of net lending within the industrial sector was 127.7 percent and the same figure for the non-industrial sector was 99.9 percent.

In recent years, financial intermediation by the banking sector has significantly increased due to the fact that money supply outside the banking system has diminished as individuals and businesses have begun to turn to banks for their financial needs. However, the majority of bank financing is being used for non-industrial purposes, so it could be concluded that a policy to divert these funds to the industrial sector is needed to invigorate the economy. In other words, banks should work towards decreasing interest rates and lengthening loan duration in order to create a more favorable financial environment for businesses.

Source: www.mongolbank.mn

Table 14. Loan report of the banking sector (in billions of togrog) 2003.12.31

	Beginning of year	Loan issuance	Loan payment	Out-standing
Total loan	281.9	714.7	560.0	441.2
Manufacturing	147.0	214.2	171.0	194.9
Agriculture, hunting, forestry and fishing	13.8	24.5	16.7	24.2
Electricity, gas and water supply	3.6	14.0	8.2	9.4
Construction	14.3	44.6	27.6	31.3
Mining and quarrying	35.6	47.9	46.9	37.5
Processing	79.7	83.2	71.6	92.5
Non-manufacturing	134.9	500.5	389.0	246.3
Whole and retail trade, repair of household goods	80.7	307.2	236.6	150.4
Tourism, hotel and restaurants	7.2	5.7	5.8	7.2
Transport, storage and communication	6.5	19.3	12.4	13.6
Real estate, renting and business activities	3.0	9.3	5.2	7.6
Health and education	1.3	2.9	2.2	2.1
Financial intermediation	4.0	5.2	4.9	4.4
Others	32.2	150.9	121.9	61.0

Prima facie evidence suggests that the bulk of funds attracted through sight and time deposits were spent for lending activities and this tendency matches the previous year. There is, however, a change in lending activity, which can be attributed to the grouping of borrowers and the creation of new types and forms of loans suitable for them. In addition, the introduction of new services and financial products not only helped banks to earn extra incomes, but also allowed them to attract new customers and therefore, financing.

Compared to previous year results, total income, total expenses and pre-tax earnings grew by 58.4, 70.0, and 15.1 percent respectively. These developments were mainly caused by the following changes: interest income leapt by 65.5 percent, but interest expenses ramped up by 96.6 percent, provisions for loan losses were accumulated and the growth of other expenses outran growth of other income. Over the last 2 years, lending rates based on systemic average and actual interest incomes have been gradually decreasing. Interest paid on deposits is rarely changed, which indicates the intention of banks to maintain their market share. As a result, return on assets in the banking system declined by 1.2 to 3.1 percent.

Table 15. Changes of loan, deposits and currency outside banks In millions of togrog

	1997	1998	1999	2000	2001	2002	2003
1 Total loan outstanding	50.4	85.6	77.5	66.8	135.1	231.4	442.1
Change(%)	-22.3	70.0	-9.5	-13.9	102.3	71.4	91.0
2 Non-performing loans	14.5	32.6	42.1	15.9	10.9	16.6	36.7
Change(%)	-56.1	125.8	29.0	-62.2	-31.6	52.4	121.6
3 Deposits	58.5	59.3	70.0	92.7	134.6	218.4	363.5
Change(%)	27.3	1.4	18.0	32.5	45.2	62.2	0.7
4 Currency outside banks	49.8	56.4	87.3	100.9	109.2	120.8	131.5
Change(%)	19.3	13.4	54.6	15.6	8.2	10.6	8.9

Table 16. Banks' income and expense — In billions of togrog

	2001 он		2002 он		2003 он		2003 / 2001		2003 / 2002	
	Amount	Share[1]	Amount	Share[1]	Amount	Share[1]	Amount	Share[2]	Amount	Share[2]
Total income	52.1	100	84.6	100	134	100.0	81.9	157.2	49.4	58.4
Interest	35	67.1	57.9	68.4	95.8	71.5	60.8	173.7	37.9	65.5
Trading	5.1	9.8	12.3	14.5	4.3	3.2	-0.8	-15.7	-8	-65
Exchange revaluation	2.5	4.8	4.1	4.9	19.8	14.8	17.3	692	15.7	382.9
Fee	5.2	10	7.3	8.6	10.2	7.6	5	96.2	2.9	39.7
Other	4.3	8.3	3	3.5	3.9	2.9	-0.4	-9.3	0.9	30
Total expense	36.1	69.2	66.7	78.9	113.4	84.7	77.3	214.1	46.7	70
Interest	13.4	25.7	24.2	28.7	47.7	35.6	34.3	256	23.5	97.1
Reserves for risk	2.3	4.4	5.9	7	10.1	7.5	7.8	339.1	4.2	71.2
Trading	3.7	7.1	11.4	13.5	2.3	1.7	-1.4	-37.8	-9.1	-79.8
Exchange revaluation	2.5	4.9	3.8	4.5	18.7	14.0	16.2	648	14.9	392.1
Personnel	5.9	11.3	9.5	11.2	14.7	11.0	8.8	149.2	5.2	54.7
Depreciation	1.2	2.3	1.9	2.2	3.2	2.4	2	166.7	1.3	68.4
Other	7	13.5	9.9	11.8	16.8	12.5	9.8	140	6.9	69.7
Net profit before tax	16	30.8	17.8	21.1	20.5	15.3	4.5	28.1	2.7	15.2
Tax	6.2	11.8	6.8	8.1	6.7	5.0	0.5	8.1	-0.1	-1.5
Net profit	9.9	18.9	11	13	13.8	10.3	3.9	39.4	2.8	25.5

[1] -share of total income
[2] -percent of changes

4.2. Non-Bank Financial Institutions (NBFIs)

In order to deepen financial intermediation, extend possibilities for financial institutions to grant investment and long-term loans and decrease the general level of interest rates, there is a necessity to expand the operations of financial intermediaries other than banks. As a result of some policy actions taken by the BOM to facilitate the operation of NBFIs, within the last 2 years the number of NBFIs has increased by 76 units to 97 units, of which 88 NBFIs were considered to be functioning.

In order to attract extra funds from households and institutions into financial intermediation flows, equity capital requirements for NBFI's were set up at different levels for urban and rural areas by the BOM Governor's resolution 211 issued in 2002. The minimum equity capital requirement for NBFIs incorporated in Ulaanbaatar city was raised from MNT 30 million to MNT 100 million, while the requirement for Darkhan, Erdenet and other rural areas, which were MNT 10 million and MNT 1 million respectively, were unchanged. In accordance with the resolution, existing NBFIs were forced to increase their paid up capital, which, accompanied by the establishment of new NBFIs, led to an increase in total assets and loans of NBFIs. Last year, the BOM granted permission for 34 Limited Liability Companies to establish NFBIs, of which 3 were set up in rural areas. Furthermore, 3 foreign-owned NBFIs were granted licenses. Last year, 5 NFBI licenses were revoked.

As of the end of 2003, the number of functioning NBFIs was 88, 33.3 percent or 22 units more than in 2002. Within the last year, the number of investors in NBFIs jumped by 210, while the number of employees swelled to 285. Based on 2003 statistics, 3,400 borrowers gained access to loans through NBFIs.
There are 6 foreign NBFIs holding total capital of MNT 2.4 billion, which represents around 20 percent of total NBFI capital.

Most NBFIs are involved in lending activities, while a few were granted a license to perform money transfers, leasing and factoring businesses.

In order to broaden the scope of their business, NBFIs are cooperating with foreign individuals and institutions. Therefore, the BOM has been giving primary attention to the involvement of NBFIs in on-lending of funds provided by international financial organizations through different projects.

In order to expand the availability of microfinance services to rural residents, the Microfinance Development Fund of the World Bank (*Sustainable Livelihoods Capacity Support Project*) has granted loans worth MNT 150.0 million to NBFIs, including CitySan, Battogrog, ABTC, Capmon, and Credit Mongolia. Moreover, loans totaling MNT 120.0 million were granted to NBFIs including Devj-San, Munkh-Ariljaa and Mon-Arvis by the Employment Support Fund within the Extension of Employment Project.

During the last year, the number of NBFIs operating in rural areas increased by 3 to 9, which represent 10.2 percent of all functioning NBFIs. By area of incorporation, 3 NBFIs are located in Darkhan-Uul Aimag, 2 in Zavkhan and Arkhangai aimags and 1 each in Tuv, Selenge and Dornod aimags.

BOX 10. DEPOSITS

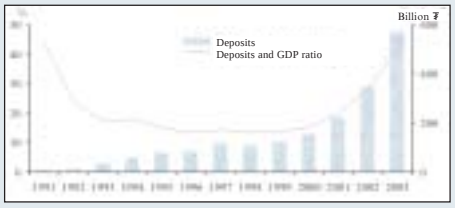
Financial intermediaries serve as a link between lenders and borrowers. The ability of financial intermediaries to create credit and expand the supply of funds contributes greatly to the smooth functioning of the economy.

The People's Revolution in 1921 enabled the establishment and further development of the national banking system and in 1924, the first Trade and Industrial Bank (Bank of Mongolia), a Mongolian-Russian joint bank, was established. Since beginning operations the Trade and Industrial Bank has been opening customer accounts, attracting deposits, making loans and carrying out payments and settlements. The bank's second-year goal was to provide conditions for money renewal. For this purpose, the Trade and Industrial Bank increased its capital and other resources in the form of deposits. In 1925 the bank's capital doubled, while deposits more than quadrupled. During this year, the percentage of deposits held by Mongolian businesses increased from 10.1 percent to 61.2 percent of total deposits. In 1940, to intensify the economic development of Mongolia, the Mongolian authorities decided to centralize investment financing within the Trade and Industrial Bank. In 1954, the Trade and Industrial Bank was restructured to become the State Bank. The bank's deposit holdings averaged MNT 2.3 million in 1927-1930, MNT 28.6 million in 1931-1940, MNT 44.1 million in 1941-1950, MNT 139.5 million in 1951-1960, MNT 523.4 million in 1961-1970, MNT 1.1 billion in 1971-1980 and MNT 3 billion in 1981-1990.

In 1991 Mongolia embarked on its transition to a market economy. Since 1999, the financial intermediation

indicator of the ratio of deposits to GDP has been steadily growing, rising from 15.5 percent in 2000 to 42 percent in 2003.

Graph 1. Deposits



Graph 2. Annual interest rate on short-term saving deposits (at the end of each year)

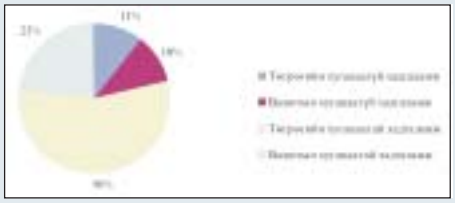
Thus financial resources have grown and the money coverage of production and services has increased, facilitating economic growth.

In order to maintain the interest rate on a real positive level and to protect personal savings deposits, the BOM introduced minimum interest rates for deposits in 1992-1996. Commercial banks' annual interest rate on saving deposits has actually been decreasing over the last years, facilitating lower loan interest rates and intensifying financing.

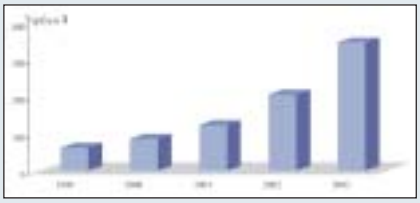
As a result of BOM activities directed at enhancing soundness in the banking system and providing economic growth, banks' attracted assets have substantially increased over the last three years. In 2003, deposits grew by MNT 222.5 billion, or 63.7 percent, reaching MNT 571.8 billion. An increase in foreign private transfers has also contributed to the growth of deposits: as the number of workers employed in foreign countries has increased, private remittances have risen. In 2003, private transfers increased by USD 9.9 million, or 15.4 percent, and accounted for USD 74.3 million in total.

In 2003, 21.3 percent of all deposits were demand deposits, while savings deposits accounted for the remaining 78.7 percent. Demand deposits held in domestic and foreign currency were similar, togrog savings deposits comprising 70.3 percent of total savings deposits and foreign currency deposits making up 29.7 percent. Savings deposits in togrog accounted for 55.3 percent of total deposits indicating increased confidence in the banking system and in the national currency, the togrog.

Graph 3. .....



Graph 4. Deposits of Individuals



Public enterprise deposits made up 1.6 percent of all deposits last year, while private sector deposits made up 2.4 percent, individuals' deposits 95.9 percent and deposits from other organizations 0.1 percent. The annual growth rate of deposits held by public enterprises was 23.9 percent, compared with the rate for private sector deposits which was 73.4 percent. Individuals' deposits, the bulk of deposits, grew by MNT 141.6 billion, or 68.4 percent. Individuals' deposits reached MNT 348.6 billion last year, of which domestic currency deposits made up 65.4 percent and foreign currency deposits 34.6 percent.

Banks' attracted assets have grown, leading to an increase in financial resources for enhancing investment. On the other hand, banks' increased assets also indicate rising public confidence in the banking sector.

Source: www.mongolbank.mn

NBFIs have established branches and representative offices in Bayankhongor, Sukhbaatar, Umnogobi, Darkhan-Uul and Uvurkhangai aimags and as a result, the total number of branches and offices has increased to 10.

During the last year, total assets of NBFIs increased by 51.7 percent, or MNT 6.4 billion, to MNT 18.9 billion, which represents 2.3 percent of all banking sector assets.

Despite the increase in cash reserves fueled by new funds, NBFI's share in total assets has fallen by 9.1 percent to 24.0 percent. Loans outstanding, however, soared by MNT 5.4 billion to MNT 11.5 billion, which represents 60.7 percent of their total assets. The latter is higher than the previous year figure by 11.4 percent.
Total receivables and fixed assets both increased by MNT 0.3 billion, but their shares in total assets fell by between 1 and 2.1 percent to 6.5 and 7.7 percent respectively, because their growth rates were lower than those of total assets. However, artificial increases in prepaid expenses, materials and prepaid taxes caused other assets to soar by MNT 93.1 million to MNT 114.0 million, which represent 0.6 percent of total assets.

Last year, the share of interest earning assets in total assets reached 60.7 percent, which indicates that NBFIs properly allocated their assets and conducted intensive credit policies. The number of new NBFIs and their funds shows a tendency to grow; therefore, outstanding loans have also shown a tendency to rise.

Total financial resources climbed by 51.7 percent to MNT 18.9 billion driven by an increase in capital accounts of 60.2 percent or MNT 5.2 billion (caused by investments in paid-up capital and an 86.2 percent growth in current year net income) and in total liabilities of 52.6 percent or MNT 0.9 billion.

The share of capital as a percentage of all financial resources soared by 3.8 percent to 72.6 percent, since its growth rates were higher than those of total financial resources. Financial resources and other liabilities increased by MNT 1 billion and MNT 0.3 billion to MNT 2.9 billion and MNT 2.3 billion respectively; however, growth in total liabilities was lower than those of total resources and so their share fell by 3.8 percent to 27.4 percent.

As of 2003, NBFIs' net income reached MNT 1.1 billion, which is 86.2 percent, or MNT 0.5

Table 17. Non-bank financial institutions' indicators — In billions of togrog

	2000	2001	2002*	2003
Loans outstanding	1.5	13.2	6.3	11.8
Total assets	3.0	23.4	12.5	18.9
Total liabilities	1.4	3.1	3.9	5.2
Capital	1.6	20.3	8.6	13.7

* Data for Chinggiskhaan NBFI have been excluded in 2002

billion, higher than the previous year figure. The increase in the number of NBFIs, accompanied by relatively stable operations, implementation of intensive credit policies in one hand and deepening financial intermediation driven by 52.6 percent growth in financial resources, which reached MNT 2.9 billion, in the other hand, caused this improvement in earnings. NBFI retained earnings reached MNT 107.6 million.

Led by a 51.7 percent increase in total resources, total income of NBFIs jumped by 90.5 percent or MNT 1.9 billion to MNT 4.1 billion.

Total income breaks out as: 80.2 percent, or MNT 3.3 billion, was interest earned on performing and over due loans; 2.0 percent, or MNT 82.2 million, were proceeds from leasing activities; 5.8 percent, or MNT 239.1 million, was revenue from forex trading, and 5.7 percent, or MNT 234.2 million, were earnings from the revaluation of foreign currency denominated assets and liabilities.

Due to the expansion of activities all expense items soared, causing total expenses to rise to MNT 2.9 billion, which is 91.9 percent, or MNT 1.4 billion, higher than in 2002.
As for some expense items, interest expenses climbed to MNT 679.8 million, which represents 23.0 percent of total expenses, resulting from an increase in total liabilities by MNT 1.9 billion to MNT 2.9 billion. Further increases in liabilities, the expansion of operations and introduction of new services may continue to cause growth in these types of expenses.

Provisioning expenses related to loans, receivables and OREO soared to MNT 240.5 million, staff expenses to MNT 491.9 million, other operational expenses to MNT 1,031.3 million, and taxes to MNT 241.5 million. These proportions break out as of total expenses are estimated as 8.0, 16.6, 34.9 and 8.2 percent respectively.

The balance of cash accounts represents 24.0 percent of total NBFI assets, which has some

Table 18. NBFI's loan portfolio quality — In millions of togrog

	2002.12.31*		2003.12.31	
	Amount	Share in total assets	Amount	Share in total assets
Loan (net)	6140.4	49.3	11470.6	60.7
Total loan	6340.1	50.9	11830.6	62.6
Performing loan	5790.1	46.5	10907.3	57.7
Non-performing loan	419.7	3.4	773.0	4.1
Past due in arrears	119.6	1.0	282.2	1.5
Substandard	102.1	0.8	216.9	1.1
Doubtful	170.0	1.4	182.2	1.0
Loss	28.0	0.2	91.6	0.5
Receivables on financial leasing	130.3	1.0	150.3	0.8
Reserves for loan losses	-199.8	-1.6	-360.0	-1.9

* Data for Chinggiskhaan NBFI have been excluded in 2002

BOX 11. RESEARCH ON MAIN INDICATORS OF BANKS AND NON BANK FINANCIAL INSTITUTIONS

Financial intermediation is one of the main factors for economic development of any country. With the participation of financial intermediation, excess capital flows to sectors with shortages; and in that way, possibilities for making the necessary investments for economic development are provided. The key purpose of this research work is to compare the main indicators of banks and non-bank financial institutions (NBFI) including loans, capital, revenue, expenditure and profit/loss statistics from the last 2 years and to draw conclusions based on those comparisons. Indicator data have been used from the first quarter of 2001, the fourth quarter 2001 and the fourth quarter of 2002 in this research work.

Table 1. Main indicators of the banking sector **(billion MNT)**

	1st quarter of 2001(1)	At the end of 2001(2)	Growth (%) (1:2)	At the end of 2002(3)	Growth (%) (2:3)
Total assets	243.9	332.7	*36.4*	493.0	*48.2*
Total loan	80.4	135.1	*67.9*	231.5	*71.3*
Non-performing loan	15.7	10.9	*-30.8*	16.6	*52.4*
Capital	27.8	47.2	*70.4*	61.3	*29.9*
Revenue	9.6	52.1	*445.7*	84.6	*62.2*
Expenditure	6.6	42.3	*539.9*	73.6	*74.0*
Profit/loss	2.9	9.9	*234.5*	11.0	*11.5*

After the banking sector crisis of 1999, statistical indicators of the banking sector have stabilized and shown some improvement. As a result of management changes at the Agricultural Bank in 2000, which was once considered to be highly illiquid and on the verge of bankruptcy, lending activities and financial services have been extended in rural areas and thus, financial intermediation has deepened.

Revenue was 4.5 times higher (by MNT 42.6 billion) by the end of 2001 than it had been in the first quarter of the same year, expenditure was 5.4 times higher (by MNT 35.7 billion), and net profit 2.3 times higher (by MNT 7.0 billion), reaching MNT 9.9 billion. Specifically, interest revenue, which makes up the majority of the bank's revenue, increased to MNT 35.0 billion from MNT 6.6 billion, or grew 5.2 times larger, while interest expenditure grew 4.9 times larger reaching MNT 13.4 billion from MNT 2.7 billion. In other words, during this time period banks' asset allocation improved and lending increased; therefore, implying deeper financial intermediation.

At the end of 2001, total outstanding loans in the banking sector were MNT 135.1 billion, which is 40.6 percent of total assets or 12.1 percent of GDP, and by the end of 2002, outstanding loans had reached MNT 231.5 billion, or 46.9 percent of the total assets or 18.8 percent of GDP. The percentage share of non-performing loans in the total of outstanding loans was 19.5 percent in the first quarter of 2001. This decreased to 8 percent at the end of 2001, and to 7.1 percent in 2002.

One measurement to evaluate a bank's profitability is Return On Assets (ROA), which is calculated as the ratio of after tax profit to total assets. In other words, ROA is an indicator to determine how profitably banks are allocating their assets and, generally, analysts consider that banking activities are satisfactory if this is higher than 1 percent. In the first quarter of 2001, this ratio across the whole banking system was 1.21 percent. It rose to 2.96 percent at the end of that year and reached 2.23 percent by the end of 2002. Another measurement of a bank's profitability is called Return On Equity (ROE) and it is the estimated ratio of after tax profit to capital. This indicator determines how much investors are earning on each togrog that they have invested as equity into a bank. Average ROE across the entire banking sector was 10.6 percent in the first quarter of 2001, 20.9 percent at the end of 2001 and 17.9 percent by the end of 2002.

Although non-bank financial activity can include up to ten different areas including loan provision, factoring and financial leasing as stated in the 'Non Bank Financial Activity Law', because activities other than these are not very common and NBFIs do not have much practical experience of executing other activities, the majority of NBFIs are only undertaking loan activities. This plays an important role in promoting small and medium size businesses and improving the main indicators of the macro economy: unemployment and poverty.

In the first quarter of 2001, the value of loans granted by NBFIs was MNT 1.82 billion. It reached MNT 13.2 billion

by the end of the same year and by the end of 2002 it had increased 2.72 times over to MNT 36.0 billion. As regards the total value of NBFI's assets, this was MNT 5.2 billion in the first quarter of 2001, MNT 23.4 billion at the end of 2001 and MNT 44.1 billion at the end of 2002. During this period the value of non-performing loans increased to MNT 0.4 billion from MNT 0.03 billion; the percentage of non-performing loans in the total loan portfolio decreased, however, from 1.7 percent to 0.28 percent between the first quarter of 2001 and the end of 2001, but then increased once more to 1.2 percent by the end of 2002. This movement could be related to a sharp increase in granted loans during the first period and issues and problems arising with repayment of those loans in the second period. The ratio of loans made by NBFIs to GDP was 1.2 percent at the end of 2001 and 2.9 percent at the end of 2002.

Table 2. Main indicators of NBFIs **(billion MNT)**

	1st quarter of 2001	End of 2001	*Growth (%)*	End of 2002	*Growth (%)*
Total assets	5.2	23.4	*350.4*	44.1	*88.5*
Total loan	1.8	13.2	*623.6*	36.0	*173.1*
Non performing loan	0.0	0.0	*15.2*	0.4	*1005.3*
Capital	1.9	20.3	*985.2*	25.7	*27.1*
Revenue	0.55	1.2	*121.6*	4.4	*263.6*
Expenditure	0.61	1.1	*81.1*	3.2	*192.0*
Profit/loss	-0.1	0.1	*296.6*	1.2	*944.8*

The total value of capital held by NBFIs was MNT 1.9 billion in the first quarter of 2001, MNT 20.3 billion at the end of 2001 and MNT 25.7 billion, an increase of 26.6 percent by the end of 2002. While NBFIs faced losses of MNT 0.06 billion in the first quarter of 2001, they turned a profit of MNT 0.1 billion by the end of the year and then increased this 12-fold to MNT 1.2 billion by the end of 2002. At the same time, revenue increased to MNT 4.4 billion from MNT 0.55 billion and expenditure to MNT 3.2 billion from MNT 0.61 billion.

Chinggis Khaan NBFI, the biggest NBFI in operation in 2002, was established and began its operations in the fourth quarter of 2001. This was the main factor explaining growth in the NBFI sector and the Chinggis Khaan NFBI has a high percentage weight in the total value of the main indicators of the sector. Therefore, in order to get a more realistic picture of the growth of the sector, it is appropriate to consider the indicators excluding Chingis Khaan NBFI as in the table below.

Table 3. **(billion MNT)**

	1st quarter of 2001	End of 2001	Growth (%)	End of 2002	Growth (%)
Total assets	5.2	8.4	*62.5*	12.5	*47.6*
Total loan	1.8	3.1	*70.2*	6.3	*104.3*
Non performing loan	0.0	0.0	*15.2*	0.4	*1005.3*
Capital	1.9	6.1	*229.2*	8.6	*39.5*
Revenue	0.55	0.9	*69.2*	2.2	*131.2*
Expenditure	0.61	0.8	*33.9*	1.5	*88.5*
Profit/loss	-0.1	0.1	*294.9*	0.6	*434.8*

It is interesting that the value of non-performing loans increased 10-fold between 2001 and 2002, reaching MNT 0.4 billion. In 2001, 50.8 percent of non-performing loans were overdue and 49.2 percent were substandard; while in 2002, 28.5 percent were overdue, 24.3 percent were substandard, 40.5 percent were doubtful, and 6.7 percent were lost. This could be attributed to the approaching repayment dates of previously issued loans as mentioned earlier. Consequently, it is crucial to assess risks accurately and to conduct an appropriate loan issue policy.

The level of endowment capital required to establish an NBFI has been set differently depending on geographical location in order to encourage the establishment of NBFIs in rural areas. Despite this however, the number of NBFIs operating in rural areas is very disappointing. A survey[1] conducted in February 2002 among rural and urban lenders, showed that only 6.6 percent of participants used an NBFI as their loan provider; 10.2 percent lower than the percentage of participants who named relatives, friends and other individuals as their borrowing source. Therefore, it can be seen that there are opportunities for NBFIs to expand their activities and to further deepen their financial services. As of 2002, ROA of all NBFIs was 3 percent and ROE was 5 percent.

Table 4. Comparison of main NBFI indicators to those of banks (percentage)

	1st quarter of 2001	End of 2001	*Growth (%)*	End of 2002	*Growth (%)*
Total assets	2.1	7.0	4.9	8.9	1.9
Total loan	2.3	9.8	7.5	15.6	5.8
Non performing loan	2.6	10.2	7.6	16.0	5.8
Capital	0.2	0.4	0.1	2.5	2.2
Revenue	6.7	42.9	36.2	42.0	-0.9
Expenditure	5.8	2.3	-3.4	5.3	2.9
Profit/loss	9.2	2.6	-6.6	4.4	1.8
Ашиг/алдагдал	-	1.2	-	11.0	9.9

In the first quarter of 2001, the total value of loans granted by NBFIs was equal to 2.3 percent of those granted by banks and this percentage has been constantly increasing since then, reaching 9.8 percent at the end of 2001 and 15.6 percent at the end of 2002. As the role of NBFIs as lenders increases, it is important to determine the associated risks with this and to implement optimal loan policies. The sharp increase in capital at the end of 2002 can be attributed to the establishment of Chinggis Khan NBFI. The ratios of NFBI revenues and expenditures to those of banks both decreased at the end of 2002 relative to the first quarter of 2001, due to a rapid increase in the value of deposits and loans issued by banks.

The previous sections have revealed the improved activities of banks and NBFIs during recent years and have demonstrated the deepening of financial intermediation. Although it has not been that long since the first NBFI was established, specifically only 3 years, their role in supplying loans to small and medium sized businesses has been increasing steadily. However, we have to pay attention to the fact that the number of NBFIs operating in rural areas is unsatisfactory, and that obtaining loans from family, friends, relatives and other individuals is still popular among private individuals and small and medium sized business owners due to a lack of information on NBFIs and their activities. Furthermore, the majority of NBFIs with permission to operate execute loan related activities and so as the amount of issued loans grows, their risk will also increase. Therefore, it is crucial to pay attention to their appropriateness, determining their risks, the optimality of their loan policies, accuracy of advertisements and promotions of their activities, and to strengthen supervision over them by not limiting it to reviewing quarterly balance and financial statements.

The BOM has set the level of capital required to establish an NBFI at MNT 100 million in urban areas and MNT 1 million in rural areas. The new 'Law on Non Bank Financial Activities' was approved in December 2002, and the 'Regulations on issuing and annulling permission to execute NBFI activities, and supervising NBFI activities' has been renewed. All of the above developments will have a significant influence on creating a favorable environment for executing NBFI activities; eliminating difficulties described earlier, and improving their role in financial intermediation.

[1] N. Amar, G. Ariunkhishig "Lenders survey", Bank of Mongolia

Source: www.mongolbank.mn

negative effects on profitability. Therefore, possibilities to make investments in relatively short-term marketable assets, like BOM bills, should be investigated.

Actions aimed at improving accounting systems, handling related software packages in a complete and comprehensive manner, conducting regular training for economists and accountants on regulations and guidelines approved by the BOM at least once every two years, thereby improving the skills of employees, are necessary for NBFIs.

5 CENTRAL BANK ACTIVITIES

ORGANIZATION CHART OF THE BANK OF MONGOLIA

GOVERNORS AND DIRECTORS OF THE BANK OF MONGOLIA

Governor
O.Chuluunbat

First Deputy Governor
A.Batsukh

Director of
Administration
Department
L.Mandal

Director of Monetary
Policy and Research
Department
B.Enhhuyag

Director of
International Department
Ts.Odongua

Director of Internal
Audit Department
Ts.Tsolmon

Director of Supervision
Department
L.Chimgee

Director of Accounting
and Information
Technology Department
B.Lkhagvasuren

Director of Legal Division G.Erdenebayar

Assistant to Governor, Chief Economist T.Ariuntungalag

Director of Service Division J.Khaltar

Director of Reserve Management Unit D.Davaasuren

Director of Monetary Policy D.Boldbaatar

Director of Research Division N.Amar

Director of Banknote Division T.Khaltar

Director of Accounting Division D.Namjilsuren

Director of Information Technology Division D.Gantulga

Director of Supervision Division D.Ganbat

Director of Non Bank Financial Institutions Division Kh.Delger

Director of Banking Division D.Batmunkh

Director of Policy Regulation Division D.Badraa

Director of Bank Training Center D.Turbat

In the current year the BOM focused on deepening financial sector recovery, the optimal placement of foreign currency reserves and economic growth, by ensuring macroeconomic stability, strengthening price and exchange rate stability and continuing restructuring in the financial sector.

5.1.Monetary policy

Reserve money

In the current year reserve money reached MNT 200.8 billion, up MNT 25.5 billion on the beginning of the year, representing 14.5 percent growth. 42 percent of reserve money growth was due to the growth of currency outside banks and the remaining 58 percent was growth in banks' reserves. The proportion of currency outside banks has fallen over the last 8 years, reaching 65.5 percent in 2003. Hence, while the share of currency is falling, the share of bank reserves was growing, reaching to 34.5 percent at the end of 2003. The growth rate of reserve money fell by 7.4 percentage points to 14.5 percent per annum.

BOX 12. DEVELOPMENTS IN MONETARY POLICY INSTRUMENTS

The Law on Central Banking states that: "The main objective of the Bank of Mongolia shall be to ensure the stability of the togrog." It then goes on to define a set of activities, monetary policy among them. The law states: "In order to implement its objectives as set forth in this law, the Bank of Mongolia shall conduct the following activities: ... 2) formulation and implementation of monetary policy..." Further it defines the range of possible policy instruments that the BOM might use for its monetary policy activities. They are: "1) setting of the amount and proportion of compulsory reserves to be maintained by banks; 2) determining the amount of credit granted to banks; 3) pursuing a unified policy on interest rates by setting the lending rate and discount rate on credit granted and securities issued by the Bank of Mongolia; 4) conducting open market operations; 5) imposing a ceiling on credit outstanding to be granted by banks."

So the BOM, as the institution that implements monetary policy, holds the authority to choose how to implement monetary policy as approved by Parliament in the State Monetary Policy Guidelines, using these instruments. These instruments, though stated in law, are not always used every year. Thus the combination of instruments used is selected by professionals to be consistent with monetary policy goals and efficiency and is not a political decision.

There is no consensus on the appropriate proportionate use of these instruments, but there is a generally agreed understanding of how one should go about combining the instruments for best effect. The legal determination of the instruments is designed to set the scope of the instruments from which the policy implementation institution can choose. However, policy activities by the BOM towards the monetary policy goal, stated in the single year policy guideline, are undetermined and conditional on the current year economic situation. In other words not all instruments always work in the same direction and all instruments have their own advantages and disadvantages and it is uncertain which of them is best suited to what use prior to the revelation of economic information. In general, monetary policy instruments are divided into two groups: direct and indirect instruments. Direct instruments are based on administrative arrangements and have a normative character, while indirect instruments are based on market structure and stimulate the market towards a policy goal. The use of direct policy instruments produces undesirable negative externalities. In contrast, indirect policy instruments do not and they also have better long-term features. Examples of direct instruments are the setting of obligatory reserve requirements, breaches of which are punishable with fines; setting a ceiling on BOM loans to banks or on loans to NBFIs from banks, and putting a floor or ceiling on interest rates. Indirect policy instruments include the BOM issuing CBBs on the inter-bank market, and open market operations such as the purchase or sale of predefined banking assets.

The positive aspect of direct instruments is that they are quick and have a strong impact on the market in a very short time. However, this quick and strong impact itself creates a negative externality since it is based solely on administrative arrangements. Whenever direct policy instruments are applied, the profitability of financial intermediaries is restricted

and therefore, i) may lead to a boost in intermediation costs, and ii) can distort or even break the financial market structure to the extent that in the end, profitability might have to be allocated administratively. In an extreme case, market structure can be distorted so much that the policy-implementing agency will not serve policy goals, but instead prefer profit-seeking activities.

By contrast, indirect instruments produce far better outcomes. Nevertheless, indirect instruments have their disadvantages and here we can highlight the dependency of instruments on market infrastructure and the uncertainty of desired outcomes. In the end, there are known negative outcomes of direct instruments and thus one should prefer to use indirect instruments whenever it possible to do so.

Indirect instruments at first influence the profitability of banks; then banks react depending on the BOM's conditions, and the result is a change in banks' reserves. The BOM is the market maker at the inter-bank market as it is the biggest participant in the market. The BOM can influence banks' liquidity by changing either the value or size of the market. The important point is that this market change should move toward a policy goal. So, the impact of an indirect instrument on the economy is delayed and the lagged impact will be weak if the financial market infrastructure is underdeveloped or if its regulations are distortionary. Therefore, the opportunity for relying on indirect instruments is conditional on the level of development of banks and the financial system; regulations; the intentions and choices of the policy-implementing agency, and political culture or public perception.

The use of direct instruments is possible in a developed and sophisticated financial environment when there is a banking crisis, currency crisis or both a banking and currency crisis, such as in the Argentinean experience of 2001.

Direct policy instruments were used intensively in Mongolia from the beginning of the establishment of a two-tier, market oriented banking system. Adjustments in the reserve requirement ratio and setting ceilings on bank to NBFI credit were the dominant instruments up to 1995. Then the credit ceiling and deposit rate floor were used more intensively until 1997. However, during these years BOM credit policy was in conflict with the goal of these instruments. The instruments were working toward limiting an explosion in money supply while credit given to banks, and sometimes to business entities, by the BOM was working in exactly the opposite direction. This is a classic example of how instrument sets can produce policy goal conflict. Since 1997 the BOM has revised its lending policy and decided to use indirect instruments more intensively. Therefore, banks' credit ceilings and floors for deposit interest rates were given less emphasis and have now been removed. Central Bank Bills, which were created in 1993, have assumed the role of main indirect instrument. Banks may change their interest rates on balance items whenever the CBB rate changes, but for now the amount of CBBs issued is more important for banks. This is because there are no other highly liquid instruments available for banks and so if banks do not hold CBB their excess reserves grow, putting pressure on credit expansion.

On the other hand the BOM's transactions in gold and foreign exchange on the domestic market are still its most influential transactions for banks and these transactions are not yet governed by monetary policy goals. The purchase of gold from mining companies is not a traditional Central Bank activity and is a hangover from the BOM's former status as a state bank. So far the BOM has sterilized cash injections due to the purchase of gold and foreign currency from the market by issuing more CBBs. However, this method is approaching unsustainability due to the growing stock of CBBs on the market. In short, the efficiency of BOM monetary policy instruments and issues surrounding their combination are as problematic as before. The dominant instruments of monetary policy today are the issue of CBBs and open market operations, especially transactions related to repurchase agreements. Gold transactions and foreign exchange interventions have not yet joined the monetary policy goal. There is no public perception of and no adopted combination for limiting the objective of achieving economic expansion through the purchase of gold and foreign currency intervention set out in the monetary policy goals.

Finally, monetary policy instruments are the core of central bank independency and are even superior to its goal independence. Monetary policy itself is not the sole macroeconomic policy that can alone ensure long-run sustainable economic development. Hence, it needs to be consistent with other macroeconomic policy frameworks such as fiscal policy and social safety net policy.

There is one more important view left in connection with monetary policy that is emphasized in many academic works and is clear from the experiences of other countries. This is the potentially destabilizing power of monetary policy in the event that incorrect policy measures are taken, that policy instrument requirements are neglected, or that monetary policy instruments are used to pursue goals other than the monetary policy goal. The outcome of this can be an expensive crisis. The Albanian crisis of the late 1990s and the Argentinean crisis in 2001 are both examples of these crises. Asian, Russian and Brazilian crises in the past have been due to the over encouragement of foreign investment.

Source: www.mongolbank.mn

Data from the last 8 years show that seasonal fluctuations in currency outside banks maps onto the reserve money seasonal pattern. Reserve money fluctuation is lower than the annual average by 6 to 10.7 percent over the first three months of the year, in April it is about average, and from May to the end of September it is higher than average by 3.5 to 8.3 percent before falling back to average once more over the last three months. Reserve money volatility is reduced, perhaps, because its growth has fallen as has M1 and M2 growth. However, the bank reserves variation trend is still not stable.

In the current year the BOM bought MNT 160.8 billion equivalent in gold and foreign currency in net terms. To sterilize this injection it kept 44.8 billion Central Bank Bills at market on average. The BOM began to adopt a liquidity forecasting method to manage reserve money fluctuations more efficiently. The greatest challenges facing liquidity forecasting today concern stable information flow channels. Information is important as it needs not only to be acquired in a timely manner, but its accuracy should allow us to use it successfully in the day-to-day prediction of possible changes in the liquidity position. For instance, information of expected income and expenditure in and from the treasury account from the MOFE as well as stable internal updates to the BOM information from other departments and divisions play an important role in the future success of forecasting.

Central Bank Bills

The BOM issues Bills to manage money supply and to keep reserve money at the desired level.

Primary market activities

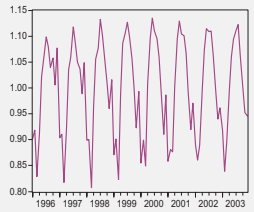
The BOM organized CBB auctions on 100 occasions in 2003 and sold CBBs with togrog value of 958.9 billion, of which MNT 537.5 billion, or 56.1 percent, had 7 day maturity dates; MNT 216.1 billion, 22.5 percent of the total, had 14 days; MNT 108.1 billion, 11.3 percent, had 28 days, and MNT 65 billion, or 6.8 percent, had 91 days to maturity. The remaining MNT 32.1 billion, 3.4 percent, were 1- or 2-day bills, which sold in irregular dated auctions.

The amount of CBBs sold by the BOM at the end of 2003 reached MNT 76 billion, 1.4 times higher than the previous month's end and 1.2 times higher than the previous year end.

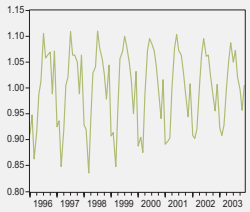
In 2003 banks held on average MNT 42.4 billion in CBB. Of this amount, 84 percent were held by TDB, Savings, Golomt, Mongol Post, Agricultural and Inter banks and the remaining 11 banks held around 16 percent.

The weighted average rate of CBBs was 11.5 percent at the end of the year. This is higher than the previous year-end figure by 1.5 percentage points. The BOM paid banks MNT 4.6 billion in interest on CBBs in 2003.

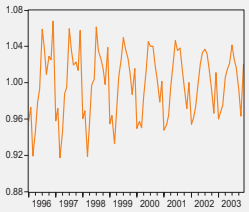
Figure 33. Seasonally adjusted index



Currency outside banks



M1



M2

Figure 34. Money multiplier

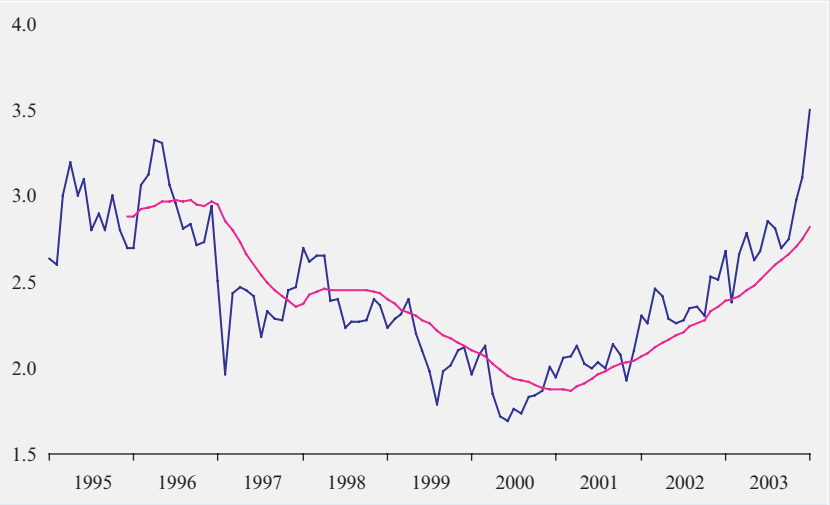
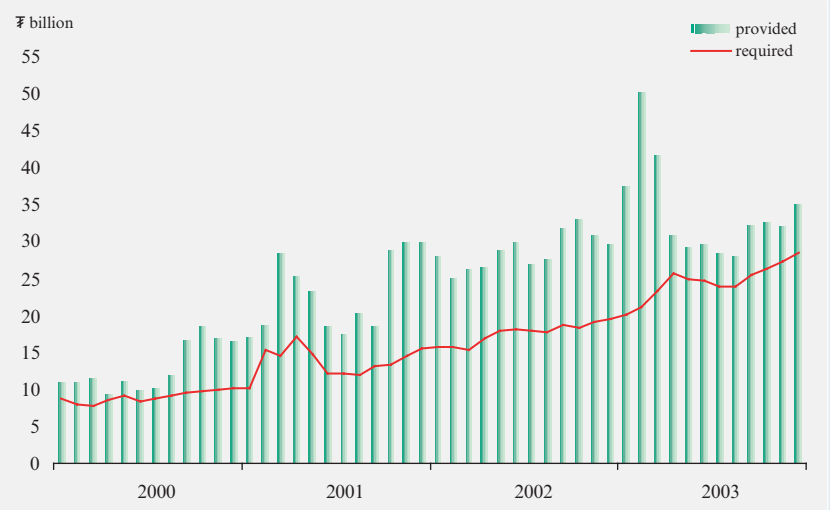


Figure 35. Reserve requirement



BOX 13. MONEY CREATION MODEL

The main purpose of this study is to model how a change in reserve money affects monetary aggregates and to employ the model to simulate the effects of monetary policy instruments on monetary aggregates.

If deposit increases are higher than equity, banks raise new loans by less than the money multiplier according to prudential ratio requirements. The foreign currency exposure risk ratio can have the same effect. The money multiplier, defined as the ratio of money supply to money reserves, depends on policy instrument change, money demand, financial market development and expectations. Actually, changes in those external factors unequally impact indicators in the numerator and denominator of the ratio. In other words, since growth in reserve money results from a change in monetary policy instruments and/or other disturbances, these may affect money aggregates differently. A multiplier change cannot explain those effects separately. Modeling for how a growth in reserve money is distributed over money supply aggregates can reach the same result as modeling for the money multiplier.

Reserve money consists of currency outside banks and bank reserves. The reserves are equal to the sum of net domestic and net foreign assets, calculated from the consolidated balance of the Central Bank. The BOM's direct transactions at the interbank market and changes in Government accounts and loans from international financial organizations are the main causes of changes in reserve money. The BOM can control direct transactions completely while changes in Government accounts and on-lending transactions related with international financial organizations are beyond the BOM's discretion.

The BOM can manage reserve money but the structure of this depends on the decisions of banks, individuals, industries and other entities (together the bank's customers). The non-banking sector decides how much money to hold as banknotes and coins in hand and how much to deposit at banks while banks decide how much non-cash reserves to hold based on their evaluation of the market. A change in reserve money disturbs the interbank market rate and other market conditions. A bank works under two types of regular pressure: to raise domestic and foreign assets. At first, a Central Bank expands the money market through a growth of reserve money and then second through an increase in deposits, beefing up bank reserves. As a result of expansion in reserve money, banks seek to engage in foreign exchange trade (to increase their net foreign assets) and issue loans to customers. The growth of reserve money will increase banks' reserves either if banks do not issue loans, or if the ratio of domestic to foreign net assets in the banking system is unchanged. Loan issues increase money supply. Therefore, banks' decisions initially become an adjustment of their asset portfolios and later effect a change in issued loans in accordance with customer demand.

Money reserves shrink when there is an inflow of funds to the Treasury Single Account (TSA) and the reserve grows when funds are paid out of the TSA. Changes in the TSA are divided into two parts: with and without effects on money supply. Variables that affect money supply are denoted 'CG' in the model. Equally, Government can participate in foreign exchange trade with the BOM to pay international claims, which could also have an effect on money supply. Generally, however, a change in Government accounts is treated as an exogenous variable by the model.

Decisions on asset portfolios held by customers depend on their income growth, the payable interest rate on assets and other income changes. As a result of the BOM purchasing gold from mining companies or granting loans to banks, currency held by customers would increase. The former type of reserve money growth produces a direct increase in money supply; the latter change increases money supply indirectly (through the money multiplier).

As banks' current accounts rise with the BOM, the BOM's liquidity injection increases excess reserves. This rise in excess reserves may, in turn, increase outstanding loans to the real sector. A growth in reserve money increases excess reserves, currency outside banks and cash in vault. An increase in reserve money through the purchase of gold drives up demand for deposits. Otherwise, the growth of outstanding loans plays a vital role.

A model, consisting of logically determined equations, based on possibile liquidity flows in to or out of the banking sector, and estimated using data from December 1997 to December 2002, showed the following results.

$$rr_t = 0.30(dd_{t-1} + td_{t-1}) + 0.00002T^2 + 0.17D1 + 0.62rr_{t-1}$$

$$re_t = 4.08 + 0.25cbb - 0.68cbbrate_t + 0.71l_{t-1} - 4.41(s_t - s_{t-6}) - 0.05fx_t + 0.01au_t - -7.44D3 + 0.09re_{t-1} + 0.13re_{t-5}0 + 0.51ar_t$$

fr_t = -0.04($cbbr_t$ -$libor_{t-1}$) +4.65? s_{t+1} -1.60D3+0.91fd_t-0.12fr_{t-1}+0.23q3+0.31D9-
-0.36D10+0.82ar_t
td_t = 1.76+0.005T+0.1dd_{t-1}-0.08cr_t -0.01$DEPR_{t-1}$+ 0.31? s_{t+1}+0.44td_{t-1}+0.39td_{t-6}-0.75ar_t
fd_t = -0.11t +0.0002T^2+0.13cr_{t-2} +0.80s_t +0.50fd_{t-1}-0.12fd_{t-6}
cr_t = 0.03cbbrate-0.002T-0.01$DEPR_t$-0.07dd_{t-1}+0.86$m0_t$+0.01lq_t+0.01fx_t+0.02Q4+
+0.05Q2+0.04Q3 + 0.08D6-0.09D8+0.18cr_{t-1}
dd_t = 1.11+0.15cbb_{t-1}+0.22l_t+0.003? au_t+0.03re_t-0.01lq_t+0.5dd_{t-1}
l_t = 0.05y_{t-5} -0.006$loanr_t$ +0.97l_{t-1}-0.08D2-0.24D7+0.28ar_{t-2}

Where rr_i is the average required reserves, dd_i is banks' togrog current accounts, td_i is banks' togrog time deposits, re_i is banks' excess reserves, cbb_i is Central Bank bills issued by BOM, cbbr is the weighted average rate of Central bank bills, l_i is outstanding loans, s_i the spot rate of MNT versus USD, fx_i is the net intervention of BOM in the foreign exchange market, au_i is payment made to gold mining companies in domestic currency for gold purchases, fr_i is banks' foreign currency current accounts and deposits at the BOM, r_i^f (libort) is the London interbank offered rate, fd_i is banks' foreign currency deposits (foreign currency deposits and current accounts), cr_i is currency outside banks, $depr_i$ is banks' average time-deposit rate, m0 is reserve money, lq_i is liquidity injected by the BOM (defined as outstanding CBBs minus loans to the banks and change in net credit to Government), y_i is estimated monthly real GDP, $loanr_i$ is the weighted average of banks' loan rates in a given month, Q_s is a seasonal dummy variable for quarter s and D_i are non-seasonal dummy variables.

From the estimation of simultaneous equations we observe that CBB rates and levels are weakly, and mutually, influencing excess reserves in opposite ways. Changes in the MNT/USD exchange rate over the last 6 months have strongly influenced banks' management of their excess reserves as expectations of each forthcoming month's MNT/USD exchange rate have a strong influence on banks' decisions over how much to accumulate in their current accounts at the BOM. The current month MNT/USD exchange rate is the strongest factor influencing domestic and foreign currency deposits.

An outcome of the model estimation is that it shows that the BOM increases reserve money by purchasing foreign currency and gold and that it affects money supply through changes in the multiplier. Changes in reserve money, money supply and the multiplier depend on the level of foreign exchange net interventions by the BOM. Gold purchases by the BOM also influence reserve money and the multiplier. The extent of the effect of gold purchases on monetary variables may depend on the use of future revenues in financing loans and advances to maintain the production process by large mining companies.

The outstanding value of CBBs may not play a significant role in reserve money management for the following possible reasons:

1) At an early stage of the banks' restructuring period the BOM used to sell CBBs, mostly to the same value as the total amount of excess reserves, in order to improve banks' asset structure.
2) The impact of the CBBs was largely blocked as the BOM purchased higher amounts of foreign exchange and gold than CBBs.
3) As a result of banks' restructuring, bank deposits increased substantially and there was an accumulation of excess reserves on the asset side, which weakened the transmission power of the CBBs.

Banks' reserves are more sensitive to changes in exchange rates than interest rates. It is possible that dollarization could have contributed to this. In other words, it is implied that the BOM would have to make arrangements to reduce the level of foreign currency in circulation to improve its management of broad money.

In addition, it would make a big contribution to speeding up development in the money market if the prediction of possible monetary policy effects were improved. Money market development would accelerate the process of flexible and appropriate allocation of resources and would increase the possibility of money being channeled into the economy more efficiently.

In conclusion, when our economy stabilizes, financial intermediation deepens and the activities of banks and other financial institutions become more predictable. Indicators of the real, monetary and financial sectors become more stable and, therefore, the estimations produced by the model improve. As a consequence, the model shall be estimated on a continual basis and monetary aggregates of the Mongolian economy shall be further advanced.

Source: www.mongolbank.mn

Secondary market activities

During 2003 banks traded CBBs on the secondary market 275 times, the nominal value of which was MNT 284.2 billion and, outright purchase/sell and repurchases were the main form of contracts. 27.7 percent of the total nominal volume of trade was outright purchase/sell and the remaining 72.3 percent was repurchases. Their nominal volumes were MNT 78.7 billion and MNT 205.5 billion respectively.

Five banks, namely the TDB, Savings, Agricultural, Mongol Post and Golomt banks, traded 84.0 percent of the total nominal volume of contracts and others about 16 percent.

Almost the same figure of 84 percent of all repurchase agreement transactions were performed by the same five banks, TDB, Saving, Agricultural, Mongol Post and Golomt banks. The other 16 percent was traded among the Anod, Inter, Capitron, Zoos, Ulaanbaatar city, Capital, Xas, and Credit banks. In other words, these banks are active in placing their excess reserves in the market or managing their needs for very short-term funds by borrowing from the market.

There is another type of contract available, the saving deposit contract in foreign currency pledged by CBBs. This type of instrument was observed 7 times with a volume of USD 9.2 million, and collateral value of MNT 12.8 billion CBB.

Obligatory reserve

The BOM imposes an obligatory reserve requirement equal to a certain proportion of a bank's deposit to maintain and improve the banks' liquidity position and protect the bank's customers and deposit holders from risk. The BOM not only determines the obligatory reserve amount, but also monitors banks' compliance with the reserve requirement on a daily basis.

In 2003, the BOM used its administrative sanction measures against banks that did not comply with the reserve requirement and collected MNT 20.2 million in fines. The banking system as whole was in compliance with the reserve requirement throughout the year. Banks were required to hold on average MNT 24.6 billion daily at the BOM. The actual figure was MNT 34 billion indicating that banks had on average MNT 9.4 billion in excess daily.

The average obligatory reserve was raised by 28.5 percent, and banks' total average reserve was higher by 15.6 percent, but excess reserves were lower by 18 percent in comparison with 2002 figures. The increase in obligatory reserves was due to deposit growth in banks and the fall in excess reserves was perhaps due to better management of reserves by banks.

In 2003 the obligatory reserve was set at 14 percent of total deposit in a bank. We believe this is higher than necessary and the BOM is planning to lower it to 12 percent in 2004. This will release a certain amount of money to finance credit growth.

Figure 36. Amount of CBB sold and purchased by banks' repo agreements in 2003

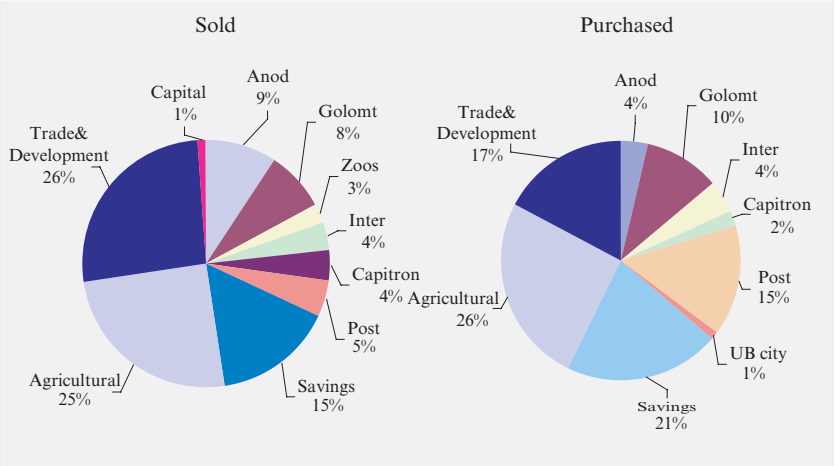


Figure 37. Amount of CBB sold and purchased on secondary market

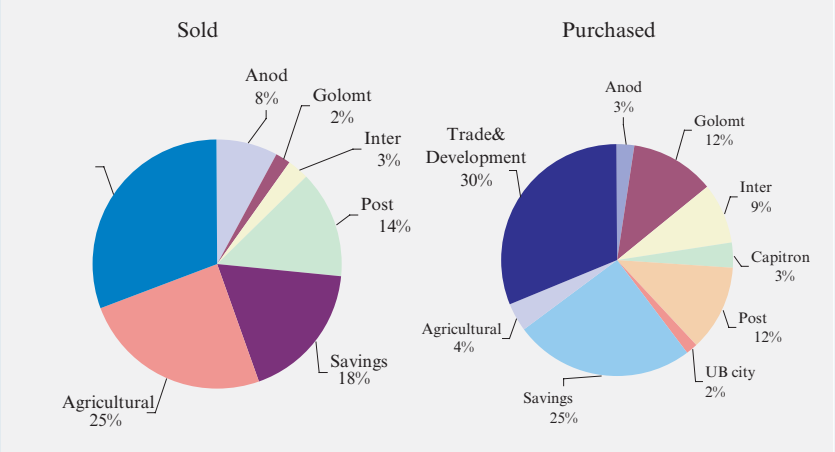
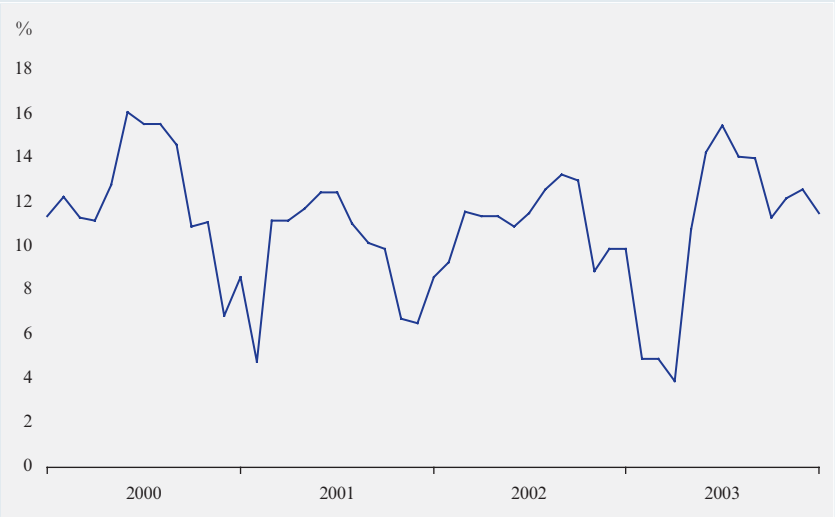


Figure 38. CBBill's weighted average rate



BOX 14. EXCESS RESERVE

An increasing accumulation of excess reserves in the banking sector between the end of 2000 and beginning of 2003 attracted the interest not only of policymakers and researchers, but also of some foreign investors.

The accumulation of excess reserves is desirable due to the absence of alternative asset forms of protection from uncertainty. In other words, banks seek out excess reserves due to a need for protective liquidity or low interest rates compared to brokerage fees on securities. The accumulation of excess reserves, in turn, is a signal to depositors that the bank is safe.

By contrast, after controlling for uncertainty in deposit and loan behavior and other external factors, excess reserves are accumulated as an unintended flow of cash due to high internal asset costs in moving from actual cash holdings.

These competing explanations for the accumulation of excess reserves present not only different behaviors of bank reserve management, but also different implications for monetary policy. According to the standard implementation rules of monetary policy, an expansionary monetary policy would strongly affect and increase the money supply if excess reserves were desired. However, if excess reserves were not desired then monetary policy would have negative effect on the money multiplier since the money supply would be increased only slightly while the monetary base (reserve money) would be increased significantly.

The purpose of this study is to investigate reasons for the accumulation of excess reserves and its effects on monetary policy. Here, a dynamic optimization model used by Lindley et al (2001) is used to examine whether excess reserves are desirable or undesirable.

Banks are assumed to minimize the expected value of the following quadratic loss function, which formulates the short-run target level of excess reserves.

$$C = \min\left[E_t \sum_{t=0}^{\infty} d^t \left[w_0 \left(ER_t - ER_t^* \right)^2 + w_1 \left(ER_t - ER_{t-1} \right)^2 \right] \right] \mid U_t$$

Where ER_t is the actual excess reserve holding, ER^*_t is the target level of excess reserve holdings, d is the subjective discount rate, $0<d<1$, w_0,w_1 are weighting factors, and U_t is the banks' information set.

The weights w_0 and w_1 are, respectively, the effective opportunity cost of holding less than the target level of excess reserves, and the asset adjustment costs for the bank to convert excess reserve into other interest-earning assets. The ratio of one to the other indicates the relative importance of the two types of cost.

From time series data for the 1994-2002 period, it can be seen that banks' excess reserves were strongly affected by structural changes in the financial sector and bankruptcies among large commercial banks. During the last few years, a more stable financial and banking sector and increased deposits in the banking sector have fuelled an increase in excess reserves. Similar to the seasonal pattern of production in the real sector and money supply, banks' excess reserves have a seasonal pattern, which changes over time and shows permanent effects from random shocks.

From the results of the paper, the level of excess reserves can be seen to have been affected by monetary policy, bank deposits and shock variables (excluding the shock variable of M2 money). However, the results of the model estimates show that the CBB rate is not a precondition for changing excess reserves in Mongolia. The results of the model indicate that, mostly since 2001, higher internal adjustment costs led to the increase in excess reserves. The costs of deviation from target excess reserves have declined due to the relative fall in interest rates over the last few years. On the other hand, a rapidly growing level of deposits, while improving banks' financial capacity and increasing market competition, have also led to an increase in the costs of changing excess reserves into other income-producing assets. Therefore, banks are not able to convert excess reserves into income-earning assets to match the level of deposit inflows due to growing internal adjustment costs so affecting the accumulation of excess reserves as a buffer. In other words, the amount of outstanding loans, while increasing, is not sufficiently large and deposit inflows into the banking sector have overwhelmed banks' ability to create income-producing assets in the economy.

Source: www.mongolbank.mn

Net credit to Government

The Government debt to the banking system including the BOM and commercial banks was MNT 211.1 billion and Government deposits totaled MNT 114.4 billion. Thus, net credit to Government was estimated at MNT 96.7 billion, which is higher than the previous year-end by MNT 129.1 billion.

Net credit to Government rose substantially due to credit growth rather than a fall in deposits.

On credit to Government

Government credit from the banking system, including from commercial banks and the BOM, totaled MNT 211.1 billion at the end of 2003. This is 6.9 times higher than the 2002 figure, or by MNT 180.4 billion. 77.7 percent of this total, or MNT 164.2 billion, is BOM receivables and the remaining 22.3 percent, or MNT 46.9 billion, is due to commercial banks.

The composition of Government debt is as follows: 75.9 percent, or MNT 160.2 billion, is credit from the BOM; 9.7 percent, or MNT 20.5 billion, is Ordinary Government Security for Bank Restructuring held by the BOM, Savings and Trade and Development banks; 14.4 percent, or MNT 30.3 billion, is short- and medium-term Government bonds held by banks, and the remaining small amount of MNT 44 million (0.02 percent) is tax prepaid by banks to the budget and MNT 74.4 million in interest receivable by banks on Government bonds.

The reason for the substantial increase in Government debt to the banking system is due to Government's borrowing from the BOM and banks to pay the hugely reduced convertible rouble debt to the Russian Federation. For this purpose the Government borrowed MNT 160.2 billion from the BOM and USD 25 million from the Trade and Development Bank.

The Ordinary Government Security for Bank Restructuring

At the end of 2003, Ordinary Government Security for Bank Restructuring amounted to MNT 20.5 billion and was held by three institutions: the BOM, Trade and Development Bank and Savings Bank. The distribution was as follows: Savings bank held nominal value

Table 19. Net credit to Government (mln. togrogs)

	2002.12.31	2003.12.31	Change
Claims on Government	30,742.6	211,121.0	180,378.4
Deposits of the Government	63,181.9	114,433.7	51,251.8
Of which: a/ Current account of Central Government	60,284.2	110,568.2	50,283.3
b/ Current account of Local Government	2,526.5	3,747.0	1,220.5
c/ Current account of Budget agencies outside Budget	344.0	100.5	(243.5)
d/ Current account (MARA)	27.2	18.0	(8.5)
Net credit to Government	-32,439.3	96,687.30	129,126.6

of MNT 16.1 billion (78.5 percent of the total), the BOM held MNT 4.0 billion (19.5 percent) and Trade and Development Bank MNT 399.6 million (1.9 percent). The Government purchased back from this security at a nominal value of MNT 4.7 billion in the current year.

The BOM bought Government securities from Savings Bank, to a MNT value of 6 billion, on a contractual basis. Of this amount the Government bought back MNT 2 billion in 2003 and paid MNT 521.4 million in interest. Previously we observed negative outcomes from buying Government securities, such as a rise in the money supply and the prices but on this occasion the impacts were small but, nevertheless, distortionary. There was distortion such as interest rate setting by the Government on their credit. For instance, the Government sets interest rates on the Ordinary Government Security for Bank Restructuring by the Minister of Finance and Economics' order 168, 2001, and this regulation was held valid for the amount we bought from the Savings Bank.

On Government's deposit with banking system

Government deposits at the end of 2003 were valued at MNT 114.4 billion. This is higher than the previous year deposits by MNT 51.2 billion, or 81.1 percent.

The deposit consisted of MNT 110.6 billion in central government deposit, MNT 3.7 billion in municipal government deposit and MNT 100.5 million in budget-financed institution deposits. Their sharse in the total deposit were 96.6, 3.2 and 0.1 percent respectively. 91.7 percent of deposits, that is MNT 80.2 billion, was kept with the BOM and the other MNT 22.7 billion, or 19.8 percent, with commercial banks.

In 2003, the BOM paid MNT 1.9 billion in interest on Government deposits. Apart from this, the Government placed short-term saving deposits 3 times, the cumulative value of which was MNT 38.2 billion and the BOM paid MNT 800 million interests on these. Paying interest on Government saving deposits at the BOM is not an appropriate way of generating earnings, but we accepted it as one way of reducing the opportunity cost of creating a Treasury Single Account for the first time. We think that in the near future, with better management of budget cash, there will be less necessity for issuing a large amount of bonds and efficiency gains in fund management may allow us to remove this habit entirely.

Government bonds

Three different types of Government bond were issued in 2003 with a sum value of MNT 113.1 billion. The 3 types were short-term, short-term discounted and USD denominated. The outstanding amount from these bonds at the end of the year was MNT 89.8 billion.

In comparison with the previous year, in 2003 the Government issued bonds worth 2.2 times as much in togrog terms, an increase of MNT 63 billion. The togrog value at the end of the year was also big, it is 14.7 times bigger than at the previous year end, which translates to a

BOX 15. DYNAMIC MOVEMENTS OF CENTRAL BANK BILLS AND TREASURY BILLS

Government securities play an important role in the development of the financial market and it is a generally agreed view that in developed countries Government securities are the most reliable risk-free debt instrument. In Mongolia's case, although Government securities still do not generate that level of confidence, the types and size of trade in securities have broadened over the last 3 years.

Comparing Central Bank Bills and Treasury Bills

Purpose disparity

Although both Central Bank Bills (CBB) and Treasury Bills (TB) are financial instruments, they differ principally in terms of their ultimate objectives. TB are issued to implement fiscal policy and manage Government debt, while CBB are issued to maintain domestic price stability. Because of their different influence on the macro-economy, certain conflicts of interest may arise during the implementation of fiscal and monetary policies. For instance, the issuance of TB leads to an expansion of money supply, while in contrast the issuance of CBB leads to a shrinkage of base money.

Market disparity

If buyers of CBB are only banks, then buyers of TB can legally be: central banks, commercial banks, Mongolian citizens, entities and organizations (except those financed by the public purse), foreign entities, organizations and citizens. Though the potential TB market is broader than that of CBB, the main purchaser of TB is currently still the banking sector. While 97 percent of all TBs traded during 2000 and 2001 were purchased by the banking sector, this rate declined slightly to 91 percent in 2002.

Interest rate disparity

Both bills are in discounted form, thus both have a discount rate. According to the "Regulation on issuance of TB", the discount rate of TB may be defined not only in connection with the CBB rate and level of inflation, but also by taking budget pressure into consideration. Therefore, it is clear that the discount rates of both bills could well be close. On the customer side, the only specific difference is that interest income from TB is exempted from tax.

Type disparity

The BOM issues bills with 7, 14, 28 and 91 day maturity dates. The Government issues bills and bonds with 30, 60, 90 and 120 day maturity dates, and in some cases stretches this to 150 days or even 1-2 years.

Disparity on technical proceedings of auctions

The main difference between the two securities in terms of the technical procedure of their auction system is that while the Central Bank holds auctions through its internal network on the basis of a general announcement to commercial banks 1 day prior to auction day, Government holds auctions through the Stock Exchange after a public announcement 7 days prior to the auction. TB auctions can be either open (buyers can participate in person) or closed (through dealers and brokers).

Similarity of the securities

- Financial instrument;
- Discounted type;
- Traded on the basis of auctions;
- Banking sector are potential buyers;
- Seasonality (no issuance of TB in 4th Quarter, only purchased back by Government, size of CBB trading increases in 1st and 4th Quarter, decreases in 2nd and 3rd Quarter).

Market conditions of CBB and TB

The following table summarizes overall information about CBB and TB transactions during 2002.

	Indicators	CBB in 2002	TB in 2002
1	Number of auctions	98	20
2	Issued amount	1000 billion	53.8 billion
3	Sold amount	833.3 billion	51.3 billion
4	Discount rate (Annual average)	11.08%	11.33%

Now let's look at the distribution of primary market by type of buyers in 2002 for each bill (noting that CBBs are traded throughout the year). Banks purchase CBBs constantly in such a manner that they can redeem those CBBs when they mature and reinvest in CBBs buying newly issued bills. Therefore the amount of CBBs owned by banks is calculated using an annual average.

With regard to the secondary market, the Central Bank holds far bigger trades than Government. For instance, in 2002 banks traded CBBs worth MNT 86.2 billion between themselves 94 times, but TBs trade in the secondary market only once or twice per year.

Buyers	CBB		TB	
	Annual average of owned amount (billion Togrog)	Share in the total amount (%)	Total purchased amount in 2002 /billion Togrog/	Share in the total amount (%)
Banking sector:				
TDB	13.1	36.9	15.05	30
AG Bank	9.0	25.3	11.32	22.5
Savings bank	3.0	8.4	11.55	22.9
Golomt	3.9	11.0	1.20	2.4
Anod	1.0	2.8	3.70	7.3
Post	0.9	2.5	-	-
Zoos	0.5	1.4	-	-
Transport	0.3	0.8	-	-
UB city	1.3	3.6	-	-
Inter	1.3	3.6	-	-
Capitron	0.7	2.0	-	-
Has	0.1	0.3	-	-
Erel	0.3	0.8	-	-
Innovation	0.2	0.6	-	-
Bank of Mongolia	-	-	4.0	7.9
Stock Exchange	-	-	0.8	1.5
Public	-	-	2.22	4.4

Empirical study for identifying possible factors affecting TB rate

Despite the fact that CBB and TB are completely different in principle due to their ultimate purpose, the main buyers are still the banking sector for both securities and this indicates that there could be a relationship between the relevant indicators for CBB and TB.

Theoretical aspects

Government will try to tie its TB rates to the market rate, since the CBB rate is the most money market determined rate. The TB rate is higher than the CBB rate, whereas the amount issued is always much less than for CBBs. The TB rate depends on excess reserves in the banking system because the major purchasers are banks. When banks' excess reserves are large, demand for TBs rise, causing TB interest rates to decrease. In contrast, when excess reserves decrease, TB interest rates rise. Consequently, we describe the above-mentioned 2 factors that can affect the TB rate, using the following formula:

$$TBR_t = C(0) + C(1)*CBBR_t + C(2)*ExRs_t$$

Where: TBR_t is the TB rate in month t, $CBBR_t$ is the CBB rate in month t, and $ExRs_t$ *is the* banks' excess reserves at the end of month t.

1. According to theory; C(1)>0 or any change of TB rate will have a positive relationship with changes in the CBB rate.
2. C(2)<0 or any change of TB rate has a negative relationship with changes in banks' excess reserves.

The data covers the period from January 2000 to December 2002. However, because of interruptions in the issue of TBs in some months, TBRt data is unavailable. Consequently, this leads to a violation of the classic assumptions of linear regression models. Therefore, we will simply drop the data of other variables for those months where TBR is missing. In that case the estimated coefficients can still show the correlation of variables (explained by William H.Greene "Econometric analysis" Second Edition). In this case we have first tried to estimate the relevant coefficients by dropping the gaps for all observations. Secondly, after finding the coefficients we calculated relevant observations, which were missing, and then re-generated the model with full observations. However, the output was worse than the dropped case. There was no gain in the estimation of C with full observations. Now we estimate the above-described equation by generating regressions using the OLS method for the Eviews 4 econometric computer program. The empirical result was as follows:

$$TBR_t = 11.32 + 0.39*CBBR_t - 0.36*ExRs_t$$
$$\textbf{(4.2688)} \quad \textbf{(1.9951)} \quad \textbf{(-3.3340)}$$

Dependent Variable: TBR
Method: Least Squares
Date: 01/08/03 Time: 22:39
Sample: 2000:01 2002:03
Included observations: 27

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	11.32030	2.651825	4.268871	0.0003
CBBR	0.390529	0.195739	1.995153	0.0575
EXRS	-0.356521	0.106933	-3.334056	0.0028
R-squared	0.487021	Mean dependent var		13.19000
Adjusted R-squared	0.444273	S.D. dependent var		2.820600
S.E. of regression	2.102675	Akaike info criterion		4.428737
Sum squared resid	106.1098	Schwarz criterion		4.572719
Log likelihood	-56.78795	F-statistic		11.39278
Durbin-Watson stat	1.771245	Prob(F-statistic)		0.000332

Shows no autocorrelation.

Breusch-Godfrey Serial Correlation LM Test:			
F-statistic	0.674956	Probability	0.519412
Obs*R-squared	1.560932	Probability	0.458192

As for TBR, the Null Hypothesis of a Unit Root is rejected since the ADF statistic is lower than its critical value.

ADF Test Statistic	-2.679581	1% Critical Value*	-3.7667
		5% Critical Value	-3.0038
		10% Critical Value	-2.6417

*MacKinnon critical values for rejection of hypothesis of a unit root.

ADF Test Statistic	-1.478007	1% Critical Value*	-3.7343
		5% Critical Value	-2.9907
		10% Critical Value	-2.6348

ADF Test Statistic	-0.625990	1% Critical Value*	-3.7343
		5% Critical Value	-2.9907
		10% Critical Value	-2.6348

*MacKinnon critical values for rejection of hypothesis of a unit root.

Results

1. The estimated coefficient for CBBR verifies a positive relationship between the TB rate and CBB rate and the absolute value of its t-statistic (1.9951) shows the statistical significance of that relationship (the estimated coefficient 0.39 forecasts that if the CBB rate increases by one percentage point, the TB rate will rise by 0.39 percentage points).
2. The value (-0.36) of the estimated coefficient of variable ExRs verifies a negative relationship between TBR and ExRs and its t-value is statistically reliable (forecasting that if the size of banks' excess reserves grows by MNT 1 billion, the TB rate will be brought down by 0.36 percentage points).

Source: www.mongolbank.mn

rise of MNT 83.7 billion. This rise was mainly due to the USD denominated bond of 75 million issued in December.

The main investors of Government bonds are banks, especially Trade and Development, Agricultural, Savings and Anod banks. They together bought bonds worth MNT 53.8 billion in 2003, which is 47.6 percent of the total issued. The company Ivanhoe Mines bought bonds worth MNT 58.4 billion (USD 50 million). This is 51.6 percent of the total.

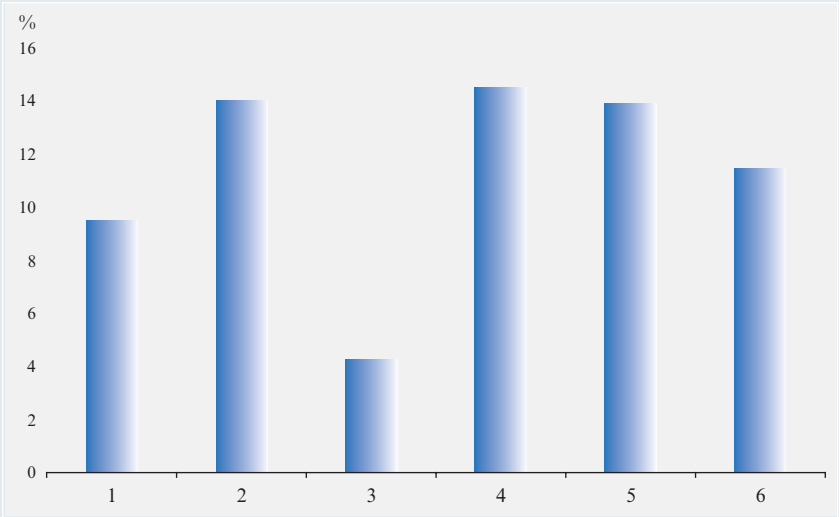
The lowest average interest rate in 2003 was on USD denominated bonds. It was in the range of 3.0 to 5.3 percent per annum. Other bond rates were 2.2 to 14.2 percent per annum for short-term discounted bonds, 14 percent for mid-term special purpose bonds and short-term bonds, and 10.8 to 15.8 percent for mid-term discounted bonds.

Data shows that the weighted average rates on short- and mid-term bonds were higher than those on other types of bond but lower than the Central Bank Bill rates.

Central Bank financing

The Central Bank refinances banks by i) purchasing or redeeming CBBs before maturity, which is known as discount based financing, ii) by entering in repurchase agreement with banks that buy CBB temporarily and sell them back at the pre-negotiated date, known as repo financing, or iii) by overnight lending to banks. These refinancing instruments are

Figure 39. Weighted average rate of the Treasury bills and CBBills



1 Short-term discounted bond
2 Short-term bond
3 Short-term USD bond
4 Medium-term special purpose /road/ bond
5 Medium-term discounted bond
6 CBB

designed to cover short-term fund needs and to smooth liquidity deficiency when there is no fund in excess available at the market.

In 2003, the BOM renewed its regulation of bank financing (refinancing). The new regulation was issued to capture changes in the financial and economic structure of the country with near future developments and it reflects banks' liquidity patterns as well. The BOM made a total of MNT 108.5 billion in refinancing in accordance with the new regulation. This included MNT 64.2 billion in overnight loans, MNT 34.3 billion in repo financing and MNT 10 billion in discount based financing. The most frequently used instrument was overnight loans. Overnight loan were disbursed 29 times, while repo agreements were done 10 times.

On lending by the BOM

The BOM participates in three projects financed by international financial institutions as the on-lending agency. The first is Export-Oriented Small and Medium Size Enterprise Development Project. The project is being implemented according to an agreement between the Mongolian and German governments and disburses EUR 5.1 million. Under the project the BOM on-lent MNT 7.4 billion in loans of which MNT 3.4 billion were disbursed in 2003. The project is implemented through Trade and Development and Mongol Post banks as final lending agencies. The amount repaid by banks was collected in a revolving fund and relent to banks for the same purposes. Funds to the value of MNT 2.1 billion were used from the revolving fund in 2003. There are two parts of the project. The first is fully disbursed and the second began in 2003: funds to the value of MNT 438.1 million were used in this part. Two-part agreements were signed with the MOFE and banks in this year as well.

The second project was Agricultural Sector Development Project. The project began in 2002 and is financed by the ADB. Under it, the BOM on-lends funds to a total value equal to USD 4.4 million to participating banks for agricultural sector development. The project intensified from the fourth quarter of 2002 on and currently the BOM has lent in total MNT 3.1 billion to Mongol Post, Zoos and XAS banks that are participating banks. MNT 1.9 billion of this total was disbursed in 2003. A revolving fund was also set up under this project in 2003 and MNT 700 million in funds have been processed through this channel already.

The third project was Employment Generation Project 1290-MON. Golomt, Zoos, Erel and Transport Development banks are participating in the project. The BOM places Special Term Deposits for employment generation at these banks and the deposited funds at the end of 2003 were worth MNT 3.1 billion. Distribution of the funds was as follows: at Golomt MNT 1.1 billion, Zoos MNT 1 billion, Erel MNT 500 million and the Transport Development Bank MNT 100 million.

In 2003, a total of MNT 785 million in additional funds were placed at Golomt, Zoos and Erel banks in accordance with the project purpose. A MNT 501.9 million fund was redeemed from the Erel and Transport Development banks. In addition, terms on MNT 1 billion in funds at each of the Golomt and Zoos banks were prolonged by 18 months.

Zoos Bank entered into this project starting May 2001, Erel Bank from June, Golomt Bank from July and Transport Development Bank from November of the same year. Since that time a total of 3,198 employment places have been generated financed through this project. The bank-by-bank composition of new employment places generated is as follows: Golomt 1,186, Erel 933, Zoos 786 and Transport Development Bank 293.

5.2. Foreign exchange policy and reserve management

In the reporting period the national foreign exchange reserve was invested in effectively, with major focus on its liquidity position. By end of the year, the country's net foreign exchange reserve reached USD 129 million, which covers 8.1 weeks of imports.

From 122 gold explorers, 11.1 tons of gold in gross weight were purchased with a net weight of 9.8 tons of gold. MNT 132.2 billion was paid for this, which is MNT 12.9 billion more than was spent on gold in the previous year. Overall 13 gold refining shipments were made and 9.8 tones of gold were added to the national reserve. The average price of gold rose above its average long-run price, which positively affected the movement of gold, one of our main export items, to account for a higher portion of national reserve assets.

Certain success has been achieved in finding less risky, higher-return securities and higher yield currencies. In 2003 national reserve has been allocated with correspondent banks and financial institutions in the form of deposits and securities. By the end of the financial year, USD 5.0 million has been received in deposit interest income, USD 3.3 million in foreign exchange trading income and USD 1.8 million in gold trade income.

Within the framework of reserve management activities, in order to decrease counter party risk and to increase interest income against a background of depressed interest levels on the international financial market, ISD Agreements were signed with new foreign counterparts and initiatives were made to adopt new financial instruments.

The rate of return on the national reserve, 4.4 percent, is higher than the approximate benchmark set by the London interbank interest rate of 1.4 percent.

Exchange rate policy

As stated in the State Monetary Policy Guidelines for 2003, the Central Bank committed its activities to broaden its free-floating regime and to maintain exchange rate stability.

The togrog exchange rate is based on actual demand and supply in the market and since January 2003 the rate has been publicly announced on a daily basis.

In reporting period, nominal exchange rate depreciation, as concerns the MNT/USD exchange rate due to USD depreciation on overseas financial markets and money supply in the domestic market was an annual 3.8 percent.

Figure 40. Net international reserves

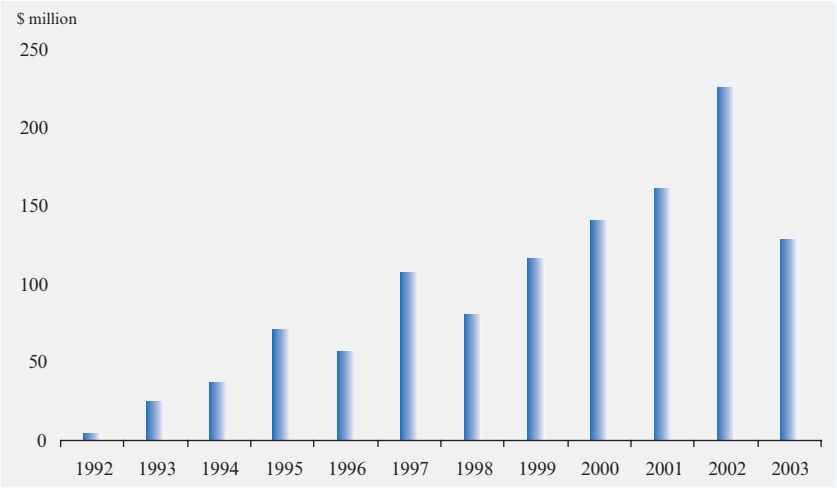


Figure 41. Togrog rate against US dollar

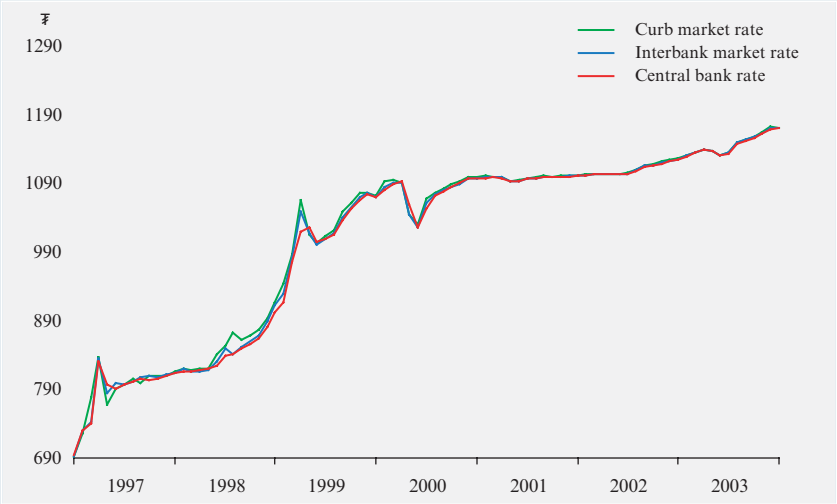
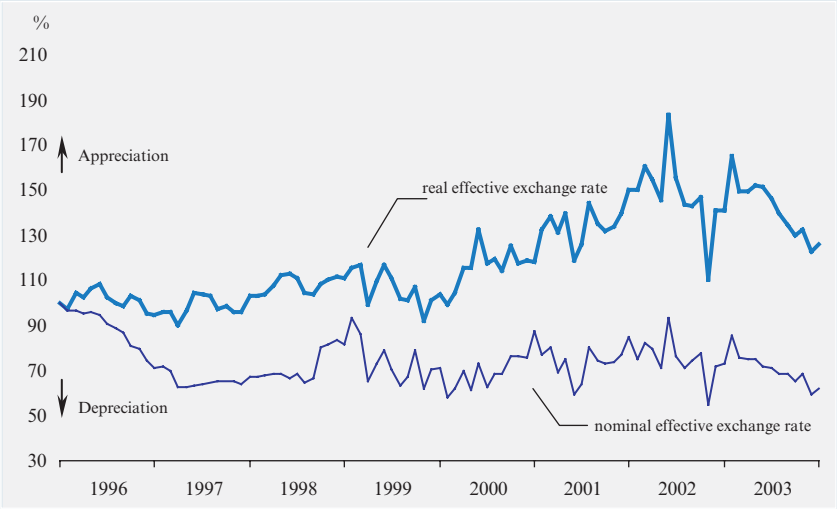


Figure 42. Real and nominal effective exchange rate



In the first 11 months of the reporting period, appreciation of the real exchange rate was 12.9 percent, which is reasonably stable in comparison with the sudden changes in money supply in the economy, price hikes on the overseas market and the volatility of foreign currency exchange rates.

Banks' comments on the foreign exchange market have been collected to develop and make it more effective and works are planned to develop the market.

In the reporting period, it was intended to increase the statistical coverage of the balance of payments, to improve the quality of data and specially to pay greater attention to broadening and improving the quality of data on the service sector - the main part of BoP statistics. As a result, errors and omissions decreased and travel, hospital services and private remittance statistics data improved. In fact, the survey on remittances of emigrants who live and work in London was performed with a high level of achievement.

Compiling reports on foreign exchange transaction via banks are being done on a continual basis. Currently 16 banks constantly submit these statistics on a monthly basis.

According to an agreement with the General Customs Office and the National Statistical Office, from the beginning of October 2003 gold export and import data have been included in foreign trade statistics.

5.3. Supervision of banks and NBFIs

Banks and NBFIs are our country's major financial institutions; therefore, the BOM has been supervising them within its remit to ensure the stability of the financial system.

Last year the number of private entities providing financial services increased and their operations have become increasingly effective. The number of NBFIs also increased and their activities, especially lending operations, have intensified. Approval of the Law on Non Bank Financial Activities established a legal framework for supervision of these institutions.

Following an expansion of the banking sector, the necessity to improve supervision over the sector has arisen and issues related to the appraisal of risks and determination of further development prospects by banks have become more crucial.

The State Monetary Policy Guidelines for 2003 had the following idiosyncrasies compared to those adhered to in previous years: to maintain and strengthen the stability and other achievements of the financial sector; to provide possibilities for banks to conduct their businesses in accordance with international standards; to facilitate the transparency of financial institutions; to ensure that the BOM supervision is conducted in line with internationally accepted methods and means, and to encourage banks to introduce new financial products and services.

The current Supervision System of banks and NBFIs has an effective structure suitable for internationally active financial institutions and measures to improve it have been taken by the BOM in response to current circumstances.

Supervision of banks

Last year, comprehensive on-site examinations of 15 banks and 1 NBFI, aimed at evaluating their financial and liquidity positions and operations, were conducted following a pre-determined schedule and general instructions approved by the Governor of the BOM. Supervision reports were discussed by the Board of Directors of the BOM and the fulfillment of related resolutions of the Board has been closely monitored. In addition, 10 banks, which are currently involved in the on-lending of project funds provided by international financial organizations and donor countries to develop small and medium enterprises, to enhance employment opportunities and improve current conditions in the agricultural sector, were supervised and resulting supervision reports were presented to the State Great Hural (Mongolian Parliament).

Off-site supervision has been making evaluations of financial and liquidity conditions based on reports submitted by banks, containing data and related dynamics of profitability, asset quality and other financial indicators. Based on these evaluations, actions aimed at banks that have started to experience financial difficulties were promptly taken.

Actions taken to improve supervision

In accordance with its objectives to ensure stability of the financial system, the BOM Supervision Department conducted on-site examinations and off-site surveillance of banks and NBFIs, taken action to improve its rules and regulations and issued specific methodology and guidelines to bring those rules and regulations to international standards and prudential norms. In addition to that, the Supervision Department is involved in the implementation of different projects funded by international financial organizations and donor countries, aimed at ensuring the stable growth of the economy and resolving issues related to the social safety net such as housing, unemployment and poverty, by establishing close cooperation with other government institutions, providing necessary information and participating in project units.

In the years subsequent to the banking sector crisis, banks' balance sheets were relatively small, their scope of operations narrow and the number of financial services on offer few. Therefore it was possible for the CEO of a bank to manage and to be involved in every aspect of day-to-day operations. However, due to recent developments in the banking sector, especially the rapid growth of assets and introduction of new financial products, it has become almost impossible for CEOs to continue to micromanage banks in this manner. Thus the necessity of improving current structures, organizational arrangements, segregation of duties, powers and responsibilities has arisen. Some banks have already taken actions regarding

these developments. In order to give some assistance in this area, the BOM, in collaboration with the ADB, has issued "Corporate Governance Guidelines" for banks to improve their structure and the efficiency of their internal audit and control systems and to enhance transparency and thereby foster public trust in banks.

One of the main objectives of banks is to improve their profitability and proper management of the different types of risks inherent in banking operations is one of the indispensable activities of financial institutions in developed countries. Since their establishment, the majority of Mongolian banks have generated their incomes mainly from deposits, lending and payment and settlement businesses. These types of business activities did not require the introduction of advanced technologies, which have become available in recent years. Within the last few years, these circumstances have changed fundamentally and information/ communication technologies have been actively utilized. However, the resulting enhancement of competition in the financial sector has increased its exposure to market risks. Therefore the necessity to increase reliance on internationally accepted methods, methodologies and related software has become crucial, rather than solely relying on conventional methods for estimating risks. In order to assist banks in this area, the "Market Risk Evaluation Methodology" has been prepared by the BOM and submitted to banks.

Some large Mongolian banks have successfully introduced new accounting software developed by the Australian Company FNS, while other banks have been using accounting software developed by domestic companies. Issues related to accounting software inevitably arise with the increasing number and variety of new financial products offered. Thus, it has become necessary for the BOM reporting standards and related chart of accounts to improve. Bookkeeping at banks was carried out in accordance with BOM accounting regulations, but it has become inconsistent with this because of the developments mentioned above; namely the introduction of new accounting software, and banks' demand to make more detailed analysis of collected information. Therefore, starting last year banks have been required to conduct their accounting in accordance with international accounting standards and to submit information in line with reporting forms approved by the BOM. As a result, the chart of accounts has become more detailed and therefore new problems in conducting comprehensive analysis of the condition of banks were partially resolved.

Following the approval of the Law on Non Bank Financial Activities and therefore, the establishment of a pertinent legal framework, the "Regulation on prudential ratios for NBFIs" and "Regulation on licensing of NBFIs" were amended and the "Regulation on on-site inspection of NBFIs" and "Guidelines on off-site surveillance of NBFIs" were issued.

During the last few years, due to some inefficiencies in the legal framework and immature control systems in some developing countries, cases of money laundering the proceeds of international criminal activities including human trafficking, slavery, drugs and arms trafficking have been widely evidenced. So far, there is no official evidence of such cases in Mongolia. However, due to the stabilization of the financial sector and the poor development

of the legal framework compared to that of other countries, there is a possibility that money launderers could in future target Mongolia. The main purpose of money laundering activities is to transform the depiction of proceeds of criminal operations as legal and then to hand it back to criminals. Therefore, there could be some incentives for these criminals to achieve their goals through stable financial systems. The experience of some countries shows that when money-laundering activities are integrated in the financial system, its stability is threatened, corruption intensifies and the moral fiber of society is eroded. Therefore, the BOM has issued its "Guideline on combating money laundering" to increase awareness among banks and other financial institutions. This guideline was based on FATF recommendations, issued in 1990 and later amended in 1996. Issues related to the legal aspects of money laundering, enforcement measures, the regulation of financial systems and international cooperation were included in the guideline. In addition to that, a Law on Preventing Money Laundering and Terrorism Financing has been drafted with the assistance of international organizations.

Capital adequacy

As of the end of last year, the risk weighted capital adequacy ratio reached 20.4 percent, which is higher than the previous year figure by 0.4 percent and higher than the regulatory minimum requirement by 10.4 percent.

On September 2001, the BOM issued a resolution requiring banks to take prompt measures to increase their equity capital to MNT 4 billion by March 31, 2004. This resolution had the intention of enhancing the ability of banks to withstand different types of risk and to expand the scope of their operations. In the subsequent 2 years, banks have been gradually raising their core equity. In addition to the injections to core equity, total banking capital increased by net earnings, which soared by the relatively large amount of MNT 49.1 billion. The growth of risky assets partially offset the above developments and therefore the change in the risk weighted capital ratio over the previous year was minimal.

In the past, banks concentrated their lending on a few small reliable borrowers and made investments in low risk assets such as Mongolian Treasury Bonds and Central Bank Bills. This tendency, however, has rapidly changed over last few years, because of the intention of banks to attract more customers and to thereby gain market share by allocating assets to financial instruments that bear relatively high interest rates. As of the end of last year, all banks were in compliance with the capital adequacy prudential requirement.

At the end of 2003, the capital accounts of NBFIs climbed to MNT 13.7 billion, which was 60.2 percent, or MNT 5.2 billion, higher than the figure from the previous year. This increase was due to the establishment of 26 new NBFIs and the growth dynamics of subordinated term debt and profit accounts.

Risk weighted assets soared by 79.4 percent, or MNT 6.4 billion, to MNT 14.4 billion, and this change was driven by the increase in loans and other assets that have a risk weighting of 100 percent.

Figure 43. Liquidity ratio

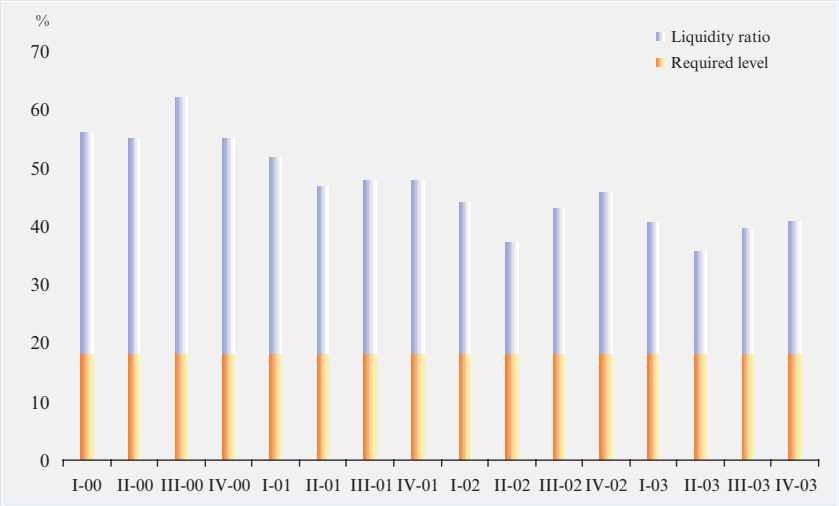
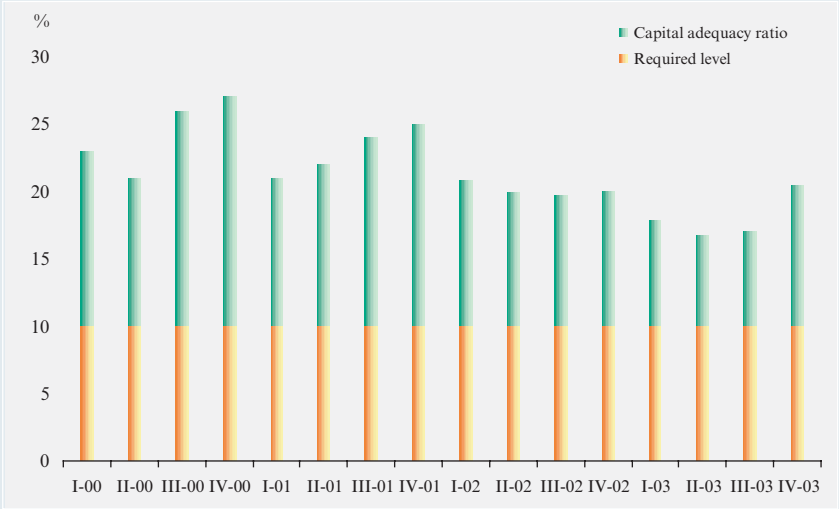


Figure 44. Capital adequacy ratio



In conclusion, capital growth was relatively lower than the growth of risk weighted assets, which led to a decrease in the capital adequacy ratio by 10.7 basis points to 92.6 percent.

The average quarterly growth of loans was approximately 5 percent. Most NBFIs met the capital adequacy requirement.

Liquidity Requirement

Banks' liquidity has been evaluated and controlled in accordance with the pertinent regulations and based on the fulfillment of the reserve and liquidity requirements. Nevertheless despite the expansion in the deposit base of banks over the last 2 years, which was relatively high compared with previous years, liquidity ratios were high and remained stable. During the

last year, the liquidity ratio decreased by 4.5 percent to 41.1 percent, but this was still well above the BOM minimum requirement of 23.1 percent. This tendency to over-fulfill the liquidity ratio requirement could be related to improvements in profitability caused by intensive investments in loans and enhancement in credit monitoring and also to the lack of possibilities to allocate assets in financial leases and financial instruments that earn relatively high interest. In other words, these changes can be attributed to the poor development of activities, similar to financial leases, and poor development of the financial sector. The liquidity ratio for domestic currency denominated assets and liabilities was 34.5 percent, compared to 54.1 percent for foreign currency denominated assets and liabilities. This fact bears out the limited trading possibilities of domestic assets against foreign ones, which can provide a means for forex risk management.

The liquidity ratio of NBFIs decreased by 51.1 basis points to 87.5 percent because NBFIs were attracting funds from equity investors and other financial institutions (total liabilities increased by 48.6 percent against the previous year figure), but liquid assets remained relatively stable. The liquidity ratio estimated on the NBFI consolidated balance sheet was higher than the prudential requirement.

80.0 percent or MNT 3.6 billion, of liquid assets were held in cash and the remaining MNT 0.9 billion were claims on other financial institutions. Total liabilities were composed of loans from other banks and financial institutions, special-type resources and other liabilities representing 48.1 percent (MNT 2.5 billion), 44.2 percent (2.3 billion) and 7.2 percent respectively.

Lending activity and quality of the loan portfolio

The growth of outstanding loans was huge, standing at 91.0 percent, which is relatively higher than those of other assets, and is higher than the previous year's growth rate by 19.7 percent. As a result, the total amount of loans sky-rocketed to MNT 442.1 billion. Non-performing loans hiked up 2.2 times higher, or MNT 20.1 billion, over the last year to MNT 36.7 billion and their share in terms of total loans also increased by 1.1 percent to 8.3 percent.

The growth of loans was lower than the growth of liabilities, which was largely a result of the shift to relatively high earning assets. The average lending rate estimated on accrued interest income decreased from the previous year's figure by 0.4 percent to 25.6 percent, which is 5.9 percent lower than the declared average lending rate. Ratios related to actual interest income earned were higher than those for the previous year, reflecting improvements in the timely repayment of accrued interest. However, it is worth mentioning that these developments were accompanied by that surge in the proportion of non-performing loans. These changes can be interpreted as follows: on the one hand, credit risk of borrowers increased and on the other, due to a rapid increase in loans issued, credit monitoring weakened, credit quality evaluations were limited to collateral valuation and assessments of borrower's situations became insufficient. Therefore, it is necessary for banks to improve their lending

activities. In addition, it is important to take measures to mitigate credit risk, such as by ensuring the reliability of financial statements and improving audit operations.

Reliable information and the analysis of borrowers' situations, such as flow of funds, is crucial for the mitigation of credit risk. In order to provide assistance in this area, the BOM has been taking actions, within the World Bank's technical assistance project, to expand the operations of the Credit Information Bureau. Primary attention has been given to the improvement of software and hardware and expansion of the scope of information on borrowers contained in the database.

International banks and other financial institutions have been applying advanced techniques for the evaluation of credit risks. Due to lack of rating agencies, the unreliability of financial statements to be utilized for rating purposes, inconsistency of financial accounting with international accounting standards, limited trading of stock and similar type of securities on specialized exchanges and also the poor operation of those exchanges, application of those advanced risk management methods in our country is hindered.

Last year, fueled by an increase in attracted funds, the total amount of outstanding NFBI loans soared by 86.8 percent, or MNT 5.3 billion, to MNT 11.5 billion, which represents 60.7 percent of their total assets.

The growth of loans was slightly lower than the growth rate of non-performing loans; therefore, increasing the share of the latter in terms of total assets, while its share in total loans remained stable at around 6.6 percent.

The exception of provisioning expenses from taxable income has not been introduced into legislation. Therefore, most NBFIs covered losses related to credit risk through capital deductions. These factors diminished the incentives for NBFIs to provide extra allowances for loan losses and thereby caused the balance and growth of non-performing loans to remain stable. Thus, there is the likelihood that non-performing loans will soar if related classification is performed in accordance with pertinent regulations.

As of the end of last year, allowances for loan losses reached MNT 360.0 million, which is MNT 1.6 million lower than the required amount of MNT 361.6 million, as stipulated in the "Regulation on loan loss provisioning". This Regulation was approved in 2000 by joint resolution 614/125 of the Minister of Finance and Economics and the Governor of the BOM.

Forex risk prudential requirement

As of the end of last year, the forex risk prudential ratio estimated on the consolidated NBFI balance sheets were not compliant with the required ratios specified in the "Regulation on Prudential Requirements for NBFIs" approved by the Governor of the BOM's Resolution 247, 2000.

Since NBFI capital and other attracted funds are denominated in domestic currency, but loans are denominated in foreign currency (to mitigate forex risks), most NBFIs are not able to meet this prudential requirement (NFBI foreign currency loans represent 22.5 percent of their total loans). Therefore, by amendments in the "Regulation on Prudential Requirements of NBFIs" introduced by the Governor of the BOM's Resolution 637 in 2003, the minimum requirement was revised upward to 40 percent for the aggregate position. Nonetheless, despite advances in the major financial indicators of NBFIs, their role in the financial intermediation process remains small.

Market risk

Over the last decade, international banks and financial organizations have tended to estimate and manage risks in accordance with internally developed methods. In Mongolia, traditional methods for risk evaluation are still applied. Limitations related to those methods, however, became evident with the development of the capacity of banks and their regulators and the introduction of certain financial instruments by relatively large companies.

Because of the expansion of the depository base, relatively numerous conditions on interest rates and loan purposes and also because of the other factors mentioned above, it has become vital to estimate risks using recently developed methods, which provide estimations of risk for certain periods of time at a certain level of confidence. As a result, errors related to subjective judgments will be diminished and the decision process will be facilitated. Therefore, the BOM has issued 'Guidelines for the Management of Market Risks', which contains major principles to be adhered to in the risk management process.

In order to mitigate banks' forex risk, the BOM has been imposing open position limits. Nonetheless, despite relatively stable exchange rates between togrog and major foreign currencies, the banks not only maintained their long position in foreign assets but increased it. Compared to previous year figures, the aggregate long position of banks grew 7.2 times to MNT 40.2 billion. However, relatively large increases in the capital of banks partially offset the surge in the prudential ratio. The latter climbed by 27.6 percent to 36.5 percent, which is 3.5 percent lower than the required level.

Bank privatization

During the last few years, within banking sector restructuring measures aimed at ensuring the stability of the financial sector, actions to privatize state-owned and state-participated banks have continued. As a result, Agricultural Bank was privatized last year. The privatization of state-owned shares to foreign investors is not only important because it creates conditions for the further development of the financial sector, and ensures its stability, but it is also significant in terms of attracting foreign direct investment. Capital bank also announced the privatization of its state-owned shares. Therefore, there remains only one state-owned bank, Savings bank, in the sector and actions to privatize it to foreign and domestic investors, after monetizing Government restructuring bonds and improving its operations, have been initiated.

5.4. Accounting and information technology

Accounting

During recent years the BOM has placed special emphasis on bringing current accounting rules into line with international standards and improving accounting discipline. In pursuit of this objective, guidelines and regulations were drawn up to improve compliance with the accounting rules, being applied in the new two-tier banking system, to international standards and following international principles. In 1997-1998, the BOM updated its entire accounting system and began a project, financed by the Asian Development Bank, to install a new computer system. This was completed in 2003. As a result of these initiatives, the BOM and commercial banks have been provided with accounting rules, have complied with international standards and have the software to record it.

In 2003, the BOM reduced the amount of non-performing assets it held that were registered on the asset side of the balance sheet by 50.2 percent and increased the bank's income by the same amount.

In the reporting year, interbank settlements increased significantly both in terms of quantity and value. As seen in Figures 1 and 2, settlement quantity and value increased respectively by 19.4 and 52.1 percent in 2001, 43.7 and 45 percent in 2002 and 83.1 and 49 percent in 2003.

This increase in the settlement quantity and value is due to, on the one hand, the systemization of State Treasury activities and their extension to rural provinces, and on the other hand, the improved public confidence in the banking sector that has led to non-cash settlements being made only through banks.

As the interbank settlement quantity and value increases, GDP turnover (the ratio of the total amount of interbank settlements to GDP) has been accelerated. While this ratio was 1.2 in 2000, it reached 1.7 in 2001, 2.2 in 2002 and 3.0 in 2003.

Information technology

In order to keep pace with rapid advances in information technology, technology and software in the banking sector has been improving. At the end of the year, there were a total of 200 users connected to four different networks: international settlement, interbank and inter-branch settlement, Central Bank accounting, and domestic settlement. The BOM is aiming at fully transferring the inter bank network into online regime and as an initial step, online regime has been applied to the above mentioned network.

In the reporting year, the BOM successfully completed implementation of a project, funded by the ADB, to improve the skills of banking staff. Within the framework of the project the Agricultural, Trade and Development, Erel, Mongol Post and Savings Banks all installed

Figure 45. Interbank settlement

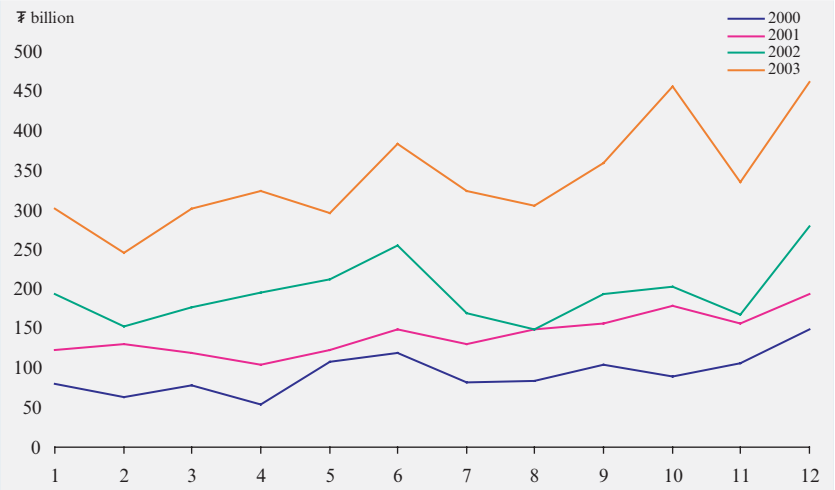


Figure 46. Interbank settlement and GDP

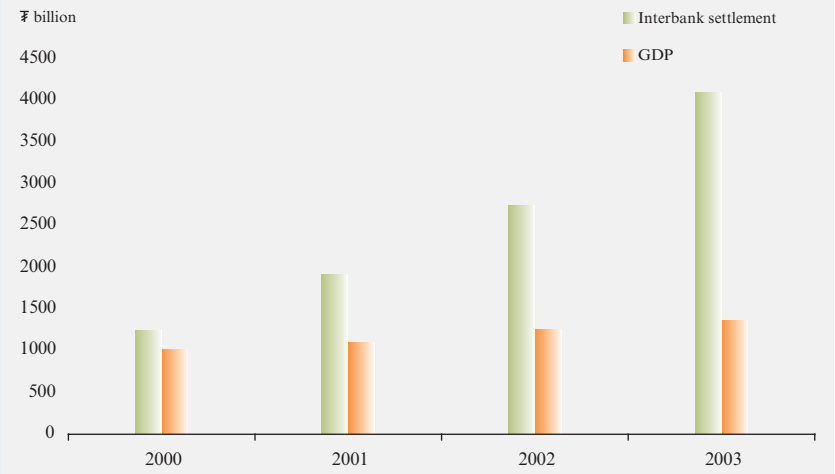
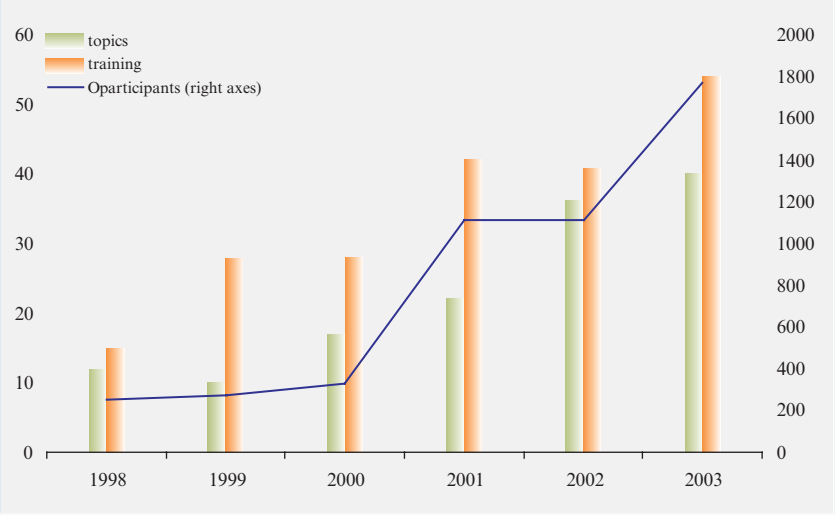


Figure 47. Organized training



complete sets of software that complied with international standards. In addition to the software, the banks were enabled to provide their services regardless of spatial distance.

Most banks used to use software designed by domestic companies or experts; however, this software was not entirely capable of working in several domains at once, managing a centralized database and network, obtaining queries from databases, or preparing reports and security and user friendliness were not satisfactory. By introducing completely new information technology, banks now have the opportunity to introduce new services, to provide services to customers promptly and to maintain the confidentiality of information. Furthermore, because banks' headquarters are connected to their branches through online networks, customers can use banking services at any branch of their bank.

The implementation of the ADB-funded project in 2000-2003 was efficient in many ways: first, it successfully applied Internet-capable software in 5 banks; second, it used the satellite telecommunication system VSAT for the first time to provide a comprehensive online service; third, it introduced a teller system into banking activities; fourth, the relational database management system Oracle RDBMS was installed; fifth, an integrated banking system was introduced to local banks and financial institutions; and sixth, in addition to software solutions, hardware and telecommunications solutions were introduced.

As of the end of the reporting year, 47 branches of the Agricultural Bank (28 in rural provinces), 17 branches of the Trade and Development Bank (6 in 5 rural provinces), and branches of Erel Bank in Ulaanbaatar and Darkhan-Uul province, are operating online systems. Moreover, the Mongol Post Bank is promptly executing settlements with its 8 branches through an online regime. As a final step of the project, the same system is being introduced to the Savings Bank and its branches in Ulaanbaatar city.

In addition to the above system, banks are installing similar systems based on their own decisions. The Anod and XAC banks are cooperating with information technology institutions in countries such as India and Russia and have introduced new accounting systems; furthermore Golomt Bank has fully renewed its software, made by a national producer: ECM Company. By using the system, Golomt Bank is now able to operate an online regime in its branch in Ulaanbaatar (Branch 6).

In 2003, as the Savings and Zoos banks were granted the right to issue international cards, the majority of banks are now offering those services. However, because the systems being used by the banks are not integrated, and as there is no legislation to regulate such activities, the BOM has started implementing a project to update the payment system to reduce variations. The project has the objectives of introducing advanced technology for non-cash payment settlements, creating a national network of interbank payments, establishing an interbank net system for the settlement of small amounts and a gross system for large settlements, and launching an integrated network of banks and financial institutions.

Within the framework of the project, all non-cash payment settlements will be executed through a unified standard process and we are aiming at creating an integrated computer network in the banking and financial sector and establishing an interbank center to operate an online regime.

In the reporting year, complete software replaced the practices of carrying paper copies of interbank settlements temporarily and of current account statements on the following day, with the practice of transferring data as files through a computer network on the day of settlements. In addition, similar to the elimination of material cards that were recorded manually and used throughout headquarters and rural branches of the Central Bank, over 3,000 manually recorded cards of fixed assets were replaced with

5.5. Other activities

Management, organization

The human resource policy of the BOM was aimed at recruiting highly specialized and well-educated personnel in order to implement policy driven activities such as stabilizing the financial and banking system and deepening and widening banking sector restructuring.

As of the 2003, the BOM had 310 employees in 6 departments, 11 divisions, 1 special sub-division, 9 units, 1 project unit, 19 provincial branches and 1 representative office. A new division in charge of Non-Bank Financial Institutions was established in the Supervision Department as workload increased, to amend relevant regulations, review application materials for licenses following the approval of NBFI law and to establish more NBFIs. Thus, the Supervision Department has 4 divisions.

66.5 percent of the Bank's employees are state administration officers, 34.8 percent are state service officers, 48 percent are female, 52 percent are male, 46 percent are in the age range 21-35, 28.8 percent are 36-45, 20.4 percent are 46-54 and 5 percent are above 55 years of age.

On average the Bank sends its employees to 1-2 training programs in a year organized by foreign banks, the World Bank, the International Monetary Fund Institute or the Banking Training Center at the Bank of Mongolia to improve the knowledge and education of employees, to upgrade their professional skills and working experience along with timely requirements. Proposals and suggestions from Department directors have been reflected since 1996 in "the training program" and the number of employees to be trained and of professional training topics have been pre-determined in accordance with this principle.

As of today, 40 employees hold post-graduate masters qualifications (31 from foreign and 9 from local institutes) and there are 2 doctoral candidates (one from a foreign and the other from a local institute). Graduates from universities in the USA, Great Britain, Japan, Australia and Mongolia work at the Bank of Mongolia.

The BOM's human resource policy is aimed at enhancing and improving the professional capability and social security of its employees (providing them with apartments, transportation facilities, healthcare, wages and cultural and public activities).

Internal Audit Activities

Within the framework of internal audit activities and according to the Internal Audit 2002-2006 program, 2003 planning in the Internal Audit Department was carried out by putting control on whether activities directed toward the implementation of state monetary policy were performed according to legislation in all the BOM's departments, divisions and provincial branches by giving instructions, recommendations and taking relevant measures to reduce risk, secure from potential risks and losses and to detect irregularities.

During the fiscal year, the BOM conducted 47 regular, surprise and partial on-site inspections in response to private messages, complaints concerning 5 BOM departments, divisions and branches. The primary focus was on high risk areas and work was done to investigate and correct irregularities.

Also, internal audit activity was assessed on a half-yearly basis, reported to the Board of Directors and relevant measures were taken according to audit results.

In the reporting year, in order to improve and develop internal audit activity and bring it to international standards, regulations and procedures to establish the internal control system with a structure directed toward reducing and eliminating risk by managing, controlling, assessing, measuring and investigating potential or actual risks in all stages of the BOM's activities were put in place in accordance with advice from the IMF. For instance, the "Internal Audit Departments Rule" and a manual for auditors, both of which are used during audit activity, were renewed and regulations and procedures that reflect the audit regime, Internal Audit Department's structure and organization were newly drafted in this context.

Further, we are planning to take step-by-step measures to develop the BOM's internal audit policy, principles, programs and planning, to put them into action, renew the above-mentioned legislation and upgrade the knowledge of personnel.

This year, the approval of the Bank of Mongolia's Supervisory Committee by the State Parliament was sufficient to develop the Bank's internal audit activity and make punctual, correct, reasonable assessment of the BOM's activities.

In the reporting year, the Internal Audit Department of the Bank of Mongolia invited the "Ernst & Young Mongolia Audit" team to audit the BOM's financial statement for 2002 and to make a special audit of foreign reserves management activities as requested by the IMF. The National Audit Department was also invited to audit the BOM's social development fund, assets deposited in foreign bank accounts and the efficiency of foreign currency reserves.

Attention was given to responding to their recommendations and relevant measures have been taken.

Issue of Banknotes and Coins

In the reporting year, the BOM carried out the following activities regarding the issuance of currency:

Notes in 5,000 togrog denominations were re-printed by the German Company, Giesecke and Devrient and have been issued into circulation since March 2003. Notes in 500 and 1,000 togrog denominations were also re-printed by Giesecke and Devrient and have been issued into circulation since November 2003. In an effort to increase the lifespan of banknotes, new notes were re-printed with a special coating of a protective transparent overlay and some additional security features against possible counterfeiting were added.

In December 2003, the BOM signed an agreement with the German company, on a tender basis, for the re-printing of 50 and 100 togrog notes to be put into circulation in the second quarter of 2004.

Moreover, activities have been carried out to supply the provinces and regions with cash in required denominations through branch offices, to withdraw damaged and worn banknotes and to re-count and verify banknotes.

In the reporting year, the BOM withdrew damaged notes worth MNT 106 billion from circulation and issued freshly printed notes worth MNT 124 billion.

In the reporting year, coin issuance was slowed due to the underutilization of coins.

The following table shows the denominational structure of the currency in circulation:

The table shows that the value of largest denomination notes accounts for the largest share of currency in circulation. This can be explained as a significant amount of transactions and payments are still undertaken outside the banking system. Also, in order to improve, speed up and provide the security and safety of he counting, verification and sorting of banknotes the new German-made banknote processing machine BPS204, and banknote canceller BC40 have been installed on-site at the BOM.

The Banking Training Center at the Bank of Mongolia

The Banking Training Center's (BTC) main focus in 2003 was to organize various training sessions and seminars in a high quality manner and to organize seminars and training sessions according to its plan. In total, 1,768 staff members attended training, seminars and other activities both inside the country and abroad. This is 31 percent of the entire banking system

BOX 16. PROFITABILITY OF BANK OF MONGOLIA

The primary objective of the Bank of Mongolia (BOM), as defined in Central Bank Law, is stability of the national currency – the togrog (MNT). Other BOM objectives include supervising the financial system, supporting sustainable economic growth, improving the monetary and credit environments and pursuing other objectives that serve the community. Although, according to Central Bank Law, the BOM's primary aim is not seeking profits, such activities as issuing credit and foreign exchange reserve management are highly profitable. This is true for almost all other Central Banks. Although profitability has never been considered important by the BOM, as the central bank the BOM has always made certain profits. Table 1 shows BOM's profits during 1991-2002, a period that overlaps the introduction of a two-tier banking system in Mongolia.

Table 1. BOM profits 1991-2002

Year	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Profit (Billion ₮)	1.5	0.2	0.7	0.3	0.4	16.4	1.7	4.2	13.9	21.8
₮/$ ER (EOP)	396	414	473	693	813	902	1072	1097	1102	1125
Profit (Mil. USD)	3.8	0.6	1.4	0.4	0.4	18.1	1.5	3.8	12.6	19.4

The structure of the BOM's financial statement shows that the largest proportion of incomes and expenses are related to operations in foreign exchange and precious metals. This implies that most of the BOM's income and expenditures are non-interest bearing. This is a consequence of the BOM's operational peculiarity. The fact that BOM income and expenditures originate from and go to the gold trade has been a result of the strong engagement of the Central Bank in gold market operations since the 1990s.

As the scope of banking services, financial tools and the financial market expands the structure of the income and expenditure statement changes significantly. As a central bank, the BOM is responsible for managing the country's foreign exchange reserves. The weight given to foreign exchange income as a proportion of the BOM's total income is significantly high. The main factor behind the increase of income through forex trading is the net income earned by the trade in gold and precious metals. There is no evidence for a strong, positive relationship between the world market price for gold and the BOM's net income from gold operations. During the last few years, as gold production has been increasing Mongolia's net official reserves have also been increasing steadily. All of this has resulted in an increase in forex trade income despite fluctuations in gold prices on the world market.

Another source of the Central Bank's profit is its interest income from refinancing banks and loans issued to the Government. As a Central Bank policy tool, refinancing loans to banks and the level of net credit to the Government depend on the monetary policy objectives of that year. During the last several years interest rate income from loans issued to banks and Government has been decreasing significantly. This is a result of the stabilization of the banking sector and the rise in private individual savings, followed by an increase in the excess reserves held by commercial banks. Therefore, the level of loans given to banks and the Government by the BOM has fallen sharply.

Movements in interest expenses can largely be explained by movements in the CBB rate, which is also directly affected by monetary policy, and is the interest base rate for the financial market. As CBB rates fall the BOM's lending rate also falls.

All income earning assets such as refinancing loans and loans to Government, and the main interest expenses are indirect policy instruments. The BOM's monetary policy has been implemented using these indirect instruments, which cause losses in terms of profitability. However, this tendency is likely to continue in the nearest future.

The BOM's profit from other activities consists of other income and expenditures. 'Other income' includes income from fees, from real estate rents, from fines and so on. 'Other expenditure' includes the provision of reserve funds, staff expenses, operating costs and amortization. These expenditures account for 5-15 percent of the BOM's total expenses and have had no influence on changes in the BOM's profitability.

Nowadays, competition in the banking sector is becoming fiercer and as a consequence the profitability of banks is declining somewhat. For example, by the end of 2002 ROA (calculated by pre-tax income) of the whole banking system excluding the BOM decreased 1.6 points to 4.3 percent. However, the BOM's profitability has been continually increasing, triggered by increased foreign exchange income. Table 2 presents the BOM's coefficients on ROA and ROE for the period 1999-2002.

Table 2. BOM's profitability ratios

Indicator	1999	2000	2001	2002
Return on Assets	0.7	3.1	3.6	4.8
Return on Equity	4.0	17.0	34.0	65.0

For the last few years, while the profitability of the banking sector has been in constant decline the BOM's profitability ratios have remained stable. For the banks, this fall in profitability was caused by a decline in credit interest rates and a rise in deposits such as saving accounts and correspondent accounts, which are high-cost sources of finance.

Source: www.mongolbank.mn

workforce. The BTC organized 54 training sessions and seminars on 40 subjects out of 45 planned domestic and foreign training sessions and seminars on 41 subjects in 2003. In total 1,449 staff members were covered by these training sessions and seminars, which is 1.8 times higher than in the previous year. The reason for such high growth is related to support for the BTC and its activities from the BOM, other banks and some NBFIs, and an increased willingness to send employees on these training sessions and seminars.

Internal Training

The BTC worked out its 2003 training planning by taking advice and suggestions from banks at the beginning of the year in order to organize training and seminars that would meet the needs and requirements of the banks' employees and as a result of organizing training and seminars according to this planning the outcome and activeness of banks were both high and satisfactory. 48 domestic training sessions and seminars on 36 subjects attended by 1,361 staff members were organized.

In the reporting year, the BTC effectively complied with 56 requests and proposals from its member organizations on time and organized trainings beyond its planning according to requests from some banks and supplied them with training premises, necessary software and equipment.

In order to improve the foreign language knowledge of banks' employees a banking and financial English course was organized twice, which were attended by 32 participants.

Also, following a request from Erel Bank an English course was held at the bank that 11 persons took part in. Out of 43 persons who attended English courses, 31 passed the final examinations and were given certificates.

In the reporting year, training under the theme "The service and attitude culture of banks employees" was organized at 10 banks and NBFIs. The BTC, for the first time under its own initiative, organized accounting and bookkeeping courses designed for nonprofessional persons who work at banking institutions and who have a desire to join the accountancy profession and work at their own organization in future as an accountant. Of 16 persons who attended the course 13 passed the final examination and were given certificates.

Considering the centralization of banking and financial organizations the BTC organized a course named "Micro credit activity and micro credit" designed for employees of banks that carry out activities in Darkhan and Erdenet cities from the 22nd to the 25th September, 2003. This was the first ever course independently organized in provincial areas by the BTC and in total 48 persons attended the course of whom 25 persons were from 12 banks in Darkhan city, and 23 persons were from 10 banks and 1 NBFI in Erdenet city.

The BTC, within the framework of 80th anniversary of the establishment of the banking system in Mongolia, is planning to organize joint training and seminars with banks by region in 2004.

In 2003 six training sessions and seminars financed and supported by SIDA, the EBRD and the Asian Productivity Organization were organized in Sweden, Luxembourg, the UK and Taipei, which were attended by 89 persons. In particular, the training, seminar and meeting designed for the bank management group and organized by the Bank of Mongolia's resident representative office in London, UK, in cooperation with the EBRD was very productive. On top of the 30 persons who were officially accepted by the course administration, 5 more persons were added at the BTC's request and this was accepted by SIDA at the three courses held in Sweden.

The financial activity and capacity of the BTC significantly improved in 2003 in comparison with those of the previous year. The punctual contribution of banks to the training membership tax is an indication that banks support our training center's activity and this is the primary condition for continuing training and seminars properly. The total income during the reporting year was MNT 48.4 million, while expenses were MNT 31.3 million. MNT 31.5 million of the total income came from the BOM, banks' and NBFIs' membership tax and MNT 16.9 million was income generated by BTC activities.

In the reporting year, the BTC also carried out and organized activities directed at promoting banks, informing the general public of the education and professional skills of bank employees, facilitating the exchange of experiences and information between bank employees, spending employees spare time in a productive manner and improving the working efficiency and skills of employees.

Foreign Cooperation

In the reporting year, the BOM developed relationships with foreign correspondent banks and international institutions.

The First Meeting of the Executive Committee of the South East Asian Central Banks was successfully organized in Ulaanbaatar in January 2003. Also, the 4th Seminar of Supervisors of Central Banks and the 16th Workshop of Directors of Supervision of Member Countries in the Union of South East Asian Central Banks (SEACEN) were held in Ulaanbaatar in August. During the workshop, research papers were presented by member banks of the region and evaluated and working experiences were exchanged between supervisors.

The signing of a contract between the Bank of Mongolia and the Central Bank of the Russian Federation on organizing the settlement of their foreign economic relationship was a significant step forward in developing trade between the two countries.

Also, the Bank of Mongolia participated in the working group on resolving the old convertible rouble debt issue.

The Bank of Mongolia attended the IMF and World Bank Annual Meetings, established new working links with correspondent foreign organizations, discussed new opportunities for

BOX 17. INTERNATIONAL COOPERATION

In the years following the victorious People's Revolution, Mongolia was incapable of supporting itself financially. Thus, with the help of the USSR, a Mongolian-Russian joint bank, 'Mongolian Trade and Industrial Bank', was established on June 2nd, 1924. From the outset the BOM as had a close relationship with foreign banks and organizations. Furthermore, the number of banks with which it cooperates has increased over the years. For example, in 1955, the bank was cooperating directly with 3 foreign banks; in 1960 with 17 foreign banks, and in 1974 with about 50 banks from 20 countries.

In October 1963, the Government of Mongolia and the governments of Bulgaria, Hungary, East Germany, Poland, Romania, Russia and Czechoslovakia signed a multilateral intergovernmental agreement introducing a comprehensive accounting system in foreign trade. This was also made possible by an agreement to establish the International Bank for Economic Cooperation (IBEC). Members of the Economic Cooperation Council (ECC) had established the International Bank for Investment, in which Mongolia, as a plenipotentiary member, participated with equal rights, and agreed to conduct foreign settlements following resolved regulations and to acquire loans to support the rapid development of the domestic economy.

After the transition to a market economy, the Bank of Mongolia has paid greater attention to widening its operations and cooperating with foreign Central Banks and other financial organizations in order to gain experience and the support of developed countries. In line with this Mongolia became a member of the International Monetary Fund, the Asian Development Bank and the World Bank in 1991.

International Monetary Fund

Mongolia joined the IMF in February 1991 and the IMF has since played an active role in overcoming difficulties arising from the transition to a free market economy, setting the legal basis for economic relations and implementing successive programs for the achievement of macroeconomic goals.

Under a 'Stand-by' program in 1991, the Government of Mongolia executed the terms for utilizing loans from donor countries, raising the level of minimum reserve requirement, increasing interest on deposits, setting a ceiling on commercial banks' loans through tight monetary policy and tightening fiscal policy by changing the taxation system to rein in hyperinflation. As a result the economy soon showed signs of stabilization.

As a next step, beginning from 1993, the implementation of the ESAF program eliminated foreign and domestic economic imbalance, stabilized economic growth and intensified the development of conditions for the transition to a market economy. The last program was approved in June 1999. The anti-poverty focus has been recently strengthened with the replacement of the old ESAF with the 'Poverty Reduction and Growth Facility' (PRGF) program. The first Fund-supported PRGF was approved on September 27, 2001 by the IMF board, following the adoption by Mongolian authorities of the nationally-owned Interim Poverty Reduction Strategy Paper. Mongolia and the IMF are today continuing their close cooperation.

World Bank

Since joining the World Bank in 1991, Mongolia was placed in category A after analyzes were made on social and economic development based on per capita Gross Domestic Product. As a result, Mongolia was given the opportunity to borrow from the International Development Association (IDA) on discount terms.

The IDA offers 35 to 40 year long-term loans, free of principal payment for the first 10 years, with the payment of an annual 0.75 percent service charge.

The Household Sustainable Livelihoods Project has been active since 2002. Meanwhile, commercial banks were selected as forwarding institutions including: Zoos Bank, Ulaanbaatar City Bank, Savings Bank, Interbank, Mongol

Post Bank, Agricultural Bank, and NBFI's like the City Foundation, ABTS, Battogrog, Kapmon and Credit Mongolia. Through their rural networks, these financial organizations have issued MNT 1,855.2 million in loans to 1,652 debtors at a mean interest rate of 30.18 percent per annum (2.51% per month). Of the project loans, 92.4 percent were issued in rural areas, of which 37.6 percent were in remote areas. Loans were issued to finance trade and services, agricultural and food manufacturing and private consumption.

The World Bank's Financial Capacity Development Project was agreed in a contract made on September 2002 between the Government of Mongolia and the IDA. The purpose of this project is to expand financial capacity, improve banks' risk management and to upgrade the payment system. Under this project, activities such as innovations in the payment system, the introduction of a non-cash payment system, the establishment of a clearing house that will serve financial organizations, customers and card holders, software installation, the creation of a favorable legal environment, the drafting of related regulations and the establishment of a dedicated network for the banking system have begun.

Asian Development Bank

Loans and technical assistance from the Asian Development Bank (ADP) have been increasing ever since Mongolia joined the ADB in 1991. The ADB is one of the main donors assisting in many sectors of Mongolia's economy.

Until 1999 the Governor of the Bank of Mongolia served as the Governor for Mongolia in the Asian Development Bank. He was responsible for ensuring proper attention was paid to channeling communications with the ADB and for regulating activities related to the preparation and coordination of loans and technical assistance from that institution.

The first ADB Country Operational Strategy adopted for Mongolia, for the period 1994-1999, focused on mid-term objectives to accelerate the process of transition from a centrally planned to a market-oriented economy. In November 1999, the ADB formulated a new mid-term Country Operational Strategy focused on poverty reduction in Mongolia for the period 2000-2005. The distinctive feature of the strategy is its overarching goal to maintain sustainable development aimed at poverty reduction with the strong commitment and active participation of the private sector. Within this program, the ADB has agreed to provide USD 25 million for implementation of the Governance Reform Program. The main objective of this program is to support the process of reforms needed to develop a new system of public governance and management. To reach these goals will require building a more efficient and accountable public sector, improving its financial management, and making it performance–based and transparent.

In 2000 Mongolia became the second country to sign 'A Poverty Partnership Agreement' with the ADB. All projects implemented under ADB country loans to Mongolia were very successful and were classified as AAA grade. Also, the ADB is implementing a Housing and Finance Sector Loan Project, a Rural Financing Project and an Expanding Employment Opportunities Project. The Housing and Finance Sector Loan Project was approved by the ADB's Board of Directors in October 2001, and by resolution of the Great State Khural in April 2002. Under this project, loans for building, purchasing, selling and repairing house are issued by selected forwarding organizations such as: Golomt Bank, Zoos Bank, the Savings Bank and the Mongol Post Bank.

The Rural Financing Project, which was approved by the ADB's Board of Directors in October 2001 and the Great State Khural in April 2003, aimed to establish saving and loan associations in rural areas, widening their operational scope and providing them with financial resources and information.

South East Asian Central Banks (SEACEN)

The BOM joined the South East Asian Central Banks (SEACEN) Union in May 1999 and took initiatives to familiarize member countries with Mongolia and the BOM. In order to stabilize the country's regional financial market through data exchange on capital flow management, a SEACEN group of experts established the SEG database system on May 2000. For this purpose member countries agreed to transfer data via a highly secure network.

Other organizations

Agreements on mutual cooperation to facilitate foreign trade have been signed with the central banks of major neighboring countries. In 1999, an agreement of cooperation was signed with the People's Bank of China. Consequently, in 2002 a banking arrangement on accounting procedures for economic and financial cooperation was signed. Also, in 1997 and 2003, agreements to promote economic and trade relationships and to strengthen cooperative affiliation in the banking sector, were signed between the Bank of Mongolia and the Central Bank of the Russian Federation. Furthermore, in order to develop cooperation in the economics and finance agreements were also reached with the State Bank of Vietnam.

The BOM also signed a Memorandum of Understanding regarding cooperation and exchange of information with the Bank Indonesia and to facilitate the exchange of experiences with similar countries undergoing transitional market economy, agreements were reached with the Romanian and Hungarian central banks.

As part of promoting and enhancing cooperation in the bilateral relationships between foreign central banks, the Bank of Mongolia and the Central Bank of Luxembourg reached a cooperation agreement on training bank personnel and staff. The Bank of Mongolia has also enhanced its relations with the Bavarian Landesbank, the European Bank for Reconstruction and Development (EBRD) and the Swedish International Development Agency, where many of our staff have been successfully trained. In 1998 the Bank Training Center under the auspices of the Bank of Mongolia was admitted as an official member of the Federation of Bank Training Centers in the Asia–Pacific region.

Relations with organizations such as the International Finance Cooperation (IFC) and Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group have been established and steps towards becoming a member of these international organizations have been taken. In 2000, Mongolia became a member country, although not country of operation, of the European Bank for Reconstruction and Development (EBRD), assuring favorable conditions for loans and grants.

As a result of the BOM's rapid foreign relations expansion, it established a Representative Office of the Bank of Mongolia in London, UK, in 2002.

Source: www.mongolbank.mn

cooperation, effective deals and new working ideas with current correspondents and entered into some agreements.

In order to spread information about the real Mongolian economic, banking and financial situation, materials related to the general situation of the Mongolian economy, investment environment and the current situation of the banking and financial system were published in internationally recognized journals including The Banker, Fortune, Euromoney and Novaya Gazeta.

The ISDA and an internationally accepted Master Agreement was made with Societe Generale, Mitsui & Co., Precious Metals. Inc. and Credittrust Bank.

In the reporting year, in collaboration with the Union of South East Asian Central Banks, the World Bank and the Federal Reserve Bank of the U.S.A the 4th Seminar for Senior Supervisors of Asia Pacific Countries was organized in Mongolia. This was an indication of the BOM's growing reputation abroad.

On the occasion of the 80th anniversary of the establishment of the Mongolian banking system, introductory material was published in English and Mongolian on compact disks showing historic facts about the BOM. These were issued in order to promote the anniversary to foreign correspondent organizations.

The activity of the Bank of Mongolia's resident representative office in London, UK.

The resident representative office of the BOM in London took its first important steps toward entering into agreements with the Central Banks of England, Luxembourg and the Federal Republic of Germany in exchanging information, professionals, organizing training and seminars and providing BOM staff members with long-term practical training.

In 2003 only 1 person attended training and seminars organized in London by the Central Bank of England, but it was agreed to send 14 staff members to similar training and seminars in 2004. Also, to commemorate the 80th anniversary of the establishment of the Mongolian banking system we have made an agreement with the 700 year-old Central Bank of England that it will organize training under the theme "Corporate Governance of the Company and Risks" on May 2004 in Mongolia. Preparations for this are well under way.

Also, an agreement was made with the Central Bank of Luxembourg to widen our cooperation on foreign exchange reserve management issues and to organize training for the BOM staff members. In this regard 3 BOM economists attended the courses in Luxembourg.

Under the framework of an agreement on general principles of cooperation with the Central Bank of the Federal Republic of Germany, an agreement was concluded to send 2 BOM staff members to pursue practical studies on supervision in order to gain experience in detailed subjects, to get advice from German specialists and to continually send BOM staff members to international seminars organized by the German Central Bank.

A 3-year training program to upgrade the knowledge and professional skill of bank staff members at the EBRD was initiated and it has been agreed that the project will be financed by the EBRD. As a result, a project of gratuitous assistance amounting to EUR 361,300 covering 120 persons in total was approved and some banking related training was organized. Of the 120 persons to take part, 20 BOM staff members and 30 commercial bank staff members are to be trained in London and Luxembourg, and 70 staff members representing all banks are to be trained in Mongolia by foreign banking specialists.

In the report year, seminars and training for banks' chief executive officers were organized in London and Luxembourg and introductions to the activities of the EBRD were also made. Also, special group tours for the banks' CEOs to the Central Bank of England, the Financial Training Institute, HSBC, the Royal Bank of Scotland, the National Bank of Canada, KBC, Natexis and training and introductions to products, services and management by specialists from visiting banks on foreign trade, project financing and the services of correspondent

banks were organized. As a result of the introductory tour to foreign banks the Golomt Bank of Mongolia opened its representative office in London and several other Mongolian banks made preparations to open accounts, make settlements and to begin money transfer services. Some activities have already started. Also, besides presenting an opportunity for Mongolian banks to establish connections with two of the world's biggest financial centers, this training was crucial to enhancing the CEO's management manner according to the EBRD's report to the BTC.

6 DEVELOPMENT OF BANKING LEGISLATION

An amendment to the Law on Central Bank (Mongolbank) was passed by Parliament on January 2, 2003, introducing Article 28[1], which defines the powers of the General Manager of the Bank of Mongolia. Art.28.1.6 was re-formulated to give the Governor the power to determine the organizational structure of the Bank of Mongolia.

An amendment to the Treasury Law was also passed on the same day. According to this amendment the treasury's staff numbers and salary fund are included in the BOM's budget. The General Manager of the Mongolbank has the power to appoint or dismiss the head of the treasury unit and the Governor has the power to determine the organizational structure of the unit. (Art.9.2)

The above-mentioned amendments were made in line with the passage of the Law of Mongolia on Management and Financing of Budget-Supported Organizations. The General Manager of the Bank of Mongolia shall have the power to determine staff numbers and the salary fund, to hire, dismiss, reward and reprimand the employees of the Bank.

The Law of Mongolia on amendments to the Law on Central Bank, passed on June 20, 2003, has the following contents:

1. Amended articles:

1/ Art. 23.1.

5) to issue loan, payment or bank guarantees to any entity or individual other than government or Bank;
6) to pledge gold or other reserve assets in order to support external or domestic borrowing of the individual or legal entity;
7) to engage in any on-balance or off-balance transactions supporting economic or commercial activities of the legal entities, individuals other than those approved by the parliament and included into medium-term budget framework or current year budget.

2/ Art.27[1]

Article 27(1). Supervisory Board of the Bank of Mongolia

1. The Supervisory Board (in supernumerary form) will function in order to supervise results

of the performance of the Board of the Bank of Mongolia, reporting of the financial reports, internal activities, implementation of the recommendations of the external auditor and results of investment package to the parliament and public. Proceedings of the Supervisory Board will be set up by the parliament.

2. Supervisory Board will not intervene in any matters related to monetary policy formulation.

3. Supervisory Board will consist of a chairman and 6 members. Chair and members of the Supervisory Board will be elected by parliament upon the introduction of the Economic Standing Committee of parliament.

4. Chair and members of the Supervisory Board shall have a professional background in banking, finance, economics or law, have professional experience in those fields, be suitable on ethical grounds and satisfy the following requirements:

1) be citizen of Mongolia, more than 30 years old, not have any criminal record;
2) to have equivalent of a master's degree or higher in banking, finance, economics or law;

5. Persons previously engaged in state organizations in charge of banking, finance or economics can be a member or chair of the Supervisory Board.
6.It is prohibited to have as a chair or member of the Supervisory Board members of parliament or government, other civil servants, member of the constitutional court, judges, prosecutors, or lead employees of the Bank of Mongolia.

7. Chair or member of the Supervisory Board shall be discharged under the following circumstances:

1) impossibility to carry out further duties due to health or other significant reasons and request for discharge has been made;
2) unsatisfactory performance of duties;
3) court proof of engagement in criminal activities;
4) other material conflicts.

8. It is prohibited to discharge chair or members of the Supervisory Board for any reasons other than those stipulated in provision 7 of the article 271.

9. Supervisory Board will execute powers provided in provision 1 of the article 27 in the following manners:

1) To discuss activities of the Board of the Bank of Mongolia according to the set-up regulation;
2) To communicate with auditors of the Internal audit department of the Bank of Mongolia or external auditors;

3) If necessary, to carry out inspection or audit into the certain matters or transactions concerning the Bank of Mongolia's management or activities;
4) To submit its own report when the Bank of Mongolia is submitting reports to the parliament according to the article 30 of this law.

2. Re-formulated articles

1/ Art. 28.1.4.

In order to carry out the Bank of Mongolia's activities, which have been listed in chapters 3 and 4 of this law, if it is necessary to issue loan, payment or bank guarantees within a size of the equity of the Bank of Mongolia on behalf of government or Bank

2/ Art.29.2.

The Bank of Mongolia's employee, chair or member of the Supervisory Board cannot disclose confidential information obtained during the course of duties even after the discharge except in cases indicated in laws.

3/ Art.30.4.

Parliament will control whether the activities of the Bank of Mongolia are in line with existing laws and regulations, and receive reports indicated in part 4 of the provision 9 of the article 29, provisions 1-3 of the article 30 of this law, however, it will not intervene in the conduct of the monetary policy.

The State Great Hural /parliament/ approved the Working Regulation /TOR/ of the Supervisory Board of the Bank of Mongolia by the Resolution No.39 of October 9, 2003.

A SHORT LIST OF POLICY AND TECHNICAL MEASURES IMPLEMENTED BY THE BANK OF MONGOLIA IN 2003

Date	Number	Title	Contents
01.02	01	Amendment to regulation(Regulation on the full scope on-site examination and evaluation of a bank's activities and its financial condition)	Methodology to define quality factors to be taken into account when supervising and assessing a bank's activities and its financial condition was added.
02.26	99	Regulation on deals conducted at the request of dealers and producers of precious metals	Transactions of precious metals shall be carried out through the Bank of Mongolia in order to prevent the price depreciation of the precious metals, an important item of national exports, and to increase export revenue of the country.
03.13	136	Adoption of the Regulation on licensing non-bank financial activities.	Following the passage of the law on non-bank financial activities, the licensing procedures for non-bank financial activities were set out by the Bank of Mongolia.
04.22	192	Revision of the model bank charter	Title of the regulation and number of the 8th clause were changed in accordance to the amendments to the Civil Code and the Law on deposits, settlements and lending activities of banks and other authorized persons.
04.23	195	Amendment to regulation	Appendix 3, titled "Model guidance for local branches and units on the full scope bank examination" was amended to the Bank of Mongolia's Governor decree No.23 of the year of 2000 on Model guidance
05.06	229	Adoption of regulation (Regulation on inter-bank settlements, contract for carrying out inter-bank settlements)	Full automation of inter- bank settlements greatly improved the speed of settlement procedures. Accordingly, settlement fees to be collected from banks were set anew depending on the time of settlement execution. Contract model was also revised in accordance with the changes in the regulation
05.06	230	Adoption of a regulation (Regulation on execution and control of corrective transactions in bank settlements)	With the purpose of ensuring correctness of everyday bank transactions, specifying ways and means of corrective transactions, improving the control over those transactions, a new regulation was adopted, and the Governor decree No. 263 of the year 1996 the Bank of Mongolia was annulled.
05.08	234	Adoption of the regulation on Central Bank refinancing.	The regulation defined the regulatory framework for the Bank of Mongolia for the short term refinancing facility (discount facility, repo financing and overnight loans) to provide banks with temporary liquidity.
05.30	271	Adoption of a methodology	This methodology contains recommendations on essential points for all levels of management in setting strategic goals for a banking organization, distribution of power and other organizational issues.
07.14	371	About the information to be provided to the public by banks	In order to ensure that the public is provided with correct and up-to-date information about banks' activities, compulsory indicators and model forms of financial statements were approved.
08.13	404	Adoption of a regulation (Regulation on the activities of the Bank of Mongolia representative abroad)	Requirements for the official to represent the Central Bank abroad, working condition, guarantees, and principles of activities were defined.

10.30	549	Adoption of a series of accounting materials.	Enhance practice of the International Accounting Standards
10.31	556	Issuance of a bank license	A bank license was issued to the Chinggis khaan bank.
11.12	576	Adoption of a regulation (Regulation on prudential ratios of credit unions)	Indicators used in evaluation of operational risks of credit unions were set according to the international standards.
12.30	637	Adoption of a revised regulation (Regulation on prudential ratios of non-bank financial institutions)	According to the revised regulation, the capital adequacy ratio shall be no less than 40 percent, liquidity ratio shall be no less than 10 percent, difference between foreign assets and foreign liabilities shall not exceed +or- 40 percent.
12.30	638	Adoption of a methodology (Methodology on off-site monitoring of non-bank financial activities)	Off-site monitoring shall be conducted for risk prevention based on the non-bank financial institutions' operational and financial reports.
12.30	639	Adoption of a regulation (Regulation on on-site examination of non-bank financial activities)	On-site examination of non-bank financial institutions' activities and financial condition shall be conducted according to the CAMELS methodology.

REPORT OF THE AUDITORS

To the Board of Directors of Bank of Mongolia

We have audited the accompanying financial statements of Bank of Mongolia as at 31 December 2003 set out on pages 4 to 39. These financial statements are the responsibility of the Bank's directors. Our responsibility is to express an opinion on these financial statements based on our audit.

Basis of Opinion

We conducted our audit in accordance with applicable International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the directors, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Transfer of Retained Profits to State Budget

On 9 October 2003, the Bank transferred an amount of MNT6.63 billion representing the whole amount of retained profits as at 31 December 2002 to the State Budget. This is not in compliance with Article 38 of the Law on Central Bank which states that the net income of the Bank of Mongolia shall be allocated according to the following priorities, namely that:-

- no less than 40% of net income shall go to the General Reserve fund; and
- any balance of net income after deducting the above amount shall be transferred to the State Budget.

This breach appeared to have the approval of Parliament based on a letter from the Standing Committee of the State Ikh Khural ratifying the suggestion made by the Governor to have the whole amount transferred without making any provision for the transfer to the General Reserve Fund.

Transfer of Retained Profits to State Budget (Contd.)

As a consequence of failing to make the transfer, the Bank is not in compliance with Paragraph 6 of the 'Regulation on Provisions and Disposals of Reserve Funds of Bank of Mongolia and the Allocation of Net Income'. This regulation states that the General Reserve Fund of the Bank shall not be less than the Charter Fund. As at 31 December 2003, it was noted that the General Reserve amount was MNT3.4 billion which is less than the Charter Fund amount of MNT5 billion by MNT1.6 billion.

Loans to Non Approved Parties

Article 23 of the Law on Central Bank states that it is prohibited for the Bank of Mongolia to undertake activities, among others, taking deposits from or extending credit or providing settlement services to individuals or legal persons other than the Government and banks. As disclosed in Note 18 to the financial statements, included in loans to companies as at 31 December 2003 is an amount of MNT18.5 billion being reclassification of matured financial assets to amounts due from mining companies. As at the date of our report this amount remains outstanding and the Bank is therefore in breach of Article 23 of the Law on Central Bank.

Advances to the Ministry of Finance and Economy ("MOFE")

As disclosed in Note 16 to the financial statements, Article 18 of the Law on Central Bank outlines the restriction for granting credit to the Government which includes among others, that the total amount of the balance outstanding shall not exceed 10% of the annual average domestic budget revenue for the preceding three years. As at the date of our report, the advances made to the Government exceeded the 10% limit. Hence, the Bank is in breach of Article 18 of the Law on Central Bank.

Opinion

In our opinion, except for the effect on the financial statements of the matters referred to in the preceding paragraphs, the financial statements have been properly drawn up in accordance with applicable International Financial Reporting Standards and Regulations issued by Bank of Mongolia so as to give a true and fair view of the financial position of the Bank as of 31 December 2003 and of the results and the cash flows for the year then ended.

Ulaanbaatar
5 April 2004

BANK OF MONGOLIA

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2003

	Note	2003 MNT million	2002 MNT million
Interest income	**5**	**6,944**	7,541
Interest expense	**6**	**(7,483)**	(5,313)
Net interest (expense)/income		**(539)**	2,228
Monetary gold (loss)/gains, net		**(999)**	11,507
Foreign currency gains, net		**20,120**	12,822
Other operating income		**843**	345
Net non interest income		**19,964**	24,674
Total income		**19,425**	26,902
Provisions	**7**	**31**	1
Administrative expenses	**8**	**(3,330)**	(2,827)
Other operating expenses	**9**	**(7,027)**	(2,314)
Profit for the year		**9,379**	21,762

The annexed notes form an integral part of these financial statements.

BANK OF MONGOLIA

BALANCE SHEET AS AT 31 DECEMBER 2003

	Note	2003 MNT million	2002 MNT million
ASSETS			
Cash in hand	**10**	**13,234**	13,771
Monetary gold and precious metals	**11**	**15,430**	63,010
Investment in foreign securities	**12**	**77,370**	51,321
Deposits and placements with foreign financial institutions	**13**	**220,820**	253,855
Loans and advances to local financial institutions	**14**	**12,992**	8,326
Government securities	**15**	**4,000**	-
Advances to the Ministry of Finance and Economy	**16**	**215,054**	39,807
Loans to companies	**17 & 18**	**18,532**	165
Other assets	**19**	**507**	1,100
Property, plant and equipment	**20**	**14,370**	13,524
TOTAL ASSETS		**592,309**	444,879
LIABILITIES AND CAPITAL FUNDS			
Cash in circulation		**152,827**	134,643
Debts issued	**21**	**75,734**	60,810
Foreign currency liabilities	**22**	**182,753**	130,704
Deposits of government agencies	**23**	**92,026**	19,091
Deposits of local financial institutions	**24**	**47,969**	44,155
Other liabilities	**25**	**3,540**	20,767
TOTAL LIABILITIES		**554,849**	410,170
CHARTER FUND AND RESERVES			
Charter fund	**26**	**5,000**	5,000
Retained earnings		**1,943**	6,628
Reserves	**27**	**30,517**	23,081
TOTAL EQUITY		**37,460**	34,709
FUNDS EMPLOYED		**592,309**	444,879
COMMITMENTS AND CONTINGENCIES	**29**	**64,766**	3,639,539

The annexed notes form an integral part of these financial statements.

BANK OF MONGOLIA

STATEMENT OF CHANGES IN EQUITY (For the year ended 31 december 2003)

	Note	Charter Fund MNT million	Retained Earnings MNT million	General Reserve MNT million	Revaluation Reserve MNT million	Foreign Exchange Revaluation Reserve MNT million	Total MNT million
At 1 January 2002		1,000	9,954	3,404	12,239	10,425	37,022
Profit for the year		-	21,762	-	-	-	21,762
Transfer to Charter Fund		4,000	(4,000)	-	-	-	-
Transfer to Revaluation Reserve		-	-	-	14,194	(14,194)	-
Transfer to State Budget	**28**	-	(10,954)	-	(7,423)	-	(18,377)
Transfer to Social Development Fund		-	(3,000)	-	-	-	(3,000)
Unrealised gain transferred to reserve		-	(7,134)	-	7,134	-	-
Net loss on available for sale financial assets		-	-	-	(6,781)	-	(6,781)
Currency translation differences		-	-	-	-	3,769	3,769
Net gain on revaluation of property, plant and equipment		-	-	-	314	-	314
At 31 December 2002		**5,000**	**6,628**	**3,404**	**19,677**	**-**	**34,709**
Profit for the year		-	9,379	-	-	-	9,379
Unrealised net gain transferred to reserve		-	(7,436)	-	7,436	-	-
Transfer to State Budget	**28**	-	(6,628)	-	-	-	(6,628)
At 31 December 2003		**5,000**	**1,943**	**3,404**	**27,113**	**-**	**37,460**

The annexed notes form an integral part of these financial statements.

CASH FLOW STATEMENT

(For the year ended 31 december 2003)

	2003 MNT million	2002 MNT million
CASH FLOWS FROM OPERATING ACTIVITIES		
Profit for the year	**9,379**	21,762
Adjustments for -		
Net realised gains on available for sale financial assets taken directly to reserve	**-**	(2,698)
Unreliased gain on revaluation of property, plant and equipment	**-**	(605)
Property, plant and equipment written off	**846**	681
Loss on disposal of property, plant and equipment	**25**	1
Depreciation	**527**	503
Operating profit before working capital changes	**10,777**	19,644
(Increase) / Decrease in operating assets:-		
Monetary gold and precious metals	**47,580**	4,818
Investment in foreign securities	**(26,049)**	(27,509)
Loans and advances to local financial institutions	**(4,666)**	(1,109)
Government securities	**(4,000)**	13,570
Advances to Ministry of Finance and Economy	**(175,247)**	(1,493)
Loans to companies	**(18,367)**	-
Other assets	**593**	(984)
Increase / (Decrease) in operating liabilities:-		
Cash in circulation	**18,184**	15,437
Debts issued	**14,924**	10,810
Foreign currency liabilities	**52,049**	1,359
Deposits of government agencies	**72,935**	5,785
Deposits of local financial institutions	**3,814**	17,574
Other liabilities	**(17,227)**	13,113
Net cash (used in)/generated from operating activities	**(24,700)**	71,015

BANK OF MONGOLIA

CASH FLOW STATEMENT

For the year ended 31 december 2003 (contd.)

	2003 MNT million	2002 MNT million
Net cash (used in)/generated from operating activities	**(24,700)**	71,015
CASH FLOW FROM FINANCING ACTIVITIES		
Transfer to State Budget	**(6,628)**	(18,377)
Contribution to Social Development Fund	**-**	(3,000)
Net cash flow from financing activities	**(6,628)**	(21,377)
CASH FLOW FROM INVESTING ACTIVITIES		
Proceeds from disposal of property, plant and equipment	**6**	2
Purchase of property, plant and equipment	**(2,250)**	(1,826)
Net cash flow from investing activities	**(2,244)**	(1,824)
Net (decrease)/increase in cash and cash equivalents	**(33,572)**	47,814
Cash and cash equivalents brought forward	**267,626**	219,812
Cash and cash equivalents carried forward	**234,054**	267,626

	2003 MNT million	2002 MNT million
Cash and cash equivalents comprises:		
Cash in hand	**13,234**	13,771
Deposits and placements with foreign financial institutions	**220,820**	253,855
	234,054	267,626

The annexed notes form an integral part of these financial statements.

BANK OF MONGOLIA

NOTES TO THE FINANCIAL STATEMENTS - 31 DECEMBER 2003

1. CORPORATE INFORMATION

Bank of Mongolia, the Central Bank of Mongolia (the "Bank") is established under a resolution by the Mongolian Government dated 2 June 1924, and is located at Baga Toiruu 9, Ulaanbaatar 46, Mongolia.

The Bank constitutes a single business, all conducted in Mongolia with no branches or operations abroad. The Bank, however has a representative office in London, England. Accordingly, no further analysis into business or geographical segments is appropriate in the financial statements.

These financial statements of the Bank for the year ended 31 December 2003 were authorised for issue by the Board of Directors in accordance with a resolution of the directors.

2. MAIN RESPONSIBILITIES

The Bank's main responsibilities are those that fall within the exclusive jurisdiction of a central bank.

The Bank formulates and conducts monetary policy with the aim of ensuring price stability. To this end, it takes measures aimed at regulating interest rate levels and fine-tuning bank liquidity by granting assistance to the banking system, by buying and selling securities, and by withdrawing liquidity from credit institutions.

The Bank regulates the relationship between the Mongolian Togrog and foreign currencies on behalf of the State. To this end, the Bank holds and manages the State's gold and foreign exchange reserves. In the course of these activities, the Bank enters into transactions with commercial banks and other central banks on the foreign currency denominated securities and deposits markets as well as on the spot and forward markets.

The Bank is the only body authorised to issue banknotes that are legal tender in Mongolia.

3. BASIS OF PREPARATION

The Bank's financial statements have been prepared so as to present fairly the financial position of the Bank, and its results, cash flows and total recognised gains or losses, and in accordance with applicable International Financial Reporting Standards ("IFRS"), insofar as they are appropriate to a central bank, with the modifications explained below.

As part of its central banking responsibilities, the Bank may undertake actions to maintain monetary and financial stability, and may act as a "lender of last resort" to financial institutions in difficulties in order to prevent a loss of confidence spreading through the financial system as a whole. In some cases confidence can best be sustained if the Bank's support is disclosed only when the conditions giving rise to potentially systemic disturbance have improved. Accordingly, although the financial effects of such operations will be included in the financial statements in the year in which they occur, these financial statements may not explicitly identify the existence of such support. However, the existence of such support will be disclosed in the financial statements when the need for secrecy or confidentiality has ceased.

As a result, the Bank's financial statements may disclose less detail of the constituent elements of the income statement, particularly of interest income and expense and any provisions for bad and doubtful debts, together with consequential restrictions in detailed disclosures in the balance sheet, cash flow statement and the notes to the financial statements that would be required under IFRS.

The realised and unrealised revaluation differences on forex differences, property, plant and equipment revaluations and fair value changes of financial instruments are recorded in the Revaluation Reserve of the Bank in accordance with the requirements of the Law on Central Bank. This represents a departure from IFRS whereby realised revaluation differences should be transferred to income statement or retained earnings.

The financial statements have been prepared on the historical cost basis of accounting, modified to include the revaluation of certain assets. The reporting currency used in the financial statements is the Mongolian Togrog, which is denoted by the symbol MNT, shown rounded to the nearest million.

4. SIGNIFICANT ACCOUNTING POLICIES

(a) Interest Income and Expense

Interest income and expense are recognised in the income statement for all interest bearing instruments on an accrual basis using the effective yield method based on the actual purchase price.

(b) Foreign Currencies

Monetary assets and liabilities denominated in foreign currencies are translated into Togrog at the rates of exchange ruling at the balance sheet date. It is the Bank's policy to revalue its monetary assets and liabilities denominated in foreign currencies at daily intervals, and to take these translation adjustments directly to a reserve fund known as Revaluation Reserve.

The principal exchange rates used are:-

	2003	2002
United States Dollar ("USD")	1,168.00	1,125.00
European Euro ("Euro")	1,460.20	1,169.40
Special Drawing Rights ("SDR")	1,729.00	1,519.20

SDR represents an international reserve asset created by the International Monetary Fund and allocated to its members in proportion to their respective quotas.

Non-monetary assets and liabilities denominated in foreign currencies are stated at cost or revalued amount, being the Togrog equivalent of the foreign currency at the date of acquisition of the assets or incurrence of the liability, or on the date the assets or liability was revalued.

Income and expenditure are translated into Togrog at the exchange rates ruling at the date of transactions. Forward foreign currency contracts are marked to market on a daily basis and translation differences are taken to the Revaluation Reserve.

(c) Cash and Cash Equivalents

Cash and cash equivalents consist of cash and short term funds, deposits and placements with other financial institutions that are readily convertible to cash with insignificant risk of changes in value.

4. SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

(d) Investments

All investments are initially recognised at cost, being the fair value of the consideration given and including acquisition charges associated with the investment.

Investment securities are securities that are acquired and held for yield or capital growth and are usually held to maturity.

Government securities are stated at cost adjusted for amortisation of premiums or accretion of discounts, where applicable, to maturity dates.

Unquoted investments are stated at cost and where applicable, adjusted for amortisation of premiums or accretion of discounts to maturity dates. Provision is made for diminution in value which is other than temporary.

On disposal of the investment securities, the differences between the net disposal proceeds and their carrying amounts are charged or credited to the income statement.

(e) Financial Instruments

Financial instruments are recognised in the balance sheet when the Bank has become a party to the contractual provisions of the instrument. The accounting policies on recognition and measurement of these items are disclosed in their respective accounting policies.

Financial instruments are classified as liabilities or equity in accordance with the substance of the contractual arrangement. Interest, dividends and gains and losses relating to a financial instrument classified as a liability, are reported as expense or income. Distributions to holders of financial instruments classified as equity are charged directly to equity. Financial instruments are offset when the Bank has a legally enforceable right to offset and intends to settle either on a net basis or to realise the asset and settle the liability simultaneously.

The Bank uses derivative financial instruments such as foreign currency contracts and interest rate swaps to hedge its risks associated with interest rate and foreign currency fluctuations. Such derivative financial instruments are stated at fair value.

(f) Monetary Gold and Precious Metals

Monetary gold is disclosed in the balance sheet at its revalued amount, a revaluation is performed daily. The revalued amount is determined by taking into consideration the market value of monetary gold and its trend, the strength of the Mongolian Togrog and its anticipated appreciation or depreciation of the currency, and the weighted-average cost of monetary gold. Translation gain or loss is taken directly to a reserve fund known as Revaluation Reserve. Non monetary gold and other precious metals are shown in the balance sheet primarily at weighted average cost. Gains and losses from the sale of monetary gold and precious metals are taken directly to income.

4. SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

(g) Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The policy for the recognition and measurement of impairment losses is in accordance with Note 4 (j).

The Bank had revalued its buildings in 2002 and the revaluation surplus has been included in the revaluation reserve. The revaluation was based on a valuation performed by a professional valuer.

The annual depreciation rates used are as follows:

Building	2.4% - 6.0%
Furniture and equipment	10.0% - 12.5%
Computers	12.5% - 20.0%
Motor vehicle	12.5% - 16.7%

Capital work in progress are not depreciated. Depreciation of these assets begins when the related assets are placed in service.

Upon disposal of an item of property, plant or equipment, the difference between the net disposal proceeds and the net carrying amount is recognised in the income statement and the unutilised portion of the revaluation surplus on that item is taken directly to retained profits.

(h) Provision for Bad and Doubtful Debts

Provision for bad and doubtful debts is made as considered necessary having regard to both specific and general factors. The general element arises in relation to existing losses which, although not separately identified, are known from experience to be present in any portfolio of bank advances. Provision made (less amounts written back) during the year is charged against profits.

Provisions relate to identified advances at risk and are raised when it is considered that recovery of the outstanding balance is in serious doubt. The provision is the amount necessary to reduce the carrying value of the advance to its expected net realisable value. The general provision is reviewed on a regular basis to ensure that it remains appropriate in the context of the perceived risk inherent in the lending portfolio and the prevailing economic climate.

4. SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

(i) Debts Issued

Debts issued are Bank of Mongolia Treasury Bills issued by the Bank to local financial institutions at a discount. These debts are recorded at the discounted cost to the Bank adjusted for accretion of discounts to maturity dates. The bills are redeemable by the Bank from the holders of the bills on the maturity dates

(j) Impairment of Assets

The Bank reviews the carrying amounts of its assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, impairment is measured by comparing the carrying values of the assets with their recoverable amounts. Recoverable amount is the higher of net selling price and value in use, which is measured by reference to discounted future cash flows.

An impairment loss is charged to the income statement immediately, unless the asset is carried at revalued amount. Any impairment loss of a revalued asset is treated as a revaluation decrease to the extent of any available previously recognised revaluation surplus for the same asset. Reversal of impairment losses recognised in prior years is recorded when there is an indication that the impairment losses recognised for the asset no longer exist or have decreased.

(k) Taxation

In accordance with the Economic Entity and Organisation Income Tax Law of Mongolia, the Bank is exempted from income taxes.

(l) Employee Benefits

(i) Short term benefits

Wages, salaries and other related expenses are recognised as an expense in the year in which the associated services are rendered by employees of the Bank. Short term accumulating compensated absences such as paid annual leave are recognised when services rendered by employees that increase their entitlement to future compensated absences, and short term non-accumulating compensated absences such as sick leave are recognised when absences occur.

4. SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

(l) Employee Benefits (contd.)

(ii) Retirement and other benefit obligations

The Bank does not have any pension arrangements apart from the state pension system of Mongolia, which requires current contributions by the employer be calculated as a percentage of current gross salary payments. Such expense is charged to the income statement in the period the related compensation is earned by the employee. In addition, Bank has no post-retirement benefits or other significant compensated benefits requiring accrual.

5. INTEREST INCOME

	2003 MNT million	2002 MNT million
Deposits and placements with foreign financial institutions	**3,707**	3,475
Investment in foreign securities	**2,398**	3,114
Government securities	**521**	861
Loans and advances to local financial institutions	**318**	91
	6,944	7,541

6. INTEREST EXPENSE

	2003 MNT million	2002 MNT million
Debts issued	**4,569**	3,741
Deposits of government agencies	**2,739**	1,159
Foreign currency liabilities	**146**	234
Deposits of local financial institutions	**29**	179
	7,483	5,313

7. PROVISIONS

	2003 MNT million	2002 MNT million
Write back of provisions on loans to companies	**(311)**	(1)

8. ADMINISTRATIVE EXPENSES

	2003 MNT million	2002 MNT million
Salaries and employee benefits	**674**	614
Directors' remuneration	**37**	36
Depreciation	**529**	503
Communication	**361**	331
Utilities	**319**	266
Transportation and travelling	**215**	179
Membership and audit expenses	**194**	223
Security	**163**	199
Compensation expense	**142**	133
Stationeries	**52**	51
Others	**644**	292
	3,330	2,827

The number of persons employed by the Bank as at the year end is as follows:

	2003 Number	2002 Number
Governor and Directors	**21**	17
Supervisors	**179**	169
Clerks and officers	**111**	116
	311	302

9. OTHER OPERATING EXPENSES

	2003 MNT million	2002 MNT million
Cost of bank notes	**7,027**	2,169
Others	**-**	145
	7,027	2,314

10. CASH IN HAND

	2003 MNT million	2002 MNT million
Cash denominated in local currency	**55**	26
Cash denominated in foreign currencies	**13,179**	13,745
	13,234	13,771

11. MONETARY GOLD AND PRECIOUS METALS

	2003 MNT million	2002 MNT million
Monetary gold	**7,769**	56,019
Non-monetary gold	**4,870**	3,900
Non-monetary silver	**103**	198
Coins and cultural valuables	**2,688**	2,893
	15,430	63,010

12. INVESTMENT IN FOREIGN SECURITIES

	2003 MNT million	2002 MNT million
Promissory notes	**37,775**	51,321
Repurchase agreement	**39,595**	-
	77,370	51,321

The promissory notes represents short term promissory notes with maturity period ranging from 8 to 10 months and bearing a discount rate in the range of 2.76% to 2.84% (2002 : 6.04% to 10.00%) per annum. The repurchase agreement matured on 2 January 2004 and bears interest at the rate of 0.85%.

13. DEPOSITS AND PLACEMENTS WITH FOREIGN FINANCIAL INSTITUTIONS

	2003 MNT million	2002 MNT million
Short-term time deposits	**135,683**	179,035
Allocation of SDR in the International Monetary Fund ("IMF")	**79,921**	71,406
Placements repayable on demand	**3,880**	1,956
World Bank	**1,326**	1,448
Others	**10**	10
	220,820	253,855

Short-term time deposits

The short-term time deposits are denominated in USD with maturity periods of up to 30 days, bear interest at annual rates ranging from 1.25% to 4.00% (2002: 1.58% to 6.00%).

Allocation of SDR in the IMF

SDR are allocated to the Bank in proportion to its subscription to the IMF. The amount allocated to the Bank is currently at SDR51.1 million, equivalent to MNT79.8 billion (2002 : SDR51.1 million, equivalent to MNT71.4 billion). This amount is matched by a corresponding liability (see note 22) and is non-interest bearing.

Placements repayable on demand

This balance represents current account deposits with foreign central banks and other financial institutions which are non interest bearing.

World Bank

This balance represents the deposit and quota at the World Bank as part of the condition to be a member of the World Bank group. This amount is matched by a corresponding liability (see note 22) and is non-interest bearing.

14. LOANS AND ADVANCES TO LOCAL FINANCIAL INSTITUTIONS

	2003 MNT million	2002 MNT million
Loans in foreign currency	**7,822**	4,277
Loans in local currency	**4,736**	3,631
Claims on a financial institutions	**3,502**	3,486
Refinancing loan	**130**	130
Gross loans and advances	**16,190**	11,524
Less: Provisions for losses	**(3,198)**	(3,198)
	12,992	8,326

Loans in foreign currency

The loans in foreign currency were disbursed to two local commercial banks, for the onward transmission to Mongolian enterprises. The funding was made available under two separate programmes by the German Government to promote small and medium scale companies (see also note 22). The loans under both programmes bear interest at the rate of 1.75% (2002 : 1.75%) per annum and are not backed up by any securities. The loans under both the programmes are disbursed in various disbursements to the two commercial banks according to the needs of the borrowers of the relevant commercial banks. Accordingly, the repayment terms for each disbursed loan varies according to the date of disbursement.

Loans in local currency - Nature, interest rates, security and repayment terms

The loans in local currency were disbursed to various commercial banks in Mongolia, for the onward transmission to Mongolian enterprises. The funding was made available by under two separate programmes by the Asian Development Bank to generate the economy, to create more job opportunities for the people of Mongolia and to develop the agricultural sector in the country. The loans under the first programme bears interest at the rate of 10% (2002 : 10%) per annum and the repayment terms for each disbursed loan varies according to the date of disbursement. The loans under the second programme bears interest at the rate of 5.5% (2002 : 5.5%) per annum with the maturity of one year for each loan disbursed.

Claims on a financial institution

These claims are in relation to payments amounting to USD3.2 million made by the Bank to settle guarantees issued in favour of a local bank which is has since been ruled insolvent. A provision amounting to USD2.8 million has been made by the Bank on this amount. The Bank is of the opinion that no additional provision is necessary for the remaining balance.

Refinancing loan

This loan was given to a bank in 1996, which has since been liquidated. The loan has been fully provided for.

15. GOVERNMENT SECURITIES

	2003 MNT million	2002 MNT million
Government securities	**4,000**	-

These government securities were bonds issued by MOFE which were purchased by the Bank from a government owned local financial institution under an agreement with the MOFE. Under this agreement, MOFE will redeem the securities held as at 31 December 2003 in two portions on 15 June 2004 and 31 December 2004 respectively. The government securities bear interest at rates ranging from 12.62% to 16.64% (2002 : Nil) per annum.

16. ADVANCES TO THE MINISTRY OF FINANCE AND ECONOMY ("MOFE")

	2003 MNT million	2002 MNT million
Advances to government	**160,216**	-
Poverty Reduction and Growth Facility Loan	**54,838**	39,807
	215,054	39,807

Advances to government

These advances were made by the Bank to the government for the purpose of the full settlement of the discounted debts to the Russian government. These non interest bearing advances were made in two portions of USD37 million and MNT117 billion respectively. Under the agreement between the Bank and MOFE, the first portion is repayable within the first quarter of 2004 and the second portion is repayable in ten equal installments of MNT11.7 billion each commencing from 15 December 2004 and the last installment is payable on 15 December 2013.

Article 18 of the Law on Central Bank outlines the restriction for granting credit to the Government which include among others, the total amount of the balance outstanding shall not exceed 10% of domestic budget revenue accumulated for the preceeding three years. As at balance sheet date, the advances made to the Government exceeded the 10% limit.

Poverty Reduction and Growth Facility Loan

The Poverty Reduction and Growth Facility (PRGF, formerly known as the Enhanced Structural Adjustment Facility) loan refers to the MOFE portion of the total PRGF loan outstanding as at year end, which is shown in the liability side under the Foreign Currency Liabilities (see note 22). The loans have a maturity period of 10 years and carry an annual interest at 0.5% (2002 : 0.5%).

17. LOANS TO COMPANIES

	2003 MNT million	2002 MNT million
Loans to local companies	**556**	867
Other loan	**18,532**	165
	19,088	1,032
Less: Provision for losses	**(556)**	(867)
	18,532	165

Movement in the provision for losses is as follows:-

	2003 MNT million	2002 MNT million
Balance at 1 January	**867**	868
Write-back for the year	**(311)**	(1)
Balance at 31 December	**556**	867

18. LOANS TO COMPANIES

Loans to local companies amounting to MNT0.6 biliion (2002 : MNT0.9 billion) relates to the loans extended prior to the introduction of the regulation prohibiting the granting of loans to non-financial institutions. The Bank granted these loans to local companies for the purpose of improving the economy. These loans are in default and full provisions have been made against these loans.

As at 31 December 2003, included in loans to companies is an amount of MNT18.5 billion being reclassification of matured financial assets to amounts due from mining companies. As at balance sheet date these amounts remain outstanding and this has triggered a breach of Article 23 of the Law on Central Bank.

19. OTHER ASSETS

	2003 MNT million	2002 MNT million
Derivative financial instruments	-	922
Others	**507**	178
	507	1,100

Others consists of advances to staff, consumable materials and stationery supplies.

In 1999, the Bank entered into a swap agreement with a financial institution which will mature in 2004. Under this agreement, the Bank exchanged 32,000 troy ounces of monetary gold for USD8.2 million and committed to repurchase this gold at maturity at a price fixed in the agreement. The Bank also pays to the counterpart an annual amount of interest, which is fixed in gold ounces as compensation for interest rate differentials. This agreement is not cancelable for the Bank. The Bank's gains and losses under the agreement will depend upon the interest rate differentials between US dollars and gold deposit markets. The Bank is not expected to incur any material loss from this transaction.

20. PROPERTY, PLANT AND EQUIPMENT

	Buildings MNT million	Furniture and office equipment MNT million	Computers MNT million	Motor vehicles MNT million	Capital work in progress MNT million	Total MNT million
Cost/valuation						
Balance at beginning of year	10,784	537	798	554	2,165	14,838
Additions	163	108	211	127	1,641	2,250
Disposals	(19)	(5)	(61)	(20)	-	(105)
Write-offs	(53)	(7)	(46)	(24)	(795)	(925)
Balance at end of year	10,875	633	902	637	3,011	16,058
Representing:						
At cost	4,604	633	902	637	3,011	9,787
At valuation	6,271	-	-	-	-	6,271
	10,875	633	902	637	3,011	16,058
Accumulated depreciation						
Balance at beginning of year	513	190	383	228	-	1,314
Charge for the year	283	53	148	43	-	527
Disposals	(1)	(2)	(58)	(13)	-	(74)
Write-offs	(8)	(6)	(43)	(22)	-	(79)
Balance at end of year	787	235	430	236	-	1,688

20. PROPERTY, PLANT AND EQUIPMENT (CONTD.)

	Buildings MNT million	Furniture and office equipment MNT million	Computers MNT million	Motor vehicles MNT million	Capital work in progress MNT million	Total MNT million
Net Book Value						
At 31 December 2003						
At cost	4,179	398	472	401	3,011	8,461
At valuation	5,909	-	-	-	-	5,909
	10,088	398	472	401	3,011	14,370
At 31 December 2002						
At cost	4,210	347	415	326	2,165	7,463
At valuation	6,061	-	-	-	-	6,061
	10,271	347	415	326	2,165	13,524
Depreciation charge for 2002	250	48	142	63	-	503

Details of the latest independent professional valuations of buildings at 31 December 2003 are as follows:

Date of Valuation	Description of Property	Amount	Valuation MNT million	Basis of Valuation
27-May-2002	**Buildings**		**6,325**	**Open market value**

Had the revalued buildings been carried at historical cost, the net book value of the buildings that would have been included in the financial statements of the Bank as at 31 December 2003 would have been MNT5,394 (2002 : MNT5,527).

21. DEBTS ISSUED

This represents Bank of Mongolia bills issued by the Bank to local financial institutions. Such bills have maturities of between one week to three months, and bear interest at a range of between 9.9% to 14.0% (2002: 12.0% to 14.5%) per annum.

22. FOREIGN CURRENCY LIABILITIES

	2003 MNT million	2002 MNT million
International Monetary Fund ("IMF")		
- Loans received under PRGF	**57,674**	47,609
- IMF subscription	**79,775**	71,401
Time deposit placed by Bank of International Settlements, Switzerland	**29,204**	-
Loans received from the German government	**9,618**	5,432
Loans from Asian Development Bank ("ADB")	**4,547**	3,539
Subscription to World Bank, ADB and International Development Agency	**1,784**	1,841
Loans from European Union ("EU")	**-**	731
Subscription to United Nations Development Programme	**151**	151
	182,753	130,704

International Monetary Fund ("IMF")

Loans received under the Poverty Reduction and Growth Facility (PRGF, formerly known as Enhanced Structural Adjustment Facility) are loans granted by the IMF with a maturity period of 10 years and carry an annual interest at 0.5% (2002 : 0.5%). These loans are disbursed under three-year arrangement, subject to observance of performance criteria and completion of programme reviews. The loans and repayments are denominated in SDR's.

The IMF subscription account is made up of three accounts namely IMF Account No.1, IMF Account No.2 and IMF Securities Account. Account No.1 is used for IMF's operational transactions whereas Account No.2 is used for administrative transactions between Mongolian and IMF. The securities are non-interest bearing and encashable by the IMF on demand. The subscription amount is denominated in SDR.

Time deposit placed by Bank of International Settlements, Switzerland

This time deposit equivalent to Euro20 million will mature on 10 March 2004 and bears interest at the annual rate of 2.19%.

22. FOREIGN CURRENCY LIABILITIES (CONTD.)

Loans received from the German government

This loans from the Government of Germany under the small and medium enterprise are made available under two separate programmes. The loans under both programmes are denominated in Euro with a tenure of 40 years. The loan under the first programme started in 1995 and bears interest of 1% per annum. This loan was disbursed in Euro and the repayment of loan principal will commence in 2005. The loan under the second programme started in 2002 and bears interest at 0.75% per annum. This loan can be disbursed in MNT and the repayment of the loan principal will commence on 2012.

Loans from Asian Development Bank ("ADB")

The loans from ADB is mainly for purposes of alleviating poverty in Mongolia, to develop and promote private enterprises and to provide training and consultancy to the Government, non-governmental organisations and local commercial banks and for the improvement of the agricultural sector. The loans carry annual interest rates ranging from 1% to 1.5% and have tenures ranging from 25 to 30 years.

Subscription to World Bank, ADB and International Development Agency

This balance is represents the Bank's subscription obligations to these various organisations. These subscriptions are non-interest bearing and it does not have any defined repayment terms.

Subscription to United Nations Development Programme

The subscription to other international organisation includes aid received from the United Nations Development Programme to promote the activities of non banking financial institutions in Mongolia. The funds are to be channelled via micro lending to the lower income earners. This subscription is non-interest bearing with no fixed term of repayment.

23. DEPOSITS OF GOVERNMENT AGENCIES

	2003 MNT million	2002 MNT million
State budget and other government accounts	**73,102**	15,344
MOFE accounts	**18,924**	3,747
	92,026	19,091

State budget accounts and other government accounts

State budget accounts are the local currency deposit accounts of government agencies maintained with the Bank. These deposits were centralised in the Bank from November 2002 onwards. Prior to that, the deposits were kept at the Bank and various other local commercial banks. These deposits are repayable on demand and carry interest at the rates ranging from 2.3% to 4.7% (2002 : 4.0% to 13.0%) per annum.

MOFE accounts

MOFE accounts are the foreign currency deposits accounts of MOFE maintained in the Bank. These deposits are repayable on demand and are non-interest bearing.

24. DEPOSITS OF LOCAL FINANCIAL INSTITUTIONS

These deposits are in relation to non-interest bearing deposit accounts maintained by local financial institutions and consists of obligatory reserves of commercial banks maintained with the Bank, calculated as a percentage of their eligible liabilities to deposit holders.

25. OTHER LIABILITIES

	2003 MNT million	2002 MNT million
Social Development Fund	**2,423**	5,383
Insurance funds	**302**	14,490
Other payables	**815**	894
	3,540	20,767

Social Development Fund represents fund allocated for the purposes of employees' social and welfare expenses.

Insurance funds represents various insurance allocations deposited by government agencies with the Bank for the benefit of their employees. These deposits are non-interest bearing.

26. CHARTER FUND

	2003 MNT million	2002 MNT million
Charter fund	**5,000**	5,000

The Bank is wholly owned by the Government of Mongolia. The Charter Fund represents the capital of the Bank.

27. RESERVES

Reserves includes General Reserve, Revaluation Reserve and Foreign Exchange Revaluation Reserve.

In accordance with the Law of Mongolia on Central Bank (Bank of Mongolia), at least 40% of the Bank's net income is allocated to its General Reserve Fund with the remaining balance transferred to the State Budget account. However, no such allocation was done in 2003 as the Government overruled this Law by approving a transfer of MNT6.63 billion to the State Budget (see note 28).

The revaluation reserve is used to record net unrealised revaluation gains on revaluation of financial assets and property, plant and equipment. The foreign exchange revaluation reserve has been combined with the revaluation reserve and as such, is no longer in use.

28. TRANSFER TO STATE BUDGET

On 9 October 2003, the Bank transferred an amount of MNT6.63 billion representing the whole amount of retained profits as at 31 December 2002 to the State Budget. This is not in compliance with Article 38 of the Law on Central Bank which states that the net income of the Bank of Mongolia shall be allocated according to the following priorities, namely that:-

- no less than 40% of net income shall go to the General Reserve fund; and
- any balance of net income after deducting the above amount shall be transferred to the State Budget.

This breach appeared to have the approval of Parliament based on a letter from the Standing Committee of the State Ikh Khural ratifying the suggestion made by the Governor to have the whole amount transferred without making any provision for the transfer to the General Reserve Fund.

29. COMMITMENTS AND CONTINGENCIES

a) Letters of credit

	2003 MNT million	2002 MNT million
Letters of credit	**64,586**	3,638,459

As at 31 December 2003, all the Bank's outstanding letter of credits were issued to MoFE and government agencies without collaterals. Notwithstanding, MoFE and these government agencies maintain foreign and local currency deposit accounts with the Bank.

b) Legal

In the ordinary course of business, the Bank is subject to legal actions and complaints. The Bank's Board of Directors is of the opinion that the contingent liability, if any, as a result of such actions and complaints will not be material to the Bank.

c) Lease obligations

The Bank has no material lease obligations as of 31 December 2003 (2002 : Nil).

d) Capital Commitments

On 20 July 2001, the Board of Directors of the Bank approved a budget for capital commitment of approximately MNT2.4 billion. However, this amount has been increased to MNT2.88 billion as at year end (2002 : 2.88 billion). This relates to the construction of a new building situated within the head office building area. As at the date of this report, the percentage of its completion is estimated at 95% (2002 : 60%) and approximately MNT2.7 billion (2002 : MNT1.8 billion) has been paid.

30. RELATED PARTY DISCLOSURES

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions. The Bank is wholly owned by the Government of Mongolia.

Apart from the remuneration paid to the Governor and the members of the Board of Directors totalling MNT37.0 million (2002 : MNT36.4 million), there were no other related party transactions during the year.

31. RISK MANAGEMENT POLICIES

The Bank of Mongolia manages its interest rate, credit, liquidity, operational, and reputational risks by decisions and regulations set by the Board of Directors to ensure all operations of the Bank are conducted in a prudent manner.

Priority is given to those risks pertaining to foreign reserves such as market, liquidity, and operational risks. Measures for regulating, monitoring, managing, and minimising these risks are covered by "Guidelines on Reserve Management" as highlighted below:

a) To minimise credit risk:

- Foreign reserves are placed in less risky assets, as demand deposit accounts with central banks from developed countries such as USA, Japan, Germany, United Kingdom, and Switzerland; and as time deposits with foreign commercial banks that carry AAA or AA rating, as well as in government securities of the above countries and in securities issued by international and regional financial institutions.
- Occasionally, parts of the reserves are held with institutions with lower ratings, but with long-term traditional partners. In that case careful analysis is conducted, and proposals are submitted for review to the Governor for approval.
- Each quarter a list of international financial institutions and their limits for each individual institution is submitted for approval.

b) To monitor and control market risk:

- General structure of reserve assets is approved annually;
- Overall limit for open positions in foreign exchange and gold is approved quarterly;
- Limit for open positions in individual financial assets is approved quarterly;
- Stop-loss limits for dealers is approved quarterly.

31. RISK MANAGEMENT POLICIES (CONTD.)

c) To manage liquidity risk of foreign reserves:

- Minimum level of foreign currency to be held in cash and in demand deposits is established;
- Minimum and maximum amount of assets to be held for fixed period of time is established;
- Maturity date for assets is set for liquidity.

d) To manage operational risk of foreign reserves:

- Separate and independent front office and back office structure is created in the bank;
- Clear definition of roles and separation of duties for each department and unit trading is set;
- Quarterly stop-loss limit and open position limit for each individual dealer for each individual financial instrument and foreign currency is set quarterly.

One of the primary goals of the Bank of Mongolia is to ensure stability of the banking and financial sector of Mongolia. In order to accomplish this goal the Bank conducts off-site surveillance and on-site inspections of banks and non-bank financial institutions, improves pertinent legal documents, including laws, rules and regulations, and issues specific manuals and guidelines necessary for their operations.

Supervision risk management policies are limited by the actions aimed at banks and non-bank financial institutions; it is also complemented by the actions to enhance awareness of staff responsible for the financial supervision. In order to enhance awareness and provide safeguards against risks related to the financial supervision, policy documents, including Organisation Secrecy Law, Central Bank Secrecy Regulation and Regulation on the legal statues of the Central Bank Supervisor has been adhered to.

In addition, the following legal documents designed to mitigate risks related to the financial supervision has been approved and adhered to:

1. Banks' off-site surveillance guideline;
2. Non-banking financial institutions' off-site surveillance guideline;
3. General guidelines to prepare an on-site inspection report on banks' operations and financial conditions;
4. General guidelines to prepare an on-site inspection report on non-bank financial institutions' operations and financial conditions;
5. Regulation on the activities of the Credit Information Bureau; and
6. Guidelines on maintaining bank's files.

In 2003, non-banking financial institutions' off-site surveillance guideline, and Regulation on prudential indicators for non-banking financial institutions were newly adopted, and necessary amendments in major risk related rules and regulations have been introduced.

The Bank of Mongolia executes its activity related to a distribution of loans to banks and the Government, purchase of securities from the Government, issue and withdrawal of currency in and from circulation according to the following risk management policy:

31. RISK MANAGEMENT POLICIES (CONTD.)

Credit, claims (receivables) risk management:

The Bank of Mongolia manages the risk on togrog loans given by the Bank of Mongolia and the risk on togrog claims of the Bank of Mongolia in accordance with "The Regulation on Establishment of Reserve Account of the Bank of Mongolia's Asset Classification and Potential Loss". The Bank of Mongolia carries out its activity by establishing a reserve account of potential loss based on the classification of the quality of credits given to the Government and banks, guarantees issued, and securities purchased from the Government and the probability of their repayment. For instance, the Bank set up 5 classifications of loans, namely standard, principal in arrears, substandard, doubtful, and bad.

The Bank has improved on the flow of information exchange with the Ministry of Finance and Economy on the net credit to the Government and receives data on income and outcome of the state general account every Friday. Hence, for the Bank is constantly informed about Government's finances.

Also, the Bank pursues the following risk policy with regard to the banknote activity:

1. All banknotes to be delivered to the provinces (aimags) for the stock replenishment have been insured by the Mongol Daatgal insurance company; and
2. "The Regulation of the Bank of Mongolia's Cash Activity", "The Regulation of the Bank of Mongolia's Banknote Counting, Supervision" has been renewed since December 2002 and relevant clauses related to provide the banknote security, supervision, and protection have been implemented accordingly.

Bank of Mongolia manages three types of audit risk such as inherent, control and detection.

Following measures are taken to prevent and minimise inherent and control risks:

- Internal Audit Department examines and evaluates units of the Bank of Mongolia according to its degree of risk, conducts an evaluation of internal control systems of the units audited and provides audit findings and recommendations.

Following measures are taken to prevent and minimise detection risk:

- Internal auditors perform audits with professional proficiency and excercises due professional care in conducting their work. As stated in Internal Audit Charter, Internal Audit Department has set stringent employment requirements for internal auditors. Also, in order to improve technical capacity, skills and knowledge of internal auditors, they periodically attend training programs.

Internal Audit Department develops and approves long-range risk based audit program, along with yearly and quarterly audit plans.

31. RISK MANAGEMENT POLICIES (CONTD.)

In order to improve management of legal risk related to activities of the Central Bank and the legal framework in a whole, the Legal Division prepared and submitted drafts of the following legislations in the year of 2003 to Parliament:

An amendment to the Law on Central Bank (the Bank of Mongolia) was passed by the Parliament on January 2nd, 2003, introducing Article 28 , which defines powers of the General Manager of the Bank of Mongolia. Art.28.1.6 was reformulated, for the Governor to have the power in determining the organisational structure of the Bank of Mongolia.

An amendment to the Treasury Law was also passed on the same day. According to this amendment the staff number and salary fund of the treasury are included in the budget of the Bank of Mongolia. The General Manager of the Bank of Mongolia has the power to appoint or dismiss the head of the treasury unit and the Governor has the power in determining the organisational structure of the unit. (Art.9.2)

The Law of Mongolia on amendments to the Law on Central Bank, passed on June 20, 2003, has the following contents: 1) to issue bank guarantees on loans and payments to any entity or individuals other than government or Bank; 2) to pledge gold or other reserve assets in order to support external or domestic borrowing of the individual or legal entity; 3) to engage in any on-balance or off-balance transactions supporting economic or commercial activities of the legal entities, individuals other than those approved by the Parliament and included into the medium-term budget framework or current year budget.

Also the amendments to the Law on Central Bank, passed on June 20, 2003, states that the function of the Supervisory Board (in supernumerary form) is to supervise results of the performance of the Board of the Bank of Mongolia, review the financial statement, internal activities, implementation of the recommendations of the external auditor and results of investment package to the Parliament and public.

The State Ikh Khural/Parliament approved the Terms of Reference of the Supervisory Board of the Bank of Mongolia by the Decree No.39 of October 9, 2003.

Time value and settlement risk

In 2003, the interbank settlements regulation has been renewed and settlement time was prolonged in accordance with newly approved regulation.

32. GEOGRAPHICAL CONCENTRATION OF MONETARY ASSETS AND LIABILITIES

(a) Credit risk

The geographical concentration of assets and liabilities are as follows:

	2003 (MNT million)		
	Mongolia	**Other Countries**	**Total**
Assets			
Cash in hand	13,234	-	13,234
Monetary gold and precious metals	7,662	7,768	15,430
Investment in foreign securities	-	77,370	77,370
Deposits and placements with foreign financial institutions	-	220,820	220,820
Loans and advances to local financial institutions	12,992	-	12,992
Government securities	4,000	-	4,000
Advances to the Ministry of Finance and Economy	215,054	-	215,054
Loans to companies	18,532	-	18,532
Other assets	507	-	507
Property, plant and equipment	14,370	-	14,370
	286,351	305,958	592,309
Liabilities			
Cash in circulation	152,827	-	152,827
Debts issued	75,734	-	75,734
Foreign currency liabilities	182,753	-	182,753
Deposits of government agencies	92,026	-	92,026
Deposits of local financial institutions	47,969	-	47,969
Other liabilities	3,540	-	3,540
	554,849	-	554,849
Net position	(268,498)	305,958	37,460

32. GEOGRAPHICAL CONCENTRATION OF MONETARY ASSETS AND LIABILITIES (CONTD.)

(a) Credit risk (contd.)

The geographical concentration of assets and liabilities are as follows:

	2002 (MNT million)		
	Mongolia	**Other Countries**	**Total**
Assets			
Cash in hand	13,771	-	13,771
Monetary gold and precious metals	6,991	56,019	63,010
Investment in foreign securities	-	51,321	51,321
Deposits and placements with foreign financial institutions	-	253,855	253,855
Loans and advances to local financial institutions	8,326	-	8,326
Advances to the Ministry of Finance and Economy	39,807	-	39,807
Loans to companies	165	-	165
Other assets	178	922	1,100
Property, plant and equipment	13,524	-	13,524
	82,762	362,117	444,879
Liabilities			
Cash in circulation	134,643	-	134,643
Debts issued	60,810	-	60,810
Foreign currency liabilities	130,704	-	130,704
Deposits of government agencies	19,091	-	19,091
Deposits of local financial institutions	44,155	-	44,155
Other liabilities	20,767	-	20,767
	410,170	-	410,170
Net position	(327,408)	362,117	34,709

33. ASSETS AND LIABILITIES BY CURRENCY

(b) Currency risk

The Bank is exposed to effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The Bank's management sets limits on the level of exposure by currencies (primarily U.S Dollar). The Bank's exposure to foreign currency exchange rate risk is as follows:

	2003 (MNT million)				
	MNT	**USD**	**SDR**	**Other currencies**	**Total**
Assets					
Cash in hand	55	11,102	-	2,077	13,234
Monetary gold and precious metals	7,662	-	-	7,768	15,430
Investment in foreign securities	-	77,370	-	-	77,370
Deposits and placements with foreign financial institutions	81,131	135,860	171	3,658	220,820
Loans and advances to local financial institutions	12,987	-	-	5	12,992
Government securities	4,000	-	-	-	4,000
Advances to the Ministry of Finance and Economy	160,216	-	-	54,838	215,054
Loans to companies	-	18,532	-	-	18,532
Other assets	507	-	-	-	507
Property, plant and equipment	14,370	-	-	-	14,370
Total assets	**280,928**	**242,864**	**171**	**68,346**	**592,309**
Liabilities					
Cash in circulation	152,827	-	-	-	152,827
Debts issued	75,734	-	-	-	75,734
Foreign currency liabilities	81,709	4,547	57,674	38,823	182,753
Deposits of government agencies	73,102	18,878	46	-	92,026
Deposits of local financial institutions	27,961	16,619	-	3,389	47,969
Other liabilities	3,540		-	-	3,540
Total liabilities	**414,873**	**40,044**	**57,720**	**42,212**	**554,849**
Charter fund	5,000	-	-	-	5,000
Reserve fund	32,460	-	-	-	32,460
Total capital funds	**37,460**	**-**	**-**	**-**	**37,460**
Total liabilities and capital funds	**452,333**	**40,044**	**57,720**	**42,212**	**592,309**

33. ASSETS AND LIABILITIES BY CURRENCY (CONTD.)

(b) Currency risk (contd.)

	2002 (MNT million)				
	MNT	**USD**	**SDR**	**Other currencies**	**Total**
Assets					
Cash in hand	26	5,961	-	7,784	13,771
Monetary gold and precious metals	6,991	-	-	56,019	63,010
Investment in foreign securities	-	51,321	-	-	51,321
Deposits and placements with foreign financial institutions	1,463	250,555	39	1,798	253,855
Loans and advances to local financial institutions	8,324	-	-	2	8,326
Advances to the Ministry of Finance and Economy	-	-	39,807	-	39,807
Loans to companies	165	-	-	-	165
Other assets	178	922	-	-	1,100
Property, plant and equipment	13,524	-	-	-	13,524
Total assets	**30,671**	**308,759**	**39,846**	**65,603**	**444,879**
Liabilities					
Cash in circulation	134,643	-	-	-	134,643
Debts issued	60,810	-	-	-	60,810
Foreign currency liabilities	73,392	4,270	47,609	5,433	130,704
Deposits of government agencies	15,344	3,707	40	-	19,091
Deposits of local financial institutions	28,351	14,772	-	1,032	44,155
Other liabilities	20,767	-	-	-	20,767
Total liabilities	**333,307**	**22,749**	**47,649**	**6,465**	**410,170**
Charter fund	5,000	-	-	-	5,000
Reserve fund	29,709	-	-	-	29,709
Total capital funds	**34,709**	**-**	**-**	**-**	**34,709**
Total liabilities and capital funds	**368,016**	**22,749**	**47,649**	**6,465**	**444,879**

34. MATURITY OF ASSETS AND LIABILITIES

The maturity structure of assets and liabilities of the Bank for the year ended 31 December 2003 is as follows:

(MNT million)	Less than 3 months	3 to 6 months	6 months to 1 year	More than 1 year	No Maturity	Total
Assets						
Cash in hand	-	-	-	-	13,234	13,234
Monetary gold and precious metals	-	-	-	-	15,430	15,430
Investment in foreign securities	5,840	-	31,935	-	39,595	77,370
Deposits and placements with foreign financial institutions	132,161	-	-	-	88,659	220,820
Loans and advances to local financial institutions	-	-	4,736	8,256	-	12,992
Government securities	-	-	4,000	-	-	4,000
Advances to the Ministry of Finance and Economy	-	-	43,216	117,000	54,838	215,054
Loans to companies	18,532	-	-	-	-	18,532
Other assets	507	-	-	-	-	507
Property, plant and equipment	-	-	-	-	14,370	14,370
Liabilities						
Cash in circulation	-	-	-	-	(152,827)	(152,827)
Debts issued	(75,734)	-	-	-	-	(75,734)
Foreign currency liabilities	-	(29,231)	-	(71,813)	(81,709)	(182,753)
Deposits of government agencies	-	-	-	(4,091)	(87,935)	(92,026)
Deposits of local financial institutions	-	-	-	-	(47,969)	(47,969)
Other liabilities	-	-	-	-	(3,540)	(3,540)
Net position	**81,306**	**(29,231)**	**83,887**	**49,352**	**(147,854)**	**37,460**
Accumulated gap	**81,306**	**52,075**	**135,962**	**185,314**	**37,460**	

34. MATURITY OF ASSETS AND LIABILITIES (CONTD.)

The maturity structure of assets and liabilities of the Bank for the year ended 31 December 2002 is as follows:

(MNT million)	Less than 3 months	3 to 6 months	6 months to 1 year	More than 1 year	No Maturity	Total
Assets						
Cash in hand	-	-	-	-	13,771	13,771
Monetary gold and precious metals	-	-	-	-	63,010	63,010
Investment in foreign securities	208	-	31,763	5,625	13,725	51,321
Deposits and placements with foreign financial institutions	178,743	2,250	-	-	72,862	253,855
Loans and advances to local financial institutions	-	-	3,631	4,695	-	8,326
Advances to the Ministry of Finance and Economy	-	-	-	-	39,807	39,807
Loans to companies	-	-	-	-	165	165
Other assets	124	-	-	-	976	1,100
Property, plant and equipment	-	-	-	-	13,524	13,524
Liabilities						
Cash in circulation	-	-	-	-	(134,643)	(134,643)
Debts issued	(60,810)	-	-	-	-	(60,810)
Foreign currency liabilities	-	-	-	(57,312)	(73,392)	(130,704)
Deposits of government agencies	-	-	-	(1,451)	(17,640)	(19,091)
Deposits of local financial institutions	-	-	-	-	(44,155)	(44,155)
Other liabilities	(84)	-	(57)	(584)	(20,042)	(20,767)
Net position	**118,181**	**2,250**	**35,337**	**(49,027)**	**(72,032)**	**34,709**
Accumulated gap	**118,181**	**120,431**	**155,768**	**106,741**	**34,709**	

35. FAIR VALUE OF FINANCIAL INSTRUMENTS

Financial instruments comprise financial assets and financial liabilities. The fair value of a financial instrument is the amount at which the instrument could be exchanged or settled between knowledgeable and willing parties in an arm's length transaction, other than in a forced or liquidation sale.

Almost all of the financial instruments as at 31 December 2003 are short term in nature with maturities of less than one year. The estimated fair values of those financial assets and financial liabilities as at the balance sheet date approximate their carrying amounts as shown in the balance sheets.

36. MONGOLIAN TRANSLATION

These financial statements are also prepared in the Mongolian language. In the event of discrepancies or contradictions between the English version and the Mongolian version, the English version will prevail.

MAIN ECONOMIC INDICATORS

	1999	2000	2001	2002	2003 [1]
GDP growth	3.2	1.1	1.0	4.0	5.5
GDP, current price, billions of togrog	925.3	1018.9	1115.6	1240.8	1362.5
Inflation (%)	10.0	8.1	8.0	1.6	4.7
Unemployment (%)	4.7	4.6	4.6	3.4	3.5
Monetary survey (billions of togrog)					
M2	220.2	258.8	331.1	470.1	703.3
Net foreign assets	167.5	201.7	220.2	308.5	256.3
Net domestic credit	116.6	84.8	129.3	200.0	514.6
M2/GDP (%)	23.8	25.4	29.7	37.9	51.6
Loan/GDP (%)	8.4	6.6	12.1	18.7	32.5
Deposit/GDP (%)	13.7	15.5	19.9	28.2	42.0
Banks' loan	77.5	66.8	135.1	231.4	442.1
Non-performing loan	42.1	15.9	10.9	16.6	36.7
Banks' interest rate	37.7	30.3	31.8	26.6	25.6
Banks' deposit rate	19.8	13.8	13.2	14.0	14.0
CBBill's weighted average rate (%)	11.4	8.6	8.6	9.9	11.5
Balance of payments (millions of U.S. dollar)					
Exports F.O.B	454.2	535.8	523.2	523.9	627.3
Imports C.I.F	-567.1	-675.9	-693.1	-752.8	-826.9
Current account	-57.8	-69.9	-61.7	-105.1	-98.7
Current account/GDP (%)	-6.4	-7.2	-6.1	-9.4	-8.3
International reserve	155.9	190.9	206.8	268.2	203.4
In weeks of imports	14.3	14.7	15.6	18.6	12.8
Togrog rate against U.S. dollar	1072.4	1097.0	1102.0	1125.0	1168.0
General government budget (billions of togrog)					
Total revenue and grants	254.7	351.0	439.3	477.0	553.9
Current revenue	247.9	346.2	430.0	469.8	545.3
Total expenditure and net lending	364.7	429.6	489.9	550.5	615.8
Current expenditure	251.0	314.1	366.8	415.3	434.8
Overall balance	-109.9	-78.6	-50.6	-73.4	-61.9
Overall balance/GDP	-11.9	-7.7	-4.5	-6.0	-4.5
Financing					
Foreign, net	93.7	66.6	72.5	81.8	-158.2
Domestic, net	16.2	12.0	21.9	-8.3	220.1

[1] Preliminary

APPENDIX 2

MONEY SUPPLY

in millions of togrogs

End-of-period	Currency issued in circulation		Of which			Money (M1)		Of which	
				Currency outside banks					
	amount	Monthly changes %	Bank's vault	amount	Monthly changes %	amount	Monthly changes %	Non-banks demand deposits (BoM)	Demand deposits (Banks)
1990 12	742.7		5.7	737.0		4,749.9		3,915.9	97.0
1991 12	2,003.0		308.7	1,694.3		7,313.7		27.3	5,592.1
1992 12	2,896.4		1,057.2	1,839.2		7,640.2		11.2	5,789.8
1993 12	10,786.1	13.2	2,035.5	8,750.6	12.0	18,548.4	-8.8	40.6	9,757.2
1994 12	21,804.8	3.1	3,037.6	18,767.2	5.7	32,871.2	-0.4		14,104.0
1995 12	29,755.7	0.8	4,164.5	25,591.2	2.6	42,636.5	-0.4		17,045.3
1996 12	46,095.8	11.8	4,391.4	41,704.4	14.4	64,301.6	14.7		22,597.2
1997 12	56,816.5	3.1	7,048.2	49,768.3	4.1	76,108.9	4.0		26,340.6
1998 03	47,551.7	-7.0	6,050.8	41,500.9	-9.3	63,773.2	-9.5		22,272.3
06	61,565.7	2.5	6,170.9	55,394.8	0.0	78,699.1	-1.2		23,304.3
09	59,996.1	-2.8	5,997.4	53,998.7	-2.3	79,175.0	-1.1		25,176.3
12	61,754.2	5.7	5,308.4	56,445.8	9.2	82,582.0	9.4		26,136.2
1999 03	52,625.8	-7.2	4,558.4	48,067.4	-9.0	66,289.8	-7.3		18,222.4
06	78,453.6	9.3	4,645.8	73,807.8	8.1	92,599.9	5.7		18,792.1
09	82,990.7	-2.1	6,630.0	76,360.7	-4.5	100,454.2	-1.5		24,093.5
12	91,567.5	13.8	4,286.2	87,281.3	15.2	114,825.7	14.9		27,544.4
2000 03	102,316.4	30.1	7,282.1	95,034.2	30.4	116,237.0	22.4		21,202.8
06	125,507.4	-2.1	6,618.0	118,889.4	1.2	143,684.2	2.7		24,794.8
09	120,879.8	-1.1	6,405.4	114,474.4	-0.4	143,562.4	2.5		29,088.0
12	107,394.4	7.8	6,461.0	100,933.4	7.3	130,775.0	8.9		29,841.6
2001 03	99,711.6	-2.4	6,000.6	93,711.0	-1.4	123,586.3	3.0		29,875.3
06	133,397.4	6.6	7,933.6	125,463.8	6.7	155,099.6	2.8		29,635.9
09	124,288.6	-1.2	7,980.1	116,308.5	-0.7	151,808.6	1.0		35,500.2
12	119,205.8	5.7	10,045.1	109,160.7	8.2	156,155.3	6.9		46,994.6
2002 01	109,607.2	-8.1	12,220.9	97,386.4	-10.8	141,027.6	-9.7		43,641.3
02	108,997.7	-0.6	13,693.8	95,303.8	-2.1	138,758.8	-1.6		43,455.0
03	110,822.1	1.7	9,538.3	101,283.8	6.3	146,932.2	5.9		45,648.4
04	129,199.1	16.6	13,321.1	115,878.0	14.4	164,200.9	11.8		48,322.9
05	139,543.7	8.0	12,847.1	126,696.6	9.3	178,267.6	8.6		51,571.0
06	145,888.0	4.5	14,093.3	131,794.6	4.0	187,708.4	5.3		55,913.8
07	148,605.2	1.9	12,891.0	135,714.2	3.0	185,360.3	-1.3		49,646.1
08	152,233.7	2.4	12,276.1	139,957.6	3.1	189,423.1	2.2		49,465.5
09	144,851.7	-4.8	14,176.1	130,675.6	-6.6	181,084.7	-4.4		50,409.0
10	136,641.6	-5.7	12,643.8	123,997.7	-5.1	177,714.5	-1.9		53,716.8
11	133,987.7	-1.9	14,590.4	119,397.2	-3.7	175,576.6	-1.2		56,179.4
12	134,642.8	0.5	13,859.2	120,783.6	1.2	187,727.8	6.9		66,944.1
2003 01	138,836.5	3.1	18,556.1	120,280.4	-0.4	196,577.6	4.7		76,297.2
02	120,935.7	-12.9	14,635.7	106,300.1	-11.6	176,951.1	-10.0		70,651.0
03	131,235.3	8.5	16,228.6	115,006.7	8.2	180,109.6	1.8		65,102.9
04	145,422.1	10.8	18,198.2	127,224.0	10.6	193,596.3	7.5		66,372.4
05	152,903.4	5.1	17,645.1	135,258.3	6.3	200,968.7	3.8		65,710.4
06	160,481.3	5.0	19,423.2	141,058.1	4.3	208,987.9	4.0		67,929.8
07	162,537.0	1.3	17,115.5	145,421.5	3.1	204,711.3	-2.0		59,289.9
08	168,875.6	3.9	18,414.8	150,460.8	3.5	217,316.7	6.2		66,855.9
09	166,532.4	-1.4	18,150.1	148,382.3	-1.4	214,417.5	-1.3		66,035.2
10	156,175.3	-6.2	14,614.6	141,560.7	-4.6	213,157.5	-0.6		71,596.8
11	151,140.6	-3.2	16,869.1	134,271.5	-5.1	203,784.6	-4.4		69,513.1
12	152,826.6	1.1	21,329.9	131,496.7	-2.1	212,833.4	4.4		81,336.7

MONEY SUPPLY

in millions of togrogs

End-of-period	Quasi money		Of which				Money (M2)	
	amount	Monthly changes %	Time saving deposits	Of which		Foreign currency deposits	amount	Monthly changes %
				Individuals	Enterprises			
1990 12	883.2		726.3	726.3	-	157.0	5,633.1	
1991 12	2,601.1		1,996.9	1,553.3	443.6	604.2	9,914.8	
1992 12	5,412.1		4,430.2	2,985.7	1,444.5	981.9	13,052.3	
1993 12	24,215.8	10.6	10,103.1	7,969.6	2,133.5	14,112.7	42,764.2	1.2
1994 12	43,905.8	-2.6	28,937.5	25,287.3	3,650.2	14,968.3	76,777.0	-1.7
1995 12	59,408.1	-4.7	38,529.1	36,602.7	1,926.4	20,879.0	102,044.6	-2.9
1996 12	64,093.7	-4.0	35,164.2	33,819.1	1,345.1	28,929.5	128,395.3	4.5
1997 12	93,956.6	13.0	44,673.8	42,892.7	1,781.1	49,282.8	170,065.5	8.8
1998 03	89,854.6	-1.8	49,870.4	43,718.6	6,151.8	39,984.2	153,627.8	-5.1
06	81,527.3	-6.1	43,492.4	40,643.1	2,849.3	38,034.9	160,226.4	-3.8
09	86,818.2	2.0	42,212.1	39,674.0	2,538.1	44,606.1	165,993.2	0.5
12	84,667.6	-0.5	44,840.1	42,044.5	2,795.6	39,827.5	167,249.6	4.2
1999 03	87,392.9	-3.3	42,874.2	40,646.1	2,228.1	44,518.7	153,682.7	-5.1
06	92,035.4	4.7	41,158.2	38,447.7	2,710.5	50,877.2	184,635.3	5.2
09	98,485.8	3.8	44,071.8	41,877.7	2,194.1	54,414.0	198,940.0	1.1
12	105,341.3	-1.6	45,052.3	43,257.9	1,794.4	60,289.1	220,167.0	6.3
2000 03	106,197.0	-5.7	47,447.8	46,009.3	1,438.5	58,749.3	222,434.0	7.2
06	111,573.9	8.3	49,036.2	46,967.5	2,068.8	62,537.7	255,258.1	5.0
09	120,927.8	3.5	54,046.5	51,485.1	2,561.4	66,881.3	264,490.2	3.0
12	128,067.7	2.1	59,004.3	54,125.9	4,878.4	69,063.4	258,842.6	5.4
2001 03	146,954.5	6.4	66,993.0	61,110.6	5,882.4	79,961.5	270,540.8	4.8
06	158,846.5	6.6	72,344.0	63,382.0	8,962.1	86,502.5	313,946.1	4.7
09	165,619.9	-3.0	81,629.0	70,893.8	10,735.3	83,990.8	317,428.5	-1.1
12	174,908.9	3.0	87,590.4	79,321.6	8,268.7	87,318.6	331,064.3	4.8
2002 01	183,708.4	5.0	93,203.5	82,549.2	10,654.3	90,504.9	324,736.0	-1.9
02	193,578.4	5.4	101,346.6	87,704.9	13,641.7	92,231.8	332,337.3	2.3
03	198,939.7	2.8	102,964.3	92,059.3	10,905.0	95,975.4	345,871.9	4.1
04	205,133.8	3.1	108,110.1	85,884.7	22,225.4	97,023.7	369,334.7	6.8
05	209,979.4	2.4	111,538.6	100,046.1	11,492.4	98,440.9	388,247.1	5.1
06	213,270.1	1.6	113,054.1	103,517.4	9,536.7	100,216.0	400,978.5	3.3
07	236,247.4	10.8	124,332.7	111,429.5	12,903.1	111,914.7	421,607.7	5.1
08	241,304.5	2.1	126,626.7	113,075.9	13,550.7	114,677.8	430,727.6	2.2
09	256,280.1	6.2	134,245.4	121,098.3	13,147.1	122,034.7	437,364.8	1.5
10	261,900.5	2.2	137,123.2	127,012.9	10,110.4	124,777.2	439,615.0	0.5
11	271,982.8	3.8	141,912.7	131,679.9	10,232.7	130,070.1	447,559.4	1.8
12	282,397.8	3.8	147,211.7	137,182.7	10,029.0	135,186.1	470,125.6	5.0
2003 01	291,039.3	3.1	154,137.4	146,258.1	7,879.3	136,902.0	487,616.9	3.7
02	313,492.5	7.7	167,210.0	159,061.9	8,148.0	146,282.5	490,443.6	0.6
03	324,137.7	3.4	176,134.3	163,836.2	12,298.1	148,003.4	504,247.3	2.8
04	336,930.3	3.9	181,237.5	168,090.5	13,147.0	155,692.8	530,526.7	5.2
05	341,454.2	1.3	186,132.1	173,389.7	12,742.4	155,322.1	542,422.9	2.2
06	348,727.8	2.1	193,137.5	180,771.4	12,366.1	155,590.3	557,715.7	2.8
07	377,666.1	8.3	203,725.4	191,044.6	12,680.8	173,940.8	582,377.4	4.4
08	371,170.3	-1.7	203,603.9	193,425.6	10,178.3	167,566.4	588,487.0	1.0
09	394,923.6	6.4	210,986.9	200,585.6	10,401.3	183,936.8	609,341.1	3.5
10	410,229.7	3.9	220,221.5	210,127.9	10,093.6	190,008.2	623,387.2	2.3
11	423,716.6	3.3	223,024.3	212,120.7	10,903.6	200,692.3	627,501.2	0.7
12	490,499.0	15.8	240,280.1	228,133.5	12,146.6	250,218.9	703,332.4	12.1

APPENDIX 3

CONSUMER PRICE INDEX

in percent

End-of-period	Food items	Of which						
		Meat and meat products	Milk, dairy products	Wheat products	Sugar, candy, tea, fruits	Potatoes and vegetables	Other food items	Soft drinks, cigarettes
1991 01 16	100.0	100.0	100.0	100.0			100.0	100.0
1991 12	134.4	136.4	156.3	124.0			131.4	126.9
1992 12	755.4	468.3	884.2	978.4			828.9	800.1
1993 12	2,247.0	1,744.3	2,153.2	2,906.7			2,736.5	1,424.5
1994 12	3,565.3	2,723.1	3,658.8	4,147.5			4,681.4	1,855.4
				*1995.12=100**				
1995 12	58.7	18.4	5.1	17.2			4.9	4.5
1996 12	78.2	19.5	7.1	27.0			7.5	6.3
1997 12	87.0	21.2	9.6	28.1			8.7	7.8
1998 12	87.7	22.0	10.0	27.6			10.1	7.7
1999 12	95.5	25.0	10.0	28.8			10.6	8.5
2000 12	46.6	12.4	5.2	12.9	4.9	4.1	3.5	3.7
				*2000.12=100***				
2001 01	50.4	14.7	6.0	12.9	4.9	4.3	3.5	4.1
03	55.5	18.6	6.5	13.1	4.9	4.8	3.5	4.1
06	56.0	21.3	4.1	13.0	5.0	4.9	3.5	4.2
09	47.4	13.9	4.1	13.2	4.9	3.6	3.5	4.2
12	50.7	14.8	5.5	13.3	4.9	4.3	3.6	4.3
2002 01	51.1	14.9	5.6	13.3	4.9	4.4	3.6	4.3
02	52.4	16.0	5.6	13.3	4.9	4.6	3.6	4.4
03	51.6	15.9	5.5	12.9	4.9	4.4	3.6	4.4
04	53.0	17.6	5.2	12.8	5.0	4.5	3.5	4.4
05	54.1	19.0	4.8	12.7	4.9	4.9	3.5	4.3
06	53.5	18.8	3.8	12.5	5.1	5.7	3.5	4.2
07	51.7	17.8	3.6	12.2	4.9	5.5	3.6	4.2
08	49.2	15.9	3.5	12.1	4.8	5.0	3.6	4.2
09	47.9	15.0	3.8	12.1	4.7	4.5	3.6	4.2
10	47.9	14.2	4.6	12.2	4.7	4.5	3.6	4.3
11	48.6	14.1	5.1	12.2	4.7	4.7	3.6	4.3
12	49.9	14.8	5.6	12.2	4.7	4.8	3.6	4.3
2003 01	51.3	15.9	5.5	12.0	4.7	5.3	3.6	4.3
02	52.5	17.3	5.6	11.7	4.7	5.5	3.6	4.2
03	54.9	19.5	5.6	11.7	4.7	5.7	3.6	4.2
04	57.8	22.3	5.6	11.8	4.6	5.7	3.6	4.2
05	61.3	26.4	5.0	11.9	4.7	5.4	3.7	4.2
06	59.0	25.3	4.1	11.9	5.0	5.0	3.6	4.2
07	57.7	23.4	3.9	12.6	5.0	5.1	3.6	4.2
08	52.2	18.9	3.6	12.5	4.7	4.8	3.6	4.1
09	50.8	17.8	3.9	13.0	4.5	3.9	3.6	4.1
10	50.7	16.0	4.3	14.5	4.6	3.5	3.7	4.1
11	52.0	16.7	5.1	14.3	4.8	3.3	3.7	4.2
12	53.8	18.3	5.3	14.2	4.8	3.5	3.7	4.2

CONSUMER PRICE INDEX

in percent

End-of-period	Clothes, shoes	Of which						Utilities
		Cotton, fabrics	Men's clothing	Women's clothing	Adult underwear	Children's clothing	Shoes	
1991 01 16	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1991 12	192.4	148.4	174.5	229.3	173.5	100.0	236.1	115.5
1992 12	679.1	676.3	347.3	541.2	397.1	440.9	965.4	245.8
1993 12	1,304.3	1,161.6	650.4	896.4	743.6	1,404.4	1,782.9	1,068.3
1994 12	2,363.1	1,957.5	1,259.4	2,110.3	972.1	2,126.9	3,377.3	1,595.7
				*1995.12=100**				
1995 12	10.3	0.4	1.5	3.4		1.0	4.0	10.4
1996 12	15.4	0.6	2.3	4.5		1.8	6.2	17.9
1997 12	20.6	0.7	2.9	6.5		2.3	8.2	27.0
1998 12	22.8	0.6	3.2	6.9		2.4	9.4	29.5
1999 12	23.9	0.6	3.1	7.1		2.4	10.2	32.1
2000 12	13.5	0.3	3.5	4.6		0.5	4.6	14.1
				*2000.12=100***				
2001 01	13.4	0.3	3.5	4.6		0.5	4.5	15.1
03	13.3	0.2	3.5	4.6		0.5	4.5	14.7
06	13.4	0.2	3.5	4.6		0.5	4.5	14.6
09	13.9	0.2	3.8	4.7		0.6	4.6	14.9
12	14.1	0.2	3.9	4.7		0.6	4.6	17.2
2002 01	14.1	0.2	3.9	4.7		0.6	4.7	17.2
02	14.1	0.2	3.9	4.7		0.6	4.6	16.7
03	13.7	0.3	3.9	4.6		0.5	4.5	16.4
04	13.6	0.3	3.8	4.6		0.5	4.5	16.4
05	13.6	0.3	3.8	4.6		0.5	4.5	16.4
06	13.6	0.3	3.8	4.6		0.5	4.5	16.3
07	13.6	0.3	3.8	4.5		0.6	4.5	17.0
08	13.5	0.3	3.7	4.5		0.5	4.5	17.5
09	13.6	0.3	3.8	4.5		0.6	4.5	17.5
10	13.8	0.3	4.0	4.5		0.6	4.5	17.9
11	14.5	0.3	4.0	4.8		0.6	4.9	18.0
12	14.9	0.3	4.0	4.8		0.6	5.2	18.0
2003 01	14.9	0.3	4.0	4.9		0.6	5.2	17.2
02	15.1	0.3	4.0	4.9		0.6	5.2	16.8
03	14.2	0.3	3.9	4.5		0.6	4.9	16.7
04	14.0	0.3	3.8	4.5		0.6	4.8	16.7
05	13.8	0.3	3.8	4.4		0.6	4.7	16.7
06	13.7	0.3	3.7	4.4		0.6	4.6	16.7
07	13.7	0.3	3.8	4.4		0.6	4.6	16.6
08	14.0	0.3	3.7	4.6		0.6	4.8	16.6
09	14.1	0.3	3.9	4.6		0.6	4.7	17.8
10	14.6	0.3	3.9	4.7		0.7	5.0	18.4
11	14.9	0.3	4.0	4.7		0.7	5.1	18.1
12	14.9	0.3	4.0	4.7		0.7	5.1	17.7

APPENDIX 3 (continued)

CONSUMER PRICE INDEX

in percent

End-of-period	Household goods	Medicine	Transport & communi-cation	Articles for cultural needs	Other goods & service	General CPI	Monthly changes %	Changes from the beginning of year	Annual changes
1991 01 16	100.0	100.0	100.0	100.0	100.0	100.0			
1991 12	209.6	100.0	137.3	277.3	152.3	152.7	5.1	52.7	
1992 12	795.8	196.7	535.3	581.0	430.2	649.8	11.0	325.5	
1993 12	2,087.2	1,933.9	1,673.3	2,154.8	1,483.8	1,838.7	2.5	183.0	
1994 12	3,247.2	1,933.9	3,221.1	4,427.9	2,904.7	3,057.8	2.1	66.3	
				*1995.12=100**					
1995 12	3.9	2.1	7.6	3.6	3.5	100.0	2.1	53.1	53.1
1996 12	5.4	3.0	13.6	5.7	5.3	144.6	3.2	44.6	44.6
1997 12	6.6	3.8	15.0	8.2	6.4	174.2	0.9	20.5	20.5
1998 12	6.1	3.9	17.8	9.8	7.4	184.7	2.1	6.0	6.0
1999 12	6.5	4.6	23.3	11.3	7.9	203.2	1.7	10.0	10.0
2000 12	3.2	1.4	10.1	7.4	3.7	100.0	2.1	8.1	8.1
				*2000.12=100***					
2001 01	3.2	1.4	10.2	7.4	3.7	104.9	4.9	4.9	10.4
03	3.3	1.4	10.2	7.4	3.7	109.5	2.7	9.5	13.2
06	3.3	1.4	10.0	7.3	3.7	109.8	-3.7	9.8	4.5
09	3.2	1.4	10.1	7.3	3.8	102.0	-2.0	2.0	5.8
12	3.3	1.4	10.2	7.3	3.8	107.9	2.1	7.9	8.0
2002 01	3.3	1.4	10.4	7.2	3.8	108.5	0.5	0.5	3.5
02	3.3	1.4	10.4	7.2	3.8	109.3	0.7	1.2	2.5
03	3.3	1.4	10.3	7.2	3.8	107.8	-1.4	-0.1	-1.6
04	3.3	1.4	10.3	7.2	3.8	109.0	1.2	1.0	-2.1
05	3.3	1.5	10.3	7.2	3.8	110.1	1.0	2.0	-3.4
06	3.3	1.5	10.3	7.2	3.8	109.5	-0.5	1.5	-0.2
07	3.3	1.5	10.3	7.2	3.8	108.5	-0.9	0.5	0.9
08	3.3	1.5	10.3	7.2	3.8	106.3	-2.0	-1.5	2.1
09	3.3	1.5	10.3	7.5	3.8	105.4	-0.9	-2.3	3.4
10	3.3	1.5	10.4	7.5	3.9	106.3	0.9	-1.5	2.9
11	3.4	1.5	10.5	7.6	3.9	108.0	1.6	0.1	2.2
12	3.4	1.5	10.5	7.6	3.9	109.8	1.6	1.6	1.6
2003 01	3.3	1.5	10.5	7.6	4.0	110.3	0.5	0.5	1.7
02	3.3	1.5	10.5	7.5	4.1	111.4	1.0	1.5	1.9
03	3.3	1.6	10.5	7.5	4.3	113.0	1.5	3.0	4.9
04	3.3	1.6	10.4	7.9	4.3	116.0	2.6	5.7	6.4
05	3.2	1.6	10.4	7.9	4.3	119.2	2.7	8.5	8.2
06	3.2	1.6	10.4	7.8	4.3	116.7	-2.0	6.3	6.6
07	3.2	1.6	10.5	7.8	4.3	115.5	-1.1	5.2	6.5
08	3.3	1.6	10.6	8.4	4.3	111.0	-3.9	1.1	4.5
09	3.3	1.6	10.7	8.4	4.4	111.1	0.1	1.2	5.4
10	3.3	1.6	10.8	8.5	4.4	112.3	1.0	2.3	5.6
11	3.2	1.6	10.8	8.5	4.5	113.6	1.2	3.5	5.2
12	3.3	1.6	10.8	8.4	4.5	114.9	1.1	4.7	4.7

* 1995 оны 12 сараас хэрэглээний сагсан дахь 123 нэр төрлийн бүтээгдэхүүнийг 205 болгож өргөтгөв
** 2000 оны 12 сараас хэрэглээний сагсан дахь 205 нэр төрлийн бүтээгдэхүүнийг 239 болгож өргөтгөв

MONETARY SURVEY

in millions of togrogs

End-of-period	Net foreign assets	Domestic credit (net)	Үүнээс							Total assets
			Central Government	Public enterprises	Private sector	Principal in arrears	Substandard doubtful, loss loans	Non-bank financial institutions	Stock & promissory note	
1991 12	495.4	10,971.2	-1,883.7	9,779.6	3,075.3		0.0	0.0	0.0	11,466.6
1992 12	-27.0	16,078.2	-3,051.7	12,204.2	6,925.7		0.0	0.0	0.0	16,051.2
1993 12	23,395.7	24,460.3	-7,143.4	21,744.4	9,859.3		0.0	0.0	0.0	47,856.0
1994 12	29,699.3	49,190.3	-3,773.1	12,193.3	40,638.0		0.0	7.8	124.3	78,889.6
1995 12	51,709.7	45,494.7	-17,227.8	10,883.3	51,653.5		0.0	61.4	124.3	97,204.4
1996 12	73,733.6	90,240.4	19,920.3	14,520.3	22,851.9	8,057.8	24,890.1	0.0	0.0	163,974.0
1997 12	135,437.2	67,635.4	13,352.1	11,713.0	28,112.6	4,553.9	9,903.8	0.0	0.0	203,072.6
1998 12	96,557.5	136,062.0	41,460.0	18,295.6	43,667.5	6,051.9	26,587.0	0.0	0.0	232,619.5
1999 12	167,541.5	116,635.6	34,555.7	8,564.5	31,408.6	2,925.7	39,181.0	0.0	0.0	284,177.1
2000 12	201,696.9	84,831.1	17,171.2	6,281.5	45,482.9	1,281.8	14,613.8	0.0	0.0	286,528.0
2001 01	187,939.5	96,095.0	21,698.0	6,201.3	51,727.3	1,845.7	14,622.7	0.0	0.0	284,034.5
03	199,864.8	107,671.8	26,210.3	5,201.4	60,415.9	1,704.0	13,989.9	150.3	0.0	307,536.6
06	222,366.1	107,107.5	9,575.3	8,765.3	76,509.5	1,420.0	10,687.1	150.3	0.0	329,473.6
09	222,664.5	116,362.0	14,208.5	8,708.7	81,368.3	1,738.6	10,187.7	150.3	0.0	339,026.5
12	220,165.7	129,259.5	-6,829.1	10,402.0	114,670.4	1,798.3	9,067.6	150.3	0.0	349,425.2
2002 01	202,909.8	142,387.8	-275.5	9,513.5	122,402.5	1,849.3	8,747.6	150.3	0.0	345,297.6
02	211,910.0	148,558.8	1,683.3	11,174.9	124,274.7	2,786.3	8,489.3	150.3	0.0	360,468.8
03	219,898.3	150,435.6	-1,724.8	10,486.9	127,431.4	3,526.4	10,565.4	150.3	0.0	370,333.9
04	220,753.8	166,629.7	1,563.0	10,181.7	141,496.3	2,748.1	10,490.3	150.3	0.0	387,383.6
05	224,544.0	179,416.9	1,543.2	11,195.4	152,716.7	3,461.9	10,349.5	150.3	0.0	403,960.9
06	223,696.2	195,587.4	3,529.6	12,675.9	163,173.1	5,437.4	10,621.1	150.3	0.0	419,283.7
07	247,989.9	191,091.1	-2,410.0	13,277.4	163,957.3	5,472.3	10,643.8	150.3	0.0	439,081.0
08	242,746.7	195,909.8	-2,753.9	13,164.6	169,146.4	4,832.1	11,370.4	150.3	0.0	438,656.5
09	276,385.3	177,337.3	-20,282.6	13,509.2	168,246.7	4,263.0	11,450.7	150.3	0.0	453,722.6
10	281,081.3	179,515.3	-22,689.6	13,910.4	171,416.5	4,293.7	12,434.0	150.3	0.0	460,596.6
11	286,248.8	193,978.2	-18,567.5	12,291.3	183,806.6	4,294.5	12,003.1	150.3	0.0	480,227.0
12	308,507.4	200,027.4	-32,439.3	12,184.9	203,567.2	4,819.4	11,744.9	150.3	0.0	508,534.8
2003 01	317,455.0	210,552.0	-33,345.3	12,045.1	214,002.3	5,710.5	11,989.1	150.3	0.0	528,007.0
02	302,249.3	231,186.8	-29,411.5	11,835.5	228,615.8	7,823.7	12,173.0	150.3	0.0	533,436.2
03	307,375.0	245,360.2	-35,418.6	11,194.3	239,107.3	11,582.1	18,744.9	150.3	0.0	552,735.2
04	310,190.3	264,074.7	-39,663.1	10,991.2	261,760.0	11,646.2	19,190.0	150.3	0.0	574,265.0
05	320,070.6	274,327.1	-43,096.0	9,448.7	273,808.6	13,515.8	20,499.8	150.3	0.0	594,397.6
06	321,357.8	284,502.7	-44,157.8	12,582.5	282,641.1	13,310.1	19,976.6	150.3	0.0	605,860.5
07	347,071.9	287,451.5	-54,417.2	14,395.1	293,791.3	12,941.0	20,591.1	150.3	0.0	634,523.5
08	352,808.3	288,619.0	-61,361.0	16,062.7	299,330.8	13,774.9	20,661.3	150.3	0.0	641,427.2
09	381,705.0	272,149.6	-81,605.8	15,712.7	304,676.9	11,538.9	21,676.5	150.3	0.0	653,854.6
10	391,665.3	277,991.6	-93,016.8	17,585.4	317,005.3	14,834.1	21,433.2	150.3	0.0	669,656.9
11	377,107.6	323,133.9	-106,829.7	17,207.2	376,970.8	14,428.2	21,207.1	150.3	0.0	700,241.4
12	256,341.5	514,615.2	96,687.3	16,203.6	365,024.4	15,549.7	21,150.3	0.0	0.0	770,956.7

APPENDIX 4 (continued)

MONETARY SURVEY

in millions of togrogs

End-of-period	Money (1)	Quasi money	Long-term foreign liabilities	Other items (net)	Total liabilities
1991 12	7,313.7	2,601.2	1,981.7	-430.0	11,466.6
1992 12	7,640.2	5,412.1	3,809.5	-810.6	16,051.2
1993 12	18,548.4	24,215.8	9,094.4	-4,002.6	47,856.0
1994 12	32,871.2	43,905.8	7,452.1	-5,339.5	78,889.6
1995 12	42,636.5	59,408.2	14,176.2	-19,016.5	97,204.4
1996 12	64,301.6	64,093.7	11,121.4	24,457.3	163,974.0
1997 12	76,108.9	93,956.6	3,659.2	29,347.9	203,072.6
1998 12	82,582.0	84,667.6	12,800.4	52,569.5	232,619.5
1999 12	114,825.7	105,341.3	5,682.5	58,327.5	284,177.1
2000 12	130,775.0	128,067.7	4,173.2	23,512.1	286,528.0
2001 01	116,271.4	133,729.3	4,331.2	29,702.6	284,034.5
03	123,586.3	146,954.5	4,226.3	32,769.5	307,536.6
06	155,099.6	158,846.5	5,370.7	10,156.8	329,473.6
09	151,808.6	165,619.9	5,756.8	15,841.2	339,026.5
12	156,155.3	174,908.9	6,603.8	11,757.2	349,425.2
2002 01	141,027.6	183,708.4	7,493.7	13,067.9	345,297.6
02	144,738.8	193,578.4	8,036.7	14,114.9	360,468.8
03	146,932.2	198,939.7	8,345.9	16,116.1	370,333.9
04	164,200.9	205,133.8	8,471.5	9,577.4	387,383.6
05	178,267.6	209,979.4	8,685.9	7,027.9	403,960.9
06	187,708.4	213,270.1	8,890.5	9,414.7	419,283.7
07	185,360.3	236,247.4	9,621.9	7,851.4	439,081.0
08	189,423.1	241,304.5	9,957.3	-2,028.4	438,656.5
09	181,084.7	256,280.2	10,606.0	5,751.7	453,722.6
10	177,714.5	261,900.5	10,100.0	10,881.6	460,596.6
11	175,576.6	271,982.8	11,343.1	21,324.5	480,227.0
12	187,727.8	282,397.8	11,718.8	26,690.4	508,534.8
2003 01	196,577.6	291,039.3	12,235.5	28,154.5	528,007.0
02	176,951.1	313,492.5	11,964.7	31,027.9	533,436.2
03	180,109.6	324,137.7	11,177.2	37,310.7	552,735.2
04	193,596.3	336,930.3	11,552.4	32,185.9	574,265.0
05	200,968.7	341,454.2	12,405.7	39,569.1	594,397.6
06	208,987.9	348,727.8	12,475.9	35,668.9	605,860.5
07	204,711.3	377,666.1	13,215.4	38,930.6	634,523.5
08	217,316.7	371,170.3	15,502.3	37,437.9	641,427.2
09	214,417.5	394,923.6	15,867.6	28,645.9	653,854.6
10	213,157.5	410,229.7	16,541.6	29,728.1	669,656.9
11	203,784.6	423,716.6	42,580.0	30,160.2	700,241.4
12	212,833.4	490,499.0	44,100.0	23,524.2	770,956.7

DEPOSIT INTEREST RATE

in percent

End-of-period	Deposit rates					
	Current account		Demand deposit	Time deposit		
	Domestic currency	Foreign currency		Domestic currency		Foreign currency
				1 year	1-3 year	1-3 year
1993 12	2.0		24-100	70-153	125-151.8	10-72
1994 12	2.0		10-63.8	50-101.2		6-72
1995 12	2.0		12.0-42.6	12.5-101.2		6.0-42.6
1996 12	2.0		12.0-34.5	12.7-60.1	26.8	3.6-42.6
1997 12	2.0		3.6-34.5	6.2-69.6	36.0-42.6	2.4-42.6
1998 12	0.8-6.0	1.0-3.6	3.6-19.6	6.0-42.58	24.0-30.0	1.2-24.0
1999 12	3.0-6.0	1.0-3.6	3.0-13.2	9.6-30.0		3.6-14.4
2000 01	3.0-6.0	1.0-3.6	3.6-13.2	9.6-30.0		3.6-14.4
02	3.0-6.0	1.0-3.6	3.6-13.2	9.6-30.0		3.6-14.4
03	3.0-6.0	1.0-3.6	3.6-13.2	9.6-30.0		3.6-14.4
04	3.0-6.0	1.0-3.6	1.2-13.2	3.6-30.0		2.4-14.4
05	3.0-6.0	1.0-3.6	1.2-13.2	3.6-30.0		2.4-14.4
06	3.0-6.0	1.0-3.6	1.2-13.2	3.6-30.0		2.4-14.4
07	3.0-6.0	1.0-3.6	1.2-13.2	3.6-30.0		2.4-14.4
08	3.0-6.0	1.0-3.6	1.2-13.2	3.6-30.0		1.2-14.4
09	3.0-6.0	1.0-3.6	1.2-13.2	3.6-30.0		1.2-12.0
10	3.0-6.0	1.0-3.6	1.2-13.2	3.6-24.0		1.2-12.0
11	2.4-6.0	1.0-3.6	1.2-13.2	3.6-24.0		1.2-12.0
12	2.4-6.0	1.0-3.6	1.2-13.2	3.6-24.0		1.2-12.0
2001 01	2.4-6.0	1.0-3.6	1.2-9.6	2.4-24.0		1.2-12.0
02	2.4-6.0	1.0-3.6	1.2-9.6	2.4-24.0		1.0-12.0
03	2.4-6.0	1.0-3.6	1.2-9.6	2.4-24.0		1.0-12.0
04	2.4-4.8	1.0-3.6	1.2-9.6	2.4-24.0		1.0-12.0
05	2.4-4.8	1.0-3.6	1.2-9.6	2.4-24.0		1.0-12.0
06	2.4-4.8	1.0-3.6	1.2-9.6	2.4-25.2		1.0-18.0
07	2.4-4.8	1.0-3.6	1.2-9.6	2.4-24.0		1.0-12.0
08	2.4-4.8	1.0-3.6	1.2-9.6	2.4-25.2		1.0-18.0
09	0.3-4.8	0.3-3.6	1.2-9.6	2.4-24.0		1.0-14.4
10	0.3-4.8	0.3-3.6	1.2-9.6	2.4-36.0		1.0-12.0
11	0.0-4.8	0.3-3.6	1.2-9.6	2.4-36.0		1.0-12.0
12	0.0-5.1	0.3-4.2	1.2-9.6	2.4-24.0		1.0-13.2
2002 01	0.0-5.1	0.3-4.2	1.2-9.6	2.4-24.0		1.0-13.2
02	0.0-5.1	0.3-4.2	1.2-9.6	2.4-24.0		1.0-13.2
03	0.0-5.1	0.3-4.2	1.2-9.6	2.4-24.0		1.0-13.2
04	0.0-5.1	0.3-4.2	1.2-9.6	2.4-24.0		1.0-13.2
05	0.0-6.0	0.3-3.6	1.2-9.6	2.4-24.0		1.0-13.2
06	0.0-6.0	0.3-3.6	2.4-9.6	2.4-22.0		1.0-13.2
07	0.0-4.8	0.3-3.6	2.4-10.0	2.4-22.0		1.0-13.2
08	0.0-4.8	0.3-3.6	2.4-10.0	2.4-22.0		1.0-13.2
09	0.0-4.8	0.3-3.6	2.4-10.2	6.0-22.0		1.2-13.2
10	0.0-4.8	0.3-3.6	2.4-10.2	6.0-22.0		1.2-13.2
11	0.0-4.8	0.3-3.6	2.4-10.2	6.0-22.0		1.2-12.0
12	0.0-6.0	0.3-3.0	2.4-10.2	6.0-22.0		1.2-12.0
2003 01	0.0-6.0	0.3-3.0	2.4-10.2	6.0-22.0		1.2-12.0
02	0.0-6.0	0.3-3.0	2.4-10.2	6.0-22.0		1.2-12.0
03	0.0-6.0	0.3-3.0	2.4-10.2	6.0-22.0		1.2-12.0
04	0.0-6.0	0.3-3.0	2.4-10.2	6.0-22.0		1.2-12.0
05	0.0-6.0	0.3-3.0	2.4-10.2	6.0-22.0		1.2-22.1
06	0.0-6.0	0.3-3.0	6.0-10.2	6.0-22.0		1.81-12.0
07	0.0-6.0	0.3-3.0	6.0-10.2	6.0-22.0		1.81-12.0
08	0.0-6.0	0.3-3.0	6.0-10.2	6.0-22.2		1.81-12.0
09	0.0-6.0	0.3-3.0	3.6-10.2	6.0-22.2		2.4-12.0
10	0.0-6.0	0.3-3.0	2.4-10.0	6.0-22.0		2.4-12.0
11	0.0-6.0	0.3-3.0	2.4-10.0	6.0-22.0		2.4-12.0
12	0.0-6.0	0.3-3.0	1.8-10.0	6.0-22.0		2.4-12.0

APPENDIX 6

LOAN INTEREST RATE

in percent

End-of-period	Loan rates					
	Bank of Mongolia	Commercial loans				
		Short-term		Medium & long-term		
		Domestic currency	Foreign currency	1 year	3-5 year	more than 5
1993 12	120-300					
1994 12	72-264					
1995 12	72-150					
1996 12	72-109					
1997 12	45.0-50.0					
1998 12	23.3	45.8	34.2			
1999 12	11.4	38.8	36.5			
2000 01	12.3	33.4	33.1			
02	11.3	45.0	26.5			
03	11.2	36.5	31.7			
04	12.8	37.0	29.7			
05	16.1	37.3	26.7			
06	15.6	38.9	27.1			
07	15.6	32.2	30.9			
08	14.6	35.3	23.5			
09	10.9	42.7	29.3			
10	11.1	37.7	31.6			
11	6.9	32.7	26.6			
12	8.6	34.7	25.8			
2001 01	4.8	38.8	23.7			
02	11.2	40.1	27.2			
03	11.2	38.0	21.5			
04	11.7	37.9	21.6			
05	12.5	37.6	24.2			
06	12.5	34.5	22.8			
07	11.1	33.9	20.7			
08	10.2	35.0	23.5			
09	9.9	37.4	21.4			
10	6.7	36.2	25.5			
11	6.5	37.4	23.3			
12	8.6	41.4	22.2			
2002 01	9.3	39.0	24.2			
02	11.6	34.2	21.4			
03	11.4	39.3	21.1			
04	11.4	37.8	22.3			
05	10.9	35.5	19.6			
06	11.5	33.4	22.3			
07	12.6	33.2	19.9			
08	13.3	35.0	20.4			
09	13.0	35.0	23.6			
10	8.9	35.1	19.9			
11	9.9	35.3	20.4			
12	9.9	33.4	19.8			
2003 01	4.9	30.7	20.7			
02	4.9	31.4	21.3			
03	3.9	32.6	20.8			
04	10.8	31.0	20.2			
05	14.3	32.0	16.6			
06	15.5	32.4	20.9			
07	14.1	32.8	19.9			
08	14.0	33.2	23.5			
09	11.3	32.2	22.6			
10	12.2	29.9	20.8			
11	12.6	33.2	21.7			
12	11.5	31.5	19.6			

MARKET RATES — Togrog exchange rate against foreign currencies

End-of-period	USD		EUR	SEK	BGN	HUF	CZK	EGP	ECU	JPY	CHF	GBP	HKD
	End-of-period	monthly average											
1993 12	396.51	395.03							349.19	3.55	275.01	592.70	51.32
1994 12	414.09	413.00							498.77	4.12	310.99	639.77	53.51
1995 12	473.62	473.48							604.81	4.63	409.53	731.27	61.23
1996 12	693.51	692.76							860.82	5.98	514.28	1172.48	89.64
1997 12	813.16	811.95							904.88	6.28	565.93	1358.14	104.93
1998 12	902.00	891.86							1052.86	7.71	656.72	1508.05	116.45
1999 01	950.00	916.45	1099.96							8.30	687.16	1572.96	122.67
03	1041.24	1019.63	1120.58							8.67	703.30	1689.93	134.37
06	1014.73	1008.06	1056.64							8.36	660.33	1608.35	130.81
09	1058.62	1052.28	1104.51							10.04	689.30	1737.09	136.29
12	1072.37	1070.43	1086.85							10.42	676.15	1734.56	137.99
2000 01	1087.61	1080.76	1065.97							10.17	661.87	1765.63	139.79
03	1090.00	1091.83	1065.15							10.20	670.60	1736.04	140.01
06	1065.00	1053.57	997.59							10.18	643.00	1598.62	136.69
09	1085.62	1084.14	957.25							10.05	628.98	1583.43	139.21
12	1097.00	1097.00	1006.61							9.74	659.53	1615.11	140.66
2001 01	1099.00	1097.77	1020.31							9.40	668.53	1611.46	140.91
02	1098.00	1098.99	993.42							9.43	648.28	1588.75	140.78
03	1097.00	1098.00	977.04							8.93	623.40	1563.83	140.66
04	1091.00	1092.95	985.34							8.80	640.71	1573.33	139.88
05	1095.00	1092.67	943.18							9.10	617.67	1548.06	140.39
06	1097.00	1096.00	936.51							8.82	616.15	1551.05	140.65
07	1098.00	1096.67	964.37							8.87	638.78	1567.23	140.77
08	1099.00	1098.43	1006.46							9.18	662.47	1591.08	140.90
09	1099.00	1099.50	1013.20							9.40	689.70	1607.60	140.90
10	1100.00	1099.57	982.90							9.00	666.80	1574.80	141.00
11	1100.00	1100.00	966.20							8.87	661.40	1545.60	141.00
12	1102.00	1101.29	973.60							8.39	657.30	1598.60	141.30
2002 01	1102.00	1102.00	964.50	104.50	494.20	3.90	30.20	238.10		8.18	675.00	1567.50	141.30
02	1104.00	1103.40	957.50	105.00	492.60	3.90	30.20	239.30		8.23	648.80	1572.90	141.60
03	1104.00	1104.00	971.70	108.00	498.10	4.00	31.30	238.30		8.34	664.70	1574.30	141.50
04	1104.00	1104.00	992.60	107.60	509.30	4.10	32.60	238.30		8.60	678.30	1606.20	141.50
05	1103.00	1103.35	1014.20	111.30	519.40	4.20	33.00	239.30		8.82	696.60	1603.00	141.40
06	1105.00	1104.00	1067.40	117.80	548.20	4.30	35.10	239.70		8.96	725.90	1657.30	141.70
07	1110.00	1108.38	1110.70	117.80	570.10	4.50	36.30	239.60		9.44	768.30	1753.00	142.30
08	1116.00	1113.23	1095.10	119.80	562.50	4.50	35.80	242.40		9.42	746.80	1711.40	143.10
09	1117.00	1116.05	1092.90	119.80	561.40	4.50	36.00	242.80		9.12	747.10	1738.00	143.30
10	1121.00	1119.00	1096.20	120.00	563.10	4.50	35.20	245.00		9.05	747.10	1742.60	143.70
11	1123.00	1122.22	1126.20	125.40	576.60	4.80	36.60	242.40		9.22	765.80	1777.30	144.00
12	1125.00	1124.09	1169.40	128.00	599.30	5.00	37.30	242.80		9.38	804.00	1804.00	144.30
2003 01	1132.00	1129.50	1224.70	133.20	626.20	5.00	39.00	210.40		9.54	833.50	1862.90	145.10
02	1138.00	1134.05	1228.50	135.10	628.50	5.00	38.70	204.30		9.72	840.10	1804.50	145.90
03	1140.00	1139.74	1219.30	132.10	625.30	4.90	38.30	198.40		9.48	824.50	1783.70	146.20
04	1134.00	1136.18	1243.70	136.10	638.90	5.10	39.50	193.00		9.45	826.00	1805.40	145.40
05	1130.00	1130.00	1328.80	145.30	682.80	5.40	42.40	189.40		9.51	871.00	1850.50	144.90
06	1139.00	1133.67	1302.20	142.20	669.20	4.90	41.30	188.90		9.53	844.60	1891.40	146.10
07	1153.00	1146.59	1318.50	143.50	677.40	5.00	41.30	188.20		9.62	852.00	1872.20	147.80
08	1154.00	1152.19	1255.20	136.30	644.80	4.90	38.70	187.60		9.86	816.20	1820.10	148.00
09	1159.00	1156.64	1321.80	147.90	678.60	5.20	41.80	188.50		10.40	857.80	1914.20	149.60
10	1165.00	1161.39	1306.30	151.10	698.50	5.30	42.40	189.60		10.78	876.00	1979.50	150.10
11	1171.00	1168.26	1397.60	154.90	716.30	5.20	43.60	190.00		10.72	903.10	2010.00	150.80
12	1168.00	1170.30	1460.20	160.60	746.50	5.60	44.90	188.80		10.92	935.70	2073.40	150.50

APPENDIX 7 (continued)

MARKET RATES — Togrog exchange rate against foreign currencies

End-of-period	RUB	CNY	KRW	CAD	AUD	THB	IDR	MYR	SGD	XAU	XAG	SDR
1993 12				298.28								549.62
1994 12	0.12	48.60		295.08								602.19
1995 12	0.10	56.94		347.61								708.53
1996 12	0.12	83.57	0.82	506.86								999.35
1997 12	0.14	98.21	0.49	567.27								1095.06
1998 12	42.65	108.96	0.74	582.16	547.97	24.73	0.11	237.68	543.18	257,761.60	4446.86	1271.24
1999 01	40.77	100.00	0.80	625.45	601.40	25.57	0.10	250.33	563.55	272,032.50	4849.75	1331.50
03	39.74	125.75	0.85	688.15	660.30	27.63	0.12	274.02	599.97	291,859.57	5692.56	1417.69
06	41.50	122.59	0.88	692.34	671.19	27.66	0.15	267.39	596.27	263,119.49	5346.59	1361.01
09	41.73	127.89	0.87	719.73	691.33	25.98	0.13	278.95	620.35	290,591.19	5853.91	1469.60
12	39.95	129.53	0.95	730.75	691.09	28.52	0.15	282.20	642.41	308,574.47	5651.60	1473.72
2000 01	38.01	131.38	0.97	753.01	694.17	28.92	0.15	286.21	636.36	307,521.73	5601.65	1482.71
03	38.44	131.66	0.98	745.20	666.37	28.89	0.15	287.62	635.05	310,541.00	5442.91	1459.80
06	37.81	128.67	0.95	717.95	632.34	27.26	0.12	281.02	614.86	301,288.50	5261.10	1417.14
09	39.01	131.13	0.96	729.56	594.97	25.46	0.12	285.69	621.78	295,994.29	5319.54	1407.44
12	39.18	132.52	0.89	720.81	608.56	26.10	0.12	288.68	634.84	300,358.60	5062.66	1426.96
2001 01	38.74	132.75	0.86	730.48	599.12	25.67	0.12	289.21	629.15	291,235.00	5297.18	1415.57
02	38.25	132.66	0.88	713.50	573.65	25.48	0.11	288.95	629.05	283,942.80	4864.14	1411.76
03	38.12	132.53	0.84	700.29	542.41	24.80	0.11	288.68	615.15	287,797.95	4771.95	1388.36
04	37.71	131.81	0.82	707.18	558.32	23.88	0.09	287.77	599.88	288,624.05	4800.40	1388.05
05	37.60	132.29	0.85	709.50	570.99	24.08	0.10	288.16	607.05	305,778.75	5026.05	1377.52
06	37.66	132.54	0.84	719.79	566.55	24.23	0.10	288.68	602.38	298,877.65	4760.98	1370.43
07	37.50	132.66	0.84	716.15	557.29	24.04	0.11	288.95	609.83	292,562.10	4677.48	1385.18
08	37.42	132.78	0.86	713.66	587.69	24.72	0.13	289.21	627.57	302,609.65	4654.27	1408.25
09	37.30	132.80	0.85	701.70	539.00	24.90	0.12	289.20	631.90	318,847.40	4951.00	1423.20
10	37.10	132.90	0.85	698.70	551.90	24.50	0.11	289.50	601.80	304,865.00	4647.50	1394.00
11	36.70	132.90	0.86	687.20	570.00	24.80	0.10	289.50	599.10	300,685.00	4477.00	1388.80
12	36.20	133.10	0.83	691.00	559.70	24.90	0.11	290.00	595.90	306,080.50	4937.00	1382.40
2002 01	36.00	133.10	0.83	687.30	572.40	25.00	0.11	290.00	600.10	307,733.50	4738.60	1373.50
02	35.70	133.40	0.84	693.20	567.60	25.20	0.11	290.50	602.30	324,410.40	4890.70	1374.80
03	35.40	133.40	0.84	699.60	585.90	25.40	0.11	290.50	603.50	324,024.00	4979.00	1384.40
04	35.40	133.40	0.85	705.60	601.40	25.50	0.12	290.50	610.80	339,866.40	5111.50	1397.30
05	35.20	133.30	0.88	716.60	612.10	25.70	0.12	290.30	612.90	353,621.80	5382.60	1414.30
06	35.10	133.50	0.91	723.10	634.20	26.30	0.13	290.80	623.20	358,075.30	5425.60	1438.70
07	35.20	134.10	0.94	706.70	599.10	26.70	0.12	292.10	631.40	343,656.00	5383.50	1484.90
08	35.30	134.80	0.93	718.50	618.20	26.40	0.13	293.70	638.00	348,192.00	5033.20	1473.70
09	35.20	134.90	0.91	708.90	609.40	25.70	0.12	294.30	628.30	357,998.50	5048.80	1474.50
10	35.30	135.40	0.91	715.90	622.30	25.80	0.14	295.40	631.40	350,312.50	4921.20	1471.70
11	35.30	135.70	0.93	712.10	632.10	25.90	0.12	295.50	634.70	357,619.40	5031.00	1493.90
12	35.40	135.90	0.94	720.60	634.90	26.00	0.13	296.10	647.60	393,187.50	5298.80	1519.20
2003 01	35.60	136.70	0.97	744.30	666.70	26.50	0.13	297.90	653.50	415,302.50	5433.60	1561.60
02	36.00	137.50	0.96	762.70	690.30	26.70	0.13	299.50	656.60	403,534.80	5325.80	1558.00
03	36.30	137.70	0.91	777.90	683.80	26.60	0.13	300.00	644.30	376,542.00	4993.20	1554.90
04	36.50	137.00	0.94	782.40	702.30	26.40	0.13	298.40	639.00	376,488.00	5182.40	1564.00
05	36.90	136.50	0.94	814.40	731.80	27.00	0.14	297.40	651.40	409,851.00	5231.90	1598.90
06	37.60	137.60	0.95	840.70	758.50	27.30	0.14	299.70	649.40	391,986.90	5159.70	1601.50
07	38.10	139.30	0.98	826.00	762.50	27.50	0.13	303.40	656.80	415,714.20	5903.40	1616.10
08	37.80	139.40	0.98	824.60	738.60	28.00	0.13	303.70	656.70	426,547.30	5908.50	1582.20
09	37.80	140.00	1.01	876.00	798.30	29.70	0.14	305.30	674.40	432,390.00	5684.00	1666.80
10	39.00	140.80	0.99	888.50	822.00	29.20	0.14	306.60	672.20	450,592.90	5999.80	1675.20
11	39.10	141.50	0.97	897.60	847.20	29.30	0.14	308.20	679.00	464,008.80	6253.10	1685.70
12	39.90	141.10	0.98	892.60	872.10	29.50	0.14	307.40	686.40	485,537.60	6926.20	1729.00

BALANCE OF PAYMENTS

in millions of dollar

	1995	1996	1997	1998	1999	2000	2001	2002	2003[1]
Current account	38.9	-36.9	68.0	-75.6	-57.8	-69.9	-61.7	-105.1	-98.7
Trade balance	-22.0	-87.4	30.2	-120.1	-112.9	-140.1	-169.9	-228.9	-199.6
Exports F.O.B	451.0	423.4	568.5	462.3	454.2	535.8	523.2	523.9	627.3
Of which: Copper concentrate	257.6	174.5	211.4	124.8	119.2	160.3	148.0	140.2	161.7
Non-monetary gold	-	52.4	117.0	117.2	95.9	69.7	74.7	117.6	157.3
Other	193.4	196.5	240.1	220.3	239.1	305.8	300.6	266.1	308.3
Imports C.I.F	-473.0	-510.8	-538.3	-582.4	-567.1	-675.9	-693.1	-752.8	-826.9
Service balance	9.2	-6.0	-2.1	-11.6	-14.2	-17.6	-22.2	-9.3	-49.1
Receipts	57.3	55.7	52.7	77.9	71.0	77.5	113.5	184.5	207.9
Payments	-48.1	-61.7	-54.8	-89.5	-85.2	-95.1	-135.7	-193.9	-257.1
Income, net	-25.4	-13.3	-12.0	0.4	0.1	-6.5	-2.0	-4.5	-11.5
Interest payments	0.0	-9.3	-9.4	-9.2	-6.2	-9.1	-8.8	-10.8	-11.9
Transfer, net	77.1	69.8	51.9	55.7	74.5	94.3	132.4	137.6	161.5
Private unrequited transfers	0.0	6.2	4.2	2.5	7.4	-4.3	25.0	64.4	74.3
Public unrequited transfers	77.1	63.6	47.7	53.2	61.8	98.6	107.4	73.2	87.2
Capital and financial account	-16.9	41.3	27.0	128.6	67.8	89.8	117.7	157.4	4.9
Medium and long term	32.3	72.0	104.3	124.1	122.4	136.4	131.6	180.1	29.6
Direct investment	9.8	15.9	25.0	18.9	30.4	53.7	63.0	77.8	131.5
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	50.0
Loan disbursements, net	22.5	56.1	79.3	105.2	92.0	82.7	68.6	102.3	-152.1
Of which: Disbursements	83.0	93.4	116.2	122.4	112.3	156.6	167.1	185.3	190.5
Amortization	-60.5	-37.3	-36.9	-17.2	-20.3	-73.9	-98.5	-83.0	-342.6
Short term	-49.2	-30.7	-77.3	4.5	-54.7	-46.6	-13.9	-22.7	-24.5
Commercial bank, net	-15.3	-9.3	-18.1	40.0	-17.7	-13.0	1.4	-8.7	-21.0
Non-banks	-33.9	-21.4	-59.2	-35.5	-37.0	-33.6	-15.3	-14.0	-3.5
Errors and omission	11.4	-26.9	-40.2	-51.4	30.9	-19.0	-41.3	14.2	-3.1
Overall balance	33.4	-22.5	54.8	1.6	40.9	1.0	14.7	66.5	-96.9
Financing	-33.4	22.5	-54.8	-1.6	-40.9	-1.0	-14.7	-66.5	96.9
Increase in net official reserves (-)	-33.4	16.6	-55.0	-5.6	-36.1	-1.0	-19.5	-66.5	96.8
Use of IMF credit	-10.7	-3.1	6.2	0.8	4.3	1.6	-1.7	-7.8	7.1
Arrears accumulation (+)/payments (-)	0.0	5.9	0.2	4.0	-4.8	0.0	4.8	-1.9	0.0
Exceptional financing (rescheduling)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Current account deficit (in %t of GDP)	5.2	-4.0	6.2	-7.8	-6.4	-7.2	-6.1	-9.4	-8.3
Gross official reserves	115.2	98.2	157.1	123.2	155.9	190.9	206.7	268.2	203.4
In weeks of imports	12.7	10.0	15.2	11.0	14.3	14.7	15.6	18.6	12.8

[1] Preliminary

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