



Independent Evaluation Office  
of the International Monetary Fund

# BACKGROUND PAPER

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## **Growth and Adjustment in IMF-Supported Programs for Asia and Pacific**

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**IEO Background Paper**  
Independent Evaluation Office  
*of the* International Monetary Fund

Growth and Adjustment in IMF-Supported Programs for Asia and Pacific

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**ABBREVIATIONS**

AQR	Asset Quality Review
BoM	Bank of Mongolia
BOP	Balance of Payments
DBM	Development Bank of Mongolia
EA	Extended Arrangement
ECF	Extended Credit Facility
EFF	Extended Fund Facility
FDI	Foreign Direct Investment
FSL	Fiscal Stability Law
GFC	Global Financial Crisis
GRA	General Resources Account
IFI	International Financial Institution
MCM	Monetary and Capital Markets, IMF
MEFP	Memorandum of Economic and Financial Policies
PRGT	Poverty Reduction and Growth Trust
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
TA	Technical Assistance
VAT	Value-Added Tax



# **CHAPTER 1. BANGLADESH**

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## EXECUTIVE SUMMARY

Restoring macroeconomic stability was the immediate priority under Bangladesh's 2012 three-year Extended Credit Facility (ECF) arrangement. Fiscal and monetary policies were tightened, and exchange rate flexibility increased. The reform agenda aimed to create more fiscal space and reinvigorate the financial sector. Introducing a value-added tax (VAT) to make a break from the low tax revenue and low capital spending nexus, and thus stimulate long-run growth, was a major policy objective.

Macroeconomic stability was restored sooner than expected. The macro policy framework and the balance between adjustment and financing were realistic and cautious. The near-term drag on growth from policy tightening was modest as the program required limited fiscal adjustment in light of the moderate level of government debt.

Although implementation of structural conditions was good, key program goals were not met. Fiscal governance improved but the VAT was not introduced until four years after the program ended and the tax-to-GDP ratio remains low. Financial repression was also curtailed but banking fragility persists in the post-program period.

Building on Bangladesh's impressive historical growth record, growth performance under the program was in line with expectations and has continued to do well after the program. A more stable domestic macroeconomic environment, strong exports, steady remittance inflows, and reduced infrastructure bottlenecks have aided growth.

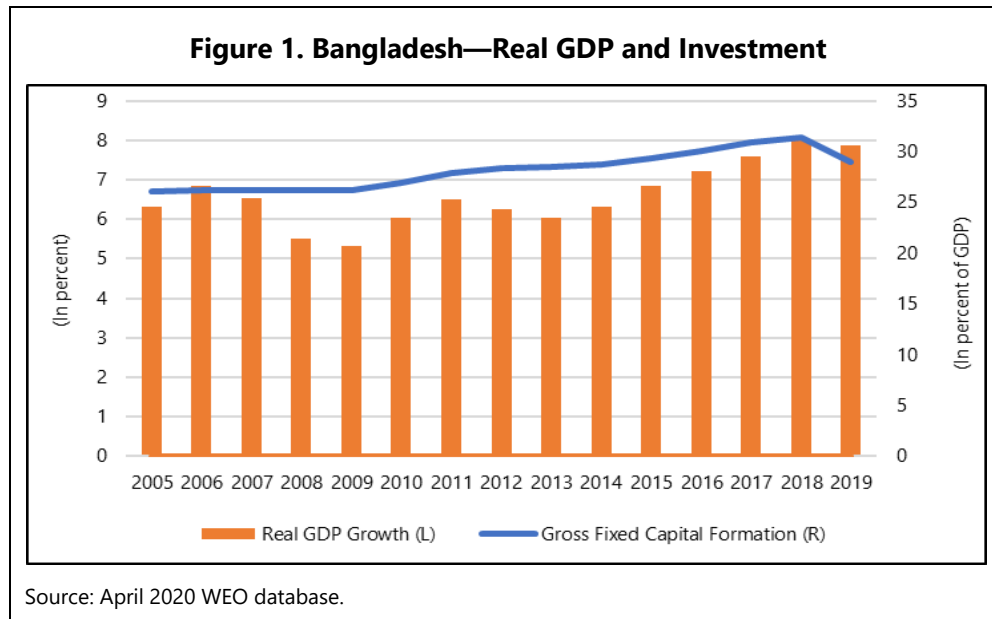
Key lessons include:

- (a) Complex reforms require effort to build a consensus and take time to implement. The program supported the authorities' ambitious intention to introduce a VAT, but implementation ran into domestic resistance. The program showed appropriate flexibility by recognizing that implementation may not fit within the limited timeframe of a program.
- (b) Other reform opportunities may have been missed. With staff resources focused on the VAT, some low hanging fruit to address medium-term impediments to growth and diversify the economy might have been missed during the program.
- (c) Contingencies for growth shortfalls should be integral to program design. Risk assessments and specification of policy contingencies for growth shocks were deficient at the start but improved during the course of the program.
- (d) An objective measure of progress in fostering inclusive growth would be valuable. For example, in addition to reporting overall growth, statistical systems should be developed so that growth at the 50<sup>th</sup> income percentile can also be reported.

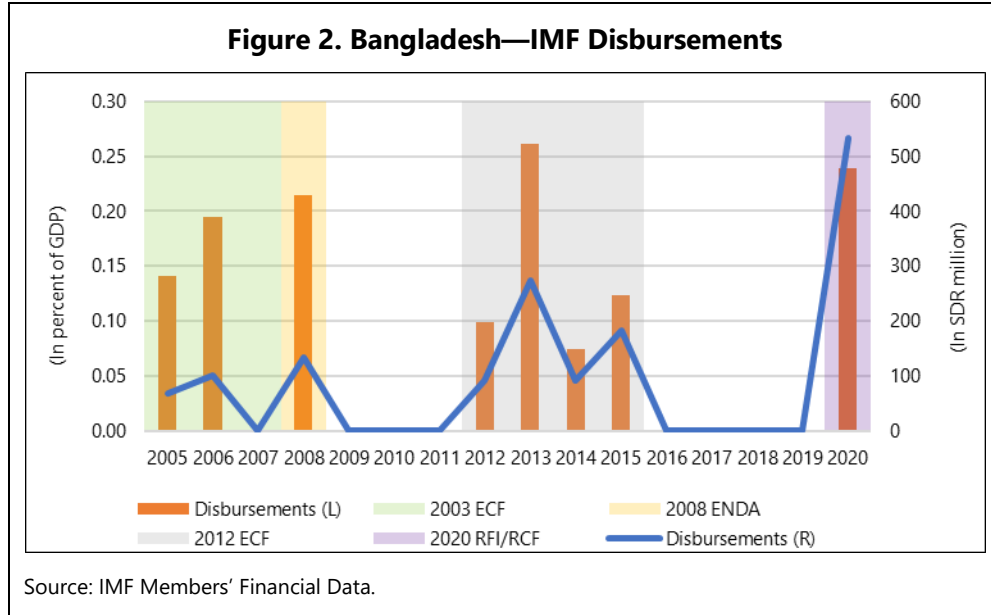


## I. INTRODUCTION

1. **Country overview.** Bangladesh is the world's eighth most populous country. Its economy has grown by 6¼ percent per year since 2000, equivalent to 5 percent per year per capita (Figure 1). Real GDP per person increased by two and a half fold between 2000 and 2019, propelling Bangladesh to lower middle-income status. Most social indicators have steadily improved. This strong growth record was achieved despite periods of political instability, poor infrastructure, insufficient power supply, and slow implementation of economic reforms. Almost half of Bangladeshis still work in agriculture, with rice being the most important product. Readymade garments dominate the industrial sector and account for about four-fifths of total exports. Extensive migration of labor to the Middle East and neighboring countries brings in substantial remittances. Strong export and remittance growth helped Bangladesh record small current account surpluses in most years from 2000 to 2016.



2. **IMF engagement.** Bangladesh is eligible for concessional financial support from the IMF under the Poverty Reduction and Growth Trust (PRGT). This case study centers on Bangladesh's Extended Credit Facility (ECF) arrangement approved in April 2012 and completed in October 2015 (Figure 2). The ECF arrangement aimed for sustained engagement to address balance of payments problems and support policies to promote growth and reduce poverty. Bangladesh's previous IMF arrangement, also an ECF, covered the period June 2003 to June 2007. In all, Bangladesh has had 10 IMF arrangements since becoming a member in 1972, the first 8 of which were between 1974 and 1993. In May 2020, Bangladesh received a disbursement of US\$732 million under the Rapid Credit Facility (16.67 percent of quota) and Rapid Financing Instrument (33.33 percent of quota) to help address the economic impact of the COVID-19 pandemic.



## II. CONTEXT

3. **Backdrop to the 2012 ECF arrangement.** Bangladesh's economy initially held up well in the aftermath of the 2008 global financial crisis. Despite global uncertainty, growth decelerated only modestly from the fast pace before the crisis, supported by resilient garment exports, more reliable electricity supply, and consumption-boosting remittance inflows. Strong remittances, buoyant exports and weak imports also raised the current account surplus to 2½ percent of GDP in FY09 (July 2008–June 2009). Gross reserves doubled to US\$10 billion in the year to November 2009, raising reserve coverage to 4.8 months of prospective imports, a 15-year high. Notwithstanding these achievements, however, Bangladesh seemed stuck in a low revenue and low capital spending equilibrium, infrastructure bottlenecks held back growth, and progress on structural reforms was mixed. Notably, Bangladesh's tax revenues amounted to only about 8 percent of GDP on average during 2008–2011. During Article IV consultation discussions in the run-up to the 2012 ECF arrangement, IMF staff and the authorities agreed on the importance of raising the revenue ratio to finance government capital spending needed to boost medium-term growth and living standards.

4. **Intensifying macroeconomic pressures.** Macroeconomic pressures began to intensify from late 2010. Fiscal pressures emerged because of rising subsidy costs, mainly due to rising fuel consumption. Inflation hit a multi-year high of 11½ percent in 2011, with demand pressure and fuel price increases being major drivers. The balance of payments came under strain because of the increased demand for oil and capital goods imports (related to rising public investment to tackle power, transport, and water supply bottlenecks) and elevated commodity prices. The combination of the negative terms of trade shock, rising oil imports, and accommodative policies led to a significant decline in reserves.

5. **Discussions leading to the ECF request.** As global headwinds and increasing oil prices accentuated these pressures, the main message of the 2011 Article IV consultation (discussed by the Executive Board in October 2011) was that without policy adjustments and additional external support, further anticipated reserve losses would heighten vulnerability to external shocks and increase the risk of a payments crisis. The 2011 Article IV consultation discussions were a continuation of an ongoing dialogue, which had begun in late 2010, on a possible IMF-supported program.

- On the macroeconomic front, policy discussions focused on upfront actions needed to reduce these pressures. Recommendations included reducing subsidy costs to achieve fiscal targets for 2012 and contain the budget's domestic financing requirement; minimizing central bank financing of the budget to allow the envisaged monetary tightening to be transmitted to the real economy; and continuing with the recent switch to greater exchange rate flexibility to relieve external pressures.
- On the structural front, further reforms to tax policy and administration, public financial management, monetary and exchange rate operations, the financial sector, and the trade and investment regime were advocated to bolster growth and poverty reduction efforts and reduce external vulnerability.

These policy discussions culminated in a request for a three-year ECF arrangement amounting to US\$1 billion or 120 percent of quota, which was approved by the Executive Board in April 2012.

6. **Political situation.** The Awami League Party, led by Sheikh Hasina, has been in office since January 2009. Political tensions intensified about nine months into the ECF arrangement. Frequent nationwide strikes (*hartals*) and episodes of violence started in February 2013 in the lead up to national parliamentary elections, which were due by January 2014. The protests were spurred by war crimes verdicts (associated with the 1971 war of independence) against the leaders of two main opposition parties and political gridlock over establishing a neutral caretaker government to oversee the election period. The blockades, violence and political uncertainty took a toll on the economy, but a loss of confidence in the currency or the financial sector was avoided. The main opposition alliance boycotted the January 2014 elections and the ruling Awami League won by a landslide with low voter turnout. Although the opposition called for fresh elections and vowed to resort to nationwide strikes if its demands were not met, relative calm and stability were restored for the remainder of the ECF arrangement.

### III. PROGRAM DESIGN

7. **Program objectives.** The program aimed to restore macroeconomic stability, build an adequate reserve buffer and strengthen the external position, and promote higher and more inclusive growth. Helping Bangladesh make a break from the nexus of low tax revenue, low capital spending, and low investment was a critical goal. To this end, the authorities committed to take action to create more fiscal space and reinvigorate the financial sector, thus catalyzing

additional resources to boost social and development-related spending and tackle power shortages and the infrastructure deficit. This, in turn, was expected to stimulate export-oriented investment and job growth.

8. **Main policy components.** Under the ECF-supported program, the main components were upfront fiscal and monetary tightening measures buttressed by greater exchange and interest rate flexibility; sound debt management; and reforms in the areas of tax policy and administration, public financial management, and the financial sector. Longer-term measures to liberalize the trade and investment regime were also envisaged.

9. **Fiscal tightening.** The below-cost provision of fuel and electricity against the backdrop of rapid expansion of oil-dependent power generation created substantial fiscal pressure (in addition to its other distortive effects), leading to a surge in government domestic borrowing in the first half of FY2012.<sup>1</sup> The authorities aimed to tighten fiscal policy to limit the FY2012 overall fiscal deficit (excluding grants) to 4½ percent of GDP—about the same level as in FY11 but modestly below what had been originally budgeted for FY2012—by implementing a range of measures to contain subsidy-related costs and reduce nonessential spending. The program sought moderate fiscal consolidation to reduce the overall deficit (excluding grants) by 1 percentage point to 3½ percent of GDP by FY2015; the primary deficit was programmed to narrow to 1.6 percent of GDP in FY2015 from 2.3 percent of GDP in FY2012. These targets were to be met by increasing the tax-to-GDP ratio through the introduction of a value-added tax (VAT) and containing subsidy costs through greater pass through of energy and fertilizer costs to end users, while putting in place safeguards for vulnerable groups. As revenue reforms were expected to take time to yield results (see below), the bulk of fiscal adjustment was back loaded.

10. **Monetary tightening and exchange rate flexibility.** Accommodative monetary policy coupled with expansionary fiscal policy and inadequate exchange rate flexibility had contributed to inflation pressure and reserve losses. Tightening measures were aimed at limiting growth of the central bank's net domestic assets and reserve money, while at the same time providing room for adequate private sector credit growth. Bangladesh Bank also committed to allow interbank foreign exchange transactions at market-determined rates, with intervention limited to smoothing short-term volatility. The goal was to reduce aggregate demand pressure, stabilize inflation expectations, and gradually rebuild reserve buffers.

11. **Structural reforms.** The structural reform agenda concentrated on public finances and the financial sector and aimed to lay the foundations for future growth.

- (i) A new VAT law, which had been approved by Cabinet as a prior action for program approval, and the steps needed to implement the VAT, was the centerpiece reform under the program. The IMF provided substantial technical assistance as the VAT was seen not only as essential to increase the tax-to-GDP ratio and create space for vital

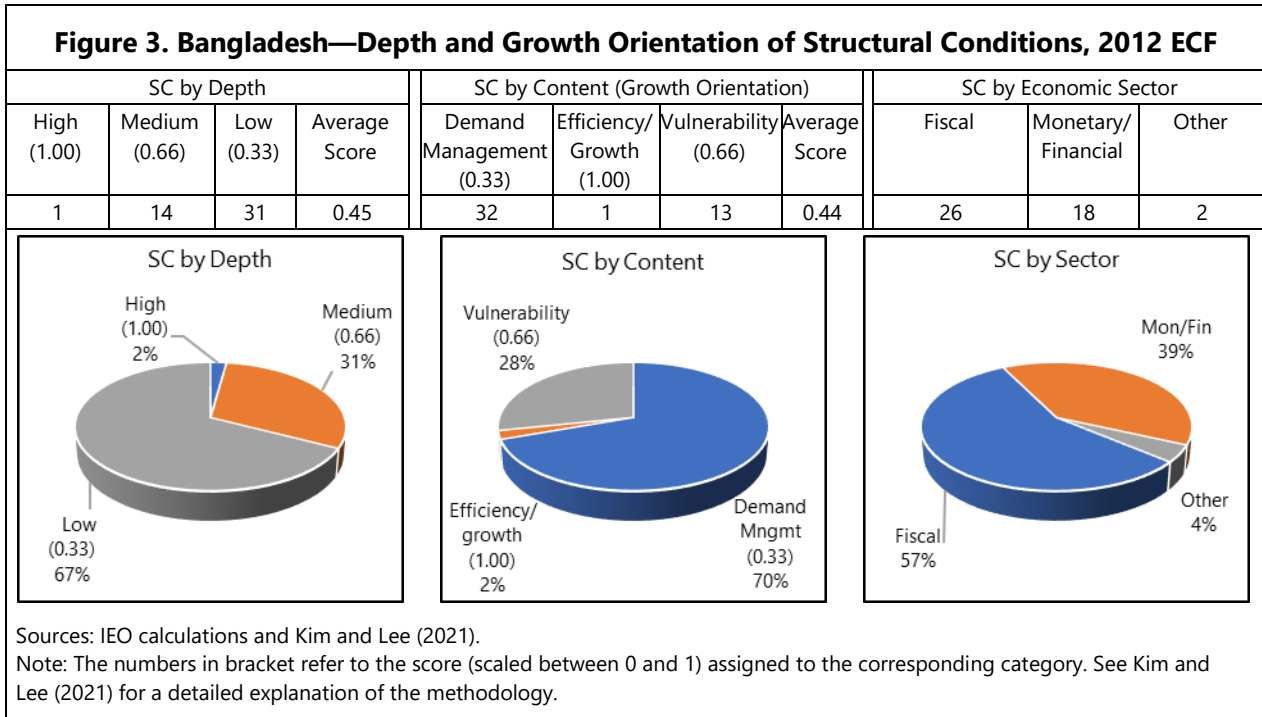
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<sup>1</sup> The Bangladesh fiscal year runs from July to June.

developmental spending, but also as an opportunity to usher in a modern tax regime built around transparency and efficiency.

- (ii) Other fiscal reforms sought to contain fiscal risks and strengthen governance by containing budget transfers and subsidy costs, improving public financial management and controls (including for the largest state-owned enterprises), and strengthening strategic planning and debt management.
- (iii) In the financial sector, policies aimed to strengthen bank governance and oversight, requiring amendments to the Bank Company Act. The program also sought to improve Bangladesh Bank’s supervisory capacity and enforcement to help it manage systemic risks, particularly those posed by state-owned commercial banks.
- (iv) The program also envisaged rationalizing trade barriers and improving the investment climate, relying on the expertise of the World Bank and the International Finance Corporation.

12. **Analysis of structural conditionality.** The depth, growth orientation and sectorial content of structural conditions in Bangladesh’s 2012 ECF arrangement are shown in Figure 3. Bangladesh’s average score of 0.44 for the growth orientation of structural conditionality is in line with the median for other PRGT countries.<sup>2</sup> For the depth of structural conditions, however, Bangladesh’s average score of 0.45 is somewhat below the median of 0.52 for other PRGT countries.



<sup>2</sup> See Kim and Lee (2021) for details about the analysis of structural conditionality in IMF-supported programs.

13. **Technical assistance.** A number of critical technical assistance (TA) and capacity building requirements were identified to support these policy efforts, to be supplied by the IMF and other development partners. The IMF provided TA in a range of areas, notably tax reforms and VAT implementation; public cash management, fiscal reporting, and subsidy reform; monetary policy operations; bank supervision and central bank accounting; and statistical methods. The World Bank Group focused on revenue administration and tax reforms; public financial management, social safety net, and vulnerability monitoring; central bank strengthening and financial sector reform; and statistical policy. The Asian Development Bank also supported revenue administration and was involved in building an operational framework for public-private partnerships and capital market development.

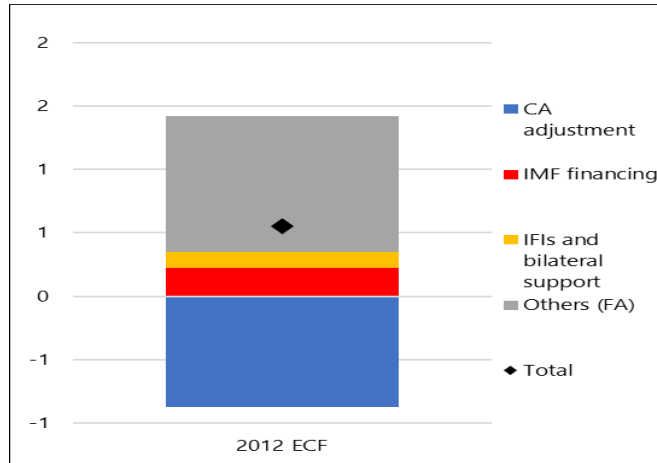
14. **Program modalities and financing.** The program included six semi-annual reviews based on quantitative targets and structural benchmarks. The relatively high access of 120 percent of quota was determined by the strength of envisaged reforms and the assessment of financing needs and was also guided by the norm of ECF arrangements for countries with outstanding concessional IMF credit of less than 100 percent of quota.<sup>3</sup> Seven equal disbursements, beginning with program approval, were envisaged. The gross financing requirement over the program period was projected to be US\$19 billion, of which IMF resources would cover US\$1 billion (Figure 4). Most of the rest of the external financing requirement was to be met by (i) multilateral and bilateral agencies (US\$11.4 billion), led by the World Bank Group, Asian Development Bank, and Japan International Cooperation Agency, mainly as project-based lending; and (ii) FDI (US\$4.7 billion; Figure 5).

15. **Balance between financing and adjustment.** Bangladesh's balance of payments need was small (0.6 percent of GDP, annual) in comparison to other PRGT programs studied in this evaluation (8.8 percent of GDP, annual). Furthermore, compared to other PRGT programs, Bangladesh's ECF arrangement tilted substantially more toward financing than planned current account adjustment to meet balance of payments needs (see Figure 4). On the financing front, as with other PRGT cases, the IMF played a catalytic role in attracting FDI and financing from other IFIs and bilateral donors. At the time the program was designed, the current account deficit for FY2012 was projected to be 1.1 percent of GDP, a deterioration of 3½ percentage points from the surplus of 2.4 percent of GDP in FY09. Over the same period, gross official reserves fell by 10 percent to about US\$9 billion (2.4 months of imports) at end FY2012. Under the program, the current account was projected to be broadly back in balance by FY2015, helped by moderate growth of remittances and with export growth benefitting from a rebound in global economic activity and the supply-side response to improved infrastructure, together with greater export-oriented FDI. Reserves were programmed to reach US\$15.5 billion by end FY2015 (nearly three months of import cover), a level that would strengthen the buffer against external shocks and align with the prevalent metrics on reserve adequacy.

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<sup>3</sup> At the time the ECF was approved in 2012, the annual PRGT access norm was 50 percent of quota.

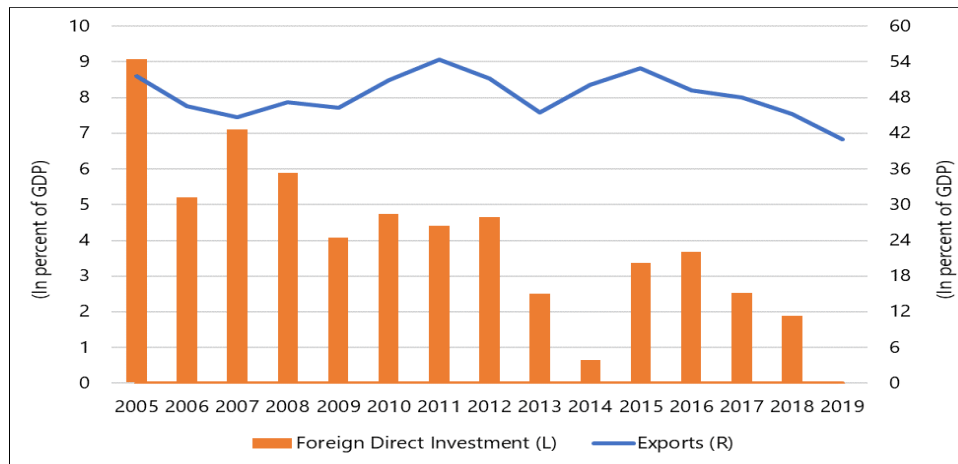
**Figure 4. Bangladesh—BOP Need Decomposition  
(In percent of GDP, Annual)**



Sources: IEO calculations and Kim and others (2021).

Note: See Kim and others (2021) for a detailed explanation of the methodology.

**Figure 5. Bangladesh—Foreign Direct Investment and Exports**



Sources: April 2020 WEO database; FFA database.

16. **Program design and the growth outlook.** Growth was forecast to slow to 5½ percent in FY2012, a percentage point lower than the average of the previous two years. The staff report for the request for the ECF arrangement stated that, “*In the design of the first year of the ECF-supported program, macro-policy tightening has been weighed against the uncertain global environment, with the balance of risks pointing to the need to contain demand-side pressures despite the anticipated growth slowdown*” (paragraph 6). Under the program baseline projections, GDP growth was expected to rise to 7 percent by FY2015, about 1 percentage point above the average historical growth record for 2000 to 2011. This outlook was premised on the

policies in train to restore macroeconomic stability, create fiscal space, and enhance financial intermediation. These policies were expected to catalyze resources to augment social and development-related spending and durably reduce power and infrastructure constraints, thus supporting growth. Program documents also emphasized the importance of increasing skill levels and creating new jobs to take advantage of Bangladesh's favorable demographics and proximity to major regional markets.

17. **Inclusive growth and social spending.** Original program documents (namely, the staff report for the ECF request and the authorities' MEFP) had several references to generating "higher and more inclusive growth," which was Bangladesh's key development objective. The following elements to promote inclusiveness were emphasized during the course of the program:

- First, greater priority for high-return projects—notably for infrastructure (roads, bridges, and ports; electricity generation, transmission, and distribution) and health and education networks—in support of poverty reduction.
- Second, policies to foster financial inclusiveness to achieve higher growth with greater equity. As a pioneer in microfinance, Bangladesh had already made considerable progress in financial inclusion over the previous few decades, but broader efforts in this area—including, for example, agricultural credit policy that gives priority to marginal farmers, underdeveloped areas in the country, and women—were envisaged in the Sixth Five Year Plan (FY2011–2015).
- Third, implementing measures to strengthen labor and safety standards, particularly in the ready-made garments industry. For example, the Labor Act was amended in July 2013 to improve safety standards and workers' collective bargaining rights. And the minimum wage for garment workers was increased in November 2013.
- Fourth, the program aimed to safeguard social spending and safety nets. To ensure adequate budgetary provision for social spending during the program period, a floor on such spending was set as an indicative target to monitor performance. The authorities also aimed to develop better-targeted subsidy schemes focused on safeguarding the poor, with financial and technical assistance from the World Bank. Assistance from the World Bank included development of a national poverty database to guide the formulation of conditional transfers and assistance-for-work programs.

18. **Risk assessment and contingencies.** At the stage of program approval, four risks were identified. First, there was limited scope to relax fiscal or monetary policy in the event of adverse real shocks, given heightened inflation and reserve losses. Second, a further rise in world oil prices could jeopardize the program's fiscal and reserve targets, necessitating additional policy adjustments (for example, adjustments to fuel, electricity, and fertilizer prices) and external support. Third, a less stable political environment in the run-up to elections in early 2014 could slow adjustment and reforms and weaken support for the program. And fourth, weak



implementation capacity and governance issues could slow the pace of reform. These concerns were to be addressed through extensive policy consultations with civil society and IMF team and sizable technical assistance (see paragraph 13 above), as well as safety net reform. As the program progressed, the discussion of risks strengthened to include a more thorough discussion of the policy response to downside risks. Notably, the November 2013 staff report for the third review (paragraph 14) stated that:

*"In case of temporary shocks, such as an intensification of election-related turbulence, reserve buffers could be used through sterilized intervention to finance the shock, smooth currency volatility, and avoid a sharp monetary tightening. In case of adverse shocks of a more prolonged nature, such as a sustained trade shock, the exchange rate should be allowed to adjust, and [Bangladesh Bank] should be prepared to tighten monetary policy to support the currency and contain pass-through effects from exchange depreciation to domestic inflation, while ensuring an adequate supply of liquidity to the markets. These policies should be complemented with moderate fiscal easing, including the expansion of well-targeted safety net schemes to protect the most vulnerable."*

19. **Country ownership and political economy of reform.** Program ownership by the country authorities was strong. The key officials, especially in Bangladesh Bank and the Ministry of Finance, recognized the benefits of their policy commitments and made their best effort to deliver. In interviews, current and former Bangladeshi officials emphasized that key initiatives were home grown and then refined based on a productive dialogue with IMF staff and that the IMF did not impose policies on the country. The introduction of a VAT was the most controversial reform under the program, but even this policy originated from Bangladesh's own reform agenda linked to the government's objective to raise the tax-to-GDP ratio. However, as discussed in greater detail in the next section, this centerpiece reform met with substantial resistance from the business community and lower level officials in the National Revenue Board, who preferred the existing indirect tax system because it gave them considerable discretion. Other reforms, including in the financial sector, were less controversial and did not attract undue political resistance. Although there were intense political tensions in the lead up to the January 2014 elections, economic issues were not at the fore in these conflicts. Nevertheless, these tensions diverted the authorities' attention and limited their room for maneuver on the economic front.

#### IV. PROGRAM IMPLEMENTATION AND OUTCOMES

20. **Evolution of the program and completion of reviews.** The first four semi-annual reviews were completed close to the originally envisaged timetable, with minimal modification to the design of the program. Completion of the fifth review was postponed in October 2014, as the authorities needed more time to finalize key actions for implementation of the new VAT. With the ECF arrangement originally expiring in April 2015, the fifth review and final sixth review were combined and the arrangement was extended first to July 31 and then to October 31, 2015. All disbursements were made. Notwithstanding these delays, various setbacks (discussed in greater detail in paragraph 22 below) pushed the planned VAT implementation date to after the end of

the program. As the VAT was a policy priority under the program and was backed by substantial technical assistance, completion of the final reviews under the program in these circumstances was controversial within the IMF (namely, the interdepartmental review process, management, and the Executive Board).

21. **Easing of macro pressure and external imbalances.** Strong macroeconomic stabilization gains were achieved by the midpoint of the program, sooner than had been expected (Figures 6, 7, and 8). Although domestic risks associated with political uncertainty were high, external conditions and supply-side developments were benign. These macroeconomic gains were solidified in the second half of the program. Specifically:

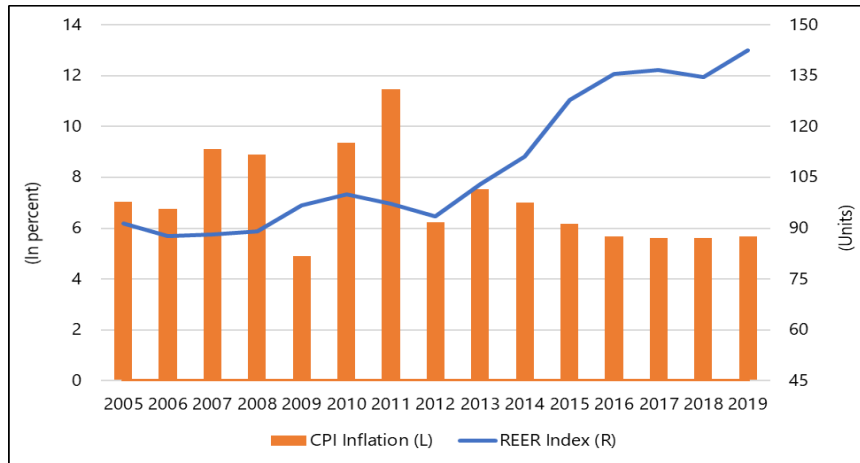
- By the third quarter of 2013, nonfood (core) inflation had fallen to 6 percent from about 12 percent at the start of the program. International reserves rose to almost 4½ months of prospective imports from 2½ months at the start of the program. Exchange rate management improved as intervention focused on preserving reserve cover and mitigating excessive currency volatility, and the real effective exchange rate (REER) was assessed to be in line with fundamentals.<sup>4</sup> In the second half of the program, however, the REER appreciated sharply as the U.S. dollar gained strength globally, but international reserves continued to rise (outperforming program performance criteria) on the back of aid-financed inflows and small, but growing, private capital inflows. Despite the appreciation, there was no clear evidence of misalignment or lack of competitiveness as Bangladesh retained a significant labor cost advantage over competitors.
- Fiscal tightening had started before the arrangement was approved, aimed at limiting the budget deficit (excluding grants) to 4½ percent of GDP in FY2012. At the time of the first review of the program in February 2013, it was estimated that the FY2012 deficit was a ½ percentage point of GDP less than envisaged at the start of the program. Progress was made in curbing poorly targeted energy subsidies and there was a small improvement in tax revenue collection, leading to the over-performance. For the remainder of the program, fiscal consolidation was limited, focusing on holding the line on the deficit, preserving space for social and development spending, improving the structure of the budget, and keeping government debt stable, rather than seeking a reduction in the deficit. Table 1 compares the program projection of the overall fiscal balance (excluding grants) at start of the ECF arrangement with the outturn, although the comparison is complicated by the introduction of a new GDP series in 2014 that increased the level of nominal GDP in FY2012 by 15½ percent compared to the previous series.

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<sup>4</sup> The 2015 Article IV Consultation staff report (Box 1 on “External Sector Assessment”) states that “The *de jure* exchange rate arrangement is classified as floating, but BB intervenes in the foreign exchange market to keep the exchange rate relatively stable against the US dollar.”

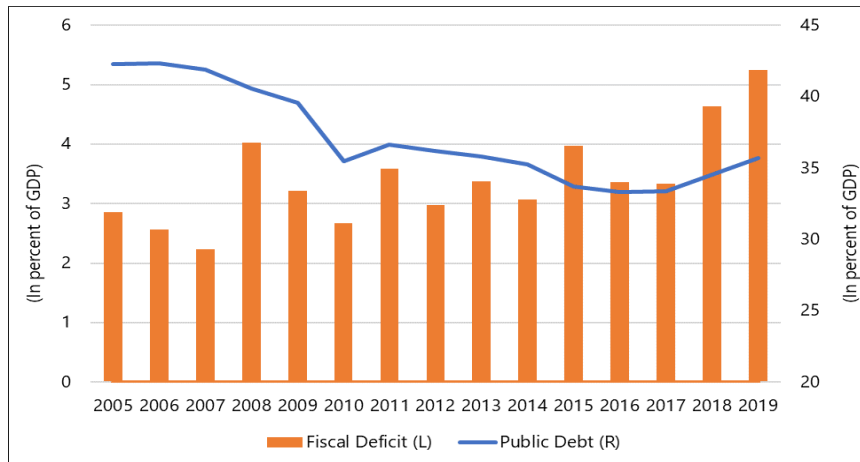
- Central government debt fell to 34 percent of GDP in FY2015, down 10 percentage points from FY2012, although some of this fall was due to the introduction of a new GDP series as noted above.<sup>5</sup>
- The current account surplus averaged 1¼ percent of GDP over the four years FY2012 to FY2015, substantially better than the projected average deficit of 0.6 percent of GDP envisaged at the start of the program.

**Figure 6. Bangladesh—Inflation and Real Effective Exchange Rate**



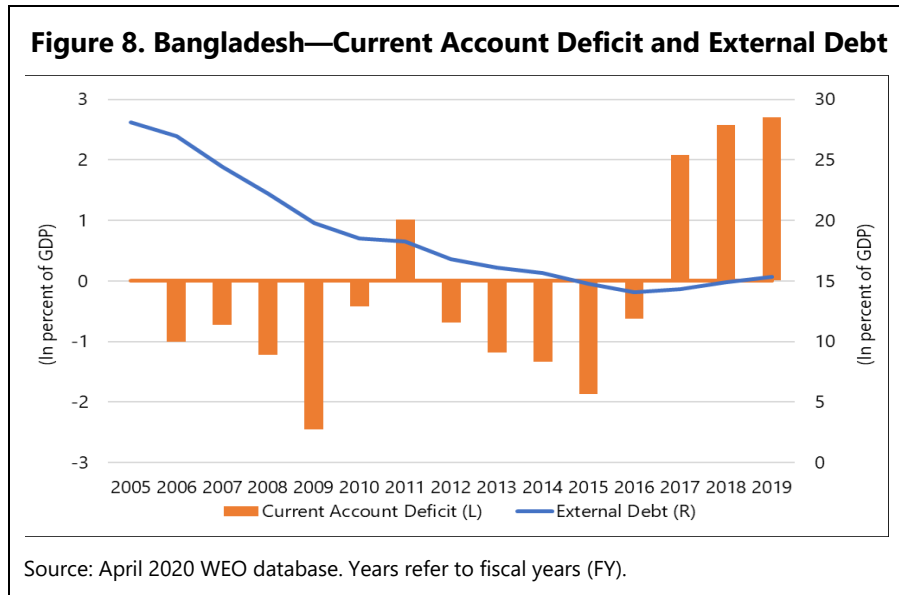
Sources: April 2020 WEO database; INS database.

**Figure 7. Bangladesh—Fiscal Deficit and Public Debt**



Source: April 2020 WEO database. Years refer to fiscal years (FY).

<sup>5</sup> Based on the old GDP series, central government debt fell from 43.9 percent of GDP in FY2012 to 40.6 percent of GDP in FY2013. When the new GDP series was introduced, FY2013 debt was revised down to 34.5 percent of GDP, falling further to 34 percent of GDP by FY2015.



**Table 1. Bangladesh—Overall Fiscal Balance: Program versus Outturn  
(In percent of GDP)**

	FY2012	FY2013	FY2014	FY2015
Program projection	- 4.5	- 4.3	- 3.8	- 3.5
Outturn <sup>1</sup>	- 3.0	- 3.4	- 3.1	- 4.0

Sources: IMF Country Report No. 12/94, *Request for a Three-Year Arrangement Under the Extended Credit Facility* (April 2012); and IMF World Economic Outlook.

<sup>1</sup> Based on revised GDP series from FY2013.

22. **Above-average structural reform implementation.** Bangladesh's compliance with structural conditionality was as follows: 81 percent of structural conditions were met as scheduled; 4 percent were met with some delay; and 15 percent were not met. This degree of compliance compares well with the program countries analyzed in the 2018 Review of Conditionality, where the corresponding medians for PRGT and PRGT/GRA blended programs were 69 percent met on schedule; 12 percent met with delay; and 19 percent not met. The structural reform agenda under the program fell into four broad categories, with varying degrees of implementation and results across these categories. Specifically:

- Improving tax policy and administration.** The centerpiece reform in this area was a new VAT law and the steps needed to implement the VAT. The plan was to implement the VAT during the course of the program. Progress was made, including the enactment of the VAT law in 2012 and defining the policy and technical actions to implement the VAT. But some structural benchmarks—for example, related to the procurement of software and a project management consultancy—were not met or met with delays. More fundamentally, however, the private sector opposed the VAT and vested interests sought a lower standard rate and multiple rate bands, which went against IMF advice. The political system was not strong enough to push back against these vested interests. The stalemate was not

resolved, and the VAT was not implemented during the course of the program. The VAT was eventually implemented in July 2019, almost four years after the end of the program, with multiple rate bands and a high threshold for VAT registration.

- **Reducing fiscal risks.** Reforms to strengthen fiscal governance and reduce risks were wide ranging and included containing budget transfers and subsidy costs (for example, by containing the wedge between international and domestic fuel prices); strengthening financial management of the largest state-owned enterprises; improving budget monitoring and controls; strengthening domestic and external public debt management; and reinforcing public financial management. Observance of prior actions and structural benchmarks in these areas was generally good and overall progress was satisfactory.
- **Making the financial sector more responsive to growth-critical financing needs.** Supported by TA from the IMF and other partners (see paragraph 13), reforms were implemented to reduce financial repression by increasing interest rate flexibility and deepening financial markets; strengthen central bank internal operations and controls; increase transparency and safeguard foreign reserves; strengthen banking system soundness and regulations; improve risk management and improve bank governance; deepen capital markets; and reduce systemic risks. Observance of prior actions and structural benchmarks in these areas was generally good, with only a few that were met with delays or rescheduled. Yet, at the end of the program, asset quality problems, especially in state-owned commercial banks, remained endemic; bank profitability remained poor; and directed lending still prevailed. Beset by poor governance and weak oversight and enforcement despite the reforms implemented under the program, banking sector fragility persists in the post-program period.
- **Reducing trade and investment barriers.** The program also envisaged rationalizing trade barriers and improving the investment climate, relying on the expertise of the World Bank and the International Finance Corporation; these policies received little attention from IMF staff during the program. Progress was made in just one area—rationalizing regulations for foreign exchange current account transactions.

23. **Growth forecast and actual outturn.** The program had envisaged that growth would slow to 5½ percent in the first year and then recover to about 6½ to 7 percent per year (Table 2). In the event, GDP growth remained healthy, averaging 6.1 percent (6½ percent in per capita terms) in the first two years of the program. For FY2012 to FY2015, the four years spanned by the program, the ex ante cumulative growth forecast was 27.8 percent. Ex post actual cumulative growth over these four years was virtually identical at 27.9 percent, suggesting that program growth forecasts were not biased toward optimism. Since the program ended in 2015, growth has been in the range of 7 percent to 8.2 percent per year before the outbreak of the COVID-19 pandemic, among the fastest in Asia and about 3 percentage points above the emerging markets average. However, despite the stated goal of fostering not just faster but also “more inclusive

growth,” program and surveillance documents do not provide an objective measure of progress on this front other than a reduction in the overall poverty rate.

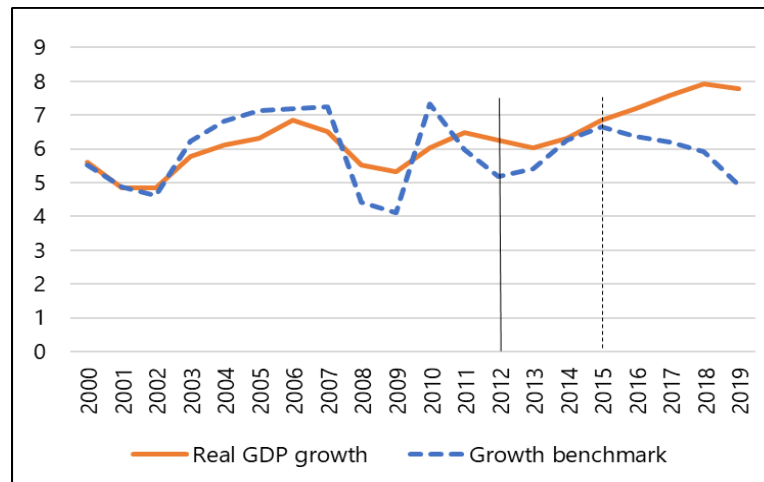
**Table 2. Bangladesh—Growth: Program versus Outturn  
(In percent)**

	FY2012	FY2013	FY2014	FY2015	Cumulative FY2012 to FY2015
Program projection	5.5	6.2	6.6	7.0	27.8
Outturn	6.3	6.0	6.3	6.8	27.9

Sources: IMF Country Report No. 12/94, *Request for a Three-Year Arrangement Under the Extended Credit Facility* (April 2012); and IMF World Economic Outlook.

24. **Actual growth versus benchmarks.** Bangladesh’s growth performance during the ECF arrangement exceeded the growth benchmark estimated by the IEO using a panel regression which relates growth to external factors alone.<sup>6</sup> Figure 9 shows the evolution of actual real GDP growth and benchmark growth over the period 2000 to 2019; the solid and dashed lines in this figure denote the starting and ending date of the ECF arrangement. The figure shows that actual growth exceeded the estimated benchmark during the ECF arrangement and that this overperformance increased further during the post-program period.

**Figure 9. Bangladesh—Growth versus Benchmark**



Source: IEO estimates.

Note: See Kim and others (2021) for a detailed explanation of the methodology.

<sup>6</sup> The external factors in the panel regression include terms of trade changes, trading partner’s growth, US interest rates, regional growth and a dummy for the global financial crisis. For technical details regarding the econometric analysis used to estimate the growth benchmarks see Kim and others (2021).

25. **Growth resilience.** Several factors have contributed to Bangladesh’s impressive growth record notwithstanding some shortfalls in reform implementation. First, quick stabilization of the macroeconomic situation allowed Bangladesh to continue to take advantage of its low-cost labor and favorable demographics to drive economic activity. Second, exports of ready-made garments were strong, with the added benefit that manufacturing these garments brought women into the formal labor force. Third, remittances supported consumption and small-scale investment, including in the agricultural sector. Both exports and remittances benefitted from improved global economic conditions. And fourth, progress was made in addressing infrastructure bottlenecks to growth, especially in the power and transport sectors. These positive factors outweighed the dampening effect of political uncertainty and strikes on economic activity during the program period. A growth accounting exercise conducted for the 2018 Article IV consultation concluded that going forward, contributions from the labor force and productivity are expected to be modest, leaving capital formation to be the main growth driver in the future. The policy priorities identified to effectively mobilize long-term capital for investment included: (i) making the financial sector more efficient by reforming the banking sector and developing capital markets; and (ii) raising tax revenue to create fiscal space to upgrade infrastructure, such as electricity, roads, rail and ports. In turn, effective implementation of such policies can be expected to improve the business environment, attract FDI, and diversify exports.

## V. AUTHORITIES AND STAFF’S PERSPECTIVES

26. **Program design and growth.** The authorities and staff were in full agreement that the restoration of macroeconomic stability was the appropriate immediate priority under the ECF arrangement. Demand pressures were high and reserve losses were mounting. The common view was that unless macroeconomic stability was restored, maintaining Bangladesh’s impressive growth record would be elusive. The near-term drag on growth from policy tightening was expected to be modest because of the limited fiscal adjustment required and the underlying strength of the private sector. In interviews, Bangladeshi representatives and staff noted their preference to err on the cautious side for growth projections, recognizing that it would take time for the program to show tangible growth results and also because the external environment remained uncertain. As noted in the previous section, macroeconomic stability was restored quickly in response to the policy tightening, adjustment objectives were met, and growth was resilient.

27. **Authorities’ appreciation for key elements of the program.** The authorities were particularly appreciative of four features of the program’s design and its support for growth in the medium-to long run:

- First, Bangladesh did not have a history of high fiscal deficits and the level of government debt was not dangerous. Therefore, the authorities viewed the program’s moderate fiscal consolidation as appropriate to keep public finances on a stable footing, while also aiming to maintain monetary and financial stability.

- Second, the program focused on creating more fiscal space by raising the revenue-to-GDP ratio and reducing excessive subsidies. The authorities noted that creating fiscal space was central to their own agenda because they saw this as essential to generate resources to meet the government's development objectives, especially fostering stronger growth. In the event, progress during the program period was disappointing, but this reflected domestic political and business resistance rather than lack of policy or technical support from the IMF.
- Third, the program protected 10 mega public investment projects (in areas such as transport, ports, and power generation) that were underway at the start of the program, despite the associated strain on public finances and the current account. Nevertheless, given the importance of these projects to promote faster and more inclusive growth, the authorities were grateful that they were incorporated into the fiscal program. They noted that project execution may have fallen short of goals, but this was not due to efforts to meet fiscal objectives by reducing capital outlays.
- Fourth, the authorities appreciated the substantial capacity building dimension of the program. They viewed the selection of structural reforms to be well aligned with Bangladesh's needs, and were grateful for the quality and quantity of technical assistance (see paragraph 13). Although the VAT was not implemented before the program ended, they viewed the impetus provided by the program for this essential reform to be crucial. And similarly, although there are still important weaknesses in the financial sector, they noted that strides made during the program put the financial sector reform agenda on the right track. As one interlocutor noted, *"The ECF put systemic reform on the agenda."* Beyond these structural reforms, the authorities also noted that the ECF arrangement helped them put in place a system for information gathering to help impose discipline and make better policy decisions, which has had lasting benefits. For example, monetary and exchange rate policies, and associated liquidity management, have been revamped to help achieve inflation and foreign exchange objectives.

28. **IMF's catalytic role and relations with other institutions.** The ECF arrangement catalyzed financial and technical assistance from the World Bank, the Asian Development Bank, and other partners. The dialogue with the World Bank, however, was colored by a controversy surrounding the "Padma Multipurpose Bridge Project," a large-scale infrastructure project to establish modern transport links. Allegations of corruption led the World Bank to withdraw from the project and affected World Bank engagement with Bangladesh during the program. The International Finance Corporation grew its private sector lending during the course of the program. Other official development agencies, including from Japan and Korea, also participated in project financing.



## VI. ASSESSMENT AND LESSONS

29. **Adjustment and growth.** The ECF arrangement succeeded in restoring macroeconomic stability and strengthening reserve buffers. The macroeconomic policy framework and the balance between financing and adjustment to achieve these stability goals were realistic and cautious. Building on Bangladesh's impressive historical growth record, growth performance under the program was in line with expectations and has continued to do well after the program. A more stable domestic macroeconomic environment, strong exports, and steady remittance inflows have aided growth. Although reducing infrastructure bottlenecks also played a role, the program was careful to assume only a modest growth payoff from these developments. In addition to these stability and growth achievements, the program had important capacity development benefits, including advancing a public finance and financial sector reform agenda and establishing a framework to make better policy decisions.

30. **Unfinished agenda.** Two issues stand out.

- First, the program did not succeed in increasing Bangladesh's low tax-to-GDP ratio, which has been stuck at about 9 percent of GDP for several years. Introduction of the VAT was seen as essential to achieve this goal and to transition to a modern, transparent and efficient tax regime. Although the VAT was eventually implemented four years after the program, the 2019 Article IV Consultation staff report cautions that, *"it is uncertain whether the implementation will have a positive revenue impact, particularly in the near term, because of multiple rates, a significant increase in the VAT threshold, and implementation challenges"* (paragraph 18). Expanding the tax base and modernizing tax administration, including a simplification of multiple VAT rates, therefore remains on the agenda to generate resources to upgrade infrastructure, support the vulnerable, and meet the potential costs of climate change.
- Second, the continued weakening of the banking sector, including a high level of bad loans despite strong growth, calls for further policy action building on progress with regulatory reforms made under the program. Priorities identified by the 2019 Article IV Consultation include stronger corporate governance in the banking sector, especially reform of state-owned commercial banks; enhanced bank regulation and supervision, including adoption of risk-based supervision; tighter criteria for loan rescheduling and restructuring; and enhanced legal systems to accelerate loan recovery.

31. **Lessons.** The following lessons from Bangladesh's ECF arrangement are relevant:

- **Laying the groundwork for complex reforms.** Politically and technically difficult reforms take time to implement and require substantial groundwork. Bangladesh's experience suggests that it is appropriate for programs to support the authorities' ambitious intentions, for example to implement a VAT, but at the same time being flexible by recognizing that implementation timetables may not fit in the timeframe of a program.

Even when there is strong ownership at the political and senior technocratic level, roadblocks can arise because of vested interests and rent seeking, which takes concerted consensus-building efforts and adequate time to overcome. In addition, fast growth can contribute to a loss of momentum on reforms because of reduced political pressure. Furthermore, compliance with prior actions and structural benchmarks does not mean that reforms necessarily stick because there may be subsequent backtracking. Although it was controversial at the time within the IMF, the pragmatic approach to completing program reviews and a short extension of the program was appropriate because it provided the opportunity to continue to advance needed reforms even if full implementation was not achieved. Thus, laying the groundwork for major reforms during a program can in and of itself be an important achievement as long as the lack of full implementation does not create a new or additional vulnerability while the country is under a program.

- **A missed reform opportunity?** The reform agenda focused primarily on macroeconomic policies and financial institution building with the aim of improving demand management policies, mobilizing additional revenue, and reducing vulnerabilities (see paragraphs 8 and 22). These reforms were seen as essential to lay the foundations for sustained faster growth in the future. The only reforms targeted more directly at improving efficiency and productivity were in the area of rationalizing trade barriers and improving the investment climate. In the event, little attention was paid to such reforms in large part because of limited availability of staff resources to devote to the issues given other higher priority items on the agenda. World Bank involvement was overshadowed by the Padma Bridge controversy (paragraph 28), and the IFC's role in improving the investment climate was limited. It remains an open question whether some low hanging fruit to raise productivity were missed during the program. It is also noteworthy that in the post program period, notably the 2018 and 2019 Article IV Consultations, staff devoted considerably more attention to analyzing impediments to medium-term growth and identifying steps to diversify Bangladesh's economy, which remains heavily reliant on exports of ready-made garments. A surveillance environment appears to be more conducive to analyze efficiency and growth-oriented reforms, as priorities related to demand management and reducing vulnerabilities tend to dominate in a program environment.
- **Improving contingency planning for growth shortfalls.** Although growth performance during the program was in line with expectations (see paragraphs 23 and 24), this outcome was not assured and there were significant risks to the growth outlook during the program. Therefore, detailed risk assessments and contingency planning in program discussions and documents would have been valuable. Although program documents typically included a risk assessment matrix, they rarely included a discussion of the policy response if risks materialize, a shortcoming that should be addressed. Risk assessments and contingency planning improved by the time of the third review (see paragraph 18),

notably by outlining how policy should react in the event of temporary or prolonged shocks and sanctioning fiscal easing if needed.

- **Improving measurement of inclusive growth.** Under the program, specific and concrete policy efforts were made to promote more inclusive growth (see paragraph 17). It is commendable that in Bangladesh this focus was not just a superficial slogan. Apart from a floor on social spending as an indicative target, these policy actions were typically not subject to conditionality. This was appropriate as additional conditionality in this area would have been onerous, especially in light of strong country ownership of the policies. Program and surveillance documents, however, do not provide an objective measure of progress in fostering inclusive growth other than a reduction in the overall poverty rate. Focus on the objective of more inclusive growth should be complimented with better data presentation. For example, a simple approach would be to report not only overall GDP growth, but also growth at the 50<sup>th</sup> income percentile (that is, median growth). If this simple measure is not available, priority should be given to generate the needed statistics.

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## **CHAPTER 2. MONGOLIA**

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## EXECUTIVE SUMMARY

Mongolia was hit hard by the global financial crisis as the price of its mineral exports collapsed. Under the 2009 18-month Stand-By Arrangement (SBA) with exceptional access, large upfront fiscal tightening, a hike in interest rates, increased exchange rate flexibility, and substantial international financial support helped stabilize market conditions. But the economy unexpectedly contracted in 2009. When it became evident that the economy was weaker than forecast, fiscal and monetary policy were relaxed under the program. Policy adjustments combined with a turnaround in commodities prices helped support a V-shaped recovery in 2010.

A fiscal stability law (FSL) was enacted under the SBA to reduce the pro-cyclicality of policies. But the fiscal rules under the FSL were circumvented after the SBA, intensifying the boom in 2011–14 as mineral production expanded and commodity prices rose. The boom turned to bust and a three-year Extended Arrangement (EA) under the Extended Fund Facility (EFF) was approved in 2017.

The financing package for the 2017 EFF helped facilitate a private debt exchange and avoid a debt default. Notwithstanding substantial fiscal adjustment and the expected drag on the economy, growth during the EFF was much stronger than forecast. The main drivers were exogenous developments, including strong mineral exports and a sharp increase in foreign direct investment (FDI) for copper mine development. Budget over-performance under the program was sizeable because of revenue windfalls.

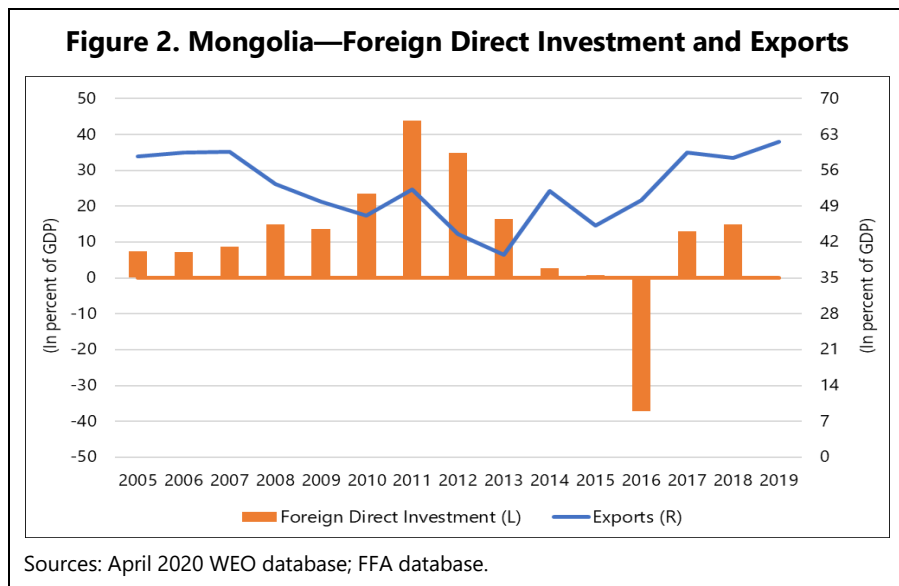
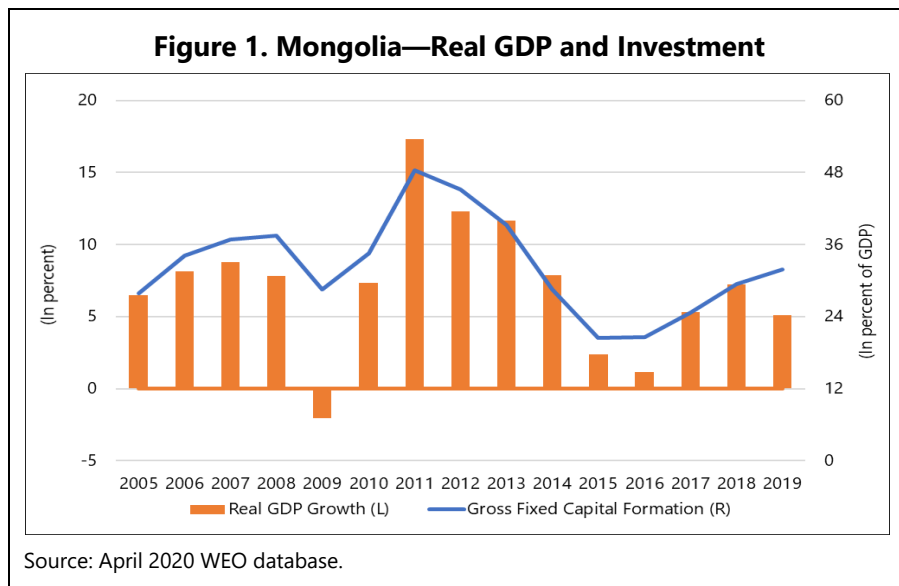
The 2017 EFF also charted a comprehensive strategy to strengthen the fragile banking sector, starting with an independent asset quality review (AQR). However, because of delays in banking reforms, including those related to the follow-up to the AQR, the EFF was allowed to lapse after completing five out of twelve planned reviews.

With strong growth potential from Mongolia's vast mineral wealth, the SBA and EFF focused on adjustment and building a more secure policy framework. Adjustment was successful, but progress toward policy discipline remains incomplete. Key lessons include:

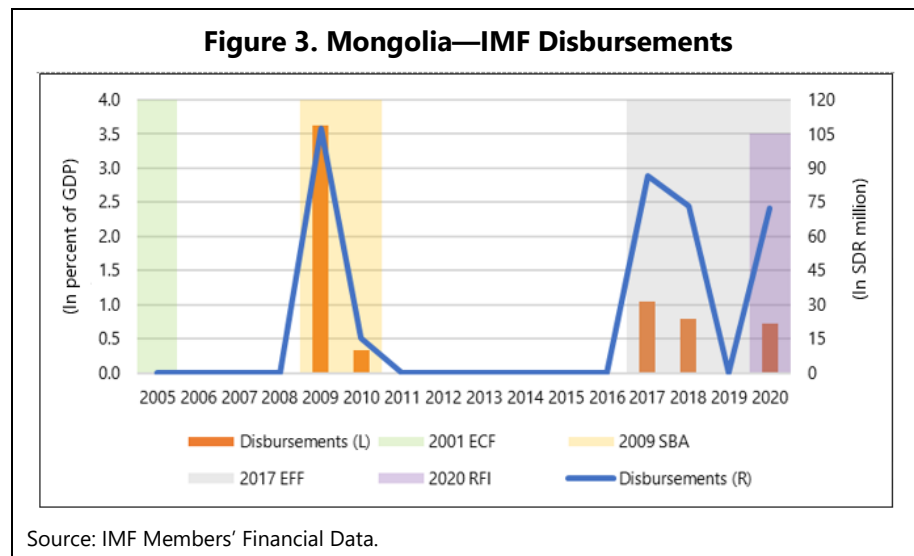
- Strengthening legislation for policy frameworks is not enough. Avoiding boom-bust cycles by saving windfalls will require greater political commitment.
- Good economic conditions diminish the incentives to deal with weak banks. It was appropriate that the IMF did not exercise forbearance on banking conditionality and instead let the EFF lapse.
- Meaningful attention to protect the vulnerable and promote inclusive growth is challenging in the midst of a program without a clear social and political consensus. Lack of IMF staff expertise and necessary attention to other policy priorities appears to have precluded deeper analysis in this area.
- Volatility and shocks complicate forecasting. This increases the importance of specifying policy contingencies in advance, including in more detailed risk assessment matrices.

## I. INTRODUCTION

1. **Country overview.** Mongolia's landlocked economy, traditionally dependent on herding and agriculture, has been transformed by substantial foreign direct investment in extractive industries. Deposits of copper, gold, coal and other important minerals are extensive, and exports now account for 40 percent of GDP. The bulk of Mongolia's external trade is with neighboring China. Growth over the last two decades has been high but volatile, fluctuating with commodity cycles and investment agreements in mining (Figures 1 and 2). On average, the economy has grown by 6.8 percent per year since 2000, equivalent to 4.9 percent per year per capita. Real GDP per person thus increased more than two-and-a-half fold between 2000 and 2019. The World Bank designates Mongolia as a lower middle-income country. The national poverty headcount rate fell sharply from 38.8 percent to 21.6 percent during the economic boom in 2010–14.



2. **IMF engagement.** Mongolia has been prone to boom-bust cycles. The country was hit hard by the global financial crisis in 2008–09, which led to a sudden collapse in the price of its key mineral exports. Although the country was PRGT-eligible at the time, the authorities sought an 18-month Stand-By Arrangement (SBA) with exceptional access—more than what would have been available under a PRGT arrangement and at a cost that was not significantly higher—as a bridge to future exports based on mineral extraction from new mines under development. This SBA, approved in April 2009, was the first non-concessional IMF arrangement in Asia since the 1997 Asian crisis (Figure 3). After the SBA, Mongolia experienced a boom during 2011–14, but this was followed by adverse external shocks and policy errors in 2015–16. Mongolia graduated from the list of PRGT-eligible countries in 2015. A loss of market confidence and looming debt rollover risks led to a three-year extended arrangement (EA) with the IMF under the Extended Fund Facility (EFF) in May 2017. The EFF stalled after the fifth review, less than 18 months into the arrangement, and was not revived prior to its expiration in May 2020. This case study covers the 2009 SBA and its legacy, and the 2017 EFF. Prior to these two IMF arrangements, Mongolia had a concessional arrangement under the Extended Credit Facility (ECF) in the first half of the 2000s, and two ECFs and an SBA in the 1990s. In June 2020, Mongolia received emergency financial assistance under the Rapid Financing Instrument equivalent to SDR 72.3 million (about US\$99 million or 100 percent of quota) to meet urgent budget and balance of payments needs stemming from the COVID-19 pandemic.



3. **Political developments.** Mongolia is a parliamentary republic and the majority party chooses the Prime Minister. The ruling Mongolian People's Revolutionary Party won the parliamentary election in June 2008 and, later that year, formed a coalition government with the opposition Democratic Party.<sup>1</sup> The 2009 SBA was launched less than a year after these elections.

<sup>1</sup> Presidential elections are held on a different cycle than parliamentary elections. Although they do not affect the composition of parliament, presidential elections can affect the direction of policies and the ability to achieve a political consensus depending on whether or not the Prime Minister and President are from the same political party.



The Democratic Party, the junior member of the coalition, won the June 2012 parliamentary elections. It formed a new government in coalition with three smaller parties. There were periods of political instability for the next three years, including changes in coalition partners and the dismissal of the Prime Minister, who was under fire for alleged corruption and economic underperformance, by vote of Parliament in November 2014. The opposition Mongolian People's Party won a landslide victory in the June 2016 parliamentary elections and came to power with a mandate to fix the economy and tackle legacy issues, setting the stage for the 2017 EFF. Overall, the experience of the last decade suggests lack of policy discipline in pre-election periods and when commodity prices are buoyant. This lack of policy discipline has accentuated Mongolia's boom-bust cycles.

4. **Organization.** This case study first provides a review of the 2009 SBA, covering the program's objectives, design and outcomes. Particular emphasis is put on the legacy of the program. This is followed by a review of the 2017 EFF, focusing on the period when the arrangement was operational.

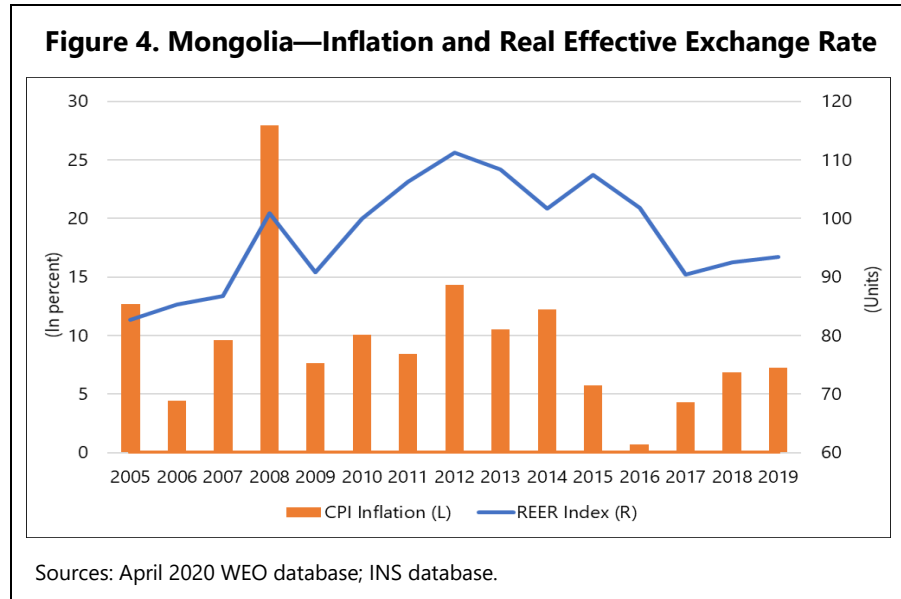
## II. THE 2009 STAND-BY ARRANGEMENT

### A. Program Design

5. **Catastrophic shock.** Aided by a sustained run-up in copper and gold prices, growth was strong till the middle of 2008, averaging 8 percent a year from 2003 to 2007. But pro-cyclical policies and overheating also fueled high inflation, which peaked at 34 percent in August 2008. Mongolia was then hit hard by the global financial crisis, which resulted in a sudden and catastrophic drop in the price of its main export. From its peak in mid-2008 to January 2009, the price of copper fell by 60 percent, creating severe imbalances in both the fiscal and external accounts. Despite a currency depreciation of almost 40 percent against the US dollar (30 percent in nominal effective terms) after November 2008, net international reserves fell by more than one-half by February 2009. Growth fell sharply because of the fall in exports and slowdown in investment flows to both the mineral sector and construction. The decline spread to domestic demand and became broad based; inflation also began to fall because of economic weakness (Figure 4). The banking system came under pressure from the shock to the economy, leading to a retrenchment of credit.

6. **Program motivation and financing.** With a third of the population in poverty, a disorderly adjustment to the external shock would have had devastating social consequences, unwinding large gains made in previous years. An 18-month exceptional access SBA of 300 percent of quota (SDR 153.3 million or US\$232 million) was approved in April 2009 and aimed to stabilize the situation and prevent disorderly adjustment. Unlike PRGT access limits, the SBA allowed for significant frontloading, with 100 percent of quota disbursed upon approval of the arrangement and another 50 percent of quota available in the next six months. Moreover, the authorities viewed the balance of payments problem to be largely transitory as two major new mines under development (Oyu Tolgoi for copper and gold, and Tavan Tolgoi for coal) were

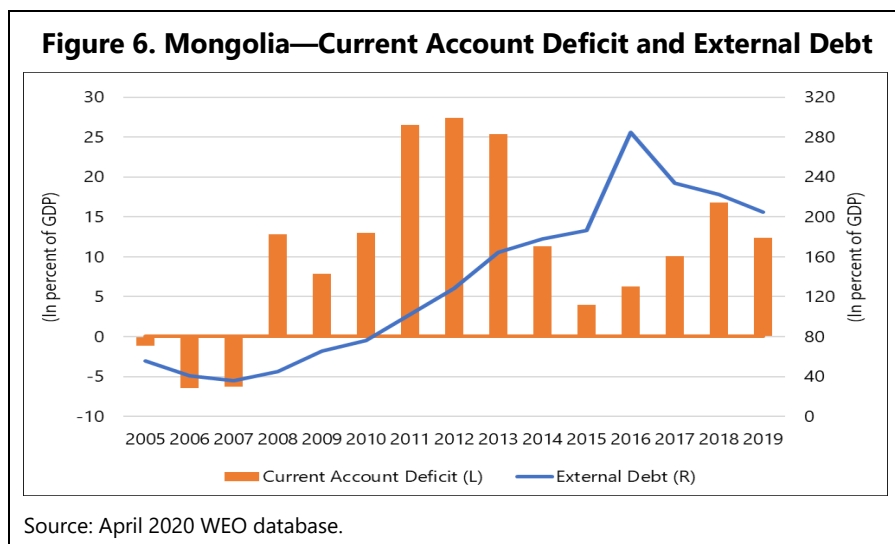
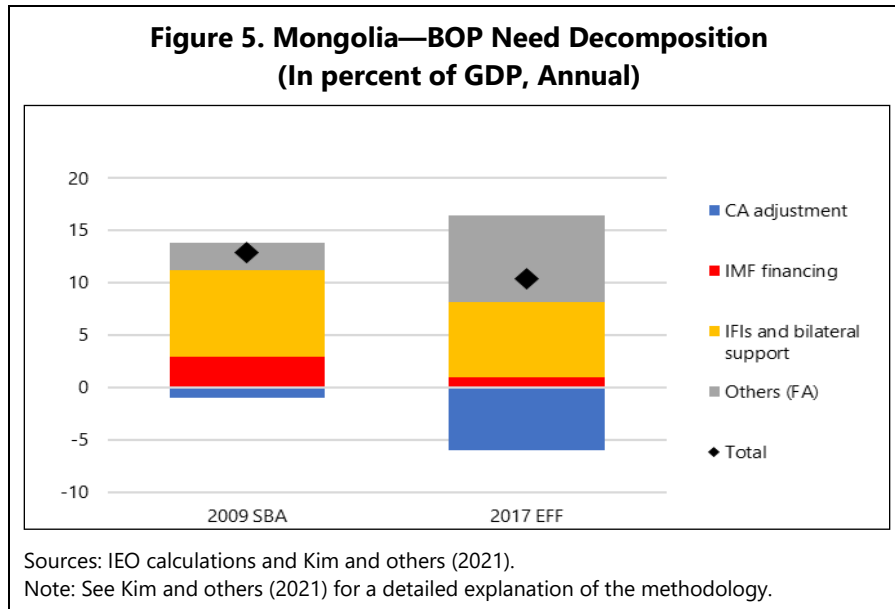
expected to start production in about two years. Frontloaded financial support from the Asian Development Bank, the World Bank and Japan was also mobilized, and totaled almost as much as access under the SBA.



7. **Balance between adjustment and financing.** The 2009 SBA relied primarily on financing rather than current account adjustment to meet balance of payments financing needs (Figure 5).<sup>2</sup> Notably, IMF financing and IFI and bilateral support covered 87 percent of balance of payments needs, compared to an average of 44 percent in other non-concessional IMF arrangements being studied. The minimal reliance on current account adjustment to meet balance of payments financing needs was due to the magnitude of the terms of trade shock and the expected start of export production from two new mines in the near term. Although the new mines would substantially improve Mongolia’s medium and long-term prospects, they also involved substantial imports financed by foreign direct investment. As a result, the current account deficit was projected to rise in the medium term before falling in the long term (Figure 6).

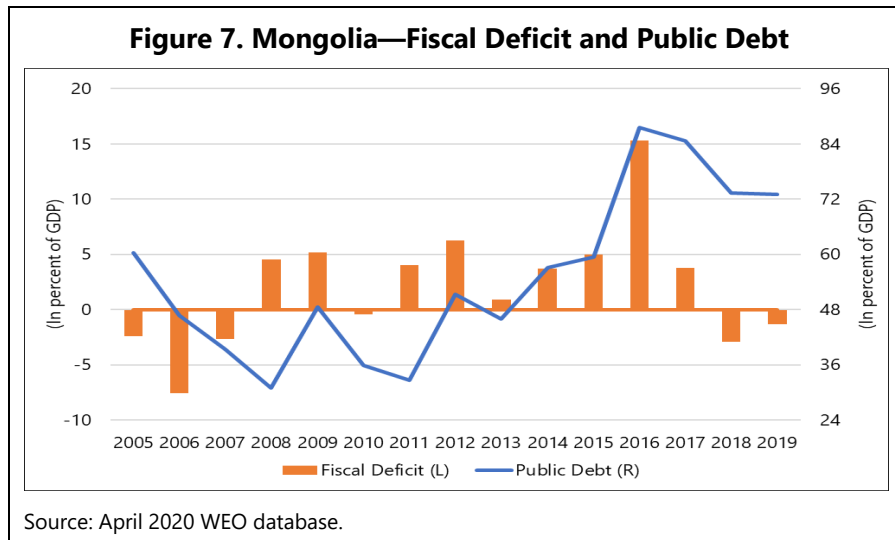
8. **Macroeconomic policies.** Substantial fiscal adjustment was the centerpiece of the IMF-supported program, with monetary policy calibrated to lower inflation while maintaining a flexible exchange rate and safeguarding international reserves.

<sup>2</sup> The estimated BOP need and contributions by current account adjustment and various sources of financing are relative to the counterfactual in the absence of a program. See Kim and others (2021) for further details.



9. **Fiscal tightening.** The 2009 fiscal deficit was projected to exceed 10 percent of GDP without action because of reduced revenue from mineral exports, which accounted for more than a third of revenue at the peak of the commodity boom in 2007. The authorities committed to contain the 2009 deficit to 6 percent of GDP and then lower it to 4 percent of GDP in 2010. Adjustment in 2009 relied primarily on expenditure savings from cuts in capital outlays, with some additional savings from a wage and hiring freeze, cuts in purchases of goods and services, and reductions in some untargeted social allowances. Revenue measures accounted for only about 10 percent of the adjustment in 2009 and relied on increases in excise taxes and customs duties. Passage by parliament of the government's revised fiscal plan for 2009 showed broad political ownership of the program. Program documents noted that staff would have preferred more balanced adjustment with greater reliance on increases in revenue and immediate

rationalization of untargeted household transfer programs, but this was not reflected in program design to accommodate the authorities' wishes and the commitment to overhaul the system of social transfers in coming months (Figure 7).



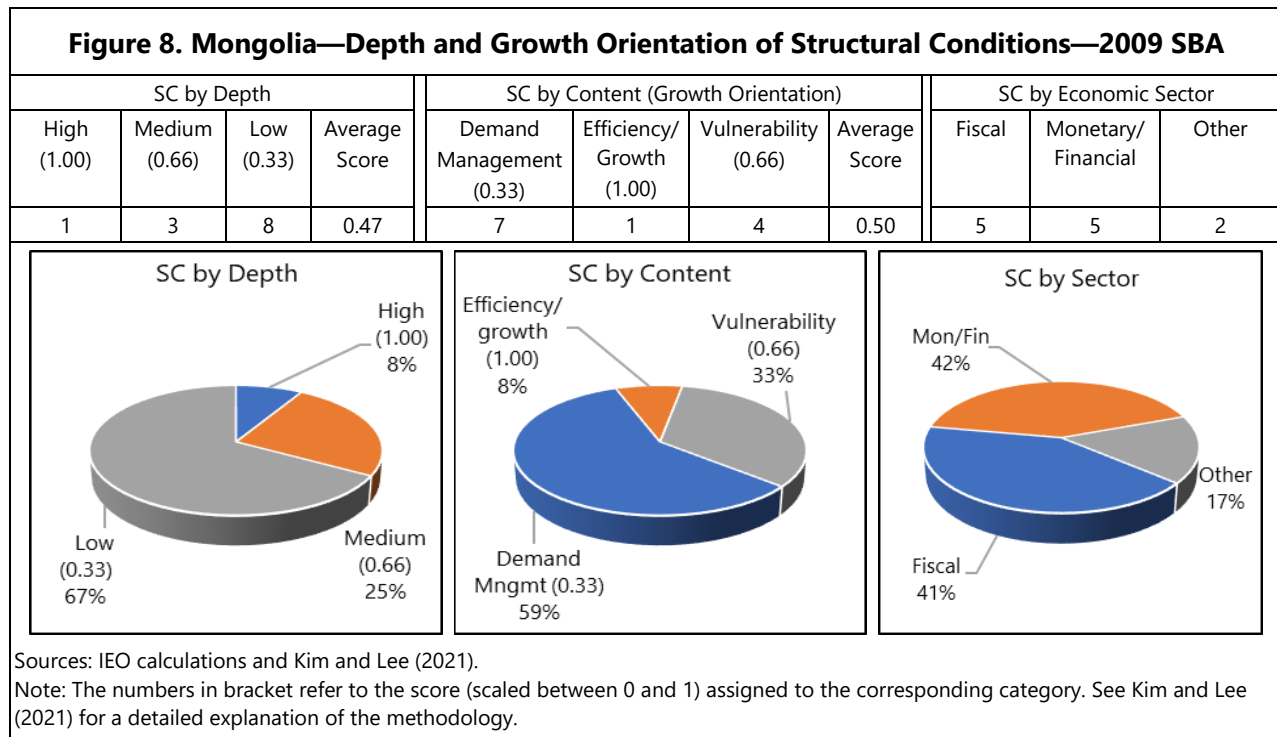
10. **Exchange rate flexibility and monetary tightening.** The authorities committed to remove existing exchange restrictions to allow the exchange rate to adjust flexibly in line with market conditions. To support the exchange rate, the central bank hiked interest rates by 425 basis points to 14 percent in March 2009, a few weeks before program approval. The central bank also committed to constrain the provision of liquidity—to both the government and the financial system—to levels consistent with the monetary aggregates agreed under the program.

11. **Fiscal responsibility legislation.** Mongolia's boom-bust fiscal cycles related to world mineral prices made it imperative to establish a stronger institutional framework to ensure savings of a greater proportion of windfall revenues. Under the program, the government committed to adopt fiscal responsibility legislation, which was to be designed in consultation with IMF and World Bank staff.

12. **Strengthening banking system confidence.** The authorities moved quickly to resolve problems with a troubled bank but recognized that the system remained vulnerable and that bad loans were likely to rise. The program therefore included steps to raise capital buffers and strengthen supervision. Strengthening the Banking Law and deposit guarantee scheme were also envisaged.

13. **Social protection.** The economic downturn was expected to have significant adverse social consequences. The existing system of social protection was complex with overlapping universal and targeted transfers. To direct more resources to the poorest, the government aimed to rationalize the system in cooperation with the World Bank and the Asian Development Bank.

14. **Structural conditionality.** Conditionality was relatively parsimonious, focusing on achieving planned fiscal adjustment, strengthening financial stability, improving the system of social transfers, and institutionalizing medium-term fiscal responsibility. The depth, growth orientation and structural content of structural conditions in Mongolia’s 2009 SBA are shown in Figure 8. The average depth score of 0.47 is somewhat below the 0.58 median for all SBA arrangements, while the average growth orientation score of 0.50 is broadly in line with the 0.46 median for SBA arrangements.



15. **Technical assistance.** Implementation of structural conditionality was supported by technical assistance (TA). Notably, MCM provided TA to help with the introduction on the foreign exchange auction system (a prior action), the conduct of monetary policy, and bank supervision and restructuring. Fiscal responsibility legislation relied on TA from FAD and other partners. The Asian Development Bank and the World Bank provided TA on social safety net reform.

16. **Program design and the growth outlook.** Hit hard by the global financial crisis, Mongolia’s growth outlook had already deteriorated markedly several months before the tightening of macroeconomic policies and the start of the SBA. Under the program, growth was projected to fall to 2¾ percent in 2009 from 8 percent the year before. But it was recognized that there were significant downside risks even to this bleak short-term outlook. Nevertheless, medium- and long-term growth prospects were seen to be bright because of Mongolia’s vast mineral resources.

17. **Risk assessment and contingencies.** Program documents had a comprehensive discussion of risks, but risks to growth were not directly addressed except in general terms (see previous paragraph). The risks highlighted included (i) the ability to deliver and sustain intended fiscal adjustment; (ii) premature reversal of the tightening of monetary policy because of the unpopularity of raising interest rates; (iii) rising banking fragility, especially with banks' exposure to interest rate and exchange rate risk, resulting in possible deposit losses; (iv) global risks and a greater decline in mineral prices than assumed; (v) political risks related to an upcoming Presidential election; and (vi) the risk that Mongolia's mineral wealth would be commercialized more slowly than envisaged, affecting the medium term outlook. Policy contingencies included, on the one hand, the potential need for further procyclical fiscal tightening measures during the course of the year if fiscal targets were at risk or if there were shortfalls in donor financing; and on the other hand, scope for loosening the monetary stance if confidence was restored more quickly than envisaged, thus stabilizing the exchange rate and lowering inflation.

## **B. Implementation and Outcome**

18. **Evolution of the program.** The first four reviews under the program were completed on schedule and Mongolia made the associated purchases. The authorities requested a delay of the fifth review (originally scheduled for June 2010) to have more time to build political consensus needed to implement fiscal measures and to advance structural reforms. The fifth and sixth reviews were therefore completed together, but the authorities did not draw on the available purchase because the economy had made a remarkable turnaround fueled by investment in the mining sector and a rebound in copper prices. Drawings under the SBA thus amounted to 80 percent of the available amount.

19. **Macroeconomic stabilization.** Strong policy implementation and international financial support helped to quickly stabilize market conditions and lower inflation. Gross reserves rose from about US\$0.7 billion million at end-2008 (3 months of prospective imports) to US\$1.3 billion at end-2009 (4 months of imports) and then US\$2.3 billion by end-2010 (almost 5 months of imports). But a few months into the SBA it became apparent that growth in 2009 would be negative and worse than foreseen, although still with a favorable outlook for 2010 given prospects in the mineral sector.

20. **Flexible macroeconomic policies.** Fiscal targets were met with a comfortable margin, initially because of spending restraint and later because of the strong recovery in copper prices. Importantly, at the second review in September 2009, when it was evident that the economy was much weaker than had been foreseen, fiscal policy was eased modestly to support the economy. Similarly, monetary policy was adjusted flexibly to economic weakness and lower inflation. Specifically, the March 2009 rate hike began to be reversed within three months as the exchange rate stabilized, and the policy rate was lowered at a measured pace. The commitment to a flexible exchange rate system as a shock absorber was reinforced under the SBA.

21. **Fiscal objectives and outcomes.** Table 1 below compares the program projection of the overall fiscal balance (including grants) at start of the SBA with the outturn. With the rebound in the economy and mineral revenue beginning in late 2009, the 2010 deficit target was revised down in successive reviews. But with smaller financing needs, these revisions still allowed for an increase in expenditure to provide further support to the economy. For the final reviews of the SBA in August 2010, the 2010 deficit was programmed to be 2.2 percent of GDP, about half of the initial program level. The eventual outturn was significantly stronger than that, with the budget registering a surplus of 0.4 percent of GDP.

	2008 (Pre-program)	2009	2010
Program Projection (SBA Request, April 2009)	-5.0	-6.0	-4.0
5 <sup>th</sup> & 6 <sup>th</sup> Review (August 2010)	-4.9	-5.4	-2.2
Outturn	-4.5	-5.2	0.4

Sources: IMF program documents and World Economic Outlook.

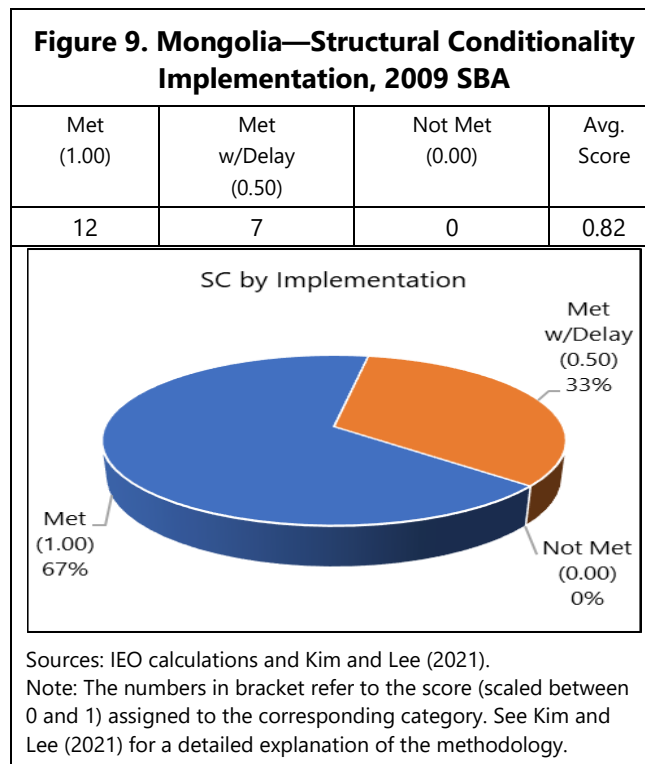
22. **Overheating pressure.** Near the end of the SBA, the economy made a remarkable turnaround fueled by investment in the mining sector and a rebound in copper prices, and the challenge became to avoid overheating. The buildup of inflation pressure led to a modest tightening of monetary policy. In retrospect, however, although the SBA's lower fiscal target was not at risk and eventual over-performance in 2010 was substantial, fiscal policy was not tight enough toward the end of the program in view of the overheating pressure. As the commodity-fueled surge in revenue was not saved, fiscal policy became even more procyclical after the SBA ended.

23. **Structural reform policies.** The SBA facilitated the adoption of significant structural reforms to strengthen the resilience of the economy against future shocks, although the commitment to implement some of these reforms remained an open question. Notably:

- **Fiscal stability law (FSL).** Parliament passed the FSL in June 2010, a slight delay from the original schedule. The comprehensive law to manage mineral revenue and secure lasting fiscal discipline benefitted from technical assistance from the IMF and other partners. The FSL put in place three complementary fiscal rules that imposed ceilings on the structural deficit and expenditure growth (to be effective in 2013) and a ceiling on public debt (to be effective in 2014).<sup>3</sup>

<sup>3</sup> For a detailed discussion of Mongolia's FSL, see IMF publication *Macroeconomic Policy Frameworks for Resource-Rich Developing Countries—Background Paper 1—Supplement 1* (August 2012) available at: <https://www.imf.org/external/np/pp/eng/2012/082412a.pdf>

- Social transfer reform.** Progress was slow. Although a Social Welfare Law was submitted to parliament in January 2010, it remained pending even after the SBA was concluded. The law aimed to introduce a targeted anti-poverty benefit and was designed with assistance from the Asian Development Bank and the World Bank. The authorities indicated that additional outreach was needed to secure the political consensus to pass the law. Meanwhile, a new universal transfer regime was introduced with the 2010 budget, contributing to a rise of social transfers as a percent of GDP. The Social Welfare Law was eventually passed in 2012.
- Bank restructuring and supervision.** The SBA was successful in managing immediate financial sector pressure and helped accelerate legislative reform. A revised banking law was passed to introduce consolidated supervision and an improved resolution framework. Legislation for a capital support program specifying a comprehensive restructuring framework that was fair to both banks and taxpayers was also submitted.<sup>4</sup> Technical assistance from the IMF and World Bank supported these initiatives.
- Structural conditionality compliance.** All structural conditionalities were met, with 67 percent on schedule and the remaining 33 percent with some delay, with a weighted average compliance score of 0.83 (Figure 9). This is broadly in line with the median score of 0.88 for all SBA arrangements.



<sup>4</sup> After the SBA ended, however, the IMF's 2011 Financial Sector Stability Assessment (Country Report 11/107) noted that prospects for passage of this legislation were slim, and it was expected that bank restructuring costs would be borne by the budget.



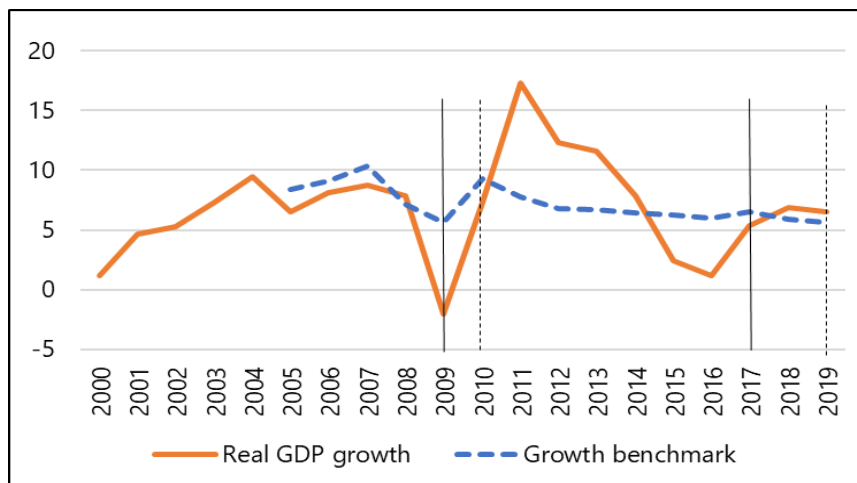
24. **Actual growth versus forecast and benchmark.** The economy contracted by 2.1 percent in 2009, versus the forecast expansion of a 2.7 percent under the SBA (Table 2). However, the 2009 contraction was followed by a V-shaped recovery, with the economy growing by 7.3 percent in 2010 versus the 4.3 percent projected under the program. Average actual annual growth was of 2.5 percent during the program period, falling short of the growth benchmark estimated by using a panel growth regression based on external factors alone (Figure 10).<sup>5</sup> The massive shocks, both negative and positive, that hit Mongolia made forecasting growth more complex than usual. In addition, the dynamics of growth in 2009 and 2010 suggests that the economy was already contracting in the months before the SBA was approved, but this was not picked up in the available near-term economic indicators, contributing to the large forecast error.

**Table 2. Mongolia—Growth: 2009 SBA Program versus Outturn (In percent)**

	2009	2010	Cumulative
Program projection			
Total	2.7	4.3	7.1
Nonmineral	4.3	5.0	8.4
Outturn			
Total	-2.1	7.3	5.0
Nonmineral	-2.7	7.0	4.1

Sources: IMF program documents; 2013 Article IV Consultation Staff Report; WEO.

**Figure 10. Mongolia—Actual and Benchmark Growth**



Sources: IEO calculations and Kim and others (2021).

Note: See Kim and others (2021) for a detailed explanation of the methodology.

<sup>5</sup> The external factors in the panel regression include terms of trade changes, trading partner's growth, US interest rates, regional growth and a dummy for the global financial crisis. For technical details regarding the econometric analysis used to estimate the growth benchmarks see Kim and others (2021).

25. **Ex post evaluation of exceptional access.** The 2009 SBA was followed by an ex post evaluation of exceptional access in 2011. The conclusions reached were sound, namely:

- The SBA was a success, notwithstanding uncertainty about its legacy. Substantial and front-loaded financing helped lessen the pain of adjusting to a massive shock. Structural reforms to reduce the pro-cyclicality of policies were also initiated.
- Flexible design and implementation of the SBA contributed to its success. Structural conditionality was streamlined, and technical assistance facilitated implementation. The Fund's openness to adapting policies to changing economic and political circumstances, while remaining focused on core objectives and measures, helped to strengthen country ownership.
- But the legacy of the SBA was clouded because it was not possible to secure the authorities' commitment to lock in reforms to avoid a return to boom-bust cycles.

26. **Post-program alarm bells.** Despite the improved policy framework initiated under the SBA, political pressure and weak governance were not conducive to saving windfalls from Mongolia's vast mineral wealth. Buoyed by expanding coal and copper production and the ongoing development of new large mining projects, growth hit 17½ percent in 2011, and then averaged 10½ percent a year in 2012–14. Non-mining growth was also strong, boosted by expansionary fiscal and monetary policy. Post-program monitoring reports in 2011 and Article IV consultations in 2012, 2013 and 2015 raised alarm bells about rising vulnerabilities and advised tighter macroeconomic policies. Warnings were issued about fiscal and quasi-fiscal activities of the Development Bank of Mongolia (DBM, infrastructure projects) and the Bank of Mongolia (BoM, subsidized lending programs), thus circumventing the fiscal rules established under the FSL. Little heed was paid to these warnings.

### III. THE 2017 EXTENDED FUND FACILITY

27. **Boom turns to bust.** The boom in 2011–14 was followed by a bust, which was intensified by policy errors. FDI declined sharply in 2015–16 after completion of the first phase of the Oyu Tolgoi gold and copper mine and a delay in the second phase because of a shareholder dispute. The situation was compounded by China's slowdown as it rebalanced its economy and weakness in the coal sector.

28. **Policy errors.** In response to these shocks, the authorities resorted to expansionary policies hoping to tide the economy over until FDI and exports could recover. This approach soon proved unsustainable. The fiscal deficit spiked to 17 percent of GDP in 2016, and public debt surged to 88 percent of GDP from 39 percent of GDP in 2011. Most of the debt was external and non-concessional. Loose monetary policy led to a surge in credit growth and sowed the seeds for a deterioration in bank asset quality. Regulatory forbearance was pervasive, allowing bank vulnerabilities to grow. Even with policy stimulus, growth slowed to 2½ percent in 2015 and

1¼ percent in 2016. Although imports were subdued because of weak activity, the balance of payments remained under pressure. The currency depreciated by 25 percent in the second half of 2016 as market uncertainty about the state of the economy and upcoming bond repayments increased and Mongolia's credit rating was downgraded. The insufficient buffers built during good times were eroded as gross reserves fell to US\$1.3 billion at the end of 2016 from US\$4.1 billion in 2012. The outcome was even worse for net international reserves, which turned negative in 2016 as the central bank relied heavily on swap lines to prop up gross reserves. With high public debt, low reserves, and weak growth, Mongolian bond yields spiked because of concerns about the capacity to meet debt service obligations.

29. **Program discussions.** Discussions about a possible new IMF-supported arrangement started in 2015, with the Article IV consultation report highlighting the urgent need for comprehensive policy adjustment to address external and fiscal imbalances and stabilize the economy. These discussions picked up pace after the parliamentary elections in June 2016 (see paragraph 3) and the installation of a new government with a stronger mandate to stabilize the economy. Staff-level agreement on a three-year Extended Arrangement under the Extended Fund Facility (EFF) was announced in February 2017. The EFF was approved in May 2017.

30. **Program objectives.** The EFF aimed to stabilize the economy, strengthen the banking sector, boost growth prospects, and safeguard debt sustainability. Avoiding a debt default was an urgent priority because of looming rollover risks for a DBM state-guaranteed bond that was maturing in March 2017. Ending boom-bust cycles and laying the foundation for sustainable and inclusive growth by addressing longstanding structural weaknesses in the economy were also important objectives.

31. **Program financing.** With a US\$580 million DBM bond repayment looming in March 2017, the February announcement of staff-level agreement on the EFF was crucial to address building liquidity pressures. The announcement outlined a total financing package of US\$5½ billion as follows:

- IMF access of 435 percent of quota, the maximum under normal access limits, equivalent to SDR 314.5 million (about US\$425 million).
- Expected commitments of concessional budget support and project financing from the Asian Development Bank, the World Bank, Japan, and Korea adding up to about US\$3 billion.
- An extension of the People's Bank of China's existing RMB 15 billion (about US\$2.2 billion) swap line with the BoM for at least another three years beyond its 2017 maturity.<sup>6</sup>

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<sup>6</sup> The authorities had drawn about US\$1.7 billion prior to the program and never drew on it again. The commitment to rollover the swap line prevented the US\$1.7 billion already drawn from falling due in 2017.

The financing parameters of the EFF also assumed that external private creditor exposure would be maintained at its current level over the program period via a market-based debt exchange on terms consistent with debt sustainability.<sup>7</sup> IMF staff outreach to market participants and investors supported the design and execution of debt exchange. Immediately after the February announcement of financing and planned adjustment under the proposed EFF, investor confidence improved and bond spreads compressed to single digits. A week later, the authorities went to market and successfully exchanged the maturing US\$580 million DBM bond for a new, seven-year sovereign bond with a coupon of 8¾ percent for existing bondholders that participated, while new investors secured a lower coupon that reflected the market rate Mongolia faced at the time. There was substantial market interest in the deal and the authorities limited the total amount raised to US\$600 million against an order book about five times as large. In sum, default was avoided and there was a small increase in the private sector's exposure to Mongolia. No official sector funds were used to repay the private sector.

32. **Balance between financing and adjustment.** As in the case of Mongolia's 2009 SBA, the 2017 EFF relied primarily on financing rather than planned current account adjustment to meet balance of payments needs (Figure 5 above). The financing provided by the IMF, IFIs and bilateral support covered 79 percent of balance of payments needs, well above the 44 percent average in other non-concessional IMF arrangements being studied. The current account deficit was projected to widen under the program with a substantial pick up in FDI associated with the development of new mines. In the IMF's "lite" framework for external balance assessments, Mongolia's currency was assessed as somewhat undervalued at the end of 2016 following the 25 percent depreciation of the togrog that year, and the current account was somewhat stronger than the norm.<sup>8</sup> IMF staff, however, assessed the overall external position to be weak and the program aimed to increase gross reserves from US\$1.3 billion in 2016 (3 months of imports) to about US\$4 billion (6½ months of imports) by end 2020.

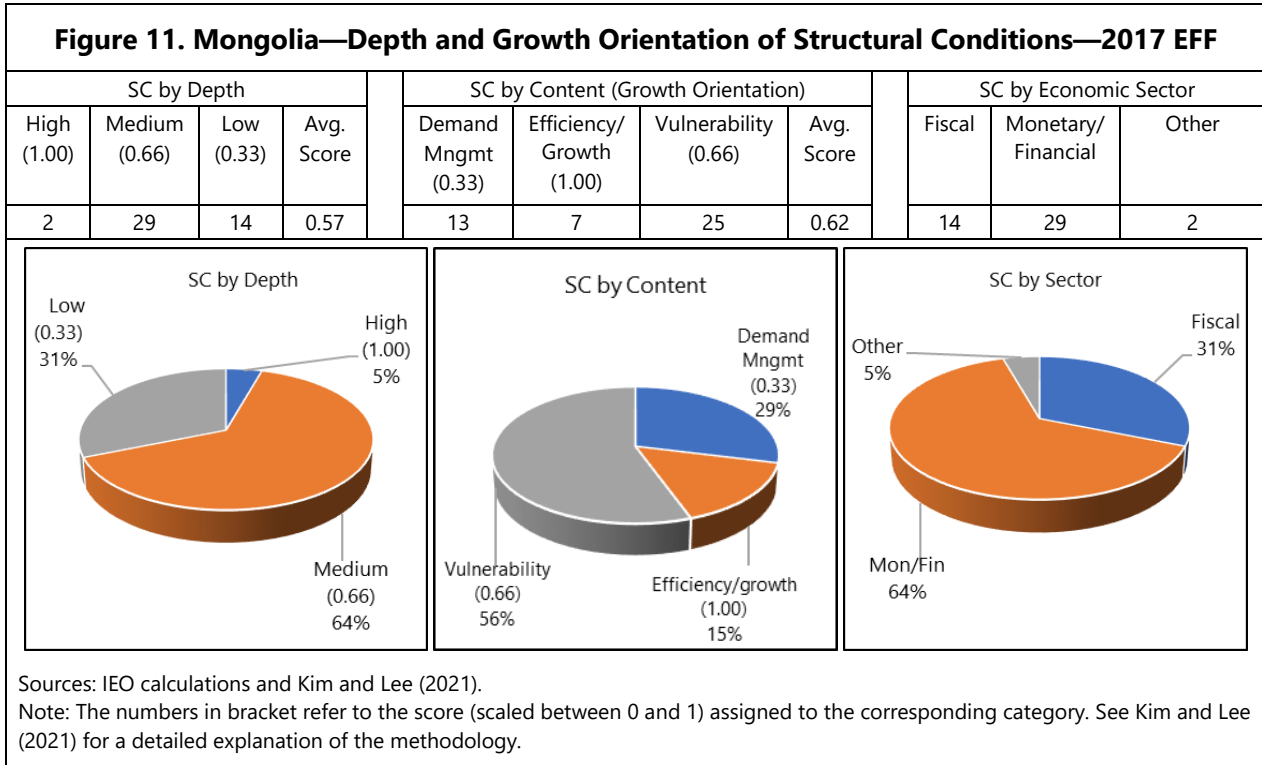
33. **Policy pillars.** The policies agreed under the EFF included strong fiscal adjustment to restore public debt sustainability, backed by reforms intended to improve fiscal discipline; prudent monetary policy and a new central bank law to strengthen its independence and governance; a comprehensive strategy to strengthen the banking sector, starting with an independent asset quality review (AQR); and measures to protect the most vulnerable and to diversify the economy; with assistance from the World Bank. The diversification effort included steps to improve the business climate and support agricultural and tourist development, linked in

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<sup>7</sup> Mongolia's public debt had risen to 87½ percent of GDP in 2016 from 59½ percent of GDP in 2015. The spike was due to revenue shortfalls caused by low commodity prices, loose fiscal policy, an increase in interest payments, and currency depreciation. Absent the fiscal adjustment, concessional financing, and private-sector creditor engagement envisaged under the EFF, debt was judged to be on an unsustainable trajectory. However, contingent on the successful implementation of these elements of the program, and the envisaged recovery of growth and normalization of borrowing costs, the staff report for the EFF request indicated that debt dynamics were projected to improve and would be on a sustainable path.

<sup>8</sup> Mongolia has a structurally large current account deficit due to interest and dividend payments and negative services (freight purchases) balances.

part to a World Bank budget support loan. Structural conditions agreed at the start of the EFF (that is, before implementation began) are shown in Figure 11. The figure shows that the depth and growth orientation of structural conditions under the EFF was better than under the 2009 SBA as shown in Figure 7.



34. **Technical assistance.** Substantial IMF TA was provided in the years prior to the 2017 EFF, and this assistance was ramped up under the new arrangement. Linked to structural conditionality, the TA covered areas such as tax policy; revenue administration; public investment management and public financial management (both in collaboration with the World Bank); banking regulation; resolution of non-performing loans; bank recapitalization reform; amendments to the central bank and foreign exchange laws; macroprudential surveillance; and a variety of statistical issues. In addition, the World Bank provided assistance on social welfare reform and reducing quasi-fiscal risks.

35. **Fiscal adjustment and the growth outlook.** In view of Mongolia's high public indebtedness, the fiscal anchor under the EFF was a reduction in the primary deficit from an estimated 13 percent of GDP in 2016 to close to balance in 2020. Adjustment was frontloaded with planned adjustment of 7½ percentage points of GDP in 2017. This was considered achievable and realistic because a portion reflected the disappearance of various one-off factors (such as arrears clearance and some pre-election programs) that bloated the 2016 outturn. For the period of the EFF, 80 percent of the fiscal adjustment was to be achieved by reducing spending (primarily capital spending) and 20 percent through revenue measures. Reliance on

cutting capital spending, especially for projects with high import intensity, was expected to limit the size of the fiscal multiplier. Nevertheless, fiscal consolidation was expected to weigh on growth, with the staff assuming a short-term multiplier somewhat above one. But with the development of mining projects and reduced geological impediments, it was expected that a sharp contraction would be avoided, and that growth would recover by 2019. Specifically, the EFF was premised on a mild economic contraction (–0.2 percent) in 2017, with activity picking up in 2018 and then reaching 8 percent in 2019.

36. **Risk assessment and contingencies.** On the domestic front, the staff highlighted the risk of policy slippage and concerns about the capacity to implement the broad policy agenda (mitigated somewhat by the TA support outlined in paragraph 34), but on the positive side staff also emphasized strong political support for the EFF. On the external front, a number of possible adverse shocks were enumerated, including lower commodity prices, weaker FDI, less supportive regional and global growth, delays in mining projects, and less favorable borrowing conditions. The resulting risks to growth and debt sustainability were underscored. The policy contingency discussion in the risk assessment matrix was brief, with emphasis given to maintaining exchange rate flexibility and tightening macroeconomic policies in the event of external shocks, while building resilience against shocks in the long term.

37. **Five out of 12 reviews completed.** Twelve quarterly reviews were scheduled under the EFF. The first five of these reviews were completed largely on schedule and the available drawings (totaling SDR 157 million) were made. The sixth review, envisaged by end-2018, was not completed because of delays in financial sector reforms, including those related to the follow-up to the AQR. Attempts were made to bring the EFF back on track, but the program went into abeyance because of the authorities' weak commitment to address financial stability risks (see paragraph 41 below for a more detailed discussion). An Article IV consultation was completed in September 2019. The authorities did not cancel the EFF and it expired in May 2020.

38. **Budget over-performance.** The fiscal primary balance turned around by 11½ percentage points of GDP in 2017, compared to 7½ percentage points planned under the EFF. The over-performance continued into 2018 with an increase in the primary surplus to 6 percent of GDP from a ½ percent of GDP surplus in 2017.<sup>9</sup> The over-performance was due primarily to higher-than-expected revenues, which reflected strong mineral exports (via royalties and corporate income tax) and investment-related imports (via value-added tax). General government debt fell to 73 percent of GDP in 2019 from 88 percent of GDP three years earlier, with all of the reduction coming from domestically held debt. Table 3 below compares the program projection of the overall fiscal balance at start of the EFF with the revised program and estimated outturns at each review based on information available at the time.<sup>10</sup> As revenue

<sup>9</sup> When the program was designed, the primary deficit in 2016 was estimated to be 13 percent of GDP (see paragraph 35 above), a figure that was later revised to 11 percent of GDP.

<sup>10</sup> The fiscal balance in Table 3 excludes privatization receipts, includes DBM commercial spending, and from 2017 onward also includes spending on mortgage interest finance.

surged, the estimated magnitude of fiscal over-performance relative to the original program increased with each successive review of the EFF.

	2016 (Pre-program)	2017	2018
EFF Request (April 2017)	-17.0	-10.6	-8.5
1 <sup>st</sup> & 2 <sup>nd</sup> Review (December 2017)	-17.0	-7.6	-6.4
3 <sup>rd</sup> Review (March 2018)	-17.0	-1.9	-5.3
4 <sup>th</sup> Review (June 2018)	-17.0	-1.9	-4.7
5 <sup>th</sup> Review (October 2018)	-17.0	-1.9	-1.1

Sources: IMF program documents and World Economic Outlook.

39. **Fast growth.** Notwithstanding large fiscal adjustment, growth was much stronger than forecast when the EFF was approved (Table 4). The economy grew by 5.3 percent in 2017 (versus the forecast of -0.2 percent) and then by 6.9 percent in 2018 (versus the forecast of 1.8 percent). The main drivers were (i) stronger commodity prices and exports, especially a doubling of prices and export volumes of coal, with knock-on effects for transport services; (ii) the earlier-than-expected resumption in the second phase of investment in the Oyu Tolgoi copper mine, and associated sharp increase in FDI; and (iii) a recovery in domestic confidence and loosening in financial conditions that supported credit-financed private consumption and domestic demand more broadly. Indeed, average actual growth during 2017–18 was broadly in line with the estimated growth benchmark from IEO panel growth regressions based on external factors alone (see Figure 10), suggesting that growth was aided significantly by strong commodity prices. With fast growth, inflation remained elevated at 8½ percent at the end of 2018, instead of easing to 6 percent as expected under the EFF.

	2017	2018	2019	2020 (Projection)	Cumulative
Program projection	-0.2	1.8	8.1	5.3	15.6
Outturn	5.3	6.9	6.5	5.4	26.4

Sources: IMF program documents and World Economic Outlook.

40. **Stalled fiscal reforms.** Important progress was made with fiscal structural reform early in the program with the passage of new laws in 2017 for the DBM and the BoM designed to prevent further quasi-fiscal spending. But progress on other fiscal reforms was limited. The end-June 2018 indicative floor on social protection spending was missed, but more fundamentally a revamp of social protection programs (in collaboration with the World Bank and Asian Development Bank) to

improve targeting, efficiency and effectiveness, including through consolidation of overlapping programs, was not achieved because of lack of political support. Separately, the authorities committed to a 5 percent increase in social security contributions (2 percent in 2018, 1 percent in 2019, and 2 percent in 2020), but the 2 percent commitment in 2020 was not implemented.

41. **Continued bank fragility.** The AQR, a key component of the strategy to strengthen the banking sector under the EFF, was completed with a short delay. Seven banks were identified as having capital shortfalls. One was closed involving a fiscal cost of about 1 percent of GDP. But the authorities did not meet commitments under the EFF to recapitalize or resolve other weak banks based on the results of the AQR and updates of banks' financial condition. In addition, the BoM made limited progress on strengthening its regulatory and supervisory framework and the official capital numbers continued to reflect significant forbearance. Notably, the results of a forensic audit were especially worrying as it found that much of the capital that banks claimed to have raised (including funds from shell companies) was not consistent with local laws and regulations. The combination of a strong recovery in growth and politically well-connected banks affected the authorities' willingness to take the necessary steps to ensure that the banking sector was sufficiently capitalized and well regulated. In the absence of necessary steps to ensure that concerns about the health of one or more systemic banks would not lead to a loss of confidence in the banking system, staff assessed that it was too risky to continue with the EFF and the arrangement was allowed to lapse.

#### IV. AUTHORITIES AND STAFF'S PERSPECTIVES

42. **Ownership, program design, and growth.** Mongolian representatives noted that there was a broad consensus on the diagnostics and policy prescriptions under both the 2009 SBA and the 2017 EFF. They noted that although pre-election periods had hampered the ability to tackle intensifying economic problems promptly, it was beneficial that both arrangements were eventually launched within a year after parliamentary elections because its enhanced ownership of the policies to restore stability. Mongolian representatives also appreciated that there was a common recognition that the immediate problems faced in 2008–09 and 2016–17 were predominantly related to liquidity and not a solvency problem in view of Mongolia's vast mineral wealth. Thus, the balance between financing and adjustment was seen as appropriate for Mongolia's circumstances. This approach was also seen as successful in limiting a damaging shock to growth because of liquidity constraints. Notably, the financing and credibility provided by agreement on the 2009 SBA quickly stopped speculative market behavior and allowed the BoM to stop foreign exchange intervention and reduce exchange controls. Similarly, the financing package under the 2017 EFF, including the private debt exchange, pulled the country back from the precipice of debt default, lifted confidence, and created the conditions for stronger growth. Securing adequate financing also increased the government's willingness to make unpopular decisions to cut spending to achieve agreed fiscal objectives. Overall, Mongolian representatives expressed their appreciation for IMF support, describing the relationship as constructive, timely, and professional.



43. **Mongolian views about other elements of the program.** In addition to the points above, the Mongolian representatives made a number of significant points about key elements of the two IMF-supported programs:

- **Avoiding boom-bust cycles.** Mongolian representatives stated that the procyclicality of policies remains a major problem and they had a bleak assessment of the outlook on this front. They noted that enactment of the FSL was crucial, but that the law has been weakened over time and its implementation has been deficient. The Ministry of Finance is not in a position to enforce the law, as Parliament has the ultimate power to implement it as it wishes. Mongolian representatives pointed out that not only is the economic impact of the mining sector volatile, but the politics around mining is also volatile as political and business elites protect their interests. At the same time, there are demands from the general public about the distribution of mining revenue, resulting in populist decisions. Mongolian representatives noted that the institutional framework is still rudimentary and at this point unable to provide the necessary checks and balances despite efforts by technical staff to inform Parliament about the harmful effects of procyclical policies and inadequate buffers.
- **Bank recapitalization.** Mongolian representatives' views on banking issues under the 2017 EFF were mixed.
  - Most were of the view that quick macroeconomic stabilization and stronger growth reduced pressure on the government to deal with banks' capital shortfalls. Banks pushed back on recapitalization requirements and there was insufficient political will to resist their appeals because parliamentarians were close to bank owners and some parliamentarians even had ownership stakes in banks. As a result, the government and central bank were unable to follow through. These representatives noted that if the macroeconomic and balance of payments situation had been worse and if there had still been financing needs, it might have increased Mongolian incentives to bring the EFF back on track. But in the prevailing circumstances the government decided that it could manage without continued IMF financial support.
  - Other representatives stated that the template for the AQR, stress testing, and recapitalization, which were modeled on EU practices, was not appropriate for Mongolian conditions. As one representative put it, "if you ask a toddler to run a hurdle race, the toddler will run under the hurdle because it is impossible to jump over it." They noted that in view of the complexities of the exercise, especially the last phase of addressing capital shortfalls, the timeline under the program was too tight. In addition, legal uncertainty related to the application of the resolution law and inadequate statutory protection for supervisors affected decisions. Furthermore, the requirement to conduct forensic audits of banks related to AML/CFT issues diverted attention and affected the ability to deal with core financial sector issues.

- **Social programs.** Mongolian representatives noted that the reform of social transfer programs is contentious, both in a program and a non-program context, because of political sensitivities. Indeed, they pointed to the difficulty of dealing with social issues even in the environment of the COVID-19 pandemic. Against this background, modifying policies in this area were not a priority for the authorities, and it was unrealistic to expect significant reforms under the IMF-supported arrangements despite good work done by the World Bank and the Asian Development Bank.
- **Growth scenarios.** Mongolian representatives noted that there were no material differences between IMF staff and the authorities' views about the growth outlook. They observed that the enormous size of the mining sector complicates growth forecasts because a small change in one project and the related FDI can have a large impact on the local economy. In addition, the discussion of scenarios related to the commodity outlook can be problematic because what matters for Mongolia is not just the international price, but the price negotiated with monopolistic Chinese firms. Issues related to transport costs and potential barriers at the border with China can also come into play. These issues sometimes led to some divergence in scenarios but there was eventual agreement between the authorities and staff.
- **Technical assistance.** There was general appreciation for the technical assistance received from the IMF. Under the 2009 SBA, technical assistance on monetary policy instruments, foreign exchange auctions, and the FSL were seen as essential to build institutional capacity in Mongolia. And under the 2017 EFF, technical assistance on bank regulation, supervision, and resolution was singled out as being especially valuable, although in the end political constraints had impeded implementation.

44. **IMF's catalytic role and relations with other institutions.** The 2009 SBA with exceptional access and the 2017 EFF catalyzed financial and technical assistance from the World Bank, the Asian Development Bank, and other partners. Notably, the IMF arrangements unlocked commitments for substantial bilateral support from Japan (2009 SBA) and Japan and Korea (2017 EFF). In addition, the swap line with the People's Bank of China was set up during the 2009 SBA. Through outreach to market participants and investors, the IMF staff also played an important role in the design and execution of the 2017 private debt exchange. The catalytic role played by the IMF was essential to cover Mongolia's large gross financing needs and address the liquidity crisis. Apart from providing sizable project and budget support, the World Bank and Asian Development bank also provided valuable technical assistance, including taking the lead on social safety net reform. The IMF and World Bank provided joint technical assistance in some areas such as the FSL and public investment and financial management. When the 2017 EFF lapsed, the World Bank and Asian Development Bank continued to provide financial support to Mongolia under ongoing programs. Relations with these institutions was constructive.

## V. APPRAISAL AND LESSONS

45. **Main achievements.** The exceptional access SBA in 2009–2010 and the truncated EFF in 2017–18 both stabilized the economy and helped it recover from serious short-term imbalances. Both arrangements were put in place within a year after parliamentary elections that provided a mandate to tackle economic problems, facilitating the needed policy tightening to restore stability. The arrangements also catalyzed substantial financing from other partners, helping Mongolia to smooth the adjustment to huge external shocks. Importantly, the financing package assembled for the 2017 EFF helped Mongolia avoid a debt default without restructuring or reprofiling its external debt or using official sector funds to repay private debt.<sup>11</sup> Essential steps to improve policy frameworks to avoid procyclical policy and boom-bust cycles were also introduced, but steadfast implementation of these frameworks has remained elusive. Structural conditionality was streamlined, and policies were adapted to changing economic and political circumstances, especially under the 2009 SBA, helping to enhance ownership. In sum, the near-term objectives of the two IMF-supported arrangements were met, but there is still a large unfinished policy agenda to meet longer-term goals.

46. **Growth and adjustment.** The two IMF-supported programs helped support growth while delivering the necessary adjustment to achieve near-term balance of payment viability. The emphasis on financing rather than current account adjustment to meet balance of payments needs was appropriate in view of the structural features of Mongolia's current account and the recognition that the country faced a liquidity crisis. Growth objectives were conservative and realistic and consistent with the design of the program and prospects for implementation. The drag on the economy from policy tightening was recognized, and the focus of adjustment on cutbacks in import-intensive capital projects likely helped contain the impact of large reductions in the fiscal deficit. It is noteworthy that the 2009 SBA allowed for modest loosening of fiscal objectives when it became apparent that the economy was weaker than expected. Overall, however, actual growth outcomes were driven primarily by favorable exogenous developments. In particular, the turnaround in the economy under both arrangements was fueled in large part by stronger-than-expected mineral exports and a rebound in investment in mining projects. An important counterfactual question, therefore, is whether the stabilization elements of the programs would have worked in the absence of positive external shocks. It is difficult to provide a definitive answer, but the following considerations are relevant:

- On the one hand, conservative program growth forecasts suggest that the programs could have worked to attain critical goals, although more slowly than what occurred. Fiscal adjustment, which was largely expenditure based, would have still been achieved but would have been less than the actual outturn. Furthermore, the private debt exchange portion of the financing package of the 2017 EFF, which preceded the

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<sup>11</sup> This was the result of an explicit policy decision to require sufficient private sector participation in the debt exchange to prevent official sector funds from being used to finance the reduction of bondholders' exposure.

favorable external developments, boosted domestic and international confidence and thus helped to spur the recovery of the economy.

- On the other hand, in the absence of favorable external developments, the exchange rate might have been more volatile and reserve accumulation would have been lower. Exchange rate weakness, in turn, would have had important balance sheet effects, worsening debt dynamics. Foreign direct investment might have also been lower. These factors would have dampened the macroeconomic achievements under the program.

47. **Continued vulnerability and insufficient buffers.** Notwithstanding these achievements and good medium-term growth prospects because of mineral wealth, Mongolia's vulnerability to shocks remains substantial. The economic base is narrow—80 percent of exports are minerals, the bulk of which go to China, and one project accounts for half of FDI—leaving the country highly exposed to external conditions. Fiscal, external and financial buffers are insufficient to smooth the economy when shocks hit. Public debt is high and external financing risks are large. After an initial increase under the EFF, foreign reserves, which are already well below adequacy metrics, declined because of rising sales of foreign exchange by the BoM to limit pressure on the exchange rate. Several banks are undercapitalized and could be a source of financial distress and amplifiers of shocks. And the ability to withstand pressure for procyclical fiscal and monetary policies, despite improved policy frameworks, remains tenuous.

48. **Unfinished agenda.** In view of Mongolia's strong growth potential from its rich mineral sector, the two Fund-supported programs in the last decade focused largely on adjustment and building a more secure macroeconomic framework. However, progress toward policy discipline remains incomplete and concerns about achieving a wider base for strong growth remain salient. To reduce vulnerabilities and place Mongolia on a stable, inclusive, and green growth path, the 2019 Article IV consultation outlined policy requirements in five broad areas: (a) making fiscal policy sustainable and more equitable; (b) building buffers against external shocks; (c) restoring health to the banking system; (d) making agriculture more productive and resilient to climate shocks; and (e) combatting corruption.

49. **Lessons.** The following lessons from Mongolia's experience are relevant:

- **Strengthening legislation for policy frameworks is not enough to mitigate boom-bust cycles.** Enactment of a comprehensive Fiscal Stability Law to manage mineral revenue and promote fiscal discipline was a major achievement under the SBA. But locking in proactive commitment to avoid boom-bust cycles by saving windfalls and building sufficient buffers has proved to be exceptionally difficult. Successive Mongolian governments have shown little appetite to dampen boom-bust cycles. There is substantial political pressure to use resources from mining and foreign borrowing to protect the interests of the elites and to appease the general public with quasi-fiscal policies and spending of questionable quality. Avoiding such boom-bust cycles will require societal changes that do not yet appear to be forthcoming. Meanwhile, with

insufficient buffers, the likelihood that Mongolia will request repeated IMF-supported financial arrangements is high.

- **Good economic conditions diminish the incentives to deal with weak banks.** Similar to the previous point, improving the regulatory and supervisory framework for banks is not enough if there is continued forbearance. Banks in Mongolia are politically well connected, making inaction the easier course in the midst of a commodity boom that hides underlying bank fragility. Furthermore, it appears unlikely that bank recapitalization objectives under the program would have been achieved even if the Mongolian authorities had been given additional time to meet the specified goals. It was therefore appropriate that the IMF did not exercise forbearance on financial sector conditionality, and instead let the EFF lapse. That said, it is also important to heed concerns expressed by some Mongolian representatives that programmed steps to deal with banking fragility should be commensurate with local conditions and that applying an ambitious standardized template should be avoided.
  
- **Meaningful attention to protecting the vulnerable and “inclusive” growth in the midst of a program is difficult without a clear social and political consensus.**
  - The 2009 SBA aimed to strengthen social transfer programs, but progress was slow and limited. That program did not refer to inclusive growth.
  - By contrast, a key objective of the 2017 EFF was to put Mongolia on an inclusive growth path. It was stated that the program included structural reforms to achieve sustainable and inclusive growth by improving the business environment and promoting economic diversification, especially reducing reliance on mining by stimulating agriculture and tourism. The authorities were also encouraged to develop programs to address Mongolia’s substantial income inequality, including with assistance from the World Bank. But there was little concrete follow up on these issues under the program, in part because of insufficient political support.
  - The staff report for the combined first and second review of the EFF included a descriptive box on how the program supported women, including by creating the conditions for inclusive job-creating growth. But much of the policy emphasis to promote inclusive growth was indirect. For example, the staff report for the third review (paragraph 29) stated: *“A well-capitalized and supervised financial sector will ensure that banks and other financial institutions contribute to inclusive growth at reasonable interest rates.”* Exchange rate flexibility and macroeconomic stability were also seen as important to maintain competitiveness and promote diversification. Such policies and objectives are important, but meaningful attention to inclusive growth also requires targeted microeconomic policies.

- The critical issue of how to distribute mineral wealth more equally was not addressed. Lack of IMF staff expertise and necessary attention to other policy priorities precluded deeper analysis of such issues.
- After the EFF went into abeyance, more concrete efforts were made in the 2019 Article IV consultation, which included a selected issues paper on *“Achieving Green and Inclusive Growth in Mongolia.”* This suggests that a surveillance environment might provide more opportunity to analyze efficiency and growth-oriented reforms, while a program environment tends to be dominated by priorities related to demand management and reducing vulnerabilities.
- **Volatility and shocks complicate forecasting, increasing the importance of policy contingencies.** The errors in short-term growth forecasts in both programs should not be a surprise in view of the magnitude of negative and positive shocks that hit the economy and limited short-term indicators and “now casting” capabilities. This makes it more important to specify policy contingencies in advance, including in more detailed risk assessment matrices.

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