

# EPRC MONTHLY NEWSLETTER

JULY AND AUGUST 2005

## Feasibility analysis of USAID's Development Credit Authority loan guarantee products for SME financing concluded

During 18 July through 5 August the project conducted an assessment of the feasibility of using USAID's Development Credit Authority (DCA) loan guarantee products to facilitate the extension of credit by domestic commercial banks to SMEs in all sectors in Mongolia.

USAID's Development Credit Authority provides four major types of products:

**1. Loan Portfolio Guarantees:** Whereby a mission decides on the definition of "borrowers" which can range from a narrow to an all-inclusive designation. The guarantee provides up to 50 percent coverage on a series of loans from a lender or lenders to a pool of borrowers.

**2. Loan Guarantees:** Both lender(s) and borrower(s) are identified and lump sum or multiple disbursements are offered. The guarantee provides up to 50 percent coverage on the principal.

**3. Portable Guarantees:** Allows the borrower to "shop" around for the best loan term and provides up to 50 percent coverage on the principal.

**4. Bond Guarantees:** This choice offers stronger impact for missions whose objectives also include capital markets development. Issue rating is strengthened and the guarantee provides up to 50 percent principal coverage to potential bond purchasers.

USAID's DCA is a market-oriented guarantee mechanism different from other donor SME financing support programs because it operates close to commercial lines:

- DCA offers a partial guarantee only—up to 50% of net principal losses
- Private lenders extend their own capital as loans—no lending funds are provided
- The lender makes credit decisions based on their own approved credit policies and procedures
- The lender sets lending interest rates according to market
- DCA guarantees are intended to be used as a catalyst and must create a demonstration effect for replication in the market.

During July and August, Chemonics loan guarantee experts, Carrie Averch and Irina Sedova worked closely with EPRC's Finance team to analyze credit market imperfections contributing to the very limited access by SMEs to appropriate financial products and services. The team conducted an illustrative SME credit demand and supply study to look at these conditions.

On the SME credit demand side, the team examined a sample of 211 SME loan applications compiled from different sources regarding the average loan size, average term desired, and average interest rate offered for the type of loan. On the supply side, the team collected preliminary information on eight commercial banks that could be considered as DCA partners and evaluated their strategy and capacity to lend to SMEs as well as the level of interest in participating in a DCA guarantee facility.

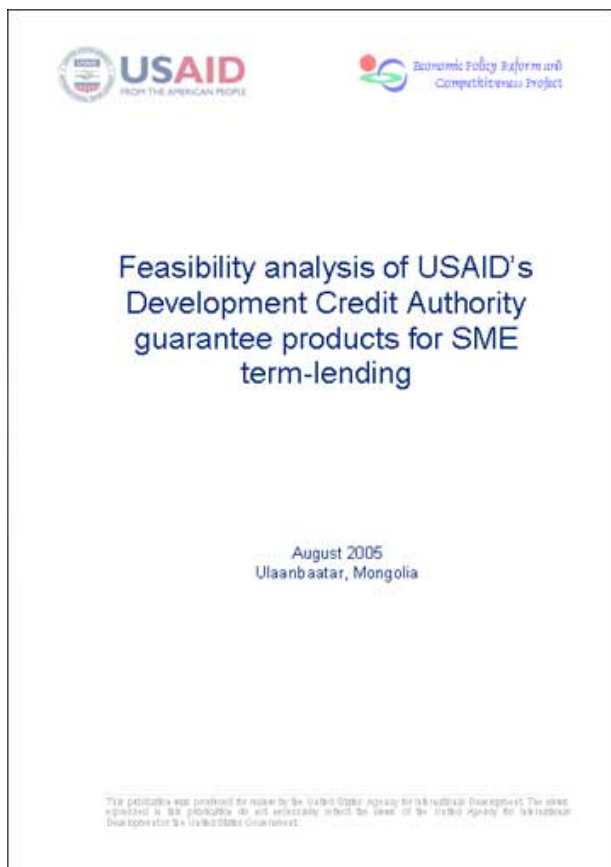


The team also conducted interviews with the other major international donor institutions engaged in SME development and financing activities to ensure that any DCA guarantees recommended for design and development would create additionality in terms of direct development impact and a longer term demonstration effect to the market that term lending to SMEs is profitable.

On 5 August, the team presented findings of its initial assessment. Taking into consideration the current economic context and other existing and planned donor interventions, the team concluded that neither the DCA Loan Portfolio Guarantee nor the DCA Bond Guarantee would be appropriate, at this point in time, to assist the banking sector to increase medium-term lending to SMEs for capital

investment and expansion. Reasons supporting such conclusion include the following:

- DCA requires that partner banks lend their own capital, but Mongolian banks have extremely limited term funds of their own to lend to SMEs
- The WB, KfW, and JBIC two-step loan programs are offering term funds at rates below the demand deposit rate, so banks have a natural incentive to use these lines of credit
- In view of these programs, a DCA LPG would not be able to correct credit market imperfections considering the volume of donor funds directed toward SMEs, and would not create the “additionality” and demonstration effect to the market required by DCA.



The team recommended further exploration of possible use of the DCA Loan Guarantee to assist a limited number of banks to secure medium term loans from foreign financial institutions to help address the problem of a shortage of medium-term funding from domestic sources. By providing up to 50% guarantee on principal for a loan from an international lender to a Mongolian bank, such a loan guarantee would:

- Establish local Mongolian banks credit history in lieu of international ratings
- Provide local Mongolian banks with sustainable source of term funds allowing capital restructuring and increased term lending
- Spin demonstration effects in markets of the benefits of transparency and international creditworthiness of Mongolian banks.

Such a DCA Loan Guarantee, paired with targeted capacity building, could have a significant positive development impact for the Mongolian banking sector by addressing the current credit market imperfection in access to longer term funds and providing access to sustainable sources of term money for onlending to SMEs.

## Over 14,000 tourists visit Tourist Information Centers

According to its visitor records, over 8,500 tourists have visited the Tourist Information Center (TIC) at the Central Post Office since its opening five months ago. An estimated additional 3,000 visited the centers in the airport and railway station. The Post Office TIC, a joint venture between the Ministry of Roads, Transport and Tourism, The Arts Council of Mongolia and The Mongolian Tourism Association was opened in April 2005, and quickly followed by satellites in the airport and railway station. EPRC provided modest funding and technical assistance to train staff and install operating procedures for the functioning of the TICs.



Results of a customer satisfaction survey conducted in late August compliments the level of service given by the TIC staff in terms of attitude and helpfulness, speed and accuracy of information and English skills. The main complaint expressed was waiting for attention during busy periods, with shortness of staff and the small information counter cited as the main cause.

The Tourist Information Center currently provides information about 150 tourism companies and 30 public venues. TIC has also partnered with the Mongolian State Orchestra to sell tickets to performances, with hotels to provide accommodation vouchers on a commission basis, and with tour operators to offer a “city tour” package. Along with its partner *The Arts Council*, the center also publishes the popular “What’s on” guide throughout the season.

## National Dispatch Center software training completed

EPRC provided the *National Dispatch Center* six days of training for seven staff members to learn to utilize a software package which will assist them with transmission/distribution system stability issues and prediction models of system stability and outages to avoid or diminish their impact.



Siemens Technologies, Inc. of Schenectady, NY, the original supplier of this software, conducted the training under a subcontract with the project.

## Project provides support for public information and dialogue on Government's tax proposals

The weekly Ministry of Finance (MoF) and General Department of National Taxation (GDNT) national newspaper tax briefing series continued during July and August. Eight additional tax briefings appeared in four national newspapers during these two months, for a total of ten tax briefings published. Topics covered and dates of release of the tax briefings are:

- Tax relief for jobs and economic growth (20 June)
- The personal income tax (27 June)
- The corporate income tax (4 July)
- What is a "good" tax system? (18 July)
- Value-added tax in Mongolia (25 July)
- Why tax reform and where to start? (1 August)
- Why tax reform and where to start? Part 2. The value added tax (15 August)
- Tax reform effort underway (21 August)
- Personal income tax comparison, Part 1 (29 August)
- Personal income tax comparison, Part 2 (for release on 5 September)

The project has been working closely with the public information officers of the MoF and the GDNT in the preparation and publication of these weekly tax briefs.

The weekly briefs are part of the public communications strategy on tax reform developed by the project at the request of the government earlier this year and will continue on a weekly basis until Parliament debates and passes a tax reform package, anticipated to take place during the fall session. The public communications campaign aims to educate Mongolians about taxes and inform about the different tax reform measures introduced by the government.



The tax briefing series will be incorporated in a "pocket book guide" to Mongolian taxes to serve as educational materials for the public and assist policy makers involved in the tax reform process. In addition to publication in newspapers, the series is also available from the following websites:

- Open Government: [www.open-government.mn](http://www.open-government.mn)
- General Department of National Taxation [www.mta.mn](http://www.mta.mn)
- Ministry of Finance [www.mof.pmis.gov.mn](http://www.mof.pmis.gov.mn)
- Open Society Forum: [www.forum.mn](http://www.forum.mn)
- Economic Policy Reform and Competitiveness project: [www.eprc-chemonics.biz](http://www.eprc-chemonics.biz)
- Olloo: [www.olloo.mn](http://www.olloo.mn)
- Mongolian Development Gateway: [www.gateway.mn](http://www.gateway.mn)



## Inflation rate picks up in Mongolia during the first half of the year

During the first half of 2005, the consumer price index (CPI) reached 14.2 % as shown in Exhibit 1 based on data from the National Statistics Office (Monthly Bulletin of Statistics, NSO, June 2005). In June 2005 it reached 17.8%, its highest level since 1999.

Exhibit 2 shows quarterly changes in consumer goods prices since 2002. The food price index skyrocketed from -7% in the second quarter of 2002 to +21% in the second quarter of 2005. During the last year the price of meat, the basic foodstuff in Mongolia, has increased by more than 40%. The cost of housing index, including heating, has kept growing for the last several quarters.

**What is wrong with inflation?** Since investment risks tend to grow together with expected price change rates, an increase in inflation usually brings a decline in investments as many potentially profitable projects are abandoned in an economy with a high (and growing) inflation. The share of Mongolian domestic private sector investments in GDP (funded from own sources) diminished from about 4% in 2001 to less than 3% in 2004. This is one of the lowest rates worldwide.

A high price inflation concurrent with a relatively stable exchange rate results in a real appreciation of a domestic currency. When in China annual inflation is 1-2% while in Mongolia it remains at a two-digit level and the exchange rate does not adjust respectively, then Mongolian products become less competitive in price. Mongolian exports, except metal ores and textiles, have declined from about \$120-180 million in 2000-03 to \$93 million in 2003 and \$63 million in 2004.

High price inflation does not help the poor. Low-income households tend to be the most affected by price increases because most of them depend on slow-growing (inelastic) incomes and lack the capacity to protect themselves against inflation by making inflation-prone investments or altering their consumption patterns. Most of their incomes are spent on so-called "necessities" and they lack the flexibility enjoyed by more prosperous families who can switch between different consumer goods, depending on relative price changes. A 21% increase of food prices and 13% of housing (heating) costs during the last year has hit the poor ger district city residents the most severely; unlike herders, these urban dwellers do not produce their own food and heating fuel, and have to spend proportionately larger proportions of their incomes on these life necessities.

High inflation makes the entire budget process more problematic. Both the revenue and expenditure projections are made in nominal terms and large shifts in overall inflation level and in relative prices may cause diverse political, social and economic tensions. A 4,000 Tg tax credit for personal income tax payers or 3,000 Tg child support allowance would be gravely affected by large consumer price changes.

Potentially the worst problem to tackle is not the high level of inflation but its ugly dynamic features. High inflation stimulates inflationary expectations that tend to drive prices even higher. Once they activate a "price spiral", they may destabilize an economy in a short period of time. Bringing inflation down becomes a painful procedure; in most cases it pushes down GDP, incomes, consumption and investment. The poor have a harder time recovering from these adjustments.

Exhibit 1: Average annual inflation rate in Mongolia (2000-2005; percent)

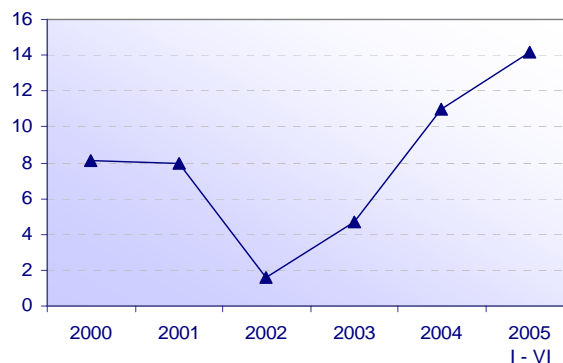


Exhibit 2: Annual consumer price index changes in Mongolia for major items (2002 - 2005; quarters, percent)

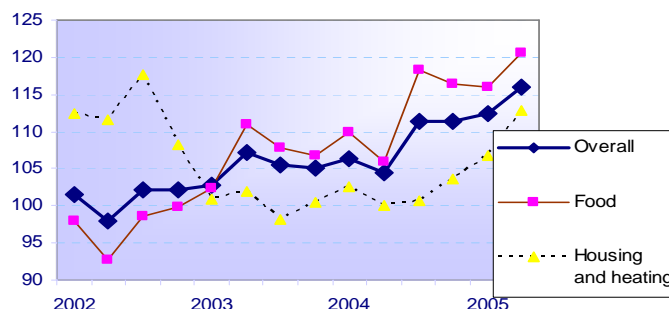
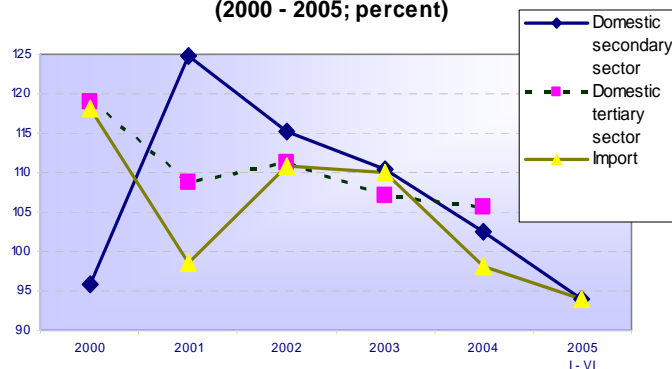
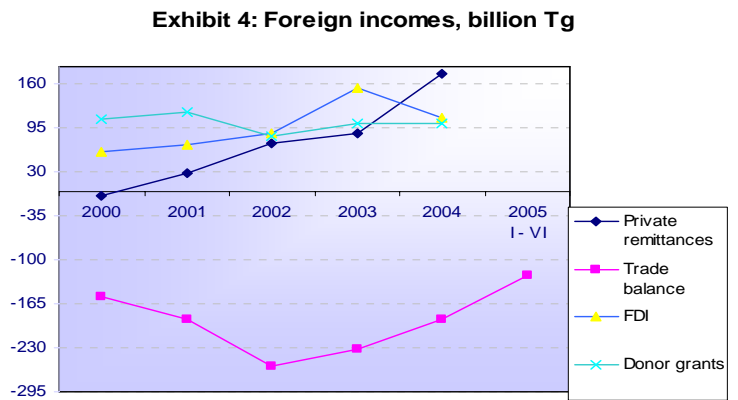


Exhibit 3: Annual percent changes in aggregate supply in Mongolia: domestic and imports (2000 - 2005; percent)



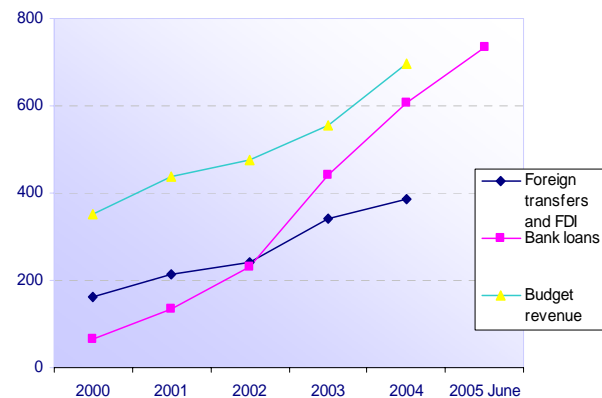
**What is behind Mongolia's inflation?** Recent trends show a reduction in the growth of aggregate supply of goods and services to the Mongolian market, as shown in Exhibit 3. According to our estimates, in the monetized segment of the Mongolian economy (i.e., excluding self-produced food and other self-produced products consumed by households) 93.5% of household expenditures are directed toward products supplied by the domestic secondary sector (manufacture and construction), domestic tertiary sector (services) and imported goods—8.8%, 35.8% and 48.9%, respectively. The real growth of these sectors has been declining: in the first half of 2005 annual rates of deliveries from manufacturing and imports became negative. Higher transportation costs have contributed to this decline, along with fiscal and monetary policies and other factors.



At the same time disposable incomes of people, businesses and government have been growing at high rates, as shown in Exhibit 4. According to official statistics, net private remittances currently bring in more money into Mongolia—174 billion Tg in 2004—than foreign direct investment (FDI) or donors' grants; the latter two have remained at high levels. The declining trade deficit during the last three years has also contributed to a growing current account surplus.

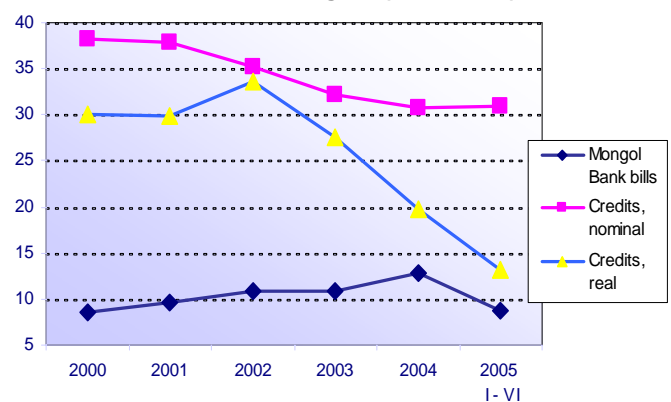
and government have been growing at high rates, as shown in

**Exhibit 5: Mongolia's selected aggregate incomes (2000 - 2005; billion Tg)**



Bank loans also expanded significantly between 2000 and 2004. They had a nine-fold increase while both net foreign transfers and budget revenue (taxes and other non-tax incomes) doubled, as shown in Exhibit 5. This expansion of commercial banks loans goes hand in hand with declining real interest rates (Exhibit 6). Bank lending currently injects the equivalent of one third gross national income (GDP) into the economy. The average annual real interest rate has declined from 30-34% in 2000-02 to 13% in the first half of 2005. Thus, while disposable incomes and bank lending have continued to grow, the availability of domestic and imported supplies has not kept an equal pace resulting in higher prices.

**Exhibit 6: Average annual nominal and real interest rates in Mongolia (2000 - 2005)**



Although the consumer price index (CPI) increased from 5% to 18% during the twelve months prior to June 2005, Mongol Bank cut its bill rate from 13.3% to 5.5% during the same period. When additional data from recent months become available to analyze more recent behavior of the CPI, the Central Bank may consider adjustments to its monetary policy to help curb further inflationary pressures.

**What to do?** The current upsurge of inflationary pressures takes place in a context of currently low real interest rates combined with a real appreciation of the Tugrik and high budget revenue and expenditure. Corrective policies focused on reducing inflation and stabilizing the economy may now need to be considered in order to secure a "soft landing" from the nascent upward price spiral. Unfortunately, the standard quick-acting monetary corrective measures are neither easy nor enjoyable as they may imply actions such as interest rate hikes to make money more expensive, reduction of money supply through the sale of treasury bills at higher (more attractive) prices.

Longer-acting, structurally effective corrective measures such as reduction of the national budget, increased infrastructure investment to improve factor productivity, lessen bottlenecks and aggregate costs are equally difficult. Data from the next two or three months will need close examination to confirm or diminish concerns about these early inflationary trends and take corrective policy actions.

*This Newsletter is a monthly electronic publication of EPRC project activities. Comments, suggestions, and requests for inclusion or deletion from our mailing list can be forwarded to: Editor, EPRC Newsletter, by e-mail [fbertoli@eprc-chemonics.biz](mailto:fbertoli@eprc-chemonics.biz) or fax: (976-11) 32 78 25.*