STRICTLY CONFIDENTIAL

MINISTRY OF FINANCE OF MONGOLIA

MSISTAP PROJECT

Final Report

MONGOLIA

TA ADVISORY ENGAGEMENT:
"MANAGING WEALTH AND OPPORTUNITIES IN MONGOLIA"

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December 2012

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PREFACE

During May 7-18 and July 16-26, 2012, I visited Ulaanbaatar to assist the Ministry of Finance of Mongolia (MFM) to work as Economic Advisor on a Study of Sovereign Wealth Funds (SWFs). This assignment has the purpose to bring a set of recommendations to have a comprehensive framework for the management of Mongolian SWFs (MSWFs). This includes a discussion and specific proposals to implement an institutional arrangement for the management of the MSWFs, to assess investment policy options and risk management, to build a communications strategy, and to propose a road map to the creation of new funds to replace the current Human Development Fund (HDF). In this context, I had several meetings with government authorities and staff, members of the Parliament, multilateral institutions, and other relevant stakeholders.

I reported directly to Mr. Batjargal (Director of the Fiscal Policy Department of the MFM) and work closely with Mr. Khuyagtsogt (Director Human Development Fund Unit at MFM) and Mr. Zorigtbat. I met with Mr. Khayankhyarvaa (Minister of Finance); Mr. Chuulun (Vice-Minister of Finance); Mr. S. Bayartsogt (former Minister of Finance); Mr. Gangerel (Advisor to the Minister of Finance); Mr. Chuluunbat (Member of Parliament and Chairman of the Standing Committee on Budget); Mr. Bud Rentsen (Member of Parliament and Chairman of the Standing Committee on Economic Policy); Mr. D. O'Connell (Resident Debt Advisor, US Treasury); Mr. Dutu (International Consultant, Macroeconomic Modeling, MSTAP); Mr. Tavinjil (Debt Division, MFM); Mr. Boldbaatar (Director General and Member of the Board, Central Bank of Mongolia); Mr. Delgersaikhan (Director General, International Economic Department, Central Bank of Mongolia); Mr. Bataa (Director, International Economic Department, Financial Market Division, Central Bank of Mongolia); Mrs. Ayush (Director, Strategic Planning Department, Ministry of Social Welfare and Labor); Mr. Jargalsaikhan (Deputy Director, Development Policy and Strategic Planning Department, National Development and Innovation Committee); Mrs. Gaadulam (Director, Capital Markets Policy and Planning Division, Securities Market Department, Financial Regulatory Commision); Mr. Tuvshintugs (Economics Department, National University of Mongolia); Mr Ying Qian (Director, Public Management, East Asia Department, Asian Development Bank); and Mr. John Woodall (Senior Specialist in Social Security, Social Security Department, International Labor Office).

GLOSSARY

CBC	Central Bank of Chile
CBM	Central Bank of Mongolia
DBM	Development Bank of Mongolia
ESSF	Economic and Social Stabilization Fund
ETT	Erdenes Tavan Tolgoi
FDI	Foreign Direct Investment
FGF	Future Generations Fund
FSF	Fiscal Stability Fund
FSL	Fiscal Stability Law
GDP	Gross Domestic Product
GSFL	Government Special Funds Law
HDL	Human Development Law
MFM	Ministry of Finance of Mongolia
MSWF	Mongolian Sovereign Wealth Fund
OT	Oyu Tolgoi
PRF	Pension Reserve Fund
SWF	Sovereign Wealth Fund
SWFL	Sovereign Wealth Fund Law
TT	Tavan Tolgoi

EXECUTIVE SUMMARY

This report was prepared in response to a request by the Mongolian authorities to recommend best practices for current and future Mongolian Sovereign Wealth Funds. The report identifies a number of design weaknesses in the current Fiscal Stability Law (FSL) and other key frameworks that need to be tackled as soon as possible in response to the rapid changes of the Mongolian economy because its natural resources. The report proposes design options while noting that further work is needed to refine some options based on the discussions with policymakers and their preferences.

Mongolia has been growing significantly in the last two years as it begins to develop its mineral wealth. However, the Mongolian economy faces significant risks in the near term. These risks echo a cumbersome global economic outlook, including uncertainty coming from China—its main trade partner. In addition, since the FSL has not been implemented fully, the fiscal policy has been pro-cyclical in the last three years with large increases in government spending. This situation has clearly contributed to high inflation rates and pressure on the current account. The 2013 budget presents an opportunity to mitigate these risks by reining in spending and anchoring fiscal policy to the FSL that goes into effect on January 1, 2013.

Rapid economic changes present both challenges and opportunities to implement a comprehensive system of Sovereign Wealth Funds in Mongolia. Currently, the two so-called sovereign wealth funds in Mongolia are the Fiscal Stability Fund (FSF) and the Human Development Fund (HDF). The former was established in the FSL (2010) with "the purpose of ensuring medium and long term fiscal stability," while the latter was established in 2009 with "the purpose to transform non-renewable natural resources into assets yielding sustained returns for equal distribution among citizens." However, the latter is only an instrument to fulfill a political promise to distribute approximately US$1,100 to every Mongolian citizen.

Mongolia Sovereign Wealth Funds (MSWFs) should have a couple of savings instruments with specific and clear objectives. The government of Mongolia should consider additional savings instruments to manage future wealth coming from mineral resources activities. There are several good examples around the world in which governments choose to have different SWFs with different policy purposes. In particular, it would be convenient to create a so-called Pension Reserve Fund and probably a Savings Fund or a Future Generations Fund, each one with specific objectives. These two funds would replace the current HDF. Thus, a possibility is to have a comprehensive set of funds—the MSWFs—with the following objectives:

- The **Fiscal Stability Fund** (FSF) should act as a truly counter-cyclical policy device that will help Mongolia weather the cyclicality of the commodity markets.
- The **Pension Reserve Fund** (PRF) will be created to establish a ring-fenced portfolio of investments specifically related to and with the object of financing future fiscal obligations that stem from guarantees of minimum pensions.
- The **Future Generations Fund** (FGF) will have the purpose to establish a ring-fenced diversified portfolio of appropriate investments for the benefit of future generations of Mongolian citizens.

The international experience could bring some best practices that Mongolia could extract regarding SWFs. Given the source of the resources (natural resources), type of funding (fiscal surpluses), and type of institutional arrangement proposed (not being an independent institution), the best model is somewhat related to Norway and Chile SWFs, whose wealth funds are financed by fiscal surpluses coming from oil and copper, respectively. These three conditions are key to model a comprehensive framework of SWFs for Mongolia. Moreover, the Norwegian and Chilean cases are examples of two policy purposes of SWFs: Macro Stabilization and Pension Reserve, which are two out of three prescribed SWFs for Mongolia.

A good institutional framework aims to provide the MSWFs with operational independence, while ensuring its accountability to the government and the public. An efficient option regarding the institutional arrangement, given the initial size and costs, is to use the Central Bank of Mongolia (CBM) as the operational manager rather than to create an independent institution to manage the natural resource wealth. The main rationale to choose central banks is given by the long experience managing international reserves. The alternative, to create a separate management institutions such as the NZ Superannuation Fund or other such funds, does not seem appropriate given the initial costs and lack of experience to manage government resources.

The institutional arrangement should include a Financial Committee to advise and/or execute the investment policy followed by the MSWFs. The Financial Committee should work on the fundamental aspects of the investment policy for the MSWFs. At the same time, the Committee would help to avoid or diminish political pressures and criticism regarding the investment policy and its performance.

The Ministry of Finance should create a new Unit/Department/Division to be in charge of International Finance issues. Ideally, the structure should include asset and liability management subunits. However, if the administrative burden is too high regarding the previous recommendation, at least the Ministry should put together an Asset Management Unit/Department/Division similar to offices in Norway or Chile. Currently, the HDF unit under the Fiscal Policy Department could play that role.

The investment policy for all funds should involve initially safest asset classes and aligned with the Santiago Principles and also all prudent investor rules for a government. This choice is based mainly on the CBM's experience managing these asset classes. This is a conservative policy given that it does not include asset classes with higher levels of risk such as equities, corporate bonds, and alternative investments. A new investment policy more closely aligned with each objective of the different funds could be considered later.

Several other recommendations are found in the Summary Table (Mongolia: Action Plan) and throughout the report.

Summary Table. Mongolia: Action Plan

Assessment	Recommendation	Timeframe
	Fiscal Stability Fund	
The Law on Government Special Funds. In particular considers accumulation if there is excess between actual revenue and structural revenue in the mineral sector and not between actual and structural budget. Thus, it is possible to find circumstances where an accumulation to the Fiscal Stability Fund (FSF) is triggered despite of having an overall fiscal deficit	Amend the Law on Government Special Funds in the future. The accumulation rule should consider not only revenues, but also the level of expenditures	Medium- term
The resources of the FSF are in a special Treasury account at the Central Bank of Mongolia gaining no return	Invest the resources accumulated in the FSF	Immediate
The structural balance target does not consider the non-mineral fiscal balance and volumes of production of minerals	The structural balance target should be refined in the medium-term, considering both GDP trends (non-mineral balance) and volumes of production of minerals	Short-term to medium-term
The Fiscal Stability Law (FSL) will start to be fully implemented in 2013	The complete implementation of the FSL will require several steps, better organization and coordination, and additional human resources	Short-term
	Human Development Fund	
The Human Development Fund (HDF) is only a mechanism to distribute future wealth given a political promise	Avoid any new version of the HDF and replace them with sovereign wealth funds (see below)	Short-term
The Development Bank of Mongolia (DBM) was used as an off-budget device	The DBM should not be considered as off-budget spending institution	Short-term
	Creation of New Funds	
There is a need to build stronger savings instruments given the application of the FSL	Mongolia Sovereign Wealth Funds (MSWFs) should have a couple of savings instruments with specific and clear objectives: • The Fiscal Stability Fund (FSF) should act as a truly counter-cyclical policy device that will help Mongolia weather the cyclicality of the commodity markets. • The Pension Reserve Fund (PRF) will be created to establish a ring-fenced portfolio of investments specifically related to and with the object of financing future fiscal obligations that stem from guarantees of minimum pensions. • The Future Generations Fund	Short-term to medium-term

Assessment	Recommendation	Timeframe
	(FGF) will have the purpose to establish a ring-fenced diversified portfolio of appropriate investments for the benefit of future generations of Mongolian citizens.	
The current framework only considers the mineral-related budget	The accumulation rule should focus on the overall fiscal surplus	Short-term
	Institutional Arrangement	
The Fiscal Stability Law (FSL) will start to be fully implemented in 2013	It is urgent that the Ministry of Finance leads the building of the new institutional arrangement in relation with asset and liability management	Immediate
The Central Bank of Mongolia has the experience and systems that deal with asset management	Use the Central Bank of Mongolia as the operational manager rather than to create an independent institution to manage the natural resource wealth	Short-term
There is a need to have an institution/body independent from the government to help in the investment policy decisions	The Ministry of Finance should also establish a Financial Committee to advise the Ministry/Minister of Finance on the investment policy of the MSWFs	Short-term to médium-term
The Ministry of Finance needs to be prepared given the challenges ahead related to asset and liability management	The Ministry of Finance should create a new Unit/Department/Division to be in charge of International Finance issues. If the administrative burden is too high regarding the previous recommendation, at least the Ministry should put together an Asset Management Unit/Department/Division similar to offices in Norway or Chile. Currently, the HDF unit under the Fiscal Policy Department could play that role	Short-term
There is a need to have a formal unit on asset management	The minimum staff requirement at the onset of the MSWFs should consider one senior economist, one junior economist, and one lawyer in the Asset Unit	Short-term
	Investment Policy	
Given the initial experience investing abroad, a safest allocation should be in order	The investment policy for all funds should involve initially safest asset classes	Short-term
The investment policy should be clear and transparent	The investment policy should be aligned with the Santiago Principles and also all prudent investor rules for a government	Short-term
Avoid any problem related to Dutch disease	All the resources of the MSWFs should be invested abroad	Short-term
	Communications and Transparency	
Communications is a key component for a transparent and credible fiscal policy and the management of stocks	The Ministry of Finance should devote additional resources and activities to have a strong communications strategy. This	Short-term

Assessment	Recommendation	Timeframe
	process could include: • Conferences/seminars to release the results of the MSWFs; • Regular speeches by authorities both in Ulaanbaatar and other cities of Mongolia; • Off the record meetings with journalists and economists; • Publication of a light brochure of MSWFs; • Activities for students (e.g., visits to the MFM and CBM; school competitions on economic issues; etc.); • Regular publication and dissemination of working papers	
Need to increase communications with stakeholders	Preparation of monthly, quarterly, and annual reports	Short-term
Need to increase communications with stakeholders	Preparation of website on MSWFs	Short-term
Need to learn about other SWFs experiences and increase communications with recipient countries	Participation in all International Fora of SWFs and dialogue with recipient countries	Short-term
	Risk Management	
Start thinking about investment mandates for each fund	The investment mandate should require to have regard to maximizing return over the long term and taking appropriate but not excessive levels of risk. Details will depend on the type of fund	Short-term to medium-term
Preserve the effectiveness of the government's ability to make investments with flexibility	Develop a rolling five-year investment plan for the MSWFs	Short-term to medium-term
	Debt and Asset Management Law	
Several news aspects regarding asset management could be considered in a separate law, focusing on Sovereign Wealth Fund issues	Split the laws in two: one for debt aspects and the other one for asset management	Short-term
Keep flexibility in the law	The draft law should include mainly general principles	Short-term
	Next Steps	
See above	Reorganization of some departments within the MFM to strengthen the capacity to organize the budget process with the new rules and the management of the MSWFs	Short-term
	Organize all the components of the institutional arrangement of the management of the MSWFs, including	Medium-term

Assessment	Recommendation	Timeframe
	the discussion about the CBM as the fiscal agent to manage the resources of the government resources	
	Prepare a Manual for Policies and Procedures	Short-term
	Prepare and review investment policies/guidelines for the MSWFs	Short-term
	Organize conferences and seminars to discuss the new framework with all relevant stakeholders	Short-term

I. INTRODUCTION

Chile's long experience in applying the structural balance policy and implementing the associated sovereign wealth funds has revealed important benefits. In fact, there is consensus among analysts that it has had six principal advantages. First, it has permitted the implementation of a counter-cyclical policy, attenuating the economy's swings and reducing uncertainty as to its medium-term performance. Second, it has meant an increase in public saving during periods of strong growth, which has, in turn, helped to prevent currency appreciation and safeguard the competitiveness of the export sector. Third, it has reduced interest rate volatility and, fourth, has boosted the Chilean government's credibility as an issuer of international debt, reducing the sovereign risk premium it has to pay, improving access to foreign financing during negative external shocks, and minimizing contagion from international crises. Fifth, it has also reduced the economy's need for foreign financing and, sixth, it has ensured the financial sustainability of social policies, facilitating their long-term planning.

In the light of these benefits, there is widespread technical and political support in Chile for the maintenance of these countercyclical policies, for continuing to improve some of its methodological aspects, and for its institutionalization. Since the policies' adoption, the way in which indicators are calculated as well as the definition of key parameters and assumptions have been made increasingly transparent, the disclosure of information to the public has been improved, and the methodology and institutional arrangement have been refined. In addition, in September 2005, the government presented a Fiscal Responsibility Law Bill to Congress, which was approved in August 2006, giving legal force to key aspects of the structural surplus, and fiscal policy that previously depended only on the voluntary commitment of the authority. However, this law does not bind future administrations to a specific structural balance target.

In this context, the Chilean and other international experiences—discussed in this report—could be replicated in Mongolia with the same benefits. The Mongolian FSL will serve as the basis for drawing up and implementing the public sector budget. To this end, Section II reviews the current macroeconomic background in Mongolia and its main challenges. Section III summarizes the Chilean experience regarding the implementation of the structural balance rule and the sovereign wealth funds. Section IV has a discussion of possible amendments to the Fiscal Stability Law and some rules regarding the Fiscal Stability Fund. Section V discusses introductory aspects to replace the Human Development Fund with new funds that will be discussed in Section VI. Section VII proposes the Institutional Arrangement of the MSWFs. Section VIII discusses the basic aspects of the Investment Policy at this early stage. Section IX considers all aspects related to Communications and Transparency. Section X examines the main components of Risk Management. Section XI (and Appendix 1) assesses and makes recommendations regarding the Debt and Management Law. Finally, section XII discusses the possible next steps to start implementing the new framework regarding the MSWFs.

II. Mongolia Macroeconomic Background

Mongolia has been growing significantly in the last two years as it begins to develop its mineral wealth. The development of the Oyu Tolgoi (OT) copper-gold mine pushed GDP growth over 17 percent in 2011 and probably the Mongolian economy will continued grow in double-digits at least until 2014, with sustained increases in exports and fiscal receipts. The Tavan Tolgoi (TT) mine will also contribute to this double-digits growth.

However, the Mongolian economy faces significant risks in the near term. These risks echo a cumbersome global economic outlook, including uncertainty coming from the Chinese economy. In addition, since the Fiscal Stability Law (FSL) has not been implemented fully, the fiscal policy has been pro-cyclical in the last three years with large increases in government spending. This situation has clearly contributed to high inflation rates and pressure on the current account. The 2013 budget presents an opportunity to mitigate these risks by reining in spending and anchoring fiscal policy to the FSL that goes into effect on January 1, 2013.

Recently growth has slowed, but should remain in double digits between 2012 and 2014, barring any severe negative shock. The current account deficit meanwhile has continued to widen, although it currently remains funded by Foreign Direct Investment (FDI) flows. However, FDI flows are expected to start easing next year as the construction of the OT mine comes to a close. On the other hand, inflation remains persistently high, due to high food prices and expansionary fiscal policy that has led to demand side pressures in an already overheating economy. The headline inflation rate was over 11 percent in 2011, and it is expected to be over two digits in 2012 and also in 2013.

The fiscal deficit for 2012 is projected to increase from the original target of 1 percent to 4.2 percent as per the September amended budget. The increase is explained by weak revenue growth due to the slowdown in exports and lower commodity prices, and sustained expenditure increases. The actual outturn may be worse as budgeted expenditures have not been reduced significantly and growth forecasts remain overly optimistic. These numbers also do not reflect the significant off-budget financing of capital expenditures by the Development Bank of Mongolia (DBM) and by construction companies on condition of repayment by the budget, which will likely impact the budget next year and beyond. Including DBM spending, the deficit could reach 9 percent of GDP in 2012. Although the OT mine is already in operation, net revenues from the mine are only expected to enter the budget with a lag around 2015-16.

The financial market also remains subject to negative shocks. Although monetary tightening over the past year has helped to slow the pace of credit growth from 73 percent at the end of 2011 to 37 percent in August, it is still high. Mongolia's banking system remains highly dollarized, with approximately a third of deposits denominated in dollars and easy convertibility out of the tugriks. A sharp economic slowdown or increased macroeconomic instability could cause risks to individual banks and to the overall financial system.

Both the domestic macroeconomic risks and the uncertainty in the global economy are caution signs for the Mongolian economy and its fiscal policy. One of the new key pillars of the Mongolian policy framework is the FSL. Thus, respecting the FSL is fundamental to support a prudent fiscal policy and provide the additional savings into the MSWFs. A prudent fiscal policy, together with an active CBM, a flexible exchange rate regime, and a sound financial sector could help to support the current global risks with any major problems. That is the current macroeconomic challenge.

III. CHILEAN EXPERIENCE: FISCAL RULE AND SWFS

Over the past twenty years, Chile's hallmark has been maintaining a fiscal responsibility policy and continuously strengthening of its institutional framework. In 2001, a structural surplus rule was introduced for the central government budget and this was followed in 2006 by the creation of the country's two sovereign wealth funds as a vehicle for managing the surpluses resulting from the application of this rule.

Under the rule, annual fiscal expenditure is calculated in accordance with the central government's structural income, independently of fluctuations in revenues caused by cyclical swings in economic activity, the price of copper and other variables that determine effective fiscal income. This implies that the government saves during upswings, when it receives significant transitory revenues, and can avoid the need for a drastic tightening of fiscal spending during downturns, thereby stabilizing the growth of public expenditure over time. In 2001, the structural surplus target was set at 1 percent of GDP and this was reduced to 0.5 percent of GDP under the fiscal budget for 2008. In 2009, the ex ante target was reduced to 0% to deal with the global crisis. Currently, the medium-term target is -1 percent.

The Fiscal Responsibility Law, which came into effect in the second half of 2006, established norms and an institutional framework for the accumulation and management of these fiscal assets. The Law created two sovereign wealth funds: the Pension Reserve Fund (PRF), into which the first payment was made on December 28, 2006, and the Economic and Social Stabilization Fund (ESSF), which was officially established under Decree with Force of Law (DFL) Nº 1, issued by the Finance Ministry in 2006. This decree merged into a single fund the savings accumulated under Decree Law (DL) Nº 3,653 (1981) and those held in the Copper Income Compensation Fund. The first payment into the ESSF was made on March 6, 2007.

Objectives of SWFs

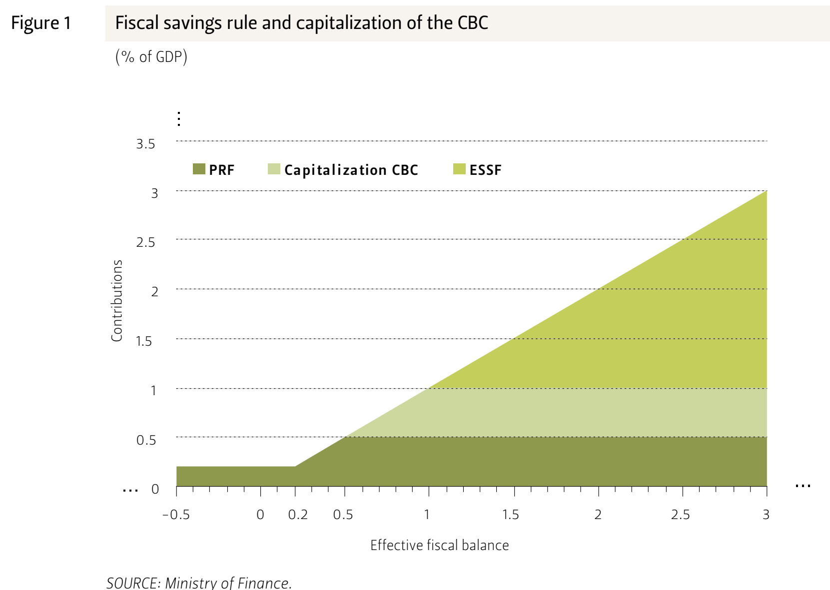
The two Funds created under the Fiscal Responsibility Law (the "Sovereign Wealth Funds" or "Funds") have clear but differing objectives. The ESSF was created to finance fiscal deficits that can occur in periods of low growth and/or a low copper price. This helps to reduce fluctuations in fiscal spending across the economic cycle. The ESSF can also finance the payment of public debt and recognition bonds as well as regular contributions to the PRF, as established under Ministry of Finance Statutory Decree DFL N°1 of 2006. The purpose of the PRF is to complement the financing of fiscal liabilities in the area of pensions and social welfare. Specifically, the fund backs the state guarantee for old-age and disability solidarity pension benefits, as well as solidarity pension contributions, as established under the pension reform.

Accumulation rules

The Fiscal Responsibility Law of 2006 establishes the rules on fund contributions. The use of the funds is also established in the same law, as well as in the Pension Law of 2008 for the PRF and DFL Nº 1 for the ESSF. The Fiscal Responsibility Law established the rules for the creation of the ESSF and the PRF and for contributions to the Funds as well as the option of capitalizing the Central Bank of Chile (CBC) during a period of five years. Figure 1 illustrates the operation of these rules for different levels of effective central government balance. Under the law, the PRF increases each year by a minimum amount equivalent to 0.2% of the previous year's Gross Domestic Product (GDP). If the effective fiscal surplus exceeds this amount, the contribution to the PRF can rise to a maximum of 0.5% of the previous year's GDP. This policy will remain in force until the PRF reaches the equivalent of 900 million *unidades de fomento* (UF). The law also authorized the government to capitalize the CBC by an annual amount equivalent to the difference between its contributions to the PRF and the effective fiscal surplus, providing this difference is positive, with an upper limit of 0.5% of the previous year's GDP. This capitalization can take place over a period of five years as from September 2006. Finally, the remainder of the effective surplus, after payment into the PRF and capitalization of the CBC, must be paid into the ESSF. Repayments of public debt and provisional payments into the ESSF during the previous year can, however, be deducted from this contribution.[1]

Figure 1 Fiscal savings rule and capitalization of the CBC

(% of GDP)



SOURCE: Ministry of Finance.

[1] The law currently in force permits the use of resources from the current year's fiscal surplus, which must be deposited in the ESSF during the following year, to pay down public debt and make provisional contributions to the ESSF.

Withdrawal rules[2]

The ESSF resources can be used at any time to complement fiscal revenue as needed in order to finance authorized public expenditures in the case of a fiscal deficit. They can also be used for the regular or extraordinary amortization of public debt (including *bonos de reconocimiento*) and for financing the annual contribution to the PRF when the Minister of Finance so decides.

The PRF is designed exclusively to complement budget financing of fiscal liabilities arising from the state guarantee on basic old-age and disability solidarity pensions and old-age and disability solidarity pension contributions. Until 2016, annual withdrawals of up to the previous year's returns may be made and, as from 2016, of up to a third of the difference between expenditure on pension liabilities in the current year and expenditure on this item in 2008 adjusted by the change in the consumer price index during the intervening period. The PRF will cease to exist in September 2021 if the withdrawals to be made in a calendar year do not exceed 5% of the sum of expenditure on the state guarantee on basic old-age and disability solidarity pensions and old-age and disability solidarity pension contributions as established in that year's budget. When the PRF ceases to exist, any balance in the Fund must be transferred to the ESSF.

Management policy

Under Decree N° 1.383 of 2006 (the "Agency Decree"), the Ministry of Finance appointed the CBC as Fiscal Agent to act in its name and on its behalf in the management and investment of the Funds' resources. The CBC must abide by specific instructions given by the Finance Minister ("Investment Guidelines") which establish the requirements and conditions necessary for the proper exercise of the functions en- trusted to the CBC in its role as fiscal agent.

IV. FISCAL STABILITY FUND AND FISCAL STABILITY LAW

Currently, the resources of the Fiscal Stability Fund (FSF) have reached US$ 250 million. The Ministry of Finance of Mongolia (MFM) transfers these resources to the FSF to fulfill the requirements of the Law on Government Special Funds. In particular, that law considers accumulation if there is excess between actual revenue and structural revenue in the mineral sector[3] and not between actual and structural budget (revenues minus expenditures). Thus, it is possible to find circumstances where an accumulation

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[2] Contributions to and withdrawals from the ESSF and PRF are formalized through a Ministry of Finance decree.

[3] Similar rule is applied in Norway, but the difference is that the Norwegian rule considers that the net cash flow from oil goes into the fund, and the non-oil deficit is covered by the fund. In addition, returns on the fund are added to the fund. If the non-oil deficit is greater than the sum of cash flows and returns, the balance of the fund will be reduced. So there is no borrowing until the fund is empty. In practice, the fund was started in 1990, but deficits higher than oil revenues meant that nothing was put in the fund until net cash flow from oil was higher than non-oil deficit from 1996 onwards.

to the FSF is triggered despite of having an overall fiscal deficit.[4] This means that debt should have been issued to transfer resources to FSF. Indeed that was the case in 2011 and probably in 2012.

It would be recommendable to make an amendment to the Law on Government Special Funds in the future. The accumulation rule should consider not only revenues, but also the level of expenditures. Therefore, the FSF should accumulate resources if there is an overall fiscal surplus. Such types of rules of accumulation are found in the cases of Australia, Chile, Ireland, Korea, Malaysia, New Zealand, and Singapore. And this rule should apply also in the case of the creation of new funds.

The resources of the FSF are in a special Treasury account at the Central Bank of Mongolia (CBM) gaining no interest. The explanation, so far, for this situation comes from Article 17.1 in the Fiscal Stability Law (FSL) that mentions that "An appropriate amount of investments to be made at the domestic or foreign markets from financial savings generated by the source of the FSF…that exceed 10 percent of the GDP…" One interpretation suggests that only resources over 10 percent of GDP should be invested, while less than 10 percent of GDP should be held in cash. However, the Government Special Funds Law (GSFL), Article 9.7, mentions that: "Under an agreement between the central public administration body in charge of finance and fiscal matters and the BOM, the latter shall administer financial managements of the BSF in order to ensure liquidity of the resources…" This would mean that even under 10 percent of GDP, the resources in the FSF can be invested in liquid assets.

It would be recommendable to invest the resources accumulated in the FSF as soon as possible. With the new comprehensive scheme of Mongolian SWFs, all the resources of the funds should be invested abroad. With annual inflation rates over 15 percent, the resources saved in the FSF are losing value rapidly. Thus, it would be convenient to prepare instructions and/or guidelines to the CBM to invest the money in liquid assets. Since the saved resources so far are in tugriks, a possible transitory solution would be converting the current balance of the FSF back to foreign currency, as well as keeping in foreign currency future inflows, which the CBM can invest for the account for the government in a similar way as it invests international reserves.

The structural balance target does not consider the non-mineral fiscal balance. The current FSL considers only the mineral balance to compute the structural balance and hence, determine fiscal expenditures. There is no consideration at all about the non-mineral balance, and consequently it does not consider any adjustment to GDP and its relationship with taxes and consequently, exclude in the calculations the long-term income from other sources than minerals. This is particularly important today because the non-mineral balance represents 70 percent of the overall fiscal balance. In addition, the same situation happens with the volumes of production of minerals. The latter is important because in the first years of production, for example, this could entail a significant jump in fiscal expenditures.

There are two problems with the current framework. First of all, since the rule focuses on structural mineral revenues, it is possible to accumulate resources in the FSF

[4] This difference is calculated using the pricing rules of the FSL to compute structural revenues.

despite the fact of running a fiscal deficit. Second, the current rule considers only non-mineral revenues instead of structural non-mineral revenues and consequently the former could undermine the FSL increasing its expenditures. This second problem is somewhat limited given the expenditure rule in the same law. In particular, total budget expenditure growth of a particular year is limited to not be more than the greatest of the non-mineral GDP growth of the particular year and the average of non-mineral GDP growth rate for 12 consecutive years preceding the particular year.

The structural balance target should be refined in the medium-term, considering both GDP trends (non-mineral balance) and volumes of production of minerals.[5] In the first case, a large part of the fiscal income is associated to taxes, therefore, it would be convenient to include a measure of GDP trend and find the elasticities with the different type of taxes coming from both mineral and non-mineral sectors. In the case of volumes, it would be convenient to have a transition period in which the quantities should have also a long-term trend. Later on, in the steady state, it would not be necessary because the production will not be so volatile.

The complete implementation of the FSL will require several steps, better organization and coordination, and additional human resources. The FSL should be fully implemented in 2013, so it is convenient to start discussing details regarding concepts associated to budget accounting, institutional arrangement, and investment policy. In addition, there is a need to measure correctly new budget items because of different rules of accumulation, rules of withdrawals, and financing, among other topics.

V. HUMAN DEVELOPMENT FUND

The discussion regarding the FSL and especially the Human Development Fund is quite politicized. Recent citizen demonstrations had put pressure on the government and political parties to fulfill their promises of bringing a total of 1.5 million of tugriks (US$1,100) to every citizen of Mongolia.[6] This policy can affect the labor force through two mechanisms: i) the Dutch Disease: a sharp rise in mineral exports will typically cause an appreciation in the real exchange rate, which in turn will reduce the international competitiveness of the country's agricultural and manufacturing exports and may reduce employment in these sectors. Although governments can do much to offset the effects of the Dutch Disease, too frequently they do not; and ii) since the distributions would take the form of income, a direct distribution plan could also encourage several types of rent-seeking.

The Human Development Law (HDL) gives the options to citizens to choose between several modalities to distribute the 1.5 million of tugriks, including cash. The following modalities will be used in Fund distributions to citizens of Mongolia: i) contribution to pension and health insurance; ii) repayment of mortgage loans; cash; and medical and education service fees. The problem with this scheme is that citizens can

[5] Richard Dutu (Macroeconomics Consultant to the Ministry of Finance of Mongolia) made similar recommendations in 2012.

[6] Apart from the Alaskan fund, however, no fund has provided for direct distribution. The idea was proposed in Sao Tome and Principe, but was immediately rejected.

choose, so it is very likely that the majority will opt for the cash. In this case, consumption will rise significantly (despite the fact that the cash could be delivered in a couple of years) with the negative consequences on the economy. And this has been evident with significant inflation rates of 14.3, 11.1, and probably 13 percent in 2010, 2011, and 2012.

The distribution through the HDF will reach approximately US$1,3 billion. This amount, through cash handouts, has been distributed every year since 2010 (see Table 1). In addition, the government has distributed school vouchers for US$112.3 million and health vouchers for US$3.8 million. Elderly and disabled people will get the total of 1.5 million tugriks probably before July 2012.

Table 1. Distribution of wealth through the HDF (cash handouts)

	Amount per person	Thousands of people			Expenditure (thousands of tugriks)		
	Tugriks	2010	2011	2012	2010	2011	2012
Feb-10	70000	2693.7	41		188559000	2870000	
Aug-Dec-2010	50000	2330.3	243		116515000	12150000	
Jan-11 onward	252000		2734.6			689119200	
Jan-12 onward	128000			2800			358400000
Jun-12	1000000			334.2			334200000
Total (tugriks)	372000				305074000	704139200	692600000
Exchange rate (end of period)					1256.47	1396.37	1316.11
Total (US$)					242,802	504,264	526,248

Source: Ministry of Finance.

Currently, there is a complementary scheme to distribute wealth to citizens through the distribution of shares from Erdenes Tavan Tolgoi (ETT). The framework requires giving to every citizen (except for the ones who completed the 1.5 million tugriks distribution) 1 million tugriks in ETT shares, equivalent to 1.072 shares. This entails a price of 933 tugriks per share and 20 percent of expected value of the company.[7] However, this is a not market price; therefore, it could be different after the IPO. In addition, the scheme allows people to exchange its shares for cash. To finance the possibility of people getting cash, the government, given the Parliament resolutions 39 of 2010 and 57 of 2011, plans to sell 10 percent of the property to local companies. This combination of possibilities has created a lot of uncertainty regarding a possible solution. There are issues regarding the future market price, the funding, the possibility of getting cash, etc. So far there is no clear signs of a solution.

I insisted that HDF is not a good idea both economically and politically as it stands. If the HDF has to be adopted completely, it would be recommendable to find mechanisms to avoid a significant raise in today's consumption and consequently, inflationary pressures, Dutch disease, and unemployment. One recommendation is to distribute some additional cash to the public, but a large share of the contributions in individual pension accounts for each citizen and postpone all the current expenditures to the future. This would transform a problem into an example of responsibility and a policy with best international standards. Certainly, this will require having a political consensus with both government parties. Having the HDF fully implemented would undermine the efforts of what the FSL is trying to achieve. Moreover, the HDF, if implemented, it would be recommendable to have it only for one time. Of course there are transfers or subsidies examples around the world, but there are three considerations:

[7] Government resolution number 181 of 2012 determines the ETT share price.

- Basic infrastructure is already in place;
- Programs are targeted to low income households and are conditional on certain actions of the households in support of their children's well being, for example;
- In countries such as Chile or Norway, the mineral earnings are also distributed to the public, but as pension benefits.

In addition, the Development Bank of Mongolia (DBM) should not be considered as off-budget spending institution. All the additional fiscal expenditures and associated debt should be included in the budget. Even when public infrastructure (roads, power, etc.) is highly productive, and when financing is available, the actual physical investment will necessarily take time to put in place, and the optimum pace is itself an economic calculation. Many investments projects impose adjustment costs that increase in proportion to the rate of investments. The optimum response in that case is to spread the investments over time, to maximize the benefits of the investments net of the adjustments costs themselves. This pacing of investments is described as investing according to the "absorptive capacity" of the economy. Perhaps the most famous example of an investment boom gone wrong was the massive and costly congestion in Nigeria's ports in the spending boom that followed the oil price increases in the early 1970s. Thus, the infrastructure needs should be included as part of the budget, otherwise there will be two parallel budgets that could weaken the FSL.

VI. CREATION OF NEW FUNDS

Currently, the two so-called sovereign wealth funds in Mongolia are the Fiscal Stability Fund and the Human Development Fund. The former was established in the FSL (2010) with "the purpose of ensuring medium and long term fiscal stability," while the latter was established in 2009 with "the purpose to transform non-renewable natural resources into assets yielding sustained returns for equal distribution among citizens." However, the latter is only an instrument to fulfill a political promise to distribute approximately US$1,100 to every Mongolian citizen (see previous section).

Mongolia Sovereign Wealth Funds (MSWFs) should have a couple of savings instruments with specific and clear objectives. The government of Mongolia should consider additional savings instruments to manage future wealth coming from mineral resources activities. There are several good examples around the world in which governments choose to have different SWFs with different policy purposes (see Table 2). In particular, it would be convenient to create a so-called Pension Reserve Fund and probably a Savings Fund or a Future Generations Fund, each one with specific objectives. These two funds would replace the current HDF. Thus, a possibility is to have a comprehensive set of funds—the MSWFs—with the following objectives:

- The **Fiscal Stability Fund** (FSF) should act as a truly counter-cyclical policy device that will help Mongolia weather the cyclicality of the commodity markets.
- The **Pension Reserve Fund** (PRF) will be created to establish a ring-fenced portfolio of investments specifically related to and with the object of financing future fiscal obligations that stem from guarantees of minimum pensions.

- The **Future Generations Fund** (FGF) will have the purpose to establish a ring-fenced diversified portfolio of appropriate investments for the benefit of future generations of Mongolian citizens.

The Pension Reserve Fund will cover a portion of future national pension costs and facilitate transitions as Mongolia enacts revised pension policies. Numerous government and financial sector representatives identifies funding a reformed pension system as the next priority for a Mongolian sovereign wealth fund. As it was lengthy discussed in a World Bank draft (2011) for discussion,[8] the Pension Reserve Fund would be an investment vehicle to pre-finance future benefit obligations while not subjecting contributors to the investment or funding risks of such funds. As discussed in that report, an essential legal distinction, which differentiates Pension Reserve Funds from a "funded" approach to pension system finances, is that the rate of return on assets of the Pension Reserve Fund in no way directly impacts the pension benefit obligation promised to the worker. Thus, a Pension Reserve Fund only complements and finance part of future pension liabilities. In other words, pension liabilities are not explicitly linked to the returns of the fund. As a result, if the PRF under-performs its desired investment objective, then the retirees are not left with an un-funded or inadequately funded shortfall.

World Bank (2011) identifies several pension costs that the authorities may want to "pre-finance" through a PRF. Among others: i) transition program for post-1960 cohorts to supplement benefits from about 2015 to 2030 during which time the impact of parametric reforms will be able to adjust the average replacement rates of these cohorts back up to a level of about 42%; ii) costs of a targeted social pension for a 15-20 year period during which time uncovered workers or workers with insufficient entitlements will have time to build up their notional account balances while many older workers closer to retirement will not have such an option; iii) matching contributions for a matching defined-contribution scheme for a discreet period; iv) projected fiscal subsidies required for pre-1960 cohorts from 2015 for a period from 2015 to 2040 by which time most expenditures will be eliminated; v) pension contributions to offset part of proposed 5% increases from 14-19% in order to much more gradually increase contributions over a 20 year period beginning in 2015; vi) anticipated contributions required for disability and survivorship benefits which could be 3.5-6.0% of covered wages for a specified period; and vii) needs for old-age income security and poverty protection but refrain from specifying the precise intended use of such funds.

A PRF would be a useful mechanism to set aside some of the mineral resources to supports a comprehensive pension system as well as to complement financing of future national pension costs. Indeed, World Bank (2011) believes that such a PRF is a preferable option to pre-finance future pension obligations when compared to establishing a Funded Defined Contribution design for the Pension Insurance Scheme.

The Future Generations Fund would be a useful mechanism to set aside some of the mineral resources to support future expenditures not explicitly defined today. Ring-fencing such resources can satisfy social policy objectives of improving inter-

[8] See draft version "Mongolia: Policy Options for Addressing Pension Reform Needs" of the World Bank Human Development Unit, East Asia and Pacific Region. February 29, 2011.

generational equity, and at the same time reducing the political temptations of increasing fiscal expenditures through amendments to the FSL. Obviously, the FSF and the PRF should have the priority in terms of accumulating resources for the future.

The accumulation rule should consider two related options focusing on the overall fiscal surplus. The first one could be related to a specific rule that would rank the importance of savings in the different funds. For example, if the fiscal surplus is 3 percent of GDP, the rule could consider that the first 1 percent goes to the PRF, then 1 percent to FGF, and the rest, 1 percent in this case, goes to the FSF. Similarly, if the fiscal surplus is 5 percent of GDP, again 1 percent will be distributed to PRF, 1 percent to FGF, and the rest, 3 percent, to FSF. This structure is similar to the case of Chile. The second alternative is to consider minimum percentages allocated to each fund. For instance, if the overall fiscal surplus is 5 percent of GDP, the rule could consider minimums of 20 percent of the total amount of the fiscal surplus for each fund. So, in a particular year, the government may want to allocate 50 percent to the FSF, 30 percent to the PRF, and 20 percent to FGF. This will give some flexibility to the governments to prioritize within this strict savings framework. The size of the annual accumulation of each fund will depend on projections regarding contingent liabilities, like pensions. Having said that, the government could start saving the resources in the funds and have the flexibility to assess every couple of years the size of the different funds.

SWFs are usually distinguished by their funding sources, objectives and institutional arrangement (see Table 2). In terms of funding, three types of sources are available:

- ***Commodity sources*** are largely oil and gas related (e.g., Middle East countries, Azerbaijan, Norway, Trinidad & Tobago, Timor-Leste), although some funds are also based on revenues from metals and minerals (e.g. Chile, Botswana). Commodity revenues are usually generated either directly through state-owned companies dividends or through taxes to private companies.
- ***Fiscal sources*** can come from fiscal surpluses, proceeds from property sales and privatizations or transfers from the government's main budget to a special purpose vehicle. Ideally fiscal sources are real savings or wealth, although some have funded SWFs through liabilities (e.g., Brazil, China, Mongolia (FSF)).
- ***Foreign reserves*** represent mainly borrowed wealth as the reserve build-up in many countries stems from sterilized foreign exchange interventions (e.g., China, Singapore (GIC), Korea). The share of foreign reserves managed by SWFs is typically viewed as "excess" reserves as it exceeds the portion of foreign reserves deemed necessary for the conduct of foreign exchange policy and precautionary reasons.

International Experience

The classification of SWFs based on their purpose usually can be broken down into four types of funds:

- **Macro stabilization** funds are designed to offset the impact of volatile commodity revenues on the government's fiscal balance and the overall economy (e.g., Chile, Mongolia (FSF), Nigeria, Russia, Timor-Leste).

- **Future generations** funds are meant to invest surpluses over longer time periods for future needs (e.g., Korea, Nigeria, Singapore (GIC)).
- **Pension reserve** funds are earmarked for particular purposes, such as covering future public pension liabilities (e.g., Australia, Chile, New Zealand, Norway, Russia).
- **Savings funds** often cover one or several of the previous three purposes and/or manage their governments' direct investments in companies. These may be domestic state-owned enterprises and private companies as well as private companies abroad.

Also, SWFs differ in their institutional arrangements. By definition, all SWFs belong to the public sector, but either the government directly owns some or they are statutory entities. All SWFs have a board, but some are entirely government controlled, while others have mixed representations from the government and private experts and a few are even independent from the government yet answerable to the legislature (e.g. Australia's Future Fund). In addition, the main difference is between SWFs that act as separate entities with their own balance sheet (e.g. UAI (ADIA), Singapore (Temasek)) and those that act as agent for one or several public-sector entities (e.g. Singapore (GIC), Korea). In some cases, the central bank acts as the agent that manages the assets of the SWF (e.g. Chile, Norway, Saudi Arabia).

Thus, we will consider relevant experiences of governments and funds that have saved financial assets related to natural resources. The most well known case is Norway. The Government Pension Fund was established to support the long-term management of petroleum revenues and facilitate the government's accumulation of financial assets in order to help cope with large, future financial commitments associated with an ageing population. The Fund consists of the Government Pension Fund – Global and the Government Pension Fund – Norway. The Pension Fund – Global's inflow consists of all state petroleum revenues, net financial transactions related to petroleum activities, as well as the return on the Fund's investments. The outflow from the Fund is the sum needed to cover the non-oil budget deficit. In other words, Norway's SWF receives the net central government receipts from petroleum activities and transfers to the budget the amounts needed to finance the non-oil deficit. Therefore, the net allocation to the SWF reflects the budget's overall balance. The Fund is thus fully integrated with the state budget and net allocations to the Fund reflect the total budget surplus (including petroleum revenues). Fiscal policy, which regulates the outflow from the Fund, is anchored in a guideline where the structural, non-oil budget deficit shall over time correspond to the real return on the Fund, estimated at 4 percent.

A clear division of responsibilities between the political authorities and the operational management marks the governance structure of the Norwegian Fund. The Ministry of Finance is the formal owner of the Fund. The Ministry has formulated the investment strategy by setting a benchmark with risk limits. Within these limits, there is full delegation of operational management to the Norges Bank. The Bank manages parts of the funds internally, while parts are managed by external managers.

Table 2. **Sovereign Wealth Fund Classification**

Source Year established Country	Policy Purpose			
	Macro stabilization	**Saving**	**Pension reserve**	**Reserve investment**
Oil and Natural Gas				
1953 Kuwait	Kuwait Investment Authority, General Reserve Fund	Kuwait Investment Authority, Future Generations Fund		
1976 Canada		Alberta Heritage Savings Trust Fund		
1976 United Arab Emirates		Abu Dhabi Investment Authority		
1976 United States		Alaska Permanent Fund		
1980 Oman		State General Reserve Fund		
1983 Brunei Darussalam		Brunei Investment Agency		
1996 Norway	Government Pension Fund-Global	Government Pension Fund-Global	Government Pension Fund-Global	
1999 Azerbaijan	State Oil Fund	State Oil Fund		
2000 Iran	Oil Stabilization Fund			
2000 Mexico	Oil Revenues Stabilization Fund			
2000 Qatar		Qatar Investment Authority		
2000 Trinidad and Tobago	Heritage and Stabilization Fund	Heritage and Stabilization Fund		
2001 Kazakhstan	National Fund			
2002 Equatorial Guinea		Fund for Future Generations of Equatorial Guinea		
2004 São Tomé and Príncipe		National Oil Account		
2005 Timor-Leste	Petroleum Fund	Petroleum Fund		
2006 Bahrain	The Future Generations Reserve Fund	The Future Generations Reserve Fund		
2006 Libya		Libyan Investment Authority		
2008 Russian Federation	Reserve Fund		National Welfare Fund	
2011 Nigeria	Nigerian Sovereign Investment Authority	Nigerian Sovereign Investment Authority		Nigerian Sovereign Investment Authority
Other Commodity				
1956 Kiribati		Kiribati, Revenue Equalization Fund		
1996 Botswana		Botswana, Pula Fund		
2006 Chile			Pension Reserve Fund	
2007 Chile	Economic and Social Stabilization Fund			
2010 Mongolia	Fiscal Stability Fund			
Fiscal Surpluses				
1974 Singapore		Singapore, Temasek		
1981 Singapore				Government of Singapore Investment Corporation
1993 Malaysia		Khazanah Nasional BHD		
2000 Ireland			Ireland, National Pensions Reserve Fund	
2001 New Zealand			New Zealand Superannuation Fund	
2004 Australia			Australia, Future Fund	
2005 Korea				Korea Investment Corporation
FX Reserves				
1981 Singapore				Government of Singapore Investment Corporation
2005 Korea				Korea Investment Corporation
2007 China				China Investment Corporation

Source: IMF, SWF Institute, authors' compilation.

Another interesting case is Trinidad and Tobago. The Heritage and Stabilization Fund (HSF) is a long-term fund that has two distinct elements: a stabilization component to insulate fiscal policy from fluctuations in energy sector revenues, and a savings component for future generations. The accumulation of foreign exchange in the Fund derives from the proceeds of exports of oil and natural gas.

The HSF is owned by the Government of Trinidad and Tobago and managed by an independent board composed of one representative each from the Ministry of Finance and the Central Bank and three representatives from the private sector. The Board delegates operational management to the Central Bank of Trinidad and Tobago and the Bank uses external fund managers to manage part of the portfolio.

In Botswana the Pula Fund is a long-term fund and forms part of the overall foreign exchange reserves. The accumulation of foreign exchange reserves stems from the general trend of surpluses in the balance of payments, which were based mainly on the export of diamonds. The Pula Fund is accounted for in the balance sheet of Bank of Botswana. Through budget surpluses, the Government has accumulated cash balances with the Bank of Botswana. The balances with the Bank of Botswana are transformed into direct government ownership of part of the Pula Fund. Currently, the Government's share of the Pula Fund is about two-thirds, while the Bank of Botswana owns the remainder.

Timor-Leste could be another good example of a SWF from a developing economy with natural resources. The Petroleum Fund of Timor-Leste was formed by the enactment of the Petroleum Fund Law promulgated in August 2005. The Petroleum Fund is a tool that contributes to sound fiscal policy, where appropriate consideration and weight is given to the long-term interests of Timor-Leste's citizens. The Petroleum Fund is to be coherently integrated into the State Budget and give a good representation of the development of public finances. The Petroleum Fund is required to be prudently managed and operate in an open and transparent fashion, within its constitutional and legal framework.

In terms of the institutional arrangement, Timor-Leste is similar to the Chilean framework. The Government of Timor-Leste, represented by the Minister of Finance, is responsible for the overall management and investment strategy of the Petroleum Fund. The Petroleum Fund law gives the responsibility to the Central Bank to undertake the operational management of the Fund under an agreement with the Minister. A Management Agreement between the BPA (predecessor of Central Bank of Timor-Leste) and the Ministry Finance was signed in 2005, amended in June 2009 and in October 2010. The Central Bank also provides the secretariat for the Investment Advisory Board, which is established in the Petroleum Fund law to provide the Minister with advice on the Fund's investment strategy.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ) is an organization whereby oil- and natural gas-related windfalls of Azerbaijan are accumulated and efficiently managed for the benefit of the country and its present and future generations.

SOFAZ has a three-tier management structure, with the President of the Republic of Azerbaijan being a supreme governing and reporting authority for the Fund. Activities of the Fund in the field of managing and spending assets of the Fund are

overseen by a Supervisory Board, composed of representatives of various government authorities, two Members of Parliament nominated by the Speaker of Parliament and community-based institutions. Administrative and operational management of the Fund is vested with the Executive Director, appointed by and accountable to the President of the Republic of Azerbaijan.

SOFAZ may finance only projects that are included in the Public Investment Program, which is to be submitted to the Parliament together with the annual consolidated budget. SOFAZ's primary expenditure items are directed to the financing of projects aimed at the socio- economic development of the country, as well as the important infrastructure projects.

Finally, Abu Dhabi Investment Authority (ADIA) is a public institution established by the Government of the Emirate of Abu Dhabi as an independent government investment institution. ADIA is wholly owned and subject to supervision by the Abu Dhabi Government and has an independent legal identity with full capacity to act in fulfilling its statutory mandate and objectives. ADIA's Law objective is "to receive funds of the Government of Abu Dhabi allocated for investment, and invest and reinvest those funds in the public interest of the Emirate in such a way so as to make available the necessary financial resources to secure and maintain the future welfare of the Emirate."

ADIA's Board of Directors is the supreme body having absolute control over its affairs and the discharge of its business. ADIA's Board does not normally involve itself in ADIA's investment and operational decisions, as Law assigns the Managing Director these responsibilities.

Thus, there are some best practices that Mongolia could extract from the international experience regarding SWFs. The previous cases only share the source of the funding (commodities), so there are differences between the type of funding and institutional arrangement. But given the source of the resources (natural resources), type of funding (fiscal surpluses), and type of institutional arrangement proposed (not being an independent institution), the best model is somewhat related to Norway and Chile SWFs, whose wealth funds are financed by fiscal surpluses coming from oil and copper, respectively.[9] These three conditions are key to model a comprehensive framework of SWFs for Mongolia. The other similar recent experiences are Colombia and Nigeria, where they have also adopted the Chilean scheme.

Moreover, the Norwegian and Chilean cases are examples of two policy purposes of SWFs: Macro Stabilization and Pension Reserve, which are two out of three prescribed SWFs for Mongolia (see discussion in next sections). In particular, the historical evidence shows that commodity volatility and its associated revenues require stabilization mechanisms to smooth fiscal expenditures and avoid boom and bust economic cycles. Norway and Chile have demonstrated during the global crisis of 2008-09 that countercyclical power. In parallel, one of the main contingent liabilities for

[9] The same recommendation is found in the recent publication "Macro Policy Framework for Sustainable Development in Mongolia" by the Ministry of Strategy and Finance of Korea and the Korea Development Institute.

countries and in particular for governments are pensions. Thus, ring-fenced resources for future pension liabilities seem sensible to avoid problems in the future.

It is worth noting that the political and economic institutions in Mongolia are strong enough to adopt prudent policies such as the MSWFs. One good example is the Fiscal Stability Law. The process to discuss the FSL was open and candid among all the stakeholders and with an obvious participation of members of the Parliament in the whole process. The FSL by any international standard is one of the best policies to commit to a sustainable fiscal policy. Mongolia is clearly ready to implement new funds such as the PRF and the FGF. At this stage, it is not clear the advantages to have some sort of a Development Fund that would invest in public investments. The Mongolian governments and politicians could clearly make long-term commitments for the benefit of Mongolian citizens. Irresponsible behavior has not pay off. The HDF is a "good bad example."

VII. INSTITUTIONAL ARRANGEMENT OF FSF AND OTHER FUNDS

It is urgent that the Ministry of Finance leads the building of the new institutional arrangement in relation with asset and liability management. The institutional arrangement should produce a framework that will rest on secure, long-term legal, management, investment mandate and funding security foundations. The framework should embody best sovereign investment fund practices for management accountability, investment independence and performance, appropriate political independence, communications and transparency. As with the best of such funds, the management should be based on objective, verifiable rule-based criteria for funding, investment, risk diversification, fiscal stabilization trigger, and use of independent technical expertise.

Long-term fiscal revenues should determine public spending, so it remains stable over time. This allows taking a countercyclical position, maintaining and even increasing spending to stimulate activity and protect growth in years when the economy is weaker. This approach to fiscal policy needs to consider efforts to create rules, institutions and mechanisms that guide fiscal policy in a predictable way, insulating social spending and public investment from economic fluctuations.

Institutional arrangements differ from one country to another. Investment policies, management and operational decisions are often centralized within the SWF or the central bank through a Board of Directors or Steering Committee.[10] However, this is not always the case and responsibilities can be more dispersed. For instance, in some cases where the SWF is not a separate legal entity the Minister of Finance or another official may be responsible for setting the specific investment objectives and benchmarks (often with the help of an advisory committee). In other cases— e.g., where the SWF is a separate legal entity— the high-ranking official will be responsible for making investment decisions directly as a member of the governing body. Lines of reporting vary as well—SWFs report either to a supervisory council, the Minister of Finance or an elected official (President or Governor), or directly to Parliament.

[10] See international experience in the section VI "Creation of New Funds."

The respective institutional framework aims to provide the SWF with operational independence, while ensuring its accountability to the government and the public. In many cases this balance is achieved by establishing a separate legal entity or by entrusting management to the central bank, while requiring disclosure of audited financial reports and regular reporting to the Ministry of Finance and Parliament. Some times ministries in charge of SWFs need to be reported to Parliament.

Where the SWF is not a separate legal entity, the governing body may comprise government officials and external advisors. In such cases, operational independence is sought through the delegation of responsibility for the SWF's operational management to the central bank or a statutory management agency. In an IMF survey, almost 2/3 mentions that its SWFs have advisory committees, while the 1/3 remaining has SWFs with supervisory boards.

Mongolia could follow the same steps in the benefit of its citizens with the implementation and management of the FSF and other future funds (the MSWFs), which will be combined with the prudent management of flows. An efficient option regarding the institutional arrangement, given the initial size and costs, is to use the Central Bank of Mongolia (CBM) as the operational manager rather than to create an independent institution to manage the natural resource wealth (see Figure 2). The CBM should also have the possibility to hire external managers if needed. This is the scheme followed by Chile, Norway, and Timor-Leste, among others. The main rationale to choose central banks is given by the long experience managing international reserves. The alternative, to create a separate management institutions such as the NZ Superannuation Fund or other such funds, does not seem appropriate given the initial costs and lack of experience to manage government resources. In any case, the framework could be flexible enough to have the future option to move towards an independent management institution if it is required given the size of the resources of the funds, changes in the investment policy, or other possibility that could hinder the central bank work on its main objective: price stability.

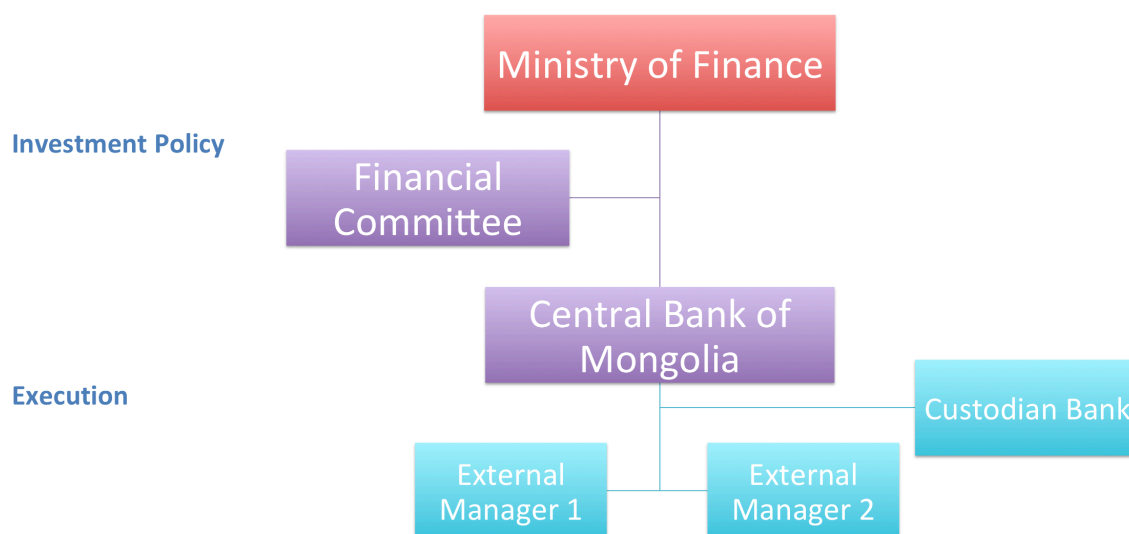
Investment of the assets of the MSWFs calls for a clear and transparent institutional framework that provides the necessary structure for making and implementing decisions, monitoring risk, and controlling investment policy. In this regard, the Ministry of Finance should appoint the CBM—subject to formal approval—as the fiscal agent for the management of the MSWFs and establish the general framework for their administration. The CBM should act on behalf of the Government to manage and invest the MSWFs resources. The CBM must follow specific instructions issued by the Ministry of Finance ("Investment Guidelines"). These guidelines should set forth the requirements and conditions applicable to the CBM for the correct and complete execution of the functions assigned to it as Fiscal Agent.

The functions of the CBM as regard the MSWFs could be as follows:

- Directly manage all or part of these fiscal resources in representation and on behalf of the Government.
- Tender and delegate the administration of all or part of these fiscal resources to external managers in representation and on behalf of the Government.
- Keep a registration of all transactions and other operations carried out in the management of the fiscal resources.

- Hire the services of a custodian institution.[11]
- Supervise and evaluate the performance of external managers and custodian institution(s).
- Report daily on the position of the funds' investments and prepare monthly, quarterly and annual reports on the management of their portfolios, as well as an annual report on the services provided by the custodian institution(s).
- Make payments corresponding to the exercise of its role as fiscal agent.

Figure 2. Institutional arrangement



The Ministry of Finance should also establish a Financial Committee to advise the Ministry/Minister of Finance on the investment policy of the MSWFs (see Figure 2). The Financial Committee should provide advice to the Ministry of Finance on the fundamental aspects of the investment policy for the MSWFs. At the same time, the Committee would help to avoid or diminish political pressures and criticism regarding the investment policy and its performance. Specific functions of the Financial Committee could be as follows:

- Provide, at the request of the Minister of Finance, advice on fundamental aspects for a long-term investment policy, such as investment allocation by asset classes, inclusion of new investment alternatives, determination of the MSWFs portfolio benchmarks, definition of the limits to allowed deviations and determination of the limits of the MSWFs investment possibilities.

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[11] Custodian institutions are responsible for the safekeeping of an investor's financial assets. Their main function is to hold and safeguard the securities entrusted to them and they are obliged to return these assets whenever so requested by the investor. They are, in addition, responsible for facilitating the transfer of these securities in accordance with the buying and selling instructions given by the investment manager and for exercising all the rights associated with the holding of these securities, such as the collection of interest and dividend payments, and for representing the investor at shareholders' and bondholders' meetings.

- Recommend to the Minister of Finance instructions of investment and custody as consulted by him, and make proposals regarding bidding and selection procedures to be carried out for managing the MSWFs portfolio.
- Express an opinion, at the request of the Minister of Finance, on the structure and contents that should be included in the annual reports on the MSWFs management and custody that must be submitted to the Ministry of Finance and, based on these reports, express an opinion on the management of the funds, particularly on their coherence with the investment policies established.
- Advice the Minister of Finance on all matters related to the investment of the MSWFs, as assigned by him.

An alternative to the advisory role of Financial Committee is to change it to an executive responsibility. In other words, the government will pass the management responsibility to an autonomous and independent body from the government. This is the recent case of the Panama SWF—*Fondo de Ahorro de Panamá*—and its Board of Directors: *Junta Directiva*. There is no tracking record, but it could be a possibility if the government wants to share both political and financial responsibility with another institution.

In any case, the Financial Committee may have the following characteristics:

- Renowned—local and/or foreign—professionals should compose the Committee. The member of the Committee should have extensive experience in the areas of finance and economics, avoiding major conflict of interest.
- The members must not be Government authorities or staff nor members of Parliament.
- An odd number of members could compose the Committee.
- The Committee should meet regularly (at least every quarter) to discuss and adopt recommendations to be submitted to the Minister of Finance for approval.
- A specialized team from the Ministry of Finance should support the Committee in all its activities.
- In order to ensure transparency, the Committee should publish all the minutes of its meetings and make public statements on its main recommendations on investment policy for the MSWFs.
- The Committee should prepare an annual report on the state of the funds to the Ministry of Finance and the Parliament.

Ideally, the Ministry of Finance should create a new Unit/Department/Division to be in charge of International Finance issues. The structure should include asset and liability management subunits.[12] However, if the administrative burden is too high regarding the previous recommendation, at least the Ministry should put together an Asset Management Unit/Department/Division similar to offices in Norway or Chile. Currently, the HDF unit under the Fiscal Policy Department could play that role.

[12] A debt unit in this context will be in charge of proposing a debt strategy that considers not only financing needs and currency composition, but also issues related to benchmarking and development of a deeper capital market.

Consider the following steps to create the unit:

- Build a core team
  - A strong executive management team recruited through a rigorous process.
  - The main competencies of the team should be focused around:
    - establishing clear investment guidelines, with the help of the Financial Committee and within the broad investment mandate defined by the Ministry;
    - ensuring that these investment strategies are implemented efficiently;
    - ensuring that there are sound operational controls and risk management systems.
- Leverage from existing infrastructure at the Ministry of Finance:
  - HR services, Communications, IT, Legal, and Audit can be leveraged from existing infrastructure.
  - This will minimize the ramp-up time and bring personnel already familiar with the budgetary process.

The minimum staff requirement at the onset should consider one senior economist, one junior economist, and one lawyer in the Asset Unit. This team should have a close relationship with the Minister given the associated financial and headlines risks of asset management activities. This team should be in close coordination with the Treasury Department and the people in charge of the budget, especially in relation to cash management, including foreign exchange issues.

VIII. INVESTMENT POLICY

The investment policy for all funds should involve initially safest asset classes. This choice is based mainly on the CBM's experience managing these asset classes. This is a conservative policy given that it does not include asset classes with higher levels of risk such as equities, corporate bonds, and alternative investments. A new investment policy more closely aligned with each objective of the different funds could be considered later.

The investment policy should be aligned with the Santiago Principles and also all prudent investor rules for a government. In particular, the investment policy should appropriately set up and investments should be made on an economic and financial basis and in the best interest of the owners of the resources: all Mongolian citizens. A clear investment policy shows an SWF's commitment to a disciplined investment plan and transparency and accountability to its stakeholders. In terms of investment policies, the "Santiago Principles" recommends different generally accepted principles and practices (GAPP):

GAPP 18. Principle. The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.

GAPP 18.1. Subprinciple. The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.

GAPP 18.2. Subprinciple. The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.

GAPP 18.3. Subprinciple. A description of the investment policy of the SWF should be publicly disclosed.

GAPP 19. Principle. The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.

GAPP 19.1. Subprinciple. If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.

GAPP 19.2. Subprinciple. The management of an SWF's assets should be consistent with what is generally accepted as sound asset management principles.

There are strong ideas within the Parliament that resources should be invested domestically. Natural resources revenues are different from other revenues. The former i) does not reduce spending in the private sector (like taxes do); ii) may weaken the fiscal disciplinary mechanism; and iii) may create governance challenges. In addition, the natural resources revenues are more volatile and uncertain. Therefore, there is a need to save a large part of the mineral revenues. So, it is necessary to separate spending from the current income from mining activities. A stabilization fund can be useful instrument to manage the mineral wealth and avoid the "resource curse." The rationale to invest everything abroad in financial assets is to:

- Protect domestic economy:
  - Provoke Dutch disease (lack of competitiveness);
  - Overheat the economy instead of sustain higher growth;
  - Avoid inflationary pressures;
  - Crowd out activity in other sectors of the economy (private sector);
  - Bad projects with high prestige and low economic and social return.
- Diversify risk and maximize returns.

All the resources of the MSWFs should be invested abroad. The fact that the fund accumulates financial assets abroad does not imply a disregard for domestic investment and especially infrastructure. Given the amounts involved, it would be impossible to convert all mineral receipts into domestic assets. Accumulating foreign assets is unavoidable in the current environment and the fund helps ensure that this capital is properly managed. That task is separated from the management of domestic assets due to differing requirements and objectives, with investments in the local economy naturally involving considerations regarding the social and not just the financial rate of return. The separation reinforces the ideal of transparently financing domestic investments via the budget and is a standard recommendation in the resource

management literature. Not only rich countries do that but also developing and emerging economies such as East Timor and Chile.

If the authorities do not want to include in the law the idea that everything should be invested abroad, it could include at least the idea that "The resources of the fund are not allowed to invest in securities issued by the government nor any government entity or government-related initiative."

IX. COMMUNICATIONS AND TRANSPARENCY

Commitment to developing and improving all aspects of the MSWFs management includes a communications strategy and transparency of decisions and access to relevant information. To this end, the MFM should systematically prepare and publish reports about the MSWFs financial situation, provide information about main issues and disclose all significant decisions about the MSWFs management adopted by the MFM. An ex ante transparency strategy is key to gain legitimacy both domestically (citizens) and internationally (recipient countries).

To guarantee public access to all relevant information about the FSF and other MSWFs, the MFM should devote additional resources to have a strong communications strategy. For instance, the Ministry of Finance should create special Websites in Mongolian and English (see additional details below) containing all reports about the MSWFs (see sections on the annual and quarterly reports); the legal and institutional framework for the MSWFs; and press releases and other relevant information. This commitment to effective and opportune access to information is particularly important for international investors and credit rating agencies and is consistent with the "Santiago Principles."[13]

In addition, economic agents would benefit from an active communication with MFM authorities and staff. This would require an active role of the MFM authorities and key managers to explain what the MFM is trying to reach in the context of managing its MSWFs. This process could include:

- Conferences/seminars to release the results of the MSWFs;
- Regular speeches by authorities both in Ulaanbaatar and other cities of Mongolia;
- Off the record meetings with journalists and economists;
- Publication of a light brochure of MSWFs;

[13] In 2008, the International Working Group (IWG) of Sovereign Wealth Funds (SWF) held a number of meetings during which its members exchanged views about the development and definition of these voluntary principles. The key meeting in this process took place in Santiago, Chile in September 2008 when broad agreement was reached on a series of principles and practices endorsed by the main countries with SWFs. This agreement is known internationally as the Santiago Principles and reflects the Chilean government's commitment to promoting transparency in the management of resources that belong to all Chileans. The Santiago Principles are available at http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.

- Activities for students (e.g., visits to the MFM and CBM; school competitions on economic issues; etc.);
- Regular publication and dissemination of working papers.

Reporting and transparency

The MSWFs shall develop policies and procedures for reporting and communicating its institutional arrangement, policies, and investment objectives in a manner generally consistent with the guiding objectives underpinning the "Santiago Principles." The "Santiago Principles" recognizes that SWF investments are both beneficial and critical to international markets. In particular, the principles demonstrate to home and recipient countries, and the international financial markets that SWF arrangements are properly set up and investments are made on an economic and financial basis. The "Santiago Principles" therefore, are underpinned by the following guiding objectives for SWFs:

(a) To help maintain a stable global financial system and free flow of capital and investment;
(b) To comply with all applicable regulatory and disclosure requirements in the countries in which they invest;
(c) To invest on the basis of economic and financial risk and return-related considerations; and
(d) To have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability.

In terms of disclosure, the "Santiago Principles" recommends different generally accepted principles and practices (GAPP):

GAPP 1.2. Subprinciple. The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and other state bodies, should be publicly disclosed.

GAPP 2. Principle. The policy purpose of the SWF should be clearly defined and publicly disclosed.

GAPP 4. Principle. There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations.

GAPP 4.1. Subprinciple. The source of SWF funding should be publicly disclosed.

GAPP 4.2. Subprinciple. The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.

GAPP 5. Principle. The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.

GAPP 10. Principle. The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.

GAPP 11. Principle. An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.

GAPP 16. Principle. The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.

GAPP 17. Principle. Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.

GAPP 18.3. Subprinciple. A description of the investment policy of the SWF should be publicly disclosed.

GAPP 19.1. Subprinciple. If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.

GAPP 22.2. Subprinciple. The general approach to the SWF's risk management framework should be publicly disclosed.

GAPP 23. Principle. The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards.

GAPP 24. Principle. A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.

Annual report

Not later than three months after the end of each financial year, the MFM shall submit a report (the "Annual Report") to the President, the Prime Minister, the Economics and Fiscal Policy Standing Committees of the State Great Hural, and other relevant representatives of its activities during the financial year concerned. The annual report should also be readily open to public.

The Annual Report should contain at least:

(a) a preamble from the Minister of Finance;
(b) a summary of MSWFs objectives, policies, and financial information;
(c) a chapter about the institutional arrangement;

(d) a chapter with a discussion about international economics developments, including economic activity, inflation, commodity prices, exchange rates, interest rates, and liquidity)

(e) a chapter of financial information of different funds managed, including the investment policy, market value, rate of returns, administration and custody costs (and securities lending flows), composition and characteristics of portfolios (list of specific investments), and benchmarks, among other relevant information.

(f) a chapter describing financial risks, including market risk, credit risk, liquidity risk, active management risk, operational risk, and volatility, among other risk indicators.

The MoF shall make the Annual Report accessible to the public on the Internet. At the time of publication, a Ministry of Finance representative may present the main financial results in a press conference.

Quarterly report

Not later than two months after the end of each quarter, the MoF shall prepare a report (the "Quarterly Report") of its activities during the financial quarter concerned.

The Quarterly Report should contain at least:

(a) a section with a discussion about international economics developments, including economic activity, inflation, commodity prices, exchange rates, interest rates, and liquidity)

(b) a section with financial information of different funds managed, including the investment policy, market value, rate of returns, administration and custody costs (and securities lending flows), composition and characteristics of portfolios (list of specific investments), and benchmarks, among other relevant information.

(c) a chapter describing financial risks, including market risk, credit risk, liquidity risk, active management risk, operational risk, and volatility, among other risk indicators.

The MoF shall make the Quarterly Report accessible to the public on the Internet.

Website content

In order to guarantee public access to all relevant information about the MSWFs, the MoF should create a special website containing monthly, quarterly, and annual reports about the funds, the recommendations of the Financial Committee and its annual report, the legal and institutional framework for the funds, press releases and other information. This commitment to effective and opportune access to information is particularly important in periods of financial stress where demand for information about the position of the institutions in which the funds' assets were invested as well as about the intermediaries and custody services used.

Participation in all International Fora of SWFs and dialogue with recipient countries

The active participation of the MFM in all international fora regarding SWFs, especially the relationships among SWFs and recipient countries, is fundamental to legitimate the savings framework in Mongolia and the role of the MSWFs.

As discussed before, one of the most important international initiatives is the agreement reached by a group of international recognized SWFs called the "Santiago Principles." The purpose of this agreement is to identify a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis. The "Santiago Principles" has helped to increase understanding of SWFs to home and recipient countries and the international financial markets.

The agreement was reached among the International Working Group of Sovereign Wealth Funds (IWG) on October 11, 2008. In completing its work, the IWG recognized that SWFs are important participants in the international monetary and financial system. Their activities have helped promote growth, prosperity, and economic development in capital exporting and receiving countries. They also help contribute to macroeconomic and financial stability. To facilitate this and to follow up on the work undertaken in the context of the "Santiago Principles," the IWG reached a consensus on April 6, 2009 to establish the International Forum of Sovereign Wealth Funds ("Forum").

Mongolia should be part of this "Forum". Membership is open to other Funds who meet the Santiago Principles definition of a SWF[14] and endorse the Santiago Principles. The purpose of the Forum will be to meet, exchange views on issues of common interest, and facilitate an understanding of the "Santiago Principles" and SWF activities. The Forum will act as a platform for:

(a) exchanging ideas and views among SWFs and with other relevant parties. These will cover, inter alia, issues such as trends and developments pertaining to SWF activities, risk management, investment regimes, market and institutional conditions affecting investment operations, and interactions with the economic and financial stability framework;
(b) sharing views on the application of the "Santiago Principles," including operational and technical matters; and
(c) encouraging cooperation with investment recipient countries, relevant international organizations, and capital market functionaries to identify potential risks that may affect cross-border investments, and to foster a non-discriminatory, constructive and mutually beneficial investment environment.

[14] SWFs are special-purpose investment funds or arrangements that are owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies that include investing in foreign financial assets. SWFs have diverse legal, institutional, and governance structures. They are a heterogeneous group, comprising fiscal stabilization funds, savings funds, reserve investment corporations, development funds, and pension reserve funds without explicit pension liabilities.

Press releases

Press releases are a communications device key for the MFM to express ex ante its institutional arrangement and investment policy. Ex post communications are also important in the cases that confidentiality in some transactions is needed to have successful businesses before release to the public at large.

Audits

The MoF (through National Audit Department) and CBM shall carry out annual internal audits of its operations and financial statements in accordance with International Financial Reporting Standards, as applied in Mongolia.

In addition, the MSWFs' operations and financial statements shall be external audited annually in accordance with International Financial Reporting Standards, as applied in Mongolia by an internationally recognized accounting firm.

X. Risk Management

The investment mandate should require, in investing the MSWFs, to have regard to maximizing return over the long term and taking appropriate but not excessive levels of risk. In general the investment strategy adopted by the MSWFs will have a dominant influence on the returns generated. Investment strategy is primarily influenced by the investment objectives of the MSWFs and the time horizon over which these are to be achieved.

The investment mandates considers several important components for the management of the national resources. In particular, it includes the objectives of the fund, the general constraints, the investment universe, the investment restrictions, the counterparty restrictions, and other relevant aspects. Thus, for each specific MSWFs should be prepared an investment mandate with all those components.

In any case, the government shall each year, for example, develop a rolling five-year investment plan for the MSWFs pursuant to such strategies, regulations, policies and guidelines as it may determine from time to time to be most effective to achieve the objective of each fund, with due regard for macroeconomic factors. To preserve the effectiveness of the government's ability to make investments, the investment plan may be subject to strict confidentiality restrictions and its distribution limited until such investments are made as may be considered appropriate by the government.

It is very likely that a significant proportion of the MSWFs will need to be held in assets carrying market risk. This means there will be considerable volatility of returns over shorter periods. The policy is that the mix of assets within the MSWFS should be as efficient as possible (that is, should offer the highest level of return for an acceptable level of risk). For this reason, the MSWFS should adopt a policy of operating a flexible asset allocation which reflects the Financial Committee's view of the market exposures which are more likely to meet the terms of the investment mandate (maximizing return without taking excessive risk) given current market conditions.

Strategy risk

The portfolio must be broadly diversified by strategy allocations, with a bias toward those strategies exhibiting lower volatility. The targeted maximum exposure to any one underlying strategy shall be limited to a fixed percentage of the portfolio, unless otherwise specifically approved by the MFM. Initial strategies are expected to include convertible arbitrage, market neutral equity, fixed-income arbitrage, merger arbitrage, distressed securities, capital structure arbitrage, volatility arbitrage, credit arbitrage, commodity relative value, multiple arbitrage, structured finance, managed futures, bank loans, origination, and equity long/short. Other absolute return strategies meeting the investment objective of the program may be included.

Market risk

The MSWFs may hold exposure to a wide range of assets, which the Financial Committee would expect, will produce returns divergent from, and superior to, the risk-free rate over the long term.

Market risk is generally managed by:

(a) adopting an appropriate risk profile that is commensurate with the return objective and time horizon of the MSWFs. That risk profile is determined after careful analysis of the prospective risk and return characteristics of each asset class in which the Fund might invest;
(b) avoiding concentration of risk by ensuring there is adequate diversification between and within asset classes; and
(c) diligent and thoughtful ongoing assessment of the Funds' risk exposures, particularly in the context of the prevailing market environment.

Interest rate risk

Principal exposures include interest rate duration, credit spread duration, credit quality migration and default risks;

Exchange rate risk

Principal exposures include currency exposure, including risks of movement in the value of foreign currencies held.

Liquidity risk

Liquidity risk is the risk that a security cannot be sold when required or the price achieved is significantly different from the quoted price. Because of the long-term nature of the MSWFs, some funds can tolerate some degree of illiquidity across the portfolio. The FSF should be by far the fund with the highest liquidity.

Liquidity risk is generally managed by:

(a) monitoring the liquidity profile of the MSWFs across all asset classes, under both normal and stressed environments;

(b) modeling the expected cash flows within the portfolio and undertaking robust planning for when liquidity is required; and
(c) incorporating into liquidity planning an appropriate margin of safety to ensure that liquidity is always available when required (for example, to meet margin payments on currency hedging contracts).

Credit risk

Credit risk (or counterparty risk) is the risk of default by the counterparty on its contractual obligations. At the level of specific funds, a framework exists to ensure that risk exposures remain within approved exposure limits based on the credit ratings of financial instruments and counterparties. Appointed managers of investments, such as the CBM, are required to ensure:

(a) the average credit quality of the manager's portfolio is within agreed guidelines;
(b) the exposure to different tiers of credit (including unrated debt) is within agreed guidelines;
(c) the maximum permitted exposure to any one issuer is within agreed guidelines; and
(d) the long-term debt of all entities in which the manager invests is either rated by an approved recognized rating agency or, if it is not-rated, is constrained to the maximum permitted exposure to such debt.

Operational risk

While the main focus of the MSWFs is the most efficient combination of asset classes to optimize the return for market risk, operational risk also needs to be managed. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The MoF and CBM acknowledges that the quality of its operational risk management procedures must be of best-practice standard. It is committed to achieving this and continues to evolve and enhance its policies over time.

Operational risk is managed by:

(a) segregation of duties achieved by separating the investing function (undertaken by the CBM and other managers) from the transaction settlement, recording and reporting of investment activities (undertaken by an independent global custodian);
(b) requiring managers and the custodian to:
- provide the MSWFs with third party covenants or assurances against these events;
- have in place insurance arrangements to cover claims in those events; and
- have in place, and regularly confirm the existence and effectiveness of, internal controls to address operational risks;

(c) establishing appropriate operational, legal and taxation due diligence processes;

(d) establishing a system of compliance reporting by managers and the custodian to the MSWFs;

Manager risk

The requirements on the MSWFs' external managers (including the CBM) to deliver superior returns also entail some risks. In particular, appointed managers (including the CBM) may exceed or fall short of the objectives set for them by the MFM.

The MFM (and also the CBM) will manage these risks by careful selection and monitoring of managers to ensure the MFM have sufficient conviction that each manager is expected to add value after taking into account costs and risks, and that any unintended biases away from the intended investment strategy are minimized; and by rigorous measurement and management of market and manager risk.

To be broadly diversified across partnership allocations, the portfolio must contain exposures to a minimum set of individual partnerships, with the maximum exposure to any one underlying partnership limited to a chosen percentage of the fund assets in the portfolio, unless otherwise specifically approved by the MFM. For instance, it would be recommendable to have at least two external managers for each asset class and limit the allocation to each one depending on the size of the MSWFs.

XI. DEBT AND ASSET MANAGEMENT LAW

There are several aspects discussed previously in this report that could be included in some way or another in this law. Thus, it is necessary to discuss with MFM staff whether to include general principles or in some instances specific ideas regarding the institutional arrangement, risk management, transparency, and communications, among other key components.

Given several news aspects regarding asset management, it would be recommendable to split the laws in two: one for debt aspects and the other one for asset management. The latter could be focused on Sovereign Wealth Fund issues (SWF Law), so it would be a complement to FSL. The SWFL will cover all the aspects regarding asset management, including the relationship with fiscal policy (FSL), the objectives of the different funds, the institutional arrangement, the investment policy and risk management, reporting and communications, transparency, etc.

The draft law should include mainly general principles. The Ministry of Finance should take a decision to either put together a general framework for both debt and assets management or incorporate more specific clauses for the asset side. My preference is to have a law that sets the general rules and all details should be in other administrative legal documents (e.g., particular regulations for each component: debt, assets, cash management, etc.)

Additional recommendations regarding financial asset management, cash management, and debt management are found in the appendix.

XII. NEXT STEPS

- Reorganization of some departments within the MFM to strengthen the capacity to organize the budget process with the new rules and the management of the MSWFs. At least, change the current HDF unit with a new Asset Management Unit under the Fiscal Policy Department. This should be done immediately.

- Organize all the components of the institutional arrangement of the management of the MSWFs, including the discussion about the CBM as the fiscal agent to manage the resources of the government resources. This would include the transition from the HDF to the new funds. The process should be done immediately.

- Prepare a Manual for Policies and Procedures. The objective of this manual of procedures is to set out in a comprehensive way all policies and practices that deal with relevant aspects related to the institutional arrangement and investment-related functions. The contents would include the following:

    - Institutional Arrangements
        - Ministry of Finance
        - Central Bank of Mongolia
        - Financial Committee
        - External asset management
        - External advisors
        - Other service providers
    - Investment Strategy—Fiscal Stability Fund
        - Investment objectives
        - Performance objectives
        - Investment guidelines
    - Investment Strategy—Pension Reserve Fund
    - Investment Strategy—Future Generations Fund
    - Risk Management
        - Strategy risk
        - Market risk
        - Liquidity risk
        - Credit risk
        - Operational risk
        - Manager risk
    - Internal Controls
        - Compliance
        - Accounting records
        - Auditing
        - Reputational risk
    - External Reporting and Communications
    - Corporate Governance Principles
        - Legal controls
        - Corporate responsibility and corporate citizenship
        - Code of business conduct, ethics, and conflict of interest
    - Portfolio Managers
        - Internal vs. external managers and custodian

    - Identification and selection process
    - Monitoring and evaluation of managers
    - Engagement and termination of managers

- Prepare and review investment policies/guidelines for the MSWFs.

- Organize conferences and seminars to discuss the new framework with all relevant stakeholders.

APPENDIX I. FINANCIAL ASSET, CASH AND DEBT MANAGEMENT

Financial Asset Management

The law should consider all type of assets and not only related to the HDF, but also related to all the resources of the FSF and future funds (Article 9). The law should consider other assets that probably will be accumulated in all MSWFs and also in the Contingent Liability Fund. Of course, the objectives are different from each other, but the principles should be applied to everyone.

The law should consider not only provision 17.1 of the FSL, but also all the resources of the FSF. The current draft, Article 9.2.2, only considers the resources over 10 percent of GDP, but it should be considered the complete FSF savings.

The law should set the general rules for the type of risks of the investment portfolio. Right now the draft law is something in the middle. It includes categories of the quality of financial assets, but it is not specific about allowed asset classes, risk tolerance or expected returns, investment horizons, limits on investments, etc. I would recommend keeping general rules, but moving other specific restrictions to future regulations.

The law should not include a credit risk allocation. This should be flexible and decided in the new institutional arrangement. The draft law includes clauses (Articles 10.2.1 and 11.1.1) that say "no less than 4/5 of the total value of financial assets designated for investment shall be invested in…" "The highest rating of the superior investment (securities, notes and deposit accounts of the legal entity with the AAA credit rating)". This entails several problems. First of all, an asset allocation that is 4/5 AAA, thus, leaving only 1/5 for other investment and non-investment grade investments. Second, it is not clear if there is room for other type of asset classes besides fixed income. This decision should be left to the new institutional arrangement and internal regulations.

The law should have only general principles. Thus, a possible new wording is: "The funds may be invested in accordance with the rules, limits, procedures and controls established by the Ministry by decree and other regulation." This should replace almost all section 10 of the current draft.

The law should consider different options regarding asset management (details left in decree/regulations→see next main paragraph). This could include the use of the Mongol Bank as a fiscal agent, the use of international external managers, or the use of internal management at the Ministry of Finance. The law should be flexible enough to consider all possible options. A specific wording could be summarized as follows:

- Investment of the assets of the MSWFs calls for a clear and transparent institutional framework that provides the necessary structure for making and implementing decisions, monitoring risk, and controlling investment policy.
- The Ministry of Finance should appoint either the CBM as the fiscal agent or other external manager for the management of the resources of the MSWFs and establish the general framework for their administration. The operational

manager should act on behalf of the Government to manage and invest the MSWFs resources.

- The operational manager must follow specific instructions issued by the Ministry of Finance ("Investment Guidelines"). These guidelines should set forth the requirements and conditions applicable to the operational manager for the correct and complete execution of the functions assigned to it.

An alternative to be included in a decree or regulation would be as follows (some local instruments are included if there are changes in economic conditions that would require extraordinary domestic investments):

Article 1. - According to what is stated in Article X of Law XX, the resources of the MSWFs may be invested in the following instruments:

1) Securities issued by the CBM;
2) Time deposits, bonds and other securities you representativeness of deposits issued in Mongolia by Mongolian financial institutions;
3) Securities guaranteed by Mongolian financial institutions;
4) Letters of credit issued by Mongolian financial institutions;
5) Bonds of Mongolian private companies, except bonds exchangeable for shares;
6) Investment fund and mutual funds;
7) Bills of exchange issued by private companies in Mongolia;
8) Receivables, securities or commercial paper and short-term deposits issued or guaranteed by foreign governments or foreign central banks;
9) Receivables, securities or commercial paper and short-term deposits issued or guaranteed by foreign banks or international institutions;
10) Stocks and bonds issued by foreign companies;
11) Participation shares issued by mutual funds and foreign investment funds;
12) Securities representing foreign stock indexes;
13) Operations that aim to cover the financial risk that may affect the Fund's investments;
14) Operations or contracts which have as their object the mutual loan or financial instruments belonging to the Fund and
15) Other securities and financial instruments, operations and contracts for financial, which are authorized in …

Article 2. - The Fund's resources may be invested in instruments, transactions and contracts mentioned in article 1 of this decree, according to the limits indicated below (those are just examples):

a) For instruments referred to in 1, the maximum will be 100% of the Fund.
b) In the case of the instruments referred to the numbers 2, 3 and 4, the maximum limit set for the sum of investments in such instruments shall be 70% of the Fund.
c) In respect of national instruments referred to the numbers 5, 7 and 15, the ceiling set for the sum of investments in such instruments shall be 30% of the Fund.
d) For the material referred to in item 6, the maximum is 30% of the Fund.
e) For the sum of investments in the instruments referred to in item 8, the maximum will be 100% of the Fund.
f) For the sum of investments in the instruments referred to in item 9, the maximum will be 70% of the Fund.

g) For the sum of investments in the instruments referred to in item 10, the ceiling is 50% of the Fund.
h) For the sum of investments in the instruments referred to in item 11 and foreign instruments referred to in item 12, the ceiling will be 40% of the Fund.
i) With respect to the transactions referred to in item 13, the investment ceiling for foreign currency without hedging is 100%.
j) Respect to transactions and contracts referred to number 14, the maximum will be 100% of the Fund.

Article 3. - The investment is made through investment instructions prepared by the Minister of Finance by means of communications addressed to the administrator or administrators of the MSWFs in light of the instruments, operations and contracts referred to in article 1 and the limits prescribed in article 2, both of this decree, in addition to the risks of each instrument, issuer or counterparty market, among others, in order to obtain an adequate return with a limited risk.

Investment guidelines shall include, at least, the following:

a) Investment criteria such as:
i) Definition of the asset class, maximum or minimum limits by asset class, type of instruments, countries and/or currencies eligible;
ii) Definition of the reference period for investments, and the margins of deviation allowed, and
iii) Definition of the limits of credit risk-acceptable for the management of the MSWFs' resources, including markets, issuers, instruments, counterparties and time of maturity or maturity of investments.

b) One or more comparators, to be used to evaluate the management of the administration of the MSWFs. The instructions contain the structure and conditions of the comparators, which are measurable, quantifiable and replicable, and periodically reviewed.

c) Criteria for assessing the investment portfolio of resources.

Article 4. - The investment instructions must also refer to the custody of the investments of the MSWFs, in which case observed, at least, the following provisions:

a) The trustees shall hold or held, or their agents, investment in the MSWFs and the cash flows generated by these investments.
b) Agreement with the trustees or custodian the delivery of daily reports of operations conducted, by amount, type of transaction counterparties and instruments, and monthly reports with current positions. In any case, the contracts with the trustees and custodians should include the power of the MFM to request position reports when appropriate.

Article 5. - To make the investments referred to in article 1, as determined by the Minister of Finance, it may use one or more of the procedures outlined below:

a) Procurement of Management Services investment portfolio of the MSWFs' resources to foreign or domestic corporations, including international, both at home and abroad.

The hiring of portfolio management services must be made by means of bids and by the bidding rules are approved by … The bidding should contain the mechanisms and/or compensation of portfolio management services.

b) Administration by the CBM, as the fiscal agent, either directly or by contracting the services of portfolio management, with national or foreign legal institutions, including international, both in the country and abroad (according to the indications in the Law).

c) Direct investment through Treasury Service (check this), only where required by the Minister of Finance statement, (according to the Law).

Article 6. - For the administration and investment of the MSWFs, the Minister of Finance may have administrative bodies and advisory support to management, which consist of staff of the Ministry and its departments, which are designated for this purpose. The Ministry of Finance should have advice from a Financial Committee (see the institutional arrangement section).

For purposes of the preceding paragraph, a decree/regulation established integration standards, activities or functions, coordination and operation of the instances mentioned above, and other necessary rules for the operation, supervision and control of the Fund.

Article 7. - The Ministry of Finance will issue quarterly reports on the status of the Fund and shall forward copies of them to the Standing Committees on Budget and Economic Policy, within thirty days at the end of the respective quarter.

The law should be more precise regarding the role of the Investment Council and the risks associated to several aspects of the group. First, it would be recommendable to have an autonomous Investment Council. For instance, previously I recommended the creation of a Financial Committee with an advisory role to the Ministry/Minister of Finance with a focus on the investment policy of the resources accumulated in the funds. The members of this Committee should be outside of the government (former Ministers of Finance, former Governors of Mongol Bank, professors, professional Board directors, foreign experts, etc.) The idea of this is to have a technical committee and that the Ministry shares responsibility with this group in terms of the investment policy. With the current proposal in the draft law, the members of the Investment Council are from the own government, so there is no gain in terms of avoiding political influence and/or increasing transparency.

Transparency is key to have a legitimate framework of both debt and asset management. But there are a couple of issues that could be improved in the draft law (see detailed section on Communications and Transparency in this report). First, it is positive to release information on daily newspapers and media annually, but it would be also recommendable to have more formal ways of communication such as a website with: market value of investments, rate of returns, legal framework, investment allocation, minutes of the Investment Council, and other relevant information. Second, it would be a good opportunity to include in the law that all type of investments of the funds should be according to the “Santiago Principles” which are the set of general practices and principles agreed by the SWFs of the world. Third, the frequency of some reports should be quarterly, or even monthly.

Cash management

The institutional arrangement around cash management is not set clearly and seems out of place in the context of a law on management of government financial assets and debts. Although cash management is related to debt management, it is more precisely regarded as a budget execution function. In any case, the following recommendations apply. First, it would be recommendable to have a unit responsible for cash management within the Ministry of Finance. It could be the same Debt Division, but with staff dedicated to this specific topic. Second, cash management is an integral part of debt and asset management, but more importantly, is key for economic policy. In particular, there will be some occasions that some expenditures would need to be financed, but at the same time there is no enough resources in tugriks, so it would be necessary to exchange dollars. However, the latter may create pressures for appreciation, so it is important to have a projection of the expenditures schedule and the composition of currency in the cash accounts. Second, the decision regarding significant movements in cash should be approved by the authority in charge of finance and budget.

In relation to the previous point, it would be recommendable to have an internal financial committee. This committee should be composed by a representative of the Debt Division, future Asset/SWF Unit, and other relevant representatives from the Ministry of Finance. In that way, the coordination of activities within the Ministry will be higher and the Minister of Finance will be constant informed about significant movements in cash and other financial accounts. The creation of this internal financial committee will also help to be accountable about the decision that divisions/departments are taking on behalf of the Ministry. The information, discussion, and agreements should be included in minutes for future reference. The frequency of meetings will depend on the timing of financing activities.

The draft law needs to be more precise regarding criteria about risk classification of banks and financial exposition. The draft law mentions that deposits "shall not exceed 5 percent of the total assets of the commercial bank", but it does not say anything about the amount of resources that could be deposited in one bank. Again, it seems that the details should be move to a decree or regulations.

The new Law on Management of Government Financial Assets and Debt should be in close relationships with other Government efforts related to asset and liability management. For example, it should be convenient to coordinate efforts related to this regulation with Government debt strategy, implementation of the FSL and HDF, and the institutional arrangement of the FSF, among other matters.

Debt management

The Parliament should define only debt ceilings in each budget and not the composition of debt. **The current draft mentions that among the powers of the Parliament is "to define the State policy on Government external debt" and "to approve the amount of domestic financing required for investment reflected in the budget"**. These decisions should be in the hands of the government/MFM to choose the way it wants to finance expenditures, while the Parliament should define the borrowing ceilings in each budget. The government/MFM decisions are going to be related to

capital markets and benchmarking, types and costs of financing, and macroeconomic conditions (e.g., exchange rates level and volatility).

The debt management council should be avoided. The debt management should be in hands of the MFM. The current proposal includes representation from the Mongol Bank, National Development and Innovation Committee and may have representation from the private sector. The MFM should have flexibility to choose between different sources to finance the overall budget and not push for specific levels of debt depending on projects and/or institutions. However, it would be recommendable to increase the coordination between the MFM and the Mongol Bank regarding debt issuance with the idea of developing a deeper bonds market in Mongolia.

All the financing of infrastructure project should be made through the budget and not be attached to debt issuance. Assuming that the public infrastructure (roads, power, etc.) is highly productive and well assessed, the financing should be discusses in the context of the budget every year. It is important to disconnect the financing of a specific project with direct debt issuance for that project. Thus, I would eliminate any reference to projects, programs, and measures to be funded by government loan capital.

The law should avoid including specific issues related to projects, programs, and measures to be funded by government borrowing. Again, the idea behind this is that money is fungible and thus, the law should focus on the regulations of debt and asset management as financial sources for the budget. And not attaching a financing source with specific projects. This will become much clearer as soon as the FSL starts working in a full fashion in 2013. The FSL should set the limit of fiscal expenditure and then that expenditure should be financed either with debt, assets or a combination of both. This would help to avoid incentives to make amendments to the budget or to the development bank activities between budgets.

The debt issuance should be subordinated to the budget discussion, the FSL, and debt limits set by the Parliament. The government of Mongolia should avoid having parallel budgets. One related to the regular budget of the Government and the other one related to the financing of infrastructure projects through the Development Bank. Having this parallel budget would clearly undermine the objective and spirit of the FSL. The FSL says explicitly in article 1 that "The purpose of the law is to establish fiscal management principles and special fiscal requirements for the purpose of ensuring fiscal stability…" Clearly, having an off balance would not help in that regard, even if it is temporary.

It is evident that Mongolia needs a lot of infrastructure, but the implementation of it should be in line with the "absorptive capacity" of the economy. Indeed, that was the main rationale behind the FSL: spend by the long-term income and not by the cyclical income. Thus, fiscal expenditures contribute to keep fiscal policies in time, in particular, social expenditures, despite the economic cycle stage (overheating or deceleration in economic activity). Consequently, this will contribute to have a sustainable economic growth, instead of having the typical boom and bust phenomenon present in several natural resource-rich economies in previous years.

Both government borrowing and government guarantee should be limited by the Parliament on an annual basis and in nominal terms. There are several issues here to consider:

- First, the best international practice suggests that within the discussion of the budget every year, the Government should propose/ask for a certain level of new indebtedness and guarantees to the Parliament.
- Second, if the Parliament approves them, these limits should not be changed during the year. Only in special circumstances the limits should be raised, for example, if there is a recession and the government wants to implement a stimulus plan (amendment budget) or in the case of a natural catastrophe.
- Third, it should be in nominal terms because it will be simple and transparent vis-à-vis the option of having it as percentage of the fiscal deficit or another measure which cannot be defined correctly.
- Forth, the limits should be specific both to the "regular" government debt, but also to the "government borrowings taken for the purpose of contributing into paid-in-capital of a foreign invested mining legal entity…or loan guarantees issued by the government…" as is phrased in the FSL.
- Fifth, this would help to understand the fiscal stance contributing to a more stable economy, and at the same time, it would help to raise credibility in debt domestic and foreign markets.

As soon as the FSL should set the expenditure limit, the government and the Parliament should engage their discussions in that context. In particular, it will be evident that not all projects (even if they are all good and with high social return) could be financed. The government and the Parliament should prioritize the type of expenditures to make or spread the financing in several years. This is natural in countries that have implemented fiscal rules. So, if governments need to increase a specific expenditure item should reduce other to comply with the limit coming from the fiscal rule.

The powers of Parliament, Government, the Ministry of Finance, and the Minister should be clearer. The ideal framework should be based on the role of the Ministry of Finance as the unit to oversee/supervise both asset and debt management and at the same time interacting with all councils created under this law. This will include all the powers set in the draft law for the Ministry and the Minister plus the approval of the working procedures of the debt and investment management council, establish the risk assessment team, administer government foreign loans and development assistance aid, approve plans for regulation of debt and asset portfolios, etc. The government should approve the main aspects of the debt management midterm strategy and other general aspects that could affect the government as a whole, because it will be quite burdensome to micromanage issues that the Ministry could do much efficiently. Of course, this is in a context of improving the capacity of the Ministry of Finance that would include supporting the Debt Division and formally creating an Asset/SWF Division in charge of the FSF and the HDF.[15] The Parliament should focus on the limits on the total amount of debt, but not on the composition of this debt. The Government and the Ministry of Finance should be in charge to establish the best combination in terms of foreign and domestic debt.

[15] Currently, there is a unit in the MFM composed by 3 people in charge of the HDF.

The coordination between the MFM and the CBM should be increased immediately. The future economic and financial challenges call for a better coordination between fiscal and monetary policies. On the one hand, without touching independence, the MFM should know how liquidity is evolving and what the amounts of debt will be issued by the CBM. This is important for the MFM to assess the level of future interest rates and its possible impact on economic activity. At the same time, the MFM should have insights regarding possible interventions by the CBM in the foreign exchange market to review the possible implications over the real exchange rate and consequently, export competitiveness. On the other hand, the CBM should have a better picture of what the plans of government debt issuance are. This is key for liquidity management purposes. Otherwise, it is very difficult for the monetary authority to project liquidity even in the short term.

It would be convenient to be more precise in the law regarding the government debt management mid-term strategy document. Currently, there is some sort of this type of document, but the law should be much clearer about the contents of it. It is a very good idea to have this type of documents that sets the debt strategy, but it will be benefit to review in the context of the following questions. Does mid-term means two years or more than that? Is this document should be produced annually? Or only when a new administration takes power? What does happen if there are constant deviations from the strategy? Is there any accountability mechanism? Will this document be publicly released? Will the report include government borrowing, contingent liabilities, and guarantees? Will the report include a risk assessment?

The reporting on government debt management by the MFM to both the Government and the Parliament should be quarterly. The rationale behind this recommendation is to be transparent all the time and in constant basis. Moreover, this is important to the members of the Parliament to review the evolution of the debt in time and the risks associated to discrete raises in debt.

There should not need approval from the Parliament regarding the issuance of Government securities (Article 33.1). The Parliament should only approve the borrowing ceiling each year. The MFM should decide how to issue within that limit. Also, there is no need to have details of domestic issuance purposes (Article 32.2.3).

The types of government securities should not be included with specific tenures (Article 33). Capital markets move quickly, so the law should be flexible enough to adopt new maturities if needed. It is enough to include the types of securities.

Government debt guarantee aspects should be more restrictive and not open as it stands. Right now there is a general statement that the government debt guarantees for the following legal entities: administration of aimag, state owned and majority of state-owned companies, and legal entities implementing a concession agreement. If the authorities choose to continue with government guarantees, those government guarantees should be analyzed case by case. The law should not be so flexible in this regard. Indeed there is an article about development, submission, and approval of government debt guarantee, but still there are some issues to review such as the independence of the risk assessment, the maximum amount of guarantees (this could be

imposed in each budget law and be approved by the Parliament), and other similar issues.

The debt guarantee should be discussed in the context of overall debt limits. Debt guarantees are contingent liabilities that may create huge exposition to the government. Thus, it should be consider the option to avoid the guarantees if possible. In the case of state owned companies or institutions there will be implicit guarantees anyway.

The Contingent Liability Risk Fund (CLF) should be considered as a simple account. Currently, the draft law establishes the contingent liability law for the purpose of accumulating a source of cash necessary to meet contingent liability risks and delivering performance of borrowing guarantees obligations. The objective is sound and clear, but it should be related to the notion of MSWFs.

Contingent liabilities should be publicly disclosed every year. To gain legitimacy in the process among citizens and also investors is fundamental to be transparent. Thus, the government through the Ministry of Finance should prepare a report with an assessment of contingent liabilities, including not only debt guarantees, but also other type such as pensions, concessions, etc.