

**UNDP MICROFINANCE
ASSESSMENT REPORT
FOR
Mongolia**

[Prepared as a component of the MicroStart Feasibility Mission]

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A. Introduction - The Partnership For Progress

The United Nations Development Programme has been an important supporter of Mongolia's development efforts since the 1970s. A new five year cycle entitled the *Partnership for Progress* which covers the period from 1997 to 2001 has begun. The UNDP activities support the Mongolian Government's Programme of Action (resolution 61 of November 1996), with its priority on economic growth under difficult transition conditions.

The impact of Mongolia's dramatic transition process in the 1990s makes economic growth a precondition for solving problems, especially those related to poverty. The successful implementation of the different parts of the Government's Programme of Action is expected to generate growth. These are favourable conditions for Mongolia's economic growth, including considerable natural resources, literate human resource base, and growth oriented Government policies. However, significant obstacles exist such as a limited infrastructure, growing poverty, a weak banking system, harsh climatic conditions and a vast territory.

UNDP's contribution to growth with equity will be three- fold. First, UNDP interventions will support the Government's Programme to stimulate equitable economic growth. Second, UNDP, through its partnership role in the national poverty programme and natural resource management, will help the Government deal with issues of people-centered sustainable development. Third, UNDP will contribute to the national capacity to formulate policy and to foster sustainable human development by helping to strengthen the governance capacity of the national government, local authorities and civil society.

The UNDP activities will bring together many partners in support of sustainable human development: Government authorities at the national and local level, civil society and NGOs, UNDP and the UN System, academia and the private sector, and bilateral and multilateral donors. The design of the Partnership for Progress combines global thinking with local actions to achieve and improve the well- being of the Mongolian people.

B. Political and Administrative Structure

Mongolia is one of the most sparsely populated countries in the world, with 2.4 million people living in an area of almost 1.6 million square kilometres¹. A population density of only 1.5 persons (compared to, for example, 820 for Bangladesh) per square kilometre combined with a highly dispersed settlement pattern and an underdeveloped physical infrastructure, makes the delivery of basic services not only logistically difficult but also expensive with a high unit transaction costs structure.

Until very recently, Mongolia had been governed by successive communist regimes, bolstered by economic assistance and political patronage from the former Soviet Union. This centrally planned economy has been based mainly on agriculture, particularly livestock. The estimated 28 million livestock population² directly accounted for the livelihoods of over 50% of the country's population³. Those that did not rely on livestock or agriculture, found employment in government and the public sector.

Since 1990, Mongolia has been in transition from a command to a market economy - a process accelerated by the wholesale withdrawal of foreign and technical assistance from Russia, loss of income from trade with COMECON countries, and the coming to power of a democratically elected, non-communist government in 1996. The transition process ushered in reform programmes for macro-economic stabilisation, structural reforms, and for political and social transformation. These reforms have been fundamental and painful given that they are having to overcome 75 years of communist rule that had (i) created a society that had institutionalised a culture of dependency on the state and other private sources, (ii) legally restricted, politically discouraged and financially restrained individual initiative and private enterprise and thus underdeveloped the growth of markets, and (iii) eroded mechanisms of local governance and the place of *corps intermediaries*.

The immediate outcomes of reforms: significant negative growth of the economy to as low as -4%, negative export growth of -13%, hyper inflation of over 300%, and an unemployment rate of 20%.

Box 1: Key indicators in transition

Average Annual Growth Rate (%)

<i>Year</i>	<i>GDP (million \$ %change)</i>		<i>Exports of goods & nonfactor services</i>	<i>Gross domestic investment</i>	<i>Inflation</i>
1980-90	2,329	5.5%	5.2%	1.7%	13.8% a
1990-94	741	-4.4%	-13.0%	-20.3%	332.4% b
1994		2.0%			66.3%

¹ World Development Report 1996, p.188.

² World Bank "Mongolia Poverty Assessment in a Transition Economy", p. v.

³ Yunden, Ya et al "This is Mongolia", p.29.

1995		5.0%			53.1%
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Source: World Development Report 1996; Human Development Report 1996; Bank of Mongolia Monthly, Statistical Bulletin March 1997. **a:** 1980-93 **b:** 1993

The implementation of the structural adjustment programme has begun to reverse the negative economic trend where annual average GDP grew to 5% in 1995 up from under -4% during the 1990-94 period, while inflation fell to just over 53% in 1995 down from a crippling 332% during the 1990-94 period. In 1997 Mongolia's economic rating rose 34 places from 1996 and the country is now ranked 117th out of 179 countries by Euromoney⁴.

⁴ Euromoney cited in "Mongolia's Economic Rating Rises", The MN-UB POST, April 15, 1997, p.2.

C. Socio-Economic Situation

Despite signs of impressive macro-economic gains, there has been a slow and steady decline in the quality of life of increasing numbers of Mongolians, much of which has been due in large part to layoffs in government and the public sector industries and to deep expenditure cuts in social services - health, education and state benefits. By end-1996, over 450,000 people were living in poverty and that the headcount has increased from single digits in the pre-reform period to 36%⁵. More worrying has been the conclusion that almost a 1/3rd of the poor live in extreme poverty, consuming only 50% of the accepted minimum level of calorific intake. Similarly, maternal mortality has doubled between 1990 and 1994 due to cut backs in health expenditure, while Mongolia's impressive record of almost universal education has collapsed to under 70%.

The country's greatest constraints are institutional - an inefficient financial sector tied up in bureaucracy with poorly performing portfolios, a spate of bank failures, and an unwillingness to embrace sound international best practices; a 'clubby' judiciary that lends itself badly to protecting contracts and to ensuring confidence in the market system so that business and enterprise can thrive; a legislature eager for change but slowed down by political considerations and perhaps more importantly by an unwieldy bureaucratic apparatus that finds the principles of subsidiarity and local governance inimical to the continuation of its vast influence and interests. Despite formidable constraints, Mongolia internal strengths are likely to enable it to mainstream within the medium term:

There is strong political will for change, particularly in overcoming institutional constraints and increasing poverty.

The increasing numbers of people being laid-off from government and (privatised) state enterprises are well educated, thus making the prospects of reducing structural unemployment far brighter than in many developing countries.

Commitment from donors to support Mongolia's wish to transform economically while enabling it to maintain its high levels of human development (Box 2).

Box 2: Comparative Profile of Human Development

<i>HDI</i>	<i>Life</i>	<i>Adult</i>	<i>Population with access to</i>		
<i>Rank</i>	<i>Expectancy</i>	<i>Literacy</i>	<i>Health Services</i>	<i>Safe Water</i>	<i>Sanitation</i>
113	63.9 years	81.7%	95%	80%	74%
ADCA ^c	63.3 years	70.6%	80%	70%	39%

Source: Human Development report 1996

c. ADCA: All Developing Country Average of Human Development indicators.

⁵ PAPO "The National Poverty Alleviation Programme: Update", p.1.

D. Finance and Banking

Before the 1990's reforms, the Mongolian financial sector resembled a mono-banking system where all banking was conducted by the State Bank of Mongolia. The State Bank had several functions beyond that of the central bank - it had a commercial banking branch network throughout the country, and allocated funds to Government departments and Public Sector Enterprises (PSEs) on the basis of Government directives. Financial viability and prudent risk management were not determining factors for financial sector operations.

In 1991, a two-tier banking structure was established and the central and commercial banking functions were abolished. The branch network of the State Bank was transferred to the private sector, while the central functions - monetary/exchange rate policy and regulation/supervision of the commercial banking sector - were handed over to a newly created and autonomous Bank of Mongolia (BoM).

The Mongolian banking sector has passed through a severe crisis of confidence and remains extremely weak. By January 1997, three of the largest commercial banks in Mongolia - Central Asia Bank, Ardyn Bank and Insurance Bank - have closed down after having been declared insolvent. Average loan loss rate is 40%, and BoM suggested in its interview that only three of the 13 commercial banks are commercially viable. Liquidity levels are dangerously low with fewer than seven banks just about managing to meet BoM's liquidity ratio of 20 percent, although most are apparently vulnerable to falling below the minimum acceptable level.

The banking sector's current woes stem from a combination of bad inherited and directed loans made during the pre-reform era (and banks are apparently still under political pressure to lend to loss making PSEs), use of imprudent accounting that did not meet international standards, and lack of capacity of bank staff to assess loans and risk. Discussion with mid-level bank officers reveals a clear lack of understanding of appraisal techniques and of conventional risk management - criteria for lending, similar to many developing countries, depends more on personal and political contacts than on the application of prudent banking principles.

On 31 March 1997, commercial banks were paying 18.7% on demand deposit and 31.7% on time deposits. Average commercial lending rates were 57.3% to PSEs, 80.3% to private businesses and an incredible 105.6% to private individuals. Average spread (unweighted) amounted to over 56%.

As the rate of inflation falls over the next few years, these rates will also decline. However, the glaring lending rate disparity between the PSEs on the one hand and private individuals on the other is likely to remain unchanged, making cost of access prohibitive. Therefore, the demand for financial services from private individuals will likely continue to be extremely high.

The microfinance market remains untapped, particularly for very small loans that meet the needs of the poor and the vulnerable non-poor. At present, there are only two commercial banks

involved in the microfinance sector - Investment and Technological Innovation Bank (ITI) and the Agricultural Bank.

The overall absorption rate has been low primarily due to liquidity problems in the banking sector and lack of capacity among the banks' branch staff to process applications quickly; total outreach to-date - 589 borrowers. Banks are losing interest in providing micro-loans, citing the high cost of credit administration as the key reason. However, given that the micro-loans are on average US\$4,000 and US\$6,000 respectively, the prospects for the vast majority of the poor who require loans of between US\$50-500 are extremely bleak.

Apart from micro-loans from the formal banking sector, only 3 NGOs and 6 government projects (predominantly donor financed) provide microfinance (and then only credit). A total of 6,252 loans have been disbursed to-date to support an estimated 17,000 people engaged in micro and small enterprises; over 4,000 of these loans have been given in-kind - seeds, livestock, sewing machine etc. Almost all of these loans have been given as one-time loans, and most programmes are not specifically designed to enable their clients to have sustained access to microfinancing (see Annex A for full summary).

A total of US\$ 2,615,400 is currently outstanding, of which on average 30% is past due.⁶

Given that there are over 300,000 poor and vulnerable non-poor families in Mongolia who do not have sustained access to microfinance, present levels of outreach, scale of lending, and numbers of microfinance providers are woefully inadequate.

Despite limited engagement and lack of experience and internal capacity, increasing numbers of organisations are looking to microfinance as a major tool either reduce income poverty or create employment.

Institutional Framework for the Banking Sector

The financial services sector is broadly occupied by five institutional actors:

- (i) *Central Bank* - regulator, supervisor and lender of last resort.
- (ii) *National Commercial Banks (NCBs)* operating in the personal retail and corporate banking market segments offering savings and loans products, exchange, and documentary credit services.
- (iii) *Specialised Banks* - providing specialised financial products.
- (iv) *Semi-formal Financial Intermediaries (SFFIs)* - NGOs and Co-operatives providing financial services to their members who are mostly the poor and the vulnerable non-poor.

⁶ Adopted and updated from UNDP "*Micro Credit Development in Mongolia: Current...*".

- (v) *Informal Financial Intermediaries (IFIs)* - individuals and pawn shops - operating primarily in the low-income market segment offering in most instances simple loan products and pawn services.

Bank of Mongolia - Central Bank

Until 1991, the Central Bank was virtually the only bank in Mongolia. While there were several commercial banks operating in Mongolia, all without exception fell under the direct control of the Central Bank.

As described in section A2, the post-1991 reforms have ushered in significant changes to the nature, remit and authority of the Central Bank. It no longer operates commercial banking operations but simply restricts itself to its central regulatory and policy making role. The new Banking Law of April 1991 and its subsequent revisions have strengthened the BoM to define and enforce prudential norms and replace management of banks that violate minimum prudential standards.

The impact of the new found powers will likely take some time to come into effect and only after the banking sector has been fully restructured. The implications of this and the Banking Law for non-banks, particularly NGOs and Co-operatives are unclear. The laws regulating NGOs and Co-operatives very broadly allow an engagement in financial services (although they use the term businesses) so long as such involvement is for the overall benefit of the members of NGOs and Co-operatives and that it is clearly articulated in the mission of these organisations. The law on Co-operatives is a little more stringent than NGOs, although the law on NGOs is arguably highly ambiguous and perhaps presents a potential risk for NGOs wishing to become involved in microfinance.

National Commercial Banks (NCBs) and Specialised Banks (SBs)

There are a total of 12 NCBs and 2 SBs providing retail, corporate, investment and savings services in Mongolia. The 12 NCBs as described earlier have at best liquidity problems or at worst have a negative net worth. Although the total branch network of 582 branches extend to even to the Sum level, their functions remain limited primarily to remittances - of salaries and project aid. While the Agriculture Bank and ITI Bank are using their branch network to extend micro to small enterprise loans, procedural bureaucracy, tight liquidity and lack of capacity of branch staff have all kept the level of absorption very low resulting in very few loans being approved and finally reaching the hand of borrowers (- only 589 loans over three years).

Apart from institutional problems, lending and deposit rates either make access prohibitive or unattractive, particularly to personal customers. While the average cost of borrowing is over 100%, the average cost of savings is 25%+ (producing net capital loss). The inconvenience and unattractiveness of existing savings products have deterred many potential savers - according to BoM, over 80% of all accounts (@40,000) in NCBs and SBs have deposits of under Tug.100,000 and this just so to remain within the system.

The present level of outreach of the NCBs and SBs presents opportunities to semi-formal organisations to provide convenient and attractive savings based products - from simple savings schemes such as term deposits to more complicated pension and insurance schemes to savings based investment schemes such as building society funds. Years of communist rule has underdeveloped the market for these products. However, with reforms well under way, private individuals will increasingly look to convenient private solutions to their need for long-term security - thus the opportunity for semi-formal microfinance providers to cater to this expanding market.

Apart from the NCBs, the two SBs are engaged in providing (i) savings service and (ii) large investment financing services. The savings services are provided by the Savings Bank which began operation in 1997. While there is a significant potential for the bank to create a market niche for long-term savings products, it is unclear whether the Savings Bank has enough credibility among the population.

The vast majority of the management and staff of the Savings Bank come from the collapsed Ardyn Bank, and until potential customers are confident that management practices have changed, the savings market will remain highly limited.

E. Government Poverty Alleviation Strategy

The Government of Mongolia's strategy in the microfinance sector is incorporated within its broad based National Poverty Alleviation Programme (NPAP) which began in 1994. NPAP's goal is: *"To reduce significantly the number of poor in Mongolia and to alleviate human and community deprivation on a sustainable basis"*. GoM envisages the achievement of this goal through pursuing the following strategy:

GoM Strategy for Poverty Alleviation⁷
Promote productive employment and creation of jobs including increasing access to credit and skill training.
Advance women's participation in economic, social and political spheres.
Strengthen markets relations and improve living standards including creating improved marketing infrastructure to promote self-employment and micro-enterprise.
Direct fiscal and monetary policy towards encouraging economic growth, stabilisation of prices and support of national production, including strengthening market mechanisms.
Restore previous levels of human development including making education and health services more accessible.
Create a realistic market based system of entitlements including strengthening social assistance.

The important GoM programmes in the microfinance/financial sector include the following (see Annex A for details):

- (i) The National Poverty Alleviation Council (NPAC) through the Poverty Alleviation Programme Office (PAPO) undertakes programmes on (a) income generation for men and especially women at Sum and Khoroo levels through co-operatives, (b) training on income generation activities, and (c) capacity building of NGOs to better implement microfinance programmes⁸. Repayments are staggered starting from Year 2.
- (ii) The Ministry of Agriculture and Industry provides credit for livestock restocking and vegetable growing. These are provided in-kind (ie. livestock and seeds) and means of payment is also in-kind. Assistance is received from IFAD, FAO and GTZ.
- (iii) The Ministry of Finance provides credit for micro-enterprises restricted to the

⁷ GoM *"Poverty Alleviation Programme"*, p.3-5.

⁸ PAPO *"The National Poverty Alleviation Programme: Update"*.

the Sums under the Sum Development Fund. Requirement of collateral makes access by poor and the vulnerable non-poor prohibitive. The programme is funded through the government's revenue budget.

(iv) In another project, the Ministry of Agriculture and Industry (a) wholesales credit to NCBs for on-lending to clients for small and medium enterprise development, (b) provides management training, and (c) supports marketing and legal advise. These loans do not reach the poor or even the vulnerable non-poor. The loan fund was created out of proceeds from an American PL480 consignment received from the US Government.

(v) The Ministry of Health and Social Welfare provides credit for small-enterprise development through the Employment Promotion Fund.

While a number of government ministries are involved in microfinance activities, the outcome of these activities are likely to exclude the poor because the programmes are designed to encourage the development of micro/small/medium enterprises and almost all require collateral to securitize risk. The poor have little or no experience in managing enterprises and do not by definition have assets to.

Additionally, most of these programmes rely on a bureaucratic loan application and approval procedure - some schemes such as the Sum Development Fund under the Ministry of Finance require loans to be formally approved at the Ministry in Ulaanbaatar, while others have to go through a range of committees and councils before final approval is granted. These not only increase the cost of delivery and thus reduce the prospects for sustainability, but they also dilute accountabilities and thus encourage poor loan supervision and ultimately poor repayment performance. Some of the schemes are directed to specific activities which weigh heavily on the borrower who may have other uses for the loans. Such loans restrict choice and the long term potential of individuals to sustain their capability secure livelihood opportunities.

Therefore, while GoM's recognition of the importance of microfinance to poverty reduction is to be wholly applauded, its present microfinancing schemes are unlikely to either directly reduce poverty significantly or to positively move towards sustainability.

F. Donor Interventions in Microfinance Sector

Since microfinance is increasingly being seen a critical tool to reduce income poverty and community deprivation, several agencies and departments are implementing microfinance programmes. GoM agencies and a small number of NGOs are involved in microfinance and are receiving external support in various ways. Donor support is currently restricted primarily to financial assistance to specific projects and programmes, and in a limited way institutional strengthening . Areas of future support are likely to include upstream policy advice and technical support.

World Bank

The **World Bank** has allocated IDA loan of US\$ 6 million for the National Poverty Alleviation Programme for microfinance.

UNICEF

UNICEF plans to invest US\$ 1,050,000 over the next five years on credit operations.

ADB

The **Asian Development Bank** has been funding ITI Bank, Mongolian Women's Federation, and Mongolian Employers' Association to provide loans for small enterprise development. The initial commitment was US\$ 3 million; the next phase will begin in 1999 with loan of US\$ 5 million.

Other Donors

The **German Government** is going providing a loan of DM 10 million for the development of small enterprise at the Sum level.

IFAD has created a US\$ 5 million credit window for agriculture.

TACIS, the EC agency plans to invest in a credit programme, the precise timing of which is unknown.

G. Local NGOs and Cooperatives Interventions in Microfinance Sector

Semi-Formal Financial Intermediaries (SFFIs)

The number of SFFIs is very small in Mongolia and their involvement began as late as 1994. The Mission has identified 3 NGOs/Co-operatives that provide microfinance for mostly small/medium enterprises enterprise development.

Mongolian Women's Federation

In the NGO sector there is only one organisation - Mongolian Women's Federation (MWF) - with a track-record in providing microfinance. MWF has a cumulative outreach of 5,000 (one-time) clients with average loans of between US\$ 60 - US\$ 250 in-kind. Cumulative value of loan disbursements amount US\$ 80,000 (1994-96) and it *claims* to have an average annual repayment rate of 98.2%. Its past and present donors include UNIFEM, FAO, the Governments of Australian and the Netherlands, UN Population Fund, the EC, and ESCAP (see Annex A and C for a detailed assessment of MWF). Despite an established service delivery network, MWF remains weak in terms of staff capacity to manage solidarity group based lend and steep growth, and in terms of an under-developed monitoring./financial systems and of strategic and programme planning (particularly financial). Support is needed at the project site level in terms creating base-lines, designing and implementation, while financial, microfinance administration and management training support is needed at the senior management or HQ level.

NGOs Interested in Promoting Microfinance

Apart from the MWF, there are no other NGOs providing or promoting microfinance schemes, although increasing numbers of organisations are showing keen interest in wanting to become involved. Two organisations with the most potential are the Liberal Women's Brain Pool (LEOS) and the Mongolian Youth Federation. Both of these organisations have two things in common - it has dynamic leadership and have an established infrastructure through which microfinance may be either provided or promoted. These are ideal as 'start-ups' and they would be atypical of the type of organisations international NGOs would support in countries like Bangladesh and India.

LEOS was established in 1992 as an advocacy organisation. It was organised by a core group of professional women interested in promoting women's role in national and local decision making process. It drew its initial membership from parliament, civil service, banking and accountancy sectors, academia, and business. Overtime, the organisation has grown to include over 5,000 members in the Aimags and in Ulaanbaatar, and these also include the vulnerable non-poor. With the growth of membership and the increasing recognition that LEOS needed to become active in areas other than advocacy to meet members' needs, it recently registered a Savings & Credit Co-operative with members from both the non-poor and the vulnerable non-poor. Operational manuals and loan approval procedure have been completed, and the Co-operative is now ready to make its first loan. The preparatory work has been thorough, and their stated strategy is to create similar Savings & Credit Co-operatives in each of their 127 branches throughout the country.

LEOS lacks practical experience; financial and reporting systems are very strong. LEOS is funded through membership fees (see Annex D).

Mongolian Youth Federation

The Mongolian Youth Federation (previously known as the Mongolian Revolutionary Youth League) is one of the oldest and most established organisations in the country. After the fall of the communist regime, the organisation was renamed. The departure of the old guard ushered in new and more dynamic leaders, more open and enthusiastic about working within an open economy. The political activities were dropped for skills training to get youth in to employment.

Their efforts won them an award and a place in the management of the Asian Youth Council. The key opportunities include 450 branches in 21 Aimags and 246 Sums, and it currently has over 90,000 members - most of whom are poor or the vulnerable non-poor. The Youth Federation has its own three story building and runs a number of small business - it has positive reserves every year after paying expenses for on-going programme activities in each of the Aimags and Sums. Key constraints include no experience of microfinance. Financial and reporting is good (see Annex E).

Cooperatives Providing Microfinance

Besides NGOs, two major co-operatives are also providing microfinance, primarily for small and medium enterprise development. These are the Mongolian Union of Production and Service Co-operatives and the Mongolian Employer's Association. As their names suggest, the target groups in these co-operatives are the non-poor. Since 1994, they have financed 121 small/medium enterprises disbursing US\$ 302,439 with an average loan size of US\$ 2,500. Their average repayment rate since 1994 amount to reasonable 83%.

Informal Financial Intermediaries (IFIs)

There are a range of IFIs that intermediate financial services to those without access to the formal or semi-formal financial sector. IFIs range from friends and relatives to independent money lenders and traders to more formalised pawn brokers.

Friends and relatives have been and will likely continue to be the most important sources of financial intermediation in Mongolia. These traditional IFIs enable those without access to financial services to borrow to smooth out peaks and troughs in expenditure, to finance purchase of capital items and production inputs such as seeds, and to inject running capital in various income generating activities and micro-enterprises. This is not at all unusual for a developing country. What is different is that borrowing from friends and relatives in Mongolia impose little or no financial cost to the borrower (although this is changing in less isolated areas and where reforms have been painful). The motivation for lending is less to do with making a quick financial return on investment than to do with creating stable alliances and safety nets for the lender. This is particularly important outside of the capital city Ulaanbaatar where geographical spread, harsh

conditions and poor infrastructure force most families to rely on their immediate social network for security during emergencies.

IFIs in the form of individual professional money lenders and traders are far less common and their activities are primarily restricted to within Ulaanbaatar, although professional traders (particularly in cashmere) operate outside of Ulaanbaatar. Professional money lenders primarily lend to the vulnerable non-poor at rates similar to that found in other developing countries - between 20-30% per month or a compound interest rate of over 300% annually. Professional traders lend in-kind - in the form of goats, and receive payment in the form of cashmere. Returns are much less than professional money-lending, but given that their core business is the production of cashmere apparels for export, margins on lending is regarded as less important.

Traders have established networks of pick-and-drop centres and these provide important opportunities for microfinance - in that the networks provide an established marketing infrastructure through which poor people can sell their produce and purchase inputs and other consumer durable.

At a higher institutionalised level are pawn brokers, locally known as “Lombards”. These provide collateralised loans of any size. In this, the lombards are similar to banks. However, there are important differences. Assets are usually discounted for present value (by about 30-50%) and loans are equated to the discounted value of assets at interest rates of 15-20% per month. While the rates are high, this form of financial intermediation has become very popular among the vulnerable non-poor due to lack of restrictions in collateral type, simple approval procedures, and shorter lead time between application and disbursement (usually no more than a day or two). This methodology provides enormous replication potential and the advantage of spreading risk in an uncollateralised system of financial intermediation for the poor and the vulnerable non-poor using principles of group lending.

H. Microfinance: Demand for and Special Considerations

A widely held view of a poor person is someone who does not have much money. For such a person, the proper management of what money they have is of critical importance. For this, they need *micro-finance*. Access to micro-finance has the potential to offer poor people self-employment opportunities that can raise them above the poverty line, or empower women. Most fundamentally, however, micro-finance will enable poor people to simply *manage better what little money they have* - to manage shocks and emergencies, to smooth out peaks and troughs in income and expenditure, to make investments in homes, families and businesses, and to provide for their old age and for their heirs.

Presently, the poor in Mongolia have very little access to microfinance - both in terms of size and scope. Key constraint to access remains existing institutional arrangement for service delivery. The formal banking sector is highly undercapitalised, maintains low quality portfolios, provides for only collateralised loans for small/medium enterprises, and is not interested in providing poor people with access to microfinance.

Co-operatives have intrinsic limitations to providing the size and scope micro-finance needed by the poor, and NGOs are few in numbers with little experience or capacity to effectively manage or promote microfinance facilities. All of these institutions have a poor track record for managing risk.

While the lombard system of pawn broking is popular, they are limited in scope and require collateral that effectively exclude those without assets, namely the poor. Professional money lending remains limited and little scope to provide access to large numbers of poor people.

Combining Capital Grants with Technical Assistance

Organisations managing or planning to manage microfinance schemes in Mongolia are constrained by three immediate requirements:

The first relates to the need for financial assistance to cover operational expenses. In the case of NGOs, donors are often reluctant to pay for such expenses, invariably resulting in poor administration, monitoring and thus the ultimate performance of these organisations. In the case of self-help co-operatives or user-owned ROSCAs, such expenses are usually covered by the members themselves and this imposes an opportunity cost either in the form of income foregone or erosion of equity or inertia - either way such costs limit the potential of these organisations to increase the size and scope of microfinancial services to their members.

The second constraint relates to under-capitalisation. All organisations managing or planning to manage microfinance schemes have an inadequate capital base for lending to the growing microfinance market. While there has been a limited injection of capital from donors, poor implementation procedures have successively eroded the capital base, making increasing outreach unattainable.

This leads on to the third immediate constraint which is the lack of capacity to effectively manage microfinance schemes to attain increasing outreach.

It should be noted that NGOs must be permitted to charge above market interest rates for microfinance services enabling them to achieve self sufficiency. In a high inflation situation, such as in Mongolia, it is essential to add the inflation rate to all the costs associated with programme delivery in order to achieve financial self-sufficiency.

Combining Poverty Alleviation with Poverty Prevention

There has been an increasing trend in the incidence of poverty in Mongolia since 1990. There were almost 830,000 poor people (over 166,000 families) in June 1995 and this figure is likely to have increased to near 1 million people by May 1997.

The World Bank's Poverty Assessment study states that "increasing the poverty line by only 10% increases the level of poverty to 43%, while decreasing the poverty line by 10% decreases the level of poverty to 29%". The implication is that there is a large concentration of people living on either side of the poverty line. In an overall sense, therefore, one can assume that the spectrum of poor people can be seen to occupy three distinct groups: the extreme poor, the moderate poor and the vulnerable non-poor. The final group, the vulnerable non-poor, is not counted in the official statistics but which constitute a large percentage of the future poor. This group is highly prone to downward mobility pressures arising out of structural change, sudden emergencies and shocks, and life-cycle changes.

If microfinance interventions are to lead to sustainable livelihoods and reductions in the incidence of poverty through economic graduation, they must necessarily enhance livelihood capabilities at all three levels of poverty: at the level of extreme poverty, moderate poverty and vulnerability. Economic graduation, in this context, should therefore mean the upward movement of the extreme and moderate poor sub-groups and the capability of the vulnerable non-poor to sustain their positions.

Promoting Diversity, Experimentation and Learning

The microfinance sector is in its infancy in Mongolia. Sectoral experience to date has been unimpressive: the formal financial sector has not been able to provide useful examples of how best to manage financial services whether to the poor or the rich, and informal financial markets have been stifled due to years to communist rule. Therefore, while enough is understood about the characteristics that microfinance programmes must demonstrate to be successful, it is difficult to predict the specific microfinancing designs that will work best in the Mongolian context or contexts.

Beyond experimenting with micro designs, there are perhaps two broad approaches that will work in the Mongolian context. The first approach is where organisations set themselves up as

providers of microfinance. The second is where local organisations are financed to promote and manage user-owned ROSCAs.

In terms of an approach, provision of microfinance has proven to be the most successful with organisations like the ASA, BRAC and the Grameen Bank in Bangladesh reaching truly large numbers - over 3.5 million borrowers with a combined population of 18 million people. The combination of generous and long-term donor support, ability to mobilise resources from members' savings and from the formal financial sector, over a decade of experience of providing microfinance services, strong capacity to effectively manage growth, and, most importantly, internal commitment to financial viability and long term presence have all contributed to the success of these organisations.

Many of the conditions and characteristics that have made the provision of microfinance a success as an approach do not exist in Mongolia, yet - donors treat microfinance as a project, there is almost no evidence of savings collection as a resource mobilisation strategy, the financial sector is itself in deep trouble and does not lend itself well to the financing of organisations providing microfinance, there is very little experience of microfinancing, organisations do not have the capacity to manage growth, and perhaps as a result of all of these factors there is little visible commitment to viability or to permanence. This does not mean that organisations can not or should not set themselves up as providers of microfinance - it is a question of whether similar conditions and characteristics can be recreated in Mongolia.

The second approach is an alternative and one where organisations would promote and manage user-owned ROSCAs.

User-owned ROSCAs are in essence Credit Unions for the poor and work under similar principles - namely that they are self-initiated, self-financed, provide a common co-operative framework within which to mobilise internal resources for lending, and manage risk through exerting peer pressure. However, there are very few examples of successful (sustainable) user-owned ROSCAs of the poor primarily because they have either not been able to raise their own savings in sufficient quantity to provide loans numerous and large enough to satisfy their members or because the members have been far too poorly educated and too socially fragmented to effectively run their own savings-and-loans club. This is particularly true in South Asia. However, given significantly higher levels of education and self-confidence in Mongolia, the potential for promoting successful user-owned ROSCAs is great, although this is only likely to work in Ulaanbaatar and with the vulnerable non-poor (see Annex F).

However, there are problems associated with ROSCAs - they rely on repetition rather than permanence to increase outreach and they are either unambiguously successful or fail completely. The successful ones get reproduced, failed one and their weak or corrupt managers simply disappear. To ensure failures do not occur in Mongolia, promotion of ROSCAs would need to be combined with the management of ROSCAs.

An Approach to Capacity Building through Direct Management Support

A recent survey⁹ of NGO capacity stated: “One of the biggest constraints ...of the Mongolian NGO sector is the restriction of its financial basis. Without external funding...a number of potentially capable organisations may not survive in the coming years. However, the extend of funding offered to these NGOs must be in balanced proportion to each individual organisation’s institutional strength and implementation capacity”.

Clearly, the illustrative examples of potential organisations described earlier have varying levels of institutional strength and limited capacity to effectively implement microfinance programmes. However, all of these organisations have strong potential for growth and wider impact. They are willing to learn and are open to new ideas, there is a commitment to root out poverty particularly for women, they have an establish infrastructure in some or all parts of the country, the local branches have developed a sensitive understanding of the needs of the poor and the vulnerable non-poor, and microfinance receives highest preference. In terms of the country, Mongolia represents open territory for microfinance with challenges no doubt but also presenting opportunities in terms of learning and of widening the net of international best practice.

Making Initial Investments in Areas Where Microfinance Can Succeed

Mongolia is characterised by scattered and sparsely populated settlements where cost of transacting is high and the total size of local markets for goods and services is small. The meso-economy is primarily non-monetized where the medium of exchange is stock and assets of any kind (most often livestock).

These characteristics are inimical to the success of microfinance interventions and are unlikely to lead to high portfolio performance, cost efficiency in service delivery, and incremental increases in the net incomes of providers and users of microfinance services.

Inflation

Microfinance projects will charge realistic lending rates to maintain the value of its capital and to tend towards sustainability. Given the present high level of inflation, they will likely charge rates in excess of 84% per annum.

If the rate of inflation does not decline, the project will find it difficult to mobilise savings as people prefer to save in kind during periods of high inflation. This may adversely affect lending volume.

Institutional Capacity

Lack of direct management support to MPP may lead to poor institutional performance in terms of achievement of outreach, lending and sustainability targets, as well as in terms of under-utilisation of resources.

Manpower

⁹ UNDP “*Mongolian NGO Capacity Survey to Support Human Development*”, p.1.

Commitment of local staff to remain with the project for at least two years will be critical to the project's success. High turnover may lead to slower growth and poorer institutional performance.

Financial Transparency

Microfinance projects will lead to an increase in the circulation of cash and the handling of large volumes by staff. There may be strong temptation among front-line staff to misappropriate 'easy' money.

Politics

Successful microfinancing requires the enforcement of strong financial discipline. Any infringement in the enforcement of that discipline due to political reasons or otherwise may reduce institutional performance.