

Mongolia: Assessment Letter for the Asian Development Bank
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1. This note provides an assessment of Mongolia's macroeconomic conditions and outlook based on the 2008 IMF's Article IV Consultation that was concluded in June and subsequent developments up to September.

Recent Developments and Policy Performance

2. **Mongolia's economic growth remains strong, but inflation has increased substantially.** Real GDP grew by 10 percent in 2007, and is projected to grow at the same rate in 2008 on the back of strong performance in agriculture and services. Inflation peaked from 6 percent (yoy) in June 2007 to 34 percent in August, before declining to 32 percent in September consistent with the recent drop in food prices. On the demand side, large increases in civil servant wages and rapid expansion of credit contributed to inflation, while on the supply side, soaring food and oil import prices played a crucial role. In an effort to stabilize food and fuel prices, the authorities introduced temporary exemptions on VAT and customs duties on wheat and flour imports, measures to build up wheat, flour, and meat reserves, and temporary subsidies to reduce interest expenses of petroleum importing companies.

3. **Fiscal policy has been expansionary, although the 2008 outcome so far has been stronger than budgeted.** Mineral revenue has been robust due to exceptionally high copper and gold prices, while nonmineral revenue also performed well driven by strong tax collection and substantial increases in import tax revenues. However, government expenditures, particularly on wages, transfers, and capital spending, have increased sharply over the past two years. As a result, the overall fiscal surplus narrowed from 8 percent of GDP in 2006 to 3 percent in 2007. The 2008 budget envisaged a 2½ percent of GDP deficit, and the recently approved budget amendment calls for a 0.3 percent deficit, but the fiscal outcome has been broadly balanced up to September.

4. **Monetary policy has been tightened, but credit expansion remains rapid.** In an attempt to lower inflation, the Bank of Mongolia (BOM) has increased the pace of its foreign exchange sales allowing the togrog to appreciate against the US\$ by 2 percent and increased the policy rate by 185 basis points since January. Broad money growth has slowed from 57 percent (yoy) at end-2007 to 16 percent in September, and the growth of reserve money, although volatile, has remained at single digits on average during the past six months. Despite this monetary tightening, credit continued to grow rapidly at 47 percent in August and the lending rates remained negative in real terms.

5. **Despite strong exports, rapid import growth led to a deterioration of the current account balance.** Exports continued to perform well, driven by exceptionally high copper and gold prices so far. However, the current account balance turned to a deficit of 14 percent of GDP in August from a surplus of 2½ percent at end-2007 owing to rapid growth of imports in mining-related capital goods and high food and oil prices. Gross international reserves

remained comfortable at \$880 million in September, covering about 3½ months of nonmining imports. The NPV of external public debt, which is mostly concessional, is estimated at 20 percent of GDP at end-2008.

Outlook and Challenges Ahead

6. **Consistent with global economic outlook and declining mineral prices, Mongolia's economic growth is expected to moderate in the near term.** Real GDP is projected to slow down to about 8 percent in 2009 from 10 percent in 2008. The balance of payments impact of lower mineral prices is expected to be broadly neutral due to lower exports and imports, but the fiscal impact could be significant.

7. **Risks to the near term outlook are tilted to the downside.** Although the current financial turmoil so far did not have any direct impact on the Mongolian economy, mineral prices could decline more than currently projected reducing exports and fiscal revenues. In addition, mining related FDI inflows could be sharply curtailed if foreign-owned mining companies face financing constraints as the global financial crisis spreads to the corporate sector.

8. **However, with vast mineral resource deposits, Mongolia's medium-term outlook remains favorable.** Mongolia's economic growth would remain strong with the expected opening of two world class mines (Oyu Tolgoi, copper and gold mine, and Tavan Tolgoi, coal mine) in the medium term. The external current account is projected to move into deficit during the next three years, reflecting large FDI-financed imports of capital equipment for the mining sector, but it is expected to move back into surplus once the new mining projects come on stream. The risks to this favorable outlook include weather-related shocks, delays in mining development, and a prolonged slump in copper prices.

9. **Mongolia needs to address major policy challenges in order to fully exploit its potential.** In the near term, significant inflationary pressures pose a risk to macroeconomic stability, calling for maintaining tight fiscal and monetary policy stances. In the medium term, Mongolia needs to establish a transparent, stable, and internationally competitive fiscal and investment regime to take full advantage of Mongolia's vast mineral wealth. Mongolia also needs a medium-term fiscal framework that can contribute to the maintenance of low inflation and fiscal sustainability. In addition, continued progress in strengthening the financial sector is also important for sustained growth.

10. **In the near future, maintaining a tight fiscal policy is essential to bring inflation down and to provide fiscal space to accommodate emerging risks.** Staff welcomes the authorities' plan to tighten fiscal policy in 2009, reversing the expansionary trend during the past two years. The budget proposal calls for a balanced budget, reducing the nonmineral deficit by about 3¾ percentage points of GDP from 10 percent of GDP consistent with achieving a staff-recommended medium term fiscal anchor of 8 percent deficit in the non-mineral balance by 2010. Fiscal tightening remains essential to tame inflationary pressures and to plan for fiscal revenue shortfalls should copper prices decline further.

11. **Maintaining a tight monetary policy and a flexible exchange rate would be needed to ensure domestic and external stability.** The recent gradual tightening of monetary policy should continue to contain inflation. However, in light of the projected decline in mineral exports, the BOM may not continue relying solely on foreign exchange operations to tighten monetary policy without jeopardizing reserve coverage of its external payment needs. This would call for a more flexible exchange rate policy, by moving away from uni-directional sales of international reserves and allowing the market to adjust to external shocks. Reversing the recent reduction in reserve requirements would help reign in credit growth. Going forward, enhancing the interest rate mechanism would be needed to make the policy rate more effective.

12. **Moving forward, Mongolia needs to strengthen its macro-fiscal framework to help cope with the inherent volatility and uncertainty of mining.** The current practice of targeting the same overall budget balance in percent of GDP over three years could lead to highly procyclical spending. To minimize the adverse impact of potentially large fluctuations in mining revenues, the authorities should aim, as a start, at a nonmineral balance target as a medium term fiscal anchor. As experience is gained with this framework, the authorities could consider a structural balance target and a separate limit on the growth of spending to reflect the capacity of economic absorption and to avoid overheating pressures. The IMF staff has been in close consultation with the authorities in strengthening the medium term fiscal framework.

13. **The authorities should move cautiously with plans to tap commercial borrowing on a large scale and to distribute mineral wealth to Mongolian citizen.** Parliament authorized the government to issue commercial foreign borrowing of up to \$1.2 billion (20 percent of GDP in 2008) to finance additional capital spending. In addition, as part of election promises, the authorities envisaged a plan to distribute mineral wealth of up to Tug 1.5 million to each citizen (about \$1,300 per person or 55 percent of projected 2009 GDP) starting in 2009. However, large borrowing and spending associated with these plans could further aggravate inflationary pressures and significantly raise the debt to GDP ratio¹. To maintain macroeconomic stability and debt sustainability, the authorities should continue to rely primarily on concessional borrowing in the near term and explore other options for distributing mineral wealth, including public investment in education and infrastructure, and only consistent with the medium term fiscal framework.

14. **Progress is being made in strengthening financial sector soundness.** The joint IMF-World Bank Financial Sector Assessment Program team found that the Mongolian financial system is developing and performing well and that the BOM's framework for banking supervision is generally well developed, but a number of challenges remain. Progress has been made in strengthening the capacity of the Financial Regulatory Commission (FRC), and the FRC has been working to relicense the saving and credit cooperatives, insurance companies, and other nonbank financial institutions. The BOM is also in the process of enhancing its own risk management capacity. Moving forward, the authorities should continue to strengthen the capacity of financial sector supervision, including by monitoring large exposures and enacting

¹ See Joint IMF/World Bank Debt Sustainability Analysis in IMF Country Report No. 08/200

draft laws to support the supervision of nonbank financial institutions. In addition, closer monitoring of the bank's loan quality is warranted considering rapid credit growth over the past two years.

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15. **Staff's engagement with Mongolia continues to focus on intensive surveillance and a comprehensive technical assistance (TA) agenda.** The 2008 Article IV consultation was concluded on June 4, 2008, and the Board documents have been published. More than 20 TA missions have taken place since January 2007. Total outstanding obligations to the Fund at end-September 2008 amounted to SDR 14 million (27 percent of quota). Staff expects to remain engaged in a close policy dialogue with the authorities, working in collaboration with the World Bank and the Asian Development Bank.