Mongolia

During 1997 economic growth recovered and inflation declined. The foreign exchange rate stabilized after March, and the 17 percent depreciation experienced during 1997 was the smallest decline in the last five years. Forecasts for 1998 indicate that GDP will increase by 4.5 percent.

RECENT TRENDS AND PROSPECTS

Real GDP growth increased from 2.4 percent in 1996 to 3.3 percent in 1997; however, continuing problems in the banking sector and energy shortages constrained growth. The service sector, which grew by 5.3 percent, provided the main impetus for the improved economic performance. Mongolia achieved higher growth, together with a marked decline in inflation, despite continued weakness in international copper and cashmere prices. The 1997 economic performance reflects successful macroeconomic stabilization and could mark the beginning of a period of sustained noninflationary growth.

Agricultural output, which accounted for almost 37 percent of GDP, grew by 2.6 percent. The weakening of domestic meat prices and lower international prices of cashmere moderated the overall impact of increased livestock herds and higher cashmere output. Despite the 4 percent reduction in land area sown, crop harvests improved in response to an improved policy environment, liberalization of wheat prices, and favorable weather conditions.

The industry sector recovered, with 2.3 percent growth in 1997, compared with 0.5 percent in 1996. Manufacturing output rose by 2.8 percent, with the private sector playing the lead role, stimulated by the government's ambitious privatization program, under which some small businesses and agro-enterprises were privatized. Construction output contracted by 6 percent, primarily because of a slowdown in public sector activity. Gold production from privately-owned mines increased from 5.4 tons in 1996 to 8 tons in 1997, thereby increasing foreign exchange reserves.

Private enterprises dominate the service sector. Services related to trade, transport, communications, hotels and restaurants, and tourism improved in 1997, aided by the stability of the exchange rate, the initiation of bank restructuring and reforms, and the abolition of price controls.

The number of those officially registered as unemployed reached 63,700, or 7 percent of the labor force. This was 15 percent higher than the 1996 level, but probably underestimates the actual level of unemployment. Unemployment resulting from problems related to state-owned enterprises (SOEs) increased during 1997. Money wages and salaries increased by 25 percent, leading to an increase in real wages of about 5 percent, the first increase since 1993. On the whole, total income per household improved in real terms during 1997.

Tax revenue collection improved, particularly of income and corporate taxes, because of the major tax reforms implemented in May 1997. Import tariffs were abolished, except on alcohol and tobacco products. To avoid further revenue losses, the authorities replaced these tax cuts with new revenue measures, including extending the coverage of domestic sales tax to about 300 additional enterprises by broadening the tax base to include the food, construction, and communication sectors; doubling excise taxes on petroleum products and alcoholic spirits when they were converted from local currency to foreign currency rates; and introducing a new excise tax on passenger vehicles. These new measures increased tax revenues by about 2 percentage points of GDP.

Expenditures and net lending remained at about 40 percent of GDP, with increases in both current and capital expenditures. The increase in current expenditures was a result of (i) an increase in civil servants' wages and salaries, (ii) the clearance of domestic arrears of both the central and local governments, (iii) the interest payments on bank restructuring bonds, and (iv) an increase in pensions. Interest payments increased from Tug4 billion ($7 million) in 1996 to Tug22 billion ($28 million) in 1997.

The net result was that the overall fiscal deficit deteriorated in 1997. While total revenues increased from 28 percent of GDP in 1996 to 30 percent in 1997, total expenditures and net lending increased from 36 to 38.8 percent of GDP in 1997. The current budget balance was 2.3 percent of GDP, compared with a target of 1 percent. However, the 1997 result was only half the 1996 level, and the overall fiscal deficit was contained at 8.6 percent, compared with the target of 10 percent.

Money supply (M2) grew by 36 percent in 1997. Time saving deposits rose by 27 percent, compared with a contraction of 8.7 percent in 1996. This reflects improvements in the banking sector resulting from restructuring undertaken in late 1996 and stronger supervision by the Bank of Mongolia. The growth in currency in circulation slowed to 23.3 percent, down from 57.6 percent in 1996. Net credit to the government from the banking sector fell sharply; credit to public sector enterprises remained constant; and credit to private enterprises rose, but not enough to sustain the required rate of capacity expansion in the manufacturing sector. The real rate of interest on bank credit was high, more than 40 to 50 percent per year, making the use of debt financing for capital investment difficult. Thus the next challenge for monetary policy is to encourage banks to reduce their lending rates while ensuring credit quality and improving recovery ratios.

Following the price decontrol and adjustments in 1996 and sharp increases in fuel and electricity prices during the first quarter of 1997, monthly inflation was as high as 5.8 percent by April 1997. In addition, the authorities removed subsidies from water rates, accommodation rents, and transport fares; however, declining meat and vegetable prices helped offset these increases. The Bank of Mongolia's tight monetary policy effectively restrained further price increases, resulting in price deceleration in the second half of 1997. Annual inflation was estimated at about 20 percent, a

Table 2.6 Major Economic Indicators: Mongolia, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth	6.3	2.4	3.3	4.5	5.0
Inflation rate (consumer price index)	56.8	49.6	20.0	15.0	10.0
Money supply (M2) growth	32.9	25.8	36.0	20.0	17.0
Fiscal balance/GDP	-3.8	-8.2	-8.6	-8.6	-7.0
Merchandise exports growth	32.3	-12.8	8.9	2.0	5.0
Merchandise imports growth	32.0	4.5	-1.5	6.0	7.5
Current account balance/GDP	-5.5	-10.0	-5.6	-11.5	-10.0
Debt service/exports	12.0	11.5	9.0	9.8	10.5

Sources: Bank of Mongolia, National Statistics Office, and staff estimates.

significant improvement over the 49.6 percent recorded in 1996.

Total export earnings reached about $461 million, an increase of about 9 percent from 1996 levels. The value of copper exports, which accounted for about 43 percent of total exports, rose by 14 percent following increased production. Other principal exports were cashmere, leather garments, gold, live animals, and animal products. Although Switzerland nominally accounted for the largest share—32 percent—of Mongolia's exports, these actually represented copper concentrate that was re-exported to the People's Republic of China (PRC) and Russia. The PRC was the second largest market for Mongolia's exports, accounting for 22 percent of total exports, followed by the Republic of Korea with 11 percent. Imports declined by 1.5 percent. Primary imports included machinery, chemicals, and energy. Russia, at 36 percent, was the largest source of imports, followed by the PRC with 14 percent. The trade deficit shrank and the current account deficit improved to around 6 percent of GDP. The inflow of concessional external finance was substantially larger in 1997 than in 1996, and was sufficient to finance the current account deficit and build up net foreign exchange reserves to $89.9 million by the end of 1997.

The Bank of Mongolia responded decisively to the sharp depreciation of the tugrik in early 1997 by tightening monetary policy and intervening in the foreign exchange market. As a result, the exchange rate stabilized in March 1997, and over the year averaged Tug794 to the US dollar. The exchange rate at the end of the year was Tug813 to the US dollar. This 17 percent depreciation was broadly in line with annual year-on-year inflation. This is the smallest depreciation rate in the last five years, and reflects the successful implementation of macroeconomic stabilization measures.

Forecasts indicate that GDP will increase by 4.5 percent in 1998, while inflation will fall to 15 percent. Services will continue to lead growth performance. A likely reduction in real interest rates for bank credit and greater inflows of foreign capital into the mining sector will result in higher investment growth. In addition, more foreign companies are likely to invest in oil exploration and production projects. The private sector will lead growth in both manufacturing and services, with the government's role increasingly focused on providing physical and social infrastructure. An accelerated program of SOE privatization will encourage private sector expansion.

Fiscal stability will continue over the medium term, with the government bringing down the tax burden on the economy. Total revenues will decline as a percentage of GDP in 1998, but will then stabilize. Privatization receipts will contribute about 1.5 percent of GDP to total revenues. The government will reduce its expenditures to lower the overall deficit to a level that will not require exceptional financing from concessional foreign sources.

Exports are expected to increase by about 2 percent in 1998, despite the expected softening of international copper prices. The increase is likely to come from higher gold and cashmere exports. Imports could increase by 6 percent, resulting in a larger balance of trade and current account deficit of about 11 percent of GDP in 1998. The inflows of official concessional financial assistance already in the pipeline will cover the current account deficit. Mongolia's external debt, all of it long-term and on concessional terms, is just over half of GDP. Given the concessional nature of the debt, the servicing requirement is well within prudential limits at less than 10 percent of exports.

POLICY AND DEVELOPMENT ISSUES

The government has successfully introduced a broad range of reforms that are achieving macroeconomic stability. It has undertaken structural reforms that are encouraging private sector-led growth, implemented a bank restructuring and reform program, is streamlining public administration, has accelerated privatization programs, is implementing tax reforms, and has made its trade regime such that it is one of the most liberal in the world. With the major structural reforms either completed or well under way, the government is now beginning to address the issues pertinent to long-term development prospects and poverty reduction. This will require identifying Mongolia's comparative advantages and adopting policies that will encourage private sector-led investment to build on these comparative advantages.

About 36 percent of the population, mostly in the provincial capitals, is living below the poverty line. Poverty has increased following the withdrawal of budgetary subsidies and the closure of SOEs. The government has initiated some labor-intensive public works programs to mitigate the unemployment and poverty situation, but rapid, sustainable economic growth and the restructuring of industrial capacity are required to solve the two related problems of unemployment and poverty. At present, however, the agencies involved in poverty alleviation lack the ability to coordinate their efforts, thereby making the formulation of a comprehensive poverty alleviation strategy difficult. Given its resource constraints and the substantial number of people living in poverty, Mongolia cannot afford inefficiency in its poverty alleviation efforts, and cooperation across agencies would facilitate the targeting of specific goods and social services for poverty alleviation.