Mongolia

Mongolia's transition to a market economy, which began in 1990, has proceeded satisfactorily, and the private sector is now the main producer of goods and services. The immediate challenges are reducing poverty and resolving the public sector imbalances that are the main barriers to growth and promotion of private sector activity.

RECENT TRENDS AND PROSPECTS

In 1999, the economy remained adversely affected by external factors, most notably continued low international prices for Mongolia's main exports of copper, cashmere, and gold and the ongoing economic instability in Russia. The extensive dependence of the country on exports of primary commodities means that even small changes in their international market prices can measurably affect GDP. Real GDP growth reached 3.5 percent in 1999, the same as the previous year, and slightly less than in 1997.

Inflation, which had declined to 6 percent by 1998, increased to 10 percent by end-December 1999. The disruption in Russia—as well as increased world prices for petroleum products and food items, particularly meat products—contributed to the high rate of inflation at the year-end.

The trade balance improved somewhat in 1999. Consequently, the trade deficit declined from 14.5 percent of GDP in 1998 to 9 percent in 1999. The tugrik fell 18.9 percent against the dollar during 1999, compared with 10.9 percent in 1998, which helped the trade balance. The current account balance also improved in 1999, as the deficit narrowed to 4.7 percent of GDP compared with 11.9 percent in 1998. Gross international reserves increased to 14.3 weeks of import equivalent at the end of 1999, compared with 8.8 weeks of imports the previous year.

Fiscal performance improved slightly during 1999, as the full impact of the mid-1998 revenue measures became effective and additional measures were introduced in mid-1999. In May 1998, the government announced a package of tax and revenue expenditure measures, which included increasing the value-added tax rate from 10 to 13 percent effective September 1998, and increasing petroleum excise tax. These should yield budgetary savings of about 2 percent of GDP per year. Additional revenue-raising measures, adopted by Parliament in May 1999, included a uniform import duty of 5 percent and an excise tax on beer, which were expected to yield revenue equivalent to 1 percent of GDP in 1999.

Partly because of these measures, tax revenues increased to 19 percent of GDP in 1999, compared with 17.5 percent in 1998. However, privatization stalled because of Parliament's resistance, so receipts from the sale of government assets were substantially below expectations. Total revenues and grants therefore declined slightly to 26 percent of GDP in 1999, from 27 percent in 1998. By cutting current expenditures, the government reduced total expenditure to 36 percent of GDP in 1999, compared with 39 percent the previous year. The overall fiscal deficit improved from 11.5 percent of GDP in 1998 to 10 percent. Reducing dependence on external concessional finance can only be achieved through more focused public expenditure and improved revenue performance. The Asian Development Bank's Governance Reform Program Loan, which emphasizes reform in public expenditure management, will help this process.

Annual GDP growth is projected to climb 0.5 percent in 2000 and another 0.5 percent in 2001, emanating from mining, manufacturing, and services. This growth rate could further accelerate if the government's privatization program gathers steam and begins to contribute to economic efficiency.

Fiscal stability is expected to strengthen over the medium term because of the governance reforms supported by multilateral donors. The International Monetary Fund's Enhanced Structural Adjustment Facility program, which was begun in mid-1997 and redefined as a Poverty Reduction and Growth Facility in November 1999, also calls for fiscal reforms. The main fiscal target for the government is to bring down the overall budget deficit so it does not require exceptional financing from concessional foreign sources. This implies reducing the overall deficit from the unsustainable levels of about 11 percent of GDP to less than 4 percent. This would require improved tax administration, decreased current expenditures, and improved public sector efficiency. It would also require focusing on operations in the private sector and on current expenditures to avoid compromising development outlays.

The government is actively trying to increase revenues. Total revenues and grants are forecast to increase and stabilize at about 28 percent of the GDP in 2000-2001. Between 2000 and 2002, receipts from privatization are targeted to contribute 5-6 percent of GDP to government revenues. This represents an ambitious but achievable target. Current expenditures are projected to increase but will be offset by reduced capital expenditure. The ratio of total expenditure to GDP will remain at 36 percent in 2000.

Table 2.6 Major Economic Indicators, Mongolia, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth	4.0	3.5	3.5	4.0	4.5
Gross domestic investment/GDP	25.3	27.3	—	—	—
Gross domestic savings/GDP	30.0	28.3	—	—	—
Inflation rate (consumer price index)	36.6	9.8	7.6	5.5	4.3
Money supply (M2) growth	32.5	-1.7	32.1	15.0	15.0
Fiscal balance/GDP	-8.6	-11.5	-10.0	-9.4	-7.7
Merchandise exports growth	16.6	-12.1	2.8	12.8	14.3
Merchandise imports growth	-1.5	9.5	-15.4	8.6	11.8
Current account balance/GDP	1.3	-11.9	-4.7	-9.5	-8.4
Debt service/exports	6.3	6.9	5.0	4.8	5.0

— Not available.

Sources: Bank of Mongolia; National Statistics Office; IMF; staff estimates.

A relatively tight monetary policy is expected to keep inflation in check for the medium term. Growth of broad money (M2) will average 15 percent annually in 2000-2001, which will provide sufficient liquidity while maintaining single-digit inflation. Government borrowing and credit to the public sector from the Bank of Mongolia must be reduced substantially to allow credit to the private sector, and to keep interest rates from increasing because of too much credit demand. Interest rates on deposits will fall in line with inflation rates, but will be kept positive in real terms to provide incentives for domestic savings. With the expected restructuring of the banking sector and improvement in banking practices, the efficiency and financial health of the major banks are expected to improve in the next three years. This could help reduce lending rates to a level more suitable for longer-term investment financing.

Prices of the main export commodities may not recover substantially in the near future, although gold prices have strengthened. The balance of payments remains a challenge, and a depreciating tugrik could contribute to reduced consumer imports. The external current account will maintain a deficit of about 10 percent of GDP in 2000, and decline to 7.5 percent over the medium term. Foreign capital inflows will have to sustain these high external liabilities.

ISSUES IN ECONOMIC MANAGEMENT

Mongolia's heavy dependence on exports of primary commodities that are subject to wide price fluctuations has made the task of macroeconomic stabilization difficult in the 1990s. Copper accounts for 26 percent of Mongolia's exports, and cashmere another 10 percent. Revenues from the copper monopoly Edernet constituted 11.3 percent of government revenues in 1996, the year before international prices fell. This slowed to 10 percent in 1997 and 1.8 percent in 1998, as a sharp decrease in international prices of copper reduced the sector's tax and dividend payments to the government budget. The slump in export earnings also exposed the inherent weaknesses in the banking system, worsening an already difficult situation in the financial sector. As large enterprises faced cash shortages, drawdowns on bank deposits and increased nonperforming loans have severely affected corporate liquidity and profitability. This situation was exacerbated by persistent managerial and governance problems in several big banks, political uncertainty, and inadequate supervision.

The immediate challenge facing the government is to put the financial sector and the fiscal balance back on track. Otherwise, any efforts at reviving sustainable economic activity and employment generation within the private sector could prove difficult. Recognizing this, the government has persevered in its efforts to reform the financial sector and promote fiscal discipline within the public sector.

POLICY AND DEVELOPMENT ISSUES

Since the start of its transition to a market economy, Mongolia has achieved commendable rates in economic growth along with reduction in inflation levels, privatization, and structural reforms in many areas. In the initial years of transition, with high export earnings and inflows of development aid replacing the former subsidies from Moscow, the government continued to help finance the social sector, housing, and heating (about 30 percent of some ministries' budget goes to heating buildings). Public expenditures on health and education still are substantial. Consequently, standards of health and education achievements are high.

However, Mongolia has been facing persistently elevated rates of poverty. The incidence of poverty grew from 15 percent of the population in 1991 to 36 percent in 1996, and since then has remained stable. Simultaneously, the severity of poverty has increased. The increasing depth of poverty indicates that the current development process does not generate sufficient opportunities for viable employment and income. The poor become poorer by depleting their last remaining assets and because of a breakdown of family and social support structures. This pattern reduces the chances for the poor to improve their situation without public assistance. This persistence of poverty, despite continued positive economic growth, is a serious cause for concern.

Various developments since the transition to a market economy may have contributed to this problem. These include (a) lack of sufficient resources to address poverty reduction directly; (b) failure to diversify the economy to generate more sustainable and inclusive growth; (c) externally financed infrastructure projects that tended to use capital-intensive technology with few employment effects; and (d) structural changes in the real economy that evolved more slowly than anticipated.

To combat poverty, the government is working with the Asian Development Bank to

- Generate more employment in the short to medium term, mainly in urban areas, particularly the *aimag* (provincial government) centers where the incidence of poverty is high
- Encourage the private sector to create new employment opportunities
- Improve the social safety net for the very poor who may be beyond the reach of self-help opportunities
- Help deliver needed social services to avoid facing new forms of poverty at a later stage.

The recent growth performance has been creditable, given the structural problems of the economy and the adverse external economic environment. Growth will remain limited until the reform process is further strengthened.