

Mongolia

Buffeted by the slump in global prices for copper and other commodities, economic growth started to slow in 2008 and will decelerate sharply in 2009. The current account and fiscal positions have deteriorated, and inflation is at high levels. The Government has pledged to restore fiscal discipline and strengthen the banking system, while protecting the poor from the impact of the economic downturn. The severe impact of the global commodity slump highlights the need for a system to mitigate revenue volatility and to diversify sources of growth.

Economic performance

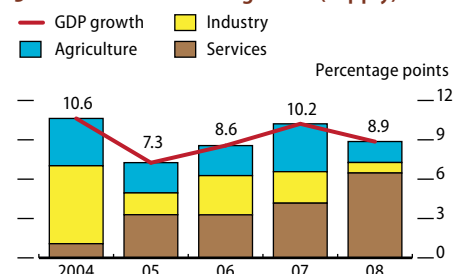
GDP grew by an estimated 8.9% in 2008, down from the previous year's double-digit rate but close to the average of the previous 5 years. Agriculture, which supports about 40% of the population, grew by 5.0%, aided by favorable weather and fiscal incentives to produce wheat. The wheat harvest itself surged by 85.5% and the livestock herd—mainly goats, sheep, and cattle—rose by 7.5% to 43.3 million. In contrast, prices of cashmere, a leading export, fell by about 45% during the year. Services output climbed by 15.9% and this was the source of most of the GDP growth last year (Figure 3.12.1). Growth in banking services was spurred by double-digit expansion in real estate services, wholesale and retail trade, and communications.

Industrial growth came in below 1% for its lowest rate in a decade. Production of copper, the country's biggest export, was hurt by a fall in the metal's price of more than 60% on the London Metal Exchange between July 2008 and year-end (Figure 3.12.2). Among other important mineral exports, global prices of coal and zinc also dropped, although gold was firm. Extended delays in concluding agreements, between the Government and the holders of the mining licenses at the large Oyu Tolgoi copper and gold deposit and the Tavan Tolgoi coal seams, hampered development of mining.

Rapid expansion in public investment, fueled by a surge in government revenue from high commodity prices during the commodity boom, contributed to an upsurge in construction. During the boom, the Government also broadened social assistance and transfer payments to about half the population, and doubled public sector wages over a period of 2 years. These moves, coupled with growth in remittances (close to a fifth of the labor force worked abroad in 2008) bolstered consumption, particularly in the first half of last year. However, many of the factors that drove high growth in the first 3 quarters of 2008 triggered a sharp contraction in the fourth, when commodity prices slumped, remittances slowed, and spending on public investment and real estate projects declined.

The hikes in government expenditure raised total public spending to the equivalent of 40.2% of GDP in 2008, from 27.5% in 2005. When mineral

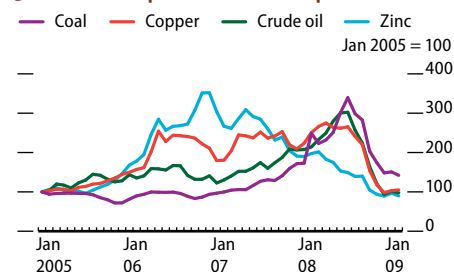
3.12.1 Contributions to growth (supply)



Source: Mongolian National Statistical Office.

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3.12.2 Global prices of main exports



Source: International Monetary Fund, *International Financial Statistics* online database, available at: <http://www.imfstatistics.org/imf>, downloaded 10 March 2009.

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prices sank last year, revenue declined to an estimated 35.2% of GDP, and the budget slid into deficit (of about 5.0% of GDP), after 3 years of surpluses.

Mongolia imports much of its food and all its petroleum. Soaring global prices for these items in the first half of 2008, together with expansionary fiscal and monetary policies, propelled inflation to a year-on-year peak of 34.2% in August (Figure 3.12.3). In response, the Bank of Mongolia tightened monetary policy by raising the reserve ratio for commercial banks by 50 basis points to 5.5% and its policy interest rate by 185 basis points to 10.25%. Money supply (M2) growth slowed in the second half; during the same period, growth of commercial bank credit decelerated from 60% to about 28% year on year. Inflation eased to 22.1% by December, giving a year-average of 26.8%.

Buoyant domestic demand for much of the year and the higher prices of imported petroleum and food products in the first half pushed up merchandise imports by about 60% in 2008. Exports grew at about half that pace. The value of most commodity exports declined as world prices slumped, and the value of clothing shipments fell by 69% during the year. The trade deficit widened to an estimated \$600 million. Inbound tourism, as well as remittance inflows, slowed in the second half. These developments contributed to a deficit on the current account of about 12.9% of GDP, the first deficit in 5 years (Figure 3.12.4).

The weakening current account put downward pressure on the togrog, prompting the Bank of Mongolia to sell foreign currency. That action contributed to a fall in international reserves from more than \$1 billion in July to \$657 million at the end of the year (and only 10 weeks of import cover). Late in 2008, the central bank eased its market intervention, and the togrog weakened sharply. Speculative pressure on the exchange rate intensified early in 2009, taking the togrog to MNT1,600/\$1 in the first week of March, from MNT1,050/\$1 in December 2008 (Figure 3.12.5).

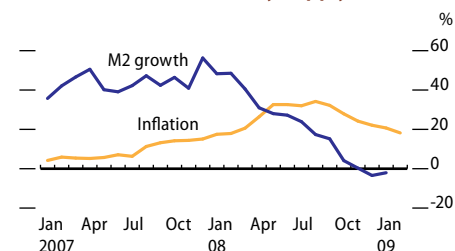
Banking also showed signs of stress. High inflation widened negative deposit interest rates which, combined with currency depreciation, led to withdrawals from togrog deposits and a liquidity squeeze among the banks. In December 2008, the Government took over the fourth-biggest bank (in terms of outstanding loans) when the bank foundered because of mismanagement and a run on deposits. In another move to stabilize the banking system, the authorities issued a blanket deposit guarantee. The banks, concerned about the health of other financial institutions as well as borrowers, clamped down on their lending. Nonperforming loans more than doubled from 3.4% of total loans in 2007 to 7.2% in 2008 (including the assets of the government-rescued bank).

External debt has declined over several years, to an estimated 33% of GDP in 2008. The debt is largely on concessional terms. Fitch Ratings in January 2009 downgraded Mongolia's sovereign debt rating from B+ to B, with a negative outlook, citing weakness in the country's reserves, exchange rate, and banking system.

Economic prospects

Economic growth will decelerate sharply in 2009, dragged down by the slump in prices for export commodities and by related fiscal weakness that will require cuts in government spending. The drop in prices for

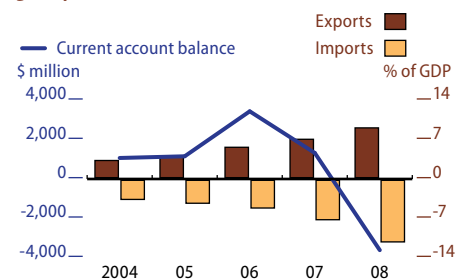
3.12.3 Inflation and money supply



Source: Bank of Mongolia, available: www.mongolbank.mn, downloaded 13 March 2009.

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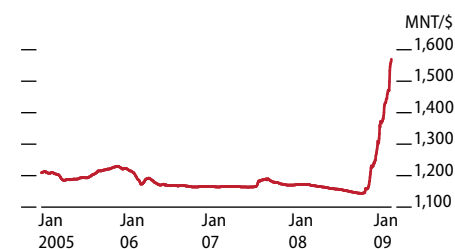
3.12.4 External sector



Source: Bank of Mongolia.

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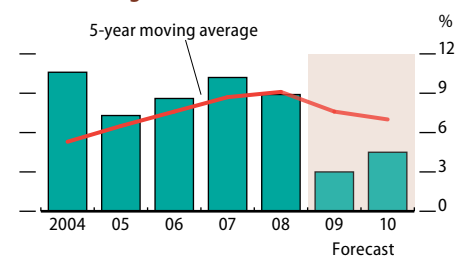
3.12.5 Exchange rate



Source: Bank of Mongolia, available: www.mongolbank.mn, downloaded 13 March 2009.

[Click here for figure data](#)

3.12.6 GDP growth



Sources: Mongolian National Statistical Office; staff estimates.

[Click here for figure data](#)

minerals and cashmere will suppress the output of these commodities and the incomes of their producers. The outturn for agriculture depends heavily on the weather, which has been favorable for several years. Construction activity will be hurt by the combined effects of the fall in property prices (which started in the second half of 2008), a likely decline in public investment, continued delays in mining-project agreements, and banks' caution. The outlook for services such as finance, domestic trade, and tourism is clouded by the banking system strains and the subdued global outlook for tourism.

Government revenue is expected to fall sharply in 2009, by as much as 11 percentage points of GDP. Unless the Government substantially curtails spending to match the decline in revenue, the fiscal deficit could reach an unsustainable level of above 10% of GDP.

Taking these factors into account, GDP growth is forecast to pull back to about 3.0% in 2009 (Figure 3.12.6). Growth is expected to pick up to about 4.5% in 2010, contingent on four factors: the global economic environment starts to recover as assumed; the Government concludes agreements for the two big mining projects and investment in them starts in 2010; the economy steadies in 2009, enabling a return to investment and employment growth next year; and the domestic financial system stabilizes, facilitating growth in banking and in domestic trade.

The decline in commodity prices, coupled with slower economic growth in the People's Republic of China, which takes nearly two thirds of Mongolia's exports, points to a fall in merchandise exports in 2009. Similarly, inflows from tourism and remittances are likely to contract. Imports, too, will decline, curtailed by the economic slowdown and lower average prices for imported food and fuel. Reflecting these influences, the current account will be in deficit by about 7.0% of GDP. Prospects for foreign direct investment in mining are clouded by substantially weaker global demand for minerals and much tighter international financial markets.

Inflation is expected to decelerate to 9.5% in 2009, and ease further in 2010, a net result of weaker domestic demand and the fall in prices of imported fuel and food on the one hand, offset partly by the impact of the currency's depreciation on the other.

In the context of weakening external and fiscal accounts, the Government agreed with the International Monetary Fund in early March 2009 on an economic program, to be supported by a \$224 million loan under an 18-month standby arrangement. Under this, the Government pledged to restore the deficit to a sustainable range, in part through spending cuts, and to strengthen the institutional framework for fiscal policy to prevent a repeat of boom-bust spending cycles. It agreed to strengthen the banking system and follow monetary policies that safeguard its dwindling international reserves. It also committed to better targeting the social transfer programs and to raising the level of support for the very poor.

Economic recovery in the medium term will depend on implementing the economic program and on improving the legal and regulatory environment for mining.

Poverty incidence has declined steadily since 2003, but more than one third of the population lives below the poverty line. High inflation, falling remittances, and plunging prices for cashmere (an income source for herders), risk driving more of the near-poor households into poverty.

3.12.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.0	4.5
Inflation	9.5	8.0
Current account balance (share of GDP)	-7.0	-6.0

Source: Staff estimates.

3.12.1 Development challenges

Addressing the immediate fiscal and banking strains requires bold measures to contain budget outlays, to restore confidence in the banking system and the currency, and to stimulate foreign direct investment. Yet crucially, vital antipoverty programs need to be protected and if possible strengthened given the potential rise in the number of poor people.

The country relies heavily on commodity prices that mirror global market swings, underscoring the need to mitigate the economic and social impact of this volatility by setting up new systems. These in turn require legal, administrative, and financial structures to manage windfall revenue during commodity booms so that sufficient financial reserves are in place during the ensuing bust. The Government set up the Mongolia Development Fund with this in mind, but drew down on its reserves even during the commodity boom. Improved standards of governance are a prerequisite for establishing a strong institutional framework for such a stabilization fund.

Diversification of the narrow base of the economy will involve substantial investment in the social and physical infrastructure and better conditions for development of the private sector. The latter is hampered by a cumbersome regulatory system, weak implementation of laws, shortages of skills, and lack of access to funding at reasonable costs for small and medium-sized enterprises.

The country is urbanizing rapidly, putting severe strains on the environment and on the state's ability to deliver services, which will only be eased by significant investments in urban infrastructure and services. Damage from mining-related toxic spills and desertification from overgrazing also need to be remedied.