

MONGOLIA'S ECONOMIC PERFORMANCE

1. Recent economic performance in Mongolia has been quite robust, with strong growth from a gradually-broadening economic base, declining inflation, growing budget and balance of payments surpluses, and improved confidence in the banking system. The fiscal position has likewise improved markedly in recent years, driven by the rapid run up in copper prices and by faster-than-expected economic growth. Similarly to many other transition economies, Mongolia has been experiencing a strong credit boom. Reserve and broad money growth has been high—between 15 and 40 percent per year since 2003. Gross international reserves more than doubled to \$718 million in 2006.
2. The economy performed well in 2006: growth in GDP picked up to 8.4%, a fourth straight year of 6%-plus expansion. Inflation moderated from high levels and both the fiscal and current accounts were in surplus. Broad money (M2) growth was high in 2006 at 35%, but inflation slowed from an average of nearly 13% in 2005 to 5.1% in 2006. This deceleration reflected a much more moderate rise in food prices and a 4% appreciation of the togrog against the US dollar, which made imports less costly. On the back of growth in mining sector production and exports, the budget was in surplus in 2006 (by 8.6% of GDP). Government expenditures are expected to rise as elections approach in 2008.
3. Exports soared (by 44%) as a result of high prices for copper and gold and an increase in cashmere production. Textile and clothing exports to the United States continued the decline that set in when global quotas ended, but rose substantially to the European Union, which exempts certain Mongolian products from import duties. Many of Mongolia's exports have benefited in recent years from strong demand from the People's Republic of China (PRC), Mongolia's main export market. Mongolia imports all its petroleum products, and the surge in global oil prices last year was the main reason for the strong growth in imports (26%). The trade account produced the first surplus for many years and the current account was in surplus (equivalent to 7% of GDP in 2006) for the third consecutive year. Foreign direct investment was \$367 million in 2006, four times as high as in 2000. Most has gone into mining.
4. Sustained economic growth in recent years, plus inflows of foreign capital (mainly into the mining sector) and a more competitive financial market have spurred sharp increases in credit growth (by more than 40% in 2006). This rapid growth has heightened risks. Officially, the reported ratio of nonperforming loans to total loans has been fairly steady at around 9%, but actual figures are likely to be higher. Some banks do not have adequate risk management and internal control mechanisms, and their rapidly inflated lending may be at the cost of quality. In this regard, the recent establishment of a financial regulatory commission and a stronger statement of intent by the Bank of Mongolia, the central bank, on banking supervision are encouraging.
5. In the policy area, the Government adopted a new mining law that gives it the right to acquire up to 50% stakes in "strategic" mineral deposits. A windfall profits tax was imposed and mining royalty rates were raised. There is the expectation, however, that the Government will maintain a mining policy stance that will maintain the confidence of international mining investors.
6. Notwithstanding strong economic performance, there remain several constraints to the sustainable economic growth. These include infrastructure bottlenecks which cause high transport costs, limited access and costly sources of finance, distortionary taxes and a narrow tax base, and weak legal enforcement and a narrow and vulnerable economic base. The incident of poverty still remains high and the inequality between the urban areas and the rural areas (especially the western part of the country) remains wide.