



Mongolia

With positive growth in 1994 and 1995, the Mongolian economy emerged from the crisis of 1990 to 1993 during which its output had declined by 23 percent. Mongolia's relatively more successful economic performance compared to that of other members of the former Council for Mutual Economic Assistance (CMEA) is attributable to its commitment to macroeconomic stabilization and structural reforms. Despite some slippage in the initial months, performance targets were generally achieved in 1995 for the second annual arrangement under the ongoing Enhanced Structural Adjustment Facility (ESAF). Although the rate of inflation declined, it was still well in excess of the target of 23 percent in 1995. There was further progress in structural reforms, including the removal of price controls on a number of items. The achievement of a trade surplus helped to reduce the size of the current account deficit and build up net international reserves. The budget deficit was fortuitously much lower than expected, but important changes in taxation structure and government administration are needed if a sound fiscal performance is to be achieved consistently. Continued macroeconomic stability will be essential if the growth momentum is to be maintained in the coming years.

Recent Trends and Prospects

Growth, Investment, and Employment. The Mongolian economy continued on its recovery path in 1995 with GDP growth improving markedly to 6.3 percent from 2.3 percent in 1994. Agricultural output increased by

5.7 percent despite some decline in the area under cultivation. Livestock numbers increased by more than 400,000 in 1995, exceeding 28 million for the first time. Price controls on grain and other agricultural commodities resulted in the withdrawal of some land from cultivation and a virtual cessation of investment in this sector; however, the recent removal of price controls and grain procurement requirements should encourage a reversal of these trends.

Industrial growth of 16.2 percent was broad based with output declining in only three subsectors: energy, furniture and wood processing, and leather processing and shoes. The private sector has begun to play an important role in industries such as leather products and garments, the processing of cashmere, and gold mining where 80 percent of mines are now operated privately. Services sector growth almost exclusively reflects increased private sector activity. Official statistics underestimate actual sectoral growth, especially of industry and services, because the statistical system inherited from the earlier regime does not fully capture private sector activities. Development of the private sector, combined with liberalization of the trade regime, has markedly improved the supply situation in Mongolia.

After several years of decline, gross domestic investment increased strongly after 1992, reaching 20.9 percent of GDP in 1994 and rising further to 23.7 percent in 1995. The savings rate has also improved steadily in recent years to reach 17 percent of GDP in 1995. The energy sector continues to absorb a large share of public investment, directed

Table 2.6 Major Economic Indicators: Mongolia

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	-3.0	2.3	6.3	4.5	4.5
Agriculture	% change	-7.1	4.7	5.7	5.8	5.4
Industry	% change	-11.4	4.4	16.2	11.6	9.7
Services	% change	-1.4	3.1	1.5	1.2	2.5
Gross Domestic Investment	% of GDP	18.8	20.9	23.7	24.4	25.9
Gross Domestic Saving	% of GDP	12.2	12.8	17.0	15.7	17.2
Inflation Rate	% change in CPI	268.4	87.6	56.8	30.0	15.0
Money Supply Growth	% change	227.6	79.5	32.9	35.0	25.0
Merchandise Exports	\$ million	366	367	451	496	545
	% change	2.8	0.3	22.9	10.0	9.9
Merchandise Imports ^a	\$ million	375	371	473	520	572
	% change	-10.5	-1.1	27.7	9.9	10.0
Current Account Balance ^b	\$ million	-39.9	-40.3	-63.7	-84.4	-88.4
	% of GDP	-7.5	-5.9	-7.3	-10.4	-11.3
External Debt Outstanding	\$ million	366	474	507	528	610
Debt-Service Ratio	% of exports	10.6	16.3	14.1	12.6	9.8

^a Cost, insurance, and freight.

^b Excludes net official transfers.

Sources: Data provided by the State Statistical Office of Mongolia; and staff estimates.

primarily towards modernizing and rehabilitating existing capacity. Investment laws, including those for foreign direct investment, have been liberalized and this has encouraged private sector investment in the manufacturing and services sectors. Foreign direct investment at \$10 million is still marginal, although there has been some interest in acquiring selected state-owned enterprises. In 1995, foreign direct investment was successfully attracted to the telecommunications sector.

With the pickup in economic activity, unemployment levels declined during 1995. Registered unemployment, which peaked at 74,900 in 1994, declined by 32 percent to 51,000 during 1995. Employment generation projects, largely financed by external donors, contributed to the fall in unemployment levels and, in consequence, the number of people living below the poverty line declined. Somewhat slower growth over the next two years will mean less progress in reducing unemployment and poverty. Nevertheless, some progress can be expected as employment generation should

exceed the number of new entrants into the labor force.

Structural adjustments have caused some disruption in the social sectors. Increases in the cost of education due to lower budgetary support and employment of school age children in the agriculture sector have resulted in an increase in the number of school dropouts. On the other hand, the shift to universal health insurance from a government-managed and funded system of health care, completed in 1994, has improved the delivery and efficiency of services. Over 92 percent of the population is now covered by health insurance.

Mongolia's economic recovery is only two years old and its macroeconomic situation is still fragile. If macroeconomic stability is achieved, the economy can be expected to grow at around 4.5 percent in both 1996 and 1997, with agricultural output increasing over the next years at much the same rate as in 1995. The industry sector, which contributes about 35 percent of GDP, will again provide strong growth impetus, with output forecast to expand by 11.6 percent in 1996 and 9.7 percent in 1997.

Gross domestic investment is projected to increase further to an average of over 25 percent of GDP for the next two years. However, with gross domestic saving at an average of about 16.5 percent in 1996 and 1997, the resource gap will widen by some two percentage points over its 1995 level.

Budget, Money, and Prices. After some slippage in the first half of 1995, because of higher expenditure on increased wages and advances to the energy sector and flour mills, fiscal performance improved. The overall budget deficit in 1995 was 11.4 percent of GDP compared with the original estimate of 13 percent. As in previous years, this was financed entirely by external concessional resources. The current budget was in surplus to the extent of 4.2 percent of GDP compared to the indicative target of 3.9 percent. The improvement in fiscal performance was largely a result of an unexpected increase in tax revenues from Erdenet Corporation, the state-owned monopoly for the processing and exporting of copper concentrate. Erdenet's profits and tax liability increased because of high international copper prices. There was also a marked improvement in monies collected from those taxpayers with large tax liabilities following the creation of a special unit for this purpose in the newly established Department of Taxation. This enabled the Government to finance the cost of a 71 percent increase in government salaries without borrowing from the Bank of Mongolia. The Government was also successful in curtailing net lending to state-owned enterprises. Targeted at tugrik (tug) 22.3 billion for 1995, actual net lending to state-owned enterprises was only tug1.38 billion at the end of September 1995.

Monetary and credit expansion has been kept under control, with the Bank of Mongolia being able to restrict its lending to government and state-owned enterprises. Net credit to government and state-owned enterprises was below targeted levels in 1995. Excessive credit expansion by commercial banks was brought under control with the Bank of Mongolia being able to finalize enforceable contracts on credit limits with each bank in September 1995. Expansion of broad money supply in 1995 was limited to the target of nearly 33 percent compared with an increase of 79.5 percent in 1994. Two factors were

responsible for the expansion of the money supply. First, working capital advances by the Bank of Mongolia to gold mines could be liquidated only with a lag after refining the gold received from them. Second, there was an increase of \$30 million in international reserves held by the Bank of Mongolia and commercial banks. Both these factors created inflationary pressure and required a compensatory contraction in domestic credit expansion and net credit to the Government. Overall, the monetary situation was better managed in 1995 with firmer control being exercised by the Bank of Mongolia.

The rate of inflation eased from over 87 percent in 1994 to nearly 57 percent in 1995. This still high inflation rate is a major cause of concern as it constitutes a destabilizing threat for the economy. The effect on prices of money supply increases was accentuated by a near doubling of grain and meat prices during the festival season in July, and there were also increases in urban fares, energy charges, and bread prices.

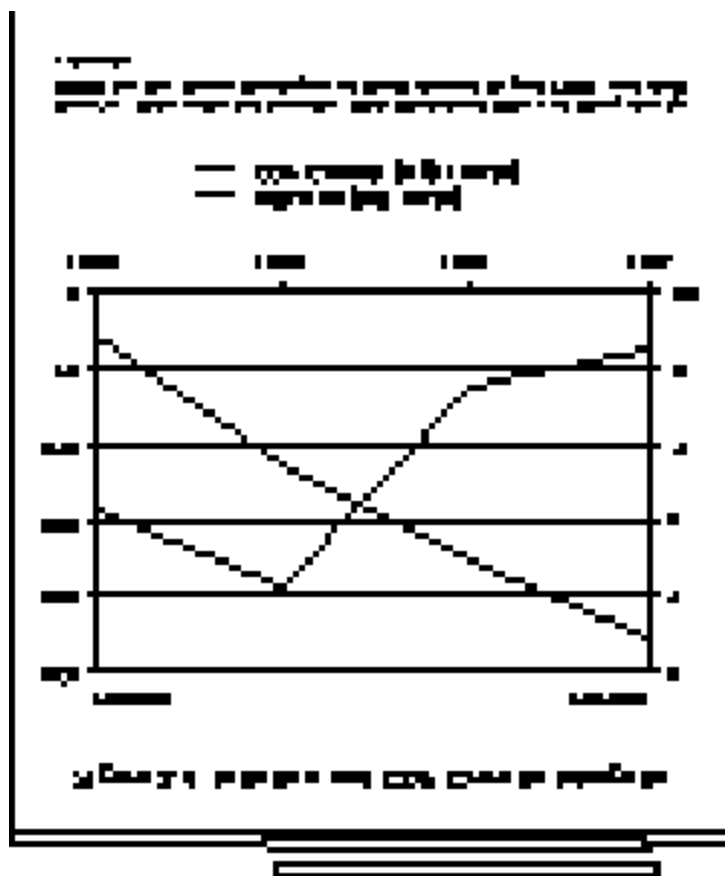
Some improvement in fiscal performance is likely during the next two years, with further reduction in expenditure and a decline in the overall deficit as the Government seeks to place the economy on a sounder macroeconomic footing. Structural reforms in tax administration, reduction of transfers to the energy sector, and rationalization of government administration are needed if this is to be achieved. An improved fiscal outcome, tighter credit ceilings on commercial banks, and better management of the supply of basic goods, especially in periods of peak demand, will help to bring down inflation. This will be affected by the speed with which the markets react to the expected removal of controls on energy and other utilities prices. Inflation is forecast to fall to 30 percent in 1996 and 15 percent in 1997.

External Trade and Payments. Mongolia's external trade increased dramatically in 1995. Export earnings rose by 23 percent, principally because of sustained demand and high international prices for copper, returns from which were 31 percent higher than in 1994. Imports also increased substantially by 28 percent, with capital goods and energy imports accounting for about half of total imports in 1995. The import surge reflected

the strong growth of the economy, the readier availability of foreign exchange, and the spurt in gross domestic investment.

Copper exports comprised 55 percent of total exports while cashmere, wool, leather, and meat and related products contributed another 13 percent. Gold exports, primarily from newly privatized mines, were also important, at more than twice what they were in 1994.

The year saw further diversification in the destination of Mongolian exports and sources of imports. The share of former CMEA countries, mainly Russia, in total imports to Mongolia declined from 79 percent in 1991 to 55 percent in 1995. Exports to former CMEA countries contracted to 29 percent of the total in 1995 from 73 percent in 1991 and Russia's share declined from 69 percent to 13 percent in 1995. The principal switch of export destination was to OECD countries whose share increased to 40 percent of total exports in 1995. Mongolia's trade with China has declined over the past two years with exports to that country falling to 14.5 percent of the total in 1995 compared with 31 percent in 1993.



The external current account deficit (excluding official transfers) increased to 7.3 percent of GDP in 1995 from 5.9 percent in 1994, and was fully financed by foreign capital inflows, which also permitted a buildup of net international reserves. These reserves increased to \$50 million at the end of 1995 from \$37.2 million in 1994. Gross official reserves were estimated at \$97.5 million, sufficient for 11 weeks of imports. The tugrik exchange rate depreciated by 14 percent during 1995. The differential between the official and market exchange rates almost disappeared. In real terms, the currency has appreciated and this may begin to adversely affect exports. External debt continued to increase in nominal terms, rising to \$507 million at the end of 1995. This was equivalent to 58 percent of GDP compared with 69 percent at the end of 1994. The debt-service ratio at 14.1 percent in 1995 remained well within prudential levels.

Export earnings are expected to increase by about 10 percent on average in 1996 and 1997. With sustained growth of the economy and import restrictions being completely removed, import growth is expected to be about 10 percent in both years. Although the trade deficit will remain modest in 1996 and 1997, a large invisibles payment for interest and remittances abroad will result in a widening of the current deficit to about 11 percent of GDP on average in the coming two years. Inflow of external finance is expected to be sufficient to cover the deficit and also to permit a further buildup of foreign exchange reserves to a likely level of \$60 million in 1996 and \$70 million in 1997. While external debt, which is made up almost exclusively of concessional loans, is likely to increase, the debt-service ratio is projected to decline to 12.6 percent in 1996 and 9.8 percent in 1997.

Policy and Development Issues

Maintaining macroeconomic stability and improving the Government's fiscal balances were considerable policy achievements

for 1995. Net lending to state-owned enterprises was substantially reduced; some types of government expenditure, including price supports, were cut sharply; and credit expansion by commercial banks was brought under control. Other policy initiatives taken include the freeing of grain and meat prices; the sale of Government equity in the telecommunications sector through international bidding; the lifting of foreign exchange surrender requirements for selected state-owned enterprises; the privatization of gold mines; the implementation of a poverty alleviation program; the establishment of an employment generation program with assistance from ADB; and the initiation of steps to restructure the social security and health insurance systems.

Mongolia's banking sector has evolved from a single bank system which operated in a centrally planned economy. Substantial progress has been made during the last four years to establish a two-tiered banking structure with the autonomous Central Bank, the Bank of Mongolia, at the apex and 14 commercial banks operating in a competitive environment. The basic legal and institutional framework for commercial banking has been created. Successfully completing the transition from a mono-banking system to a

modern commercial banking sector which can serve the needs of a market-based economy takes time and involves some learning costs. However, the Mongolian banking sector is presently faced with some severe financial problems arising from a lack of required skills and inexperience with modern banking practices and norms. The Government is committed to a comprehensive program of further reforms which will lead to a restructuring and reorganizing of the sector, enabling it to play an effective role in mobilizing and allocating financial resources in the economy. ADB, in collaboration with the World Bank and the IMF, is providing assistance to the Mongolian Government to enable it to complete these reforms of the banking sector.

Required structural reforms in other sectors include privatizing state-owned enterprises, increasing tariffs in the energy sector to reduce subsidies, rationalizing government administrative structures, improving tax administration, and establishing an internationally acceptable system of government and corporate accounts. Important policy issues for the coming two years will be the maintenance of macroeconomic stability, the reduction of the number of people living below the poverty line, and the establishment of a comprehensive social security system.