Mongolia

After contracting for the first 3 quarters of 2009, the economy started to recover late in the year as global commodity prices picked up and the government adopted an extensive policy reform program. The economy is forecast to return to solid growth this year and next, spurred by development of a large copper and gold mining project. Inflation faded in 2009 but will accelerate this year. Domestic risks to the outlook center on weaknesses in the banking system and possible fiscal pressures.

Economic performance

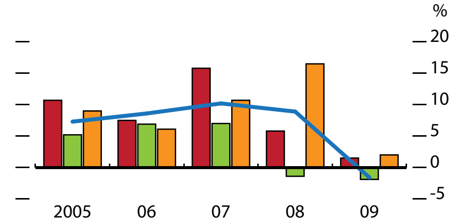
Despite a rebound in the fourth quarter, the economy contracted by 1.6% in 2009 (Figure 3.12.1), hit hard by the impact of the global recession, notably the fall in prices of Mongolia's commodity exports. The contraction in GDP followed robust average growth of 9% during 2004–2008, when world commodity prices were rising. GDP contracted in each of the first 3 quarters of 2009. The slump was mainly a result of a plunge in world copper prices in late 2008 and reduced inflows of foreign direct investment (FDI) into the country's mining and construction industries as global investment flows dwindled.

These external shocks knocked the economy at a particularly vulnerable time: macroeconomic policy had been overly expansionary during the commodity boom years, resulting in high inflation (peaking at 34.2% in August 2008), deteriorating external and fiscal balances, and serious strains in the banking system. Consequently, in early 2009 the government had to rein in spending and hike the policy interest rate, further suppressing consumption and investment.

Mongolia turned to the International Monetary Fund, agreeing in March 2009 to borrow $224 million under an 18-month standby arrangement, and received additional funding from other development institutions and governments. In return, the government pledged to follow fiscal policies that would repair the budget and monetary policies to safeguard dwindling international reserves. The authorities also agreed to allow greater exchange rate flexibility, to strengthen the fragile banking system, and to improve the targeting of social spending. The funding and policy actions stabilized the economy, positioning it to resume growth as the price of copper and other minerals recovered (Figure 3.12.2).

Still, for the full year industrial production fell by 1.9%, hurt by weakness in world markets for the major exports copper, coal, and zinc. Investment in mining was hampered by the global tightening of credit and by continued delays in reaching agreements between the government and international companies to develop new mines, especially the large Oyu Tolgoi copper and gold resource.

3.12.1 GDP growth by sector



Source: National Statistical Office of Mongolia. 2009. *Monthly Statistical Bulletin*. December. http://www.nso.mn

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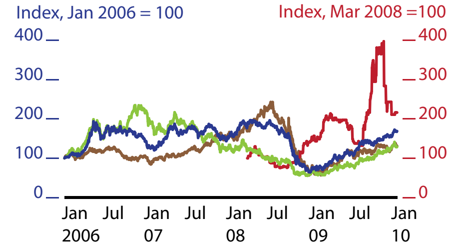
3.12.2 Mineral prices



Source: Bloomberg (accessed 18 January 2010).

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This chapter was written by Christer Ljungwall of the Mongolia Resident Mission, ADB, Ulaanbaatar.

Construction activity fell abruptly in 2009 as both the public and private sectors cut back capital investment and banks tightened lending.

Agriculture, which supports about 40% of the population, grew by just 1.5% in 2009. The sector suffered from lower prices for cashmere and other livestock-related products. Further, a summer drought, followed by heavy snow and lower than usual temperatures in late 2009, reduced feed available for livestock, worsening a problem caused by years of overgrazing, when the herd expanded to about 44 million (mainly goats, sheep, and cattle). Livestock losses from the bad weather were estimated in early 2010 at more than 5 million.

Growth in the services sector slowed sharply to 2.0% in 2009, in part reflecting a weak labor market and reduced government outlays that hurt consumer spending. Continued banking stresses hampered growth in financial services.

A Labor Force Survey put the unemployment rate in September 2009 at 10.5%, taking into account both those registered and not registered as unemployed. The loss of jobs and falling real wages in the informal sector aggravated poverty (35.2% of the population lived below the national poverty line in 2008).

Merchandise exports in US dollar terms fell by about 25% in 2009, largely a result of lower prices rather than lower volumes. Imports fell even more sharply, by about 35%, mirroring lower costs for imported oil and food, weaker consumption and investment, and a 36% depreciation of the togrog against the US dollar in the first quarter. As a result, the trade deficit narrowed. With earnings from tourism and remittances from Mongolian workers abroad taking a hit from the global recession, the current account remained in deficit, equivalent to 9.1% of GDP (Figure 3.12.3).

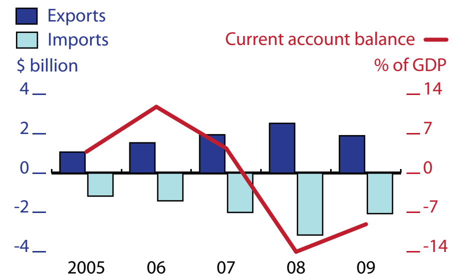
The current account gap was primarily financed by donor disbursements and FDI. International reserves, after plunging by half to about $500 million, climbed to $1.3 billion (about 7 months of import cover) by end-2009.

Inflation slowed sharply from 22.0% year on year at end-2008 to 4.2% by end-2009 (Figure 3.12.4), marking the slump in domestic demand, lower prices for imported commodities, and an increase in the policy interest rate in March. With inflation subsiding and the exchange rate recovering, the Bank of Mongolia lowered its policy interest rate in three steps starting from May 2009. Growth in the money supply (M2) picked up early in the year and posted an increase of 26.9% for all 2009.

Strains in the banking sector in 2008 persisted in 2009. The economic slump and rising real interest rates (as inflation slowed) caused a near doubling of nonperforming loans to 18.3% of total loans by end-2009 from a year earlier. Construction firms had the highest rate of bad debts. Commercial banks reported aggregate losses in 2009 (as they did in 2008), and capital-adequacy ratios fell in 2009. Poor governance and weak internal controls deepened the problems in the banking subsector.

After Anod Bank foundered and was taken over by the government in December 2008, the authorities tightened bank prudential ratios, raised capital requirements, and strengthened banking laws. The central bank provided liquidity to the banking system and introduced a blanket deposit guarantee. Nevertheless, Zoos Bank failed in November 2009 and

3.12.3 External sector



Source: Bank of Mongolia. 2009. *Balance of Payment Report*. December. http://www.mongolbank.mn

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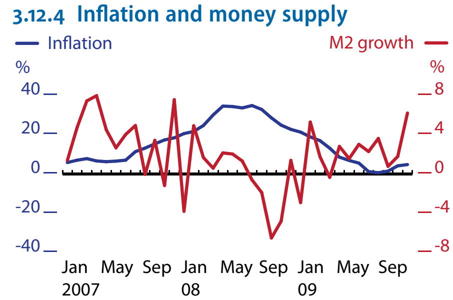
3.12.4 Inflation and money supply



Source: Bank of Mongolia. 2009. Statistical Bulletin. December. http://www.mongolbank.mn

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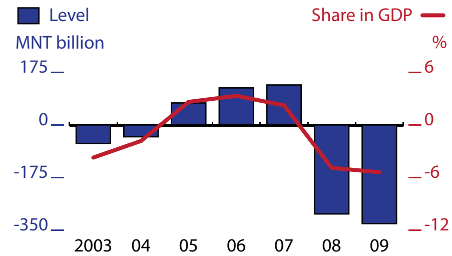
was put into receivership. The banks' difficulties, coupled with concerns about the financial soundness of borrowers, caused banks to cut lending in 2009, by 26.2%.

Reductions in government spending brought down total public expenditure and net lending to the equivalent of 38.3% of GDP (from 41.0% in 2008). In particular, the government slashed spending on construction and subsidies, partly offset by a higher wages bill. Revenue also fell, eroded by weak copper prices early in the year and the impact of the recession on tax collections. Total revenue and grants fell to 32.9% of GDP, from 36.1%. The overall fiscal deficit widened to 5.4% of GDP (Figure 3.12.5).

3.12.5 Budget balance



Source: National Statistical Office of Mongolia. 2009. *Monthly Statistical Bulletin*. December. http://www.nso.mn

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Economic prospects

The outlook depends heavily on the global price of copper, the development of new mines, and the continued implementation of policies that maintain macroeconomic stability.

As for copper, the price is projected to remain at high levels during the forecast period, which will stimulate production. Prospects for development of new mines brightened considerably in October 2009, when the government signed an agreement with an international mining company to exploit the Oyu Tolgoi copper and gold deposit. Investment in this project is expected to total $5 billion, with about $760 million to be spent this year and $1.5 billion next. Production is projected to start in 2013.

The long-awaited Oyu Tolgoi agreement and subsequent construction will raise investor confidence and have knock-on effects on other parts of the economy. Moreover, the government is considering proposals to mine the large Tavan Tolgoi coal deposit. FDI inflows into mining are expected to rise significantly over the forecast period.

Severe winter early in 2010 will curtail agricultural production. Livestock losses are likely to reduce incomes of herders, who constitute about 30% of the population. As for the services sector, transport and communications staged a strong rebound in late 2009 and other services will join in the recovery this year. However, the banking sector's problems damp its prospects for growth.

The need to strengthen public finances will limit budgetary stimulus to the economy in the forecast period. The government aims to narrow its budget deficit to 5.0% of GDP in 2010. Higher mineral prices should benefit revenue, but the scheduled ending of a windfall profit tax on mining in 2011 will erode total revenue by the equivalent of about 2% of GDP. Furthermore, donor budgetary support is expected to be phased down from 2011. On the monetary policy front, projected faster inflation limits further interest rate cuts.

Investment is expected to rebound, driven by Oyu Tolgoi. The outlook for growth in bank lending is clouded by the high level of bad loans, weak bank balance sheets, and high real interest rates. Consumption will benefit from an expected pickup in employment, offset by the impact of lower incomes in agriculture. Taken all together, the economy is forecast to grow by about 7.0% in 2010 (Figure 3.12.6).

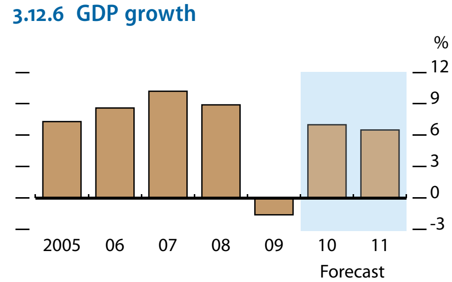
Growth is seen slowing a bit to 6.5% in 2011, mainly a result of the impact on government revenue and spending of the end of the windfall

3.12.1 Selected economic indicators (%)

	2010	2011
GDP growth	7.0	6.5
Inflation	7.9	6.0
Current account balance (share of GDP)	-16.1	-21.2

Source: ADB estimates.

3.12.6 GDP growth



Sources: National Statistical Office of Mongolia. 2009. *Monthly Statistical Bulletin*. December. http://www.nso.mn; ADB estimates.

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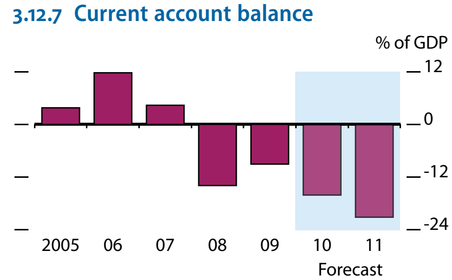
3.12.7 Current account balance



Sources: Bank of Mongolia. 2009. *Balance of Payment Report*. December. http://www.mongolbank.mn; ADB estimates.

Click here for figure data

profit tax and reduced donor budgetary financing. Implementation of a proposed fiscal responsibility law would also impose limits on government spending. On the upside, growth could be faster if agreements are reached to mine several large mineral deposits.

In the medium term, GDP growth is expected to spurt to double-digit levels once production ramps up from the Oyu Tolgoi project.

Inflation is forecast to accelerate to an average of nearly 8% in 2010 from 6.3% last year, reflecting the rebound in domestic demand, increase in oil prices, and likely higher meat prices for at least part of the year due to the bad weather. Inflation is expected to ease in 2011 as fiscal consolidation efforts strengthen.

Policy reforms planned for 2010, if followed through, will improve the economy's prospects for sustained growth. The proposed fiscal responsibility law will promote budget discipline by effectively placing ceilings on spending growth, the fiscal deficit, and public debt. The law will require mandatory cost estimates for government spending proposals to ensure that spending is consistent with a medium-term fiscal framework. More broadly, the idea behind the law is to help insulate the budget, and the economy generally, from swings in the price of copper.

In other reforms, the government plans to replace some universal social transfer programs with better targeted transfers that focus on the very poor. It also proposes to strengthen the central bank's powers to supervise the banking system and to intervene when banks strike financial trouble.

Merchandise exports are expected to rise in line with commodity prices and improved external demand. Buoyant GDP growth in the People's Republic of China (forecast at 9.6% in 2010) will underpin exports, since that market takes most of Mongolia's exports. Merchandise imports will likely increase at an even faster rate than exports, reflecting the need for machinery and equipment for Oyu Tolgoi and the pickup in consumption. The current account deficit is forecast to widen sharply to about 16% of GDP in 2010 and to 21% in 2011 (Figure 3.12.7). FDI should finance much of the gap.

Domestic risks to the economic forecasts center on the weaknesses in the banking system and possible renewed fiscal pressures. More bank failures would hurt confidence and further restrict credit, and could deal a blow to the budget (as a result of the deposit guarantee). Fiscal pressures would also arise if the government hikes spending before significant extra revenue starts flowing from mining in about 2015. However, the authorities have so far demonstrated the will to undertake agreed fiscal reforms and to improve the economic policy framework. Volatile commodity prices are a perennial risk.

3.12.1 Development challenges

Expansion of mining will bring important benefits—new investment, jobs, export income, and a surge in government revenue that could fund social and development spending, so as to increase the productive capacity of the economy and reduce poverty.

However, the flood of new investment and revenue into this small, narrowly based economy may also aggravate problems. For a start, increased demand for labor and materials, plus higher incomes and public spending, could easily spur inflation to double-digit rates. Wages in mining and in the public service are likely to rise. The boost in export earnings will put upward pressure on the real exchange rate.

Such developments would hurt the competitiveness of manufacturing and other nonmineral industries, including tourism. Nonmineral industries trying to export, or exposed to competition from imports, might well contract.

At the least, the higher costs would make it more difficult to diversify the economy away from mining. Indeed, an increase in mining's role would likely amplify the economy's vulnerability to swings in global copper prices. (Mongolia experienced some of these problems during the copper boom from 2005 to early 2008 and, when copper prices crashed, it suffered recession.)

Managing windfall revenue and smoothing public expenditure will be critical to avoiding such boom and bust cycles. The government has proposed structures to address these issues, in particular the fiscal responsibility law. The challenge now is to adopt the law and adhere to its rules. It has also put forward a stabilization fund to manage revenue volatility, but it will be several years before the fund is large enough to help buffer the economy from another copper slump.

While steps have been taken to strengthen the central bank's role in maintaining price and banking system stability, more needs to be done, including changes to make inflation its main policy goal.