

Mongolia

High international prices for export commodities and another mild winter induced further rapid economic growth in 2007. Inflation climbed, driven mainly by food prices, and is likely to be in double digits this year. Fast-paced economic growth is set to continue in the next couple of years, supported by an expansionary fiscal policy. The competing pressures to distribute gains from mining, and to control inflation and encourage investment elsewhere in the economy, will have to be reconciled.

Economic performance

Solid contributions from all sectors underpinned GDP growth of 9.9% in 2007, above the 2003–2006 average of 8.7%. Agriculture, which supports nearly half the population, had a strong year, expanding by 15.8% and contributing 3.7 percentage points to GDP growth (Figure 3.12.1). The livestock herd—mainly goats, sheep, and cattle—grew by 15% to about 40 million in response to higher cashmere prices, rising domestic demand for meat and other animal products, and good weather. However, this second straight year of large increase raises questions about the sustainability of livestock numbers at this level, particularly as goats, the most environmentally damaging of the three, now account for almost half the total number.

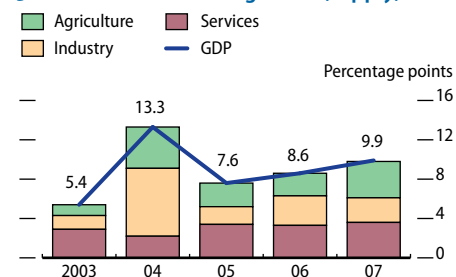
Services grew by nearly 9% and accounted for 3.6 percentage points of overall growth. Major contributors were construction, transport, trade, and tourism. Despite higher global prices for copper, gold, and coal and continued foreign investment in minerals, mining output rose only marginally, and copper concentrate by just 1.4%. Industry as a whole expanded by 7.1% and contributed 2.5 percentage points to growth.

Mining output was held back partly by uncertainty surrounding the terms of exploitation of some substantial mineral deposits. Government decisions are awaited, with regard among other things to the state's participation, particularly in the large Oyu Tolgoi copper and gold deposit to which rights are jointly owned by two foreign companies. The major issues center on the size and terms of the government stake in the deposit, the tax regime, and management. The uncertainty prompted some mining companies to reconsider investments for increasing production at existing mines and developing new resources.

A windfall tax imposed in 2006 on copper and gold exports beyond certain price thresholds has also damped expansion of mining. The value of recorded gold exports fell in 2007 despite substantially higher global prices, apparently a result of gold smuggling to evade the windfall tax. Nevertheless, mining continued to dominate exports last year, accounting for some two thirds of the total.

Robust economic growth and higher costs of imported food and oil

3.12.1 Contributions to growth (supply)



Source: Mongolian National Statistical Office.

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drove a 41.3% jump in the nominal United States (US) dollar value of merchandise imports in 2007 compared with 2006. Mongolia imports almost 80% of its food, mainly from the People's Republic of China (PRC) and the Russian Federation. The value of food imports last year soared by 150%. The cost of oil imports also rose sharply and that of machinery imports, mainly for the mining industry, more than doubled.

On the export side, the value of copper concentrate shipments increased by 28%, nearly all of it coming from price rises, and the value of zinc and coal exports climbed steeply. However, exports of textiles and clothing fell, prolonging a decline caused by the end of global quotas in 2005. The growth rate of total exports at 22.5% was well below that of imports and the merchandise trade balance switched to a deficit of \$25 million. Inflows from grants and remittances kept the current account in surplus equivalent to 1.8% of GDP, although this was substantially lower than surpluses in the previous 3 years.

Inflation ramped up in 2007 to end the year at 15.1% (Figure 3.12.2). The year-average rate of 9.0% was above the average (8.0%) of the previous 5 years. The increase was mainly driven by higher prices of food, which has a 40% weight in the consumer price index; rapid monetary expansion and a near doubling of civil service salaries also played a part.

Prices of most imported foods rose. A spurt in the cost of imported grain and flour prompted the Government to exempt flour from value-added tax. The price of domestically produced meat, too, escalated sharply as demand continued to rise. Higher prices for imported fuel and transport costs further boosted prices. M2 money supply grew by 56.3%, well above the average rate of about 30% over recent years. Credit increased by about 70%, with more than 80% of total lending to the private sector.

A budget surplus of 2.2% of GDP reflected a large increase in revenues from the windfall tax on mining and from value-added tax collections, as well as an inability on the part of a capacity-constrained government to reach targets for capital expenditures. Even then, high levels of overall spending (approximately 40% of GDP) were maintained. Tax administration also appears to have improved. The 2008 budget is even more ambitious in terms of capital spending, but the capacity limitations remain.

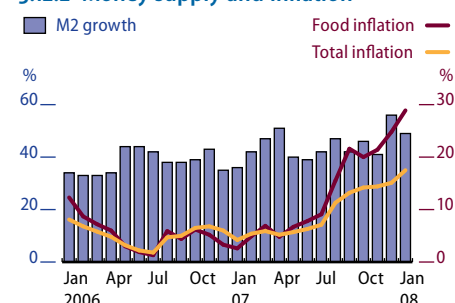
Actual inflows of foreign direct investment (FDI), mainly into mining, as well as remittances from workers abroad supported a 35.4% rise in international reserves to \$972 million, representing 24 weeks of imports (Figure 3.12.3). FDI increased by just over one third to \$500 million, some two thirds of it directed at mining. Significant FDI also went into banking and construction. Almost 70% of total FDI comes from the PRC.

The togrog depreciated by 0.4% against the dollar. The International Monetary Fund now classifies the exchange regime as a conventional peg rather than, as in the past, a float, even though the Government has made no express commitment to maintain parity against the dollar.

Economic prospects

The forecasts for 2008–2009 assume that prices will stay relatively high for the main export commodities, that the weather remains favorable for agriculture, and that economic growth in the PRC, Mongolia's main export market, slows but remains robust. The Government is expected

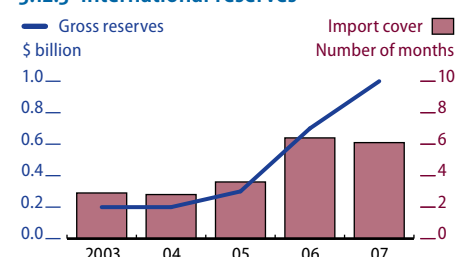
3.12.2 Money supply and inflation



Source: Bank of Mongolia, available: <http://www.mongolbank.mn>, downloaded 3 March 2008.

[Click here for figure data](#)

3.12.3 International reserves



Source: Bank of Mongolia.

[Click here for figure data](#)

3.12.1 Selected economic indicators

	2008	2009
GDP growth	9.5	9.0
Inflation	10.5	9.5
Current account balance (% of GDP)	2.0	2.0

Source: Staff estimates.

to maintain an expansionary fiscal stance while the revenue situation remains comfortable. A further assumption is that it reaches agreement on developing major mineral deposits, with the result that FDI inflows continue into mining. The financial sector, which has grown rapidly over the recent past, is expected to expand at a more stable rate as construction and rural borrowing revert to trend rates from recent spikes.

Taking these factors into account, GDP growth of 9.0–9.5% is projected for the forecast period (Figure 3.12.4). The current account surplus is seen increasing to 2.0% of GDP, on strong mineral exports and remittance inflows, and as recent spikes in the costs of imports dissipate.

Inflation pressures are likely to persist as the Government struggles to sterilize expected large capital inflows into mining and high export earnings resulting from the international commodity price boom. Additional public spending in advance of parliamentary elections in the middle of this year could add to these pressures.

Against this, the Government has negotiated agreements with exporters of petroleum products from the Russian Federation that should stabilize fuel prices. Moreover, government proposals to create reserves of petroleum products and grain (both imported primarily from the Russian Federation) could help smooth price volatility in these items. The Bank of Mongolia has adopted an inflation targeting policy, suggesting it will do more to drain liquidity (by selling central bank bills) and to introduce some measure of flexibility into the foreign exchange regime.

These factors are expected to lower inflation from the high end-2007 level, though the year-average rate is projected to remain elevated at 10.5% this year and 9.5% next year (Figure 3.12.5).

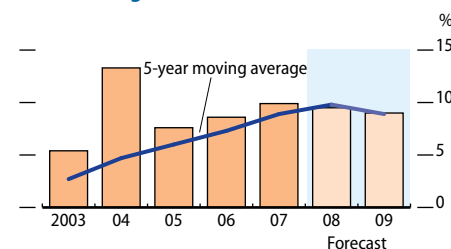
Development challenges

Balancing the pressures to distribute gains from mineral development with the need to control inflation and encourage investment in the wider economy will be a persistent challenge. Significant investment is required in social and physical infrastructure to help develop new sources of growth, given the narrow base of the economy. Diversification on the basis of price is limited by the country's geography and demographics—a small population spread over vast, often inaccessible areas, and a harsh climate. However, Mongolia can benefit from being a neighbor to two huge economies, from its mineral endowment, and—for tourism—from its natural beauty and unique rural lifestyle.

The potential to develop services, including logistics and auxiliary small manufacturing around mining, also offers an opportunity. Exploitation of this potential will require infrastructure that allows efficient transport, capital markets to channel resources to competitive enterprises, and a credible governance structure to maintain investor confidence.

At the same time, problems of urban development, such as worsening air pollution and overstretched urban services, require resolution if the country is to attract the necessary professionals from abroad that it needs to develop its potential. Damage to the natural resource base, such as toxic spills from mining and increasing desertification from overgrazing, poses serious problems not only through ruining the endowment for future generations but also through undermining economic growth.

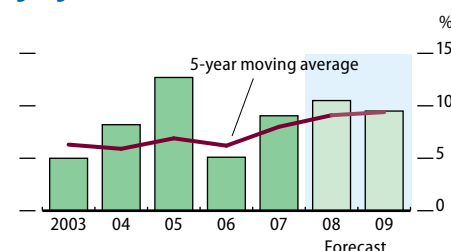
3.12.4 GDP growth



Sources: Mongolian National Statistical Office; staff estimates.

[Click here for figure data](#)

3.12.5 Inflation



Sources: Mongolian National Statistical Office; staff estimates.

[Click here for figure data](#)