

Mongolia

Buoyant commodities markets and good weather made 2006 another year of strong economic expansion. Growth is projected to step down a little in 2007, but remain brisk. The main challenges are to use the Government's revenues from mineral wealth in a manner that sets the country on a sustainable development path; and to address immediate poverty and environmental problems.

Economic performance

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. As an economy based on agriculture (which supports nearly half the population) and mining, Mongolia usually does well when the weather is favorable and commodity markets are buoyant.

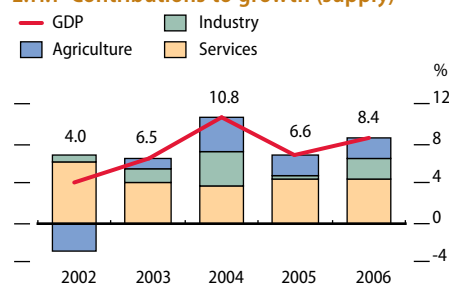
That describes 2006, when the winter was mild and copper and gold brought high prices. Livestock numbers rose by 14.5% to a record 34.8 million as herders responded to demand from the People's Republic of China (PRC). Goats and sheep make up over 80% of the total, with the remainder cattle, horses, and camels. Copper export receipts in US dollars nearly doubled, though copper export volumes increased by only 2.1%.

The clothing industry, too, was a strong performer. It contracted in 2005 after the global textile and clothing trade quota system ended, but rebounded last year as manufacturers focused on the European Union and took advantage of its tariff concessions. For mining, total mineral extraction grew marginally and reported gold production fell. The latter may have been caused by greater smuggling of gold after the Government imposed a windfall profits tax on gold and copper. Transport and telecommunications maintained robust growth, such that services contributed the most (4.4 percentage points) to total GDP growth. Agriculture and industry contributed about 2 percentage points each (Figure 2.11.1).

Broad money (M2) growth was again high in 2006 at 35% (Figure 2.11.2), but inflation slowed from an average of nearly 13% in 2005 to 5.1% last year. 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 rising income from mining, the budget was in surplus in 2006 (by 3.9% of GDP; Figure 2.11.3). Revenues benefited from the Government's 51% share in the biggest copper mine, operated by Erdenet Company, and from taxes on mineral output. In 2006 the Government also imposed a 68% windfall tax on copper and gold for prices exceeding \$6,500 a ton for copper and \$500 an ounce for gold. This tax generated \$152.4 million. Moreover, overall tax collections have been buoyed by the solid economic growth.

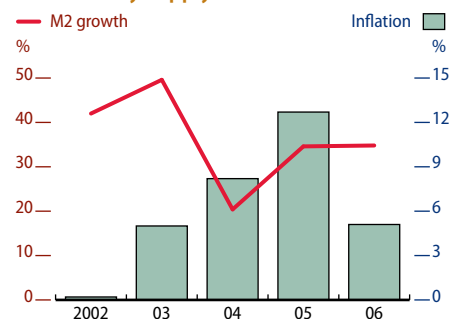
2.11.1 Contributions to growth (supply)



Source: National Statistics Office.

[Click here for figure data](#)

2.11.2 Money supply and inflation



Source: Bank of Mongolia.

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Expenditures also rose noticeably. The Government increased salaries of public officials by 30% and started cash transfers to families with newly born children, to newly married couples, and to families for each child below the age of 18. The parliament agreed to budget those payments for years into the future, raising questions about the sustainability of public finances.

Exports soared by 44% in nominal terms, as a result of high prices for copper and gold and an increase in cashmere exports (the number of goats rose by 16.5% to 15.6 million). 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 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 of 26%. The trade account produced the first surplus for many years (Figure 2.11.4) and the current account was in surplus 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. Gross international reserves more than doubled to \$718 million in 2006.

In the policy arena, the Government adopted a new mining law that gives it the right to acquire up to 50% stakes in "strategic" mineral deposits. As well as the imposition of the windfall profits tax, mining royalty rates were raised. Negotiations continued between the Government and Ivanhoe Mines Ltd. of Canada, which holds the license for the large Oyu Tolgoi copper and gold deposit, on an agreement concerning taxes and royalties. Companies from the PRC are negotiating to develop coal mines and build power plants, for export to their home market.

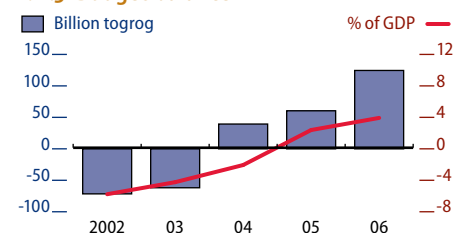
Sustained economic growth in recent years, plus inflows of foreign capital mainly into mining and a more competitive financial market, have spurred sharp increases in credit growth (by more than 40% in 2006). This rapid growth has heightened risks. Officially, the reported ratio of nonperforming loans 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.

Economic prospects

The projections assume that prices of copper and gold will be fairly stable in 2007 and that the price of cashmere will decline slightly. Government expenditures are taken to rise as elections approach in 2008. The forecasts also presuppose that policies will be implemented to maintain the confidence of international mining investors. Economic growth in the important PRC export market is forecast to ease to about 10.0% this year from 10.7% last year.

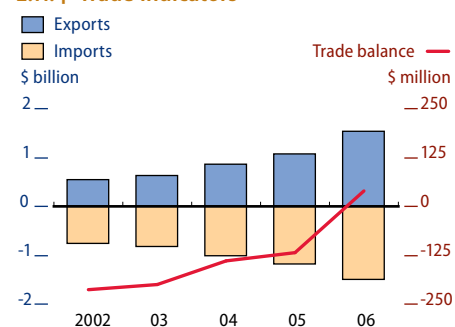
2.11.3 Budget balance



Source: National Statistics Office.

[Click here for figure data](#)

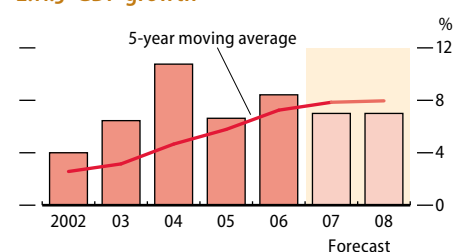
2.11.4 Trade indicators



Source: Bank of Mongolia.

[Click here for figure data](#)

2.11.5 GDP growth



Sources: National Statistics Office; staff estimates.

[Click here for figure data](#)

2.11.1 Selected economic indicators

	2007	2008
GDP growth	7.0	7.0
Inflation	6.0	6.0
Current account balance (% of GDP)	2.0	2.0

Source: Staff estimates.

On this basis, Mongolia's GDP growth in 2007 and 2008 is projected to step down to about 7% (Figure 2.11.5), after averaging 9% for 3 years. Livestock and manufacturing growth rates have been unusually high and are projected to slow. Agriculture in particular could be bumping up against sustainability constraints in terms of herd size.

The minerals law and the tax regime for mining may well be modified to be more investor friendly, which would encourage higher mining output and attract further investment. If the Government and Ivanhoe Mines agree on terms for development of the Oyu Tolgoi deposit, Ivanhoe's investments would rise substantially over the next couple of years. In that case production could start in 2010.

Major international mining company Rio Tinto would join Ivanhoe in developing the Oyu Tolgoi deposit, which could produce an estimated 1 billion pounds of copper and 330,000 ounces of gold a year for at least 35 years. This would have a significant impact on exports and government revenues. Also, initial investment in the large Tavan Tolgoi coal deposit could start over the forecast period.

A government pledge to provide 40,000 households with improved housing should stimulate the construction industry. In addition, Mongolian banks have started to tap international financial markets, which could provide an increasing flow of longer-term funding for investment projects. The Trade and Development Bank of Mongolia issued a \$75 million bond in early 2007 at a yield of 8.75%. The 3-year bond attracted strong demand from investors.

Inflation over 2007 and 2008 is projected at about 6%. The past high inflation rate (the annual average exceeded 8.0% in 3 of the past 6 years) has been driven mainly by supply shocks to food and oil prices and to exchange rate movements. Consequently, the stronger trade position is expected to support the exchange rate and so help contain price pressures. The Bank of Mongolia has found little evidence that money growth drives inflation in the economy. Continuing monetization of the economy could account for the weak link between money growth and inflation.

The current account is expected to show surpluses of about 2% of GDP in the forecast period as prices of copper and gold stabilize, but mineral export volumes rise.

The biggest risk to the economy would be a sharp drop in international metals prices. In addition to direct links to GDP, mineral exports are the major source of government revenues and affect the exchange rate, which in turn has an impact on inflation. Significant declines in prices of copper, coal, gold, and cashmere would hit the current account and, in the longer term, could lead toward debt distress. Severe winter weather can devastate agriculture in any year.

Further out, there is a threat to the sustainability of the natural-resource base. Overstocking in agriculture and lax controls over smaller mines, as well as environmental problems related to urbanization, have damaged the environment, including water resources. Unless the Government can reorient agriculture toward a sustainable growth path, this sector's growth will likely slow in the medium term and it could face longer-term contraction. Potential instability in the financial sector is a further risk, since some banks have tried to expand by offering high rates for deposits and using funds to make high-interest, high-risk loans.

2.11.1 Development challenges

Once Mongolia started its transition in 1991 from a command economy, it was quick to dismantle that system, institute legal and institutional frameworks, and adopt market-oriented policies.

Nevertheless, cumulative growth has been insufficient to resolve high levels of poverty that emerged after the initial shocks. Poverty incidence was estimated at 32.6% in 2006. The benefits from mineral wealth have not been broadly distributed.

Moreover, social services, particularly education and health, have deteriorated. Current expenditures in the budget account for an inordinately large proportion (almost 80%) of total public spending, and little public investment is directed to building infrastructure.

An important development challenge is to use government revenues from mineral resources for setting the country on a sustainable long-term development path while also addressing social and environmental problems. This will require significant investment in social and physical infrastructure, which would facilitate the development of new growth sources and an upgrading of labor productivity.

Such a plan should be linked into the budget and set out development priorities. This also will require the building of capacities in strategic planning and in project preparation and appraisal.

Among other issues the public investment plan should address the degradation of the environment. In addition to the problems outlined, the overuse and illegal trade in forest products and wildlife have inflicted heavy damage and put under threat the sustainable economic growth, primary education, and environment targets in the Millennium Development Goals.

Corruption also is a challenge to development. In 2006, Mongolia ranked 99 out of 163 countries on the Transparency International Corruption Perceptions Index.