Mongolia

In 2005, the economy grew at a robust 6.2%. High global prices for copper and gold boosted the mining industry, but manufacturing was hit by the end of global textile and clothing quotas. Inflation rose to double-digit levels. Growth in the medium term is projected at around 5%. Given its narrow base, the economy remains vulnerable to swings in the prices of a few commodities and to weather conditions. Stronger links to neighboring markets would facilitate development.

Economic performance

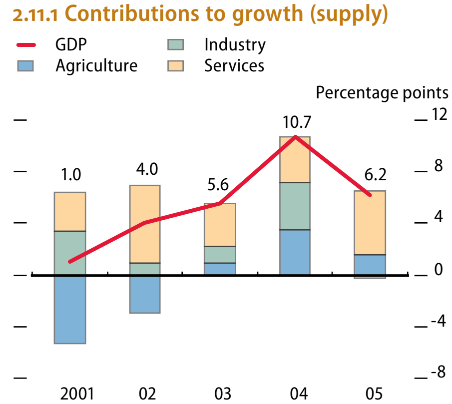
Gross domestic product (GDP) grew by a solid 6.2% in 2005, although this was below the very rapid pace of 2004 when GDP surged on the rebuilding of livestock herds and expansion of mining. The services sector made the biggest contribution to growth in 2005 (Figure 2.11.1.), bolstered by increased tourism and transit trade. Agriculture also contributed to growth. However, industrial production was hit by cutbacks in the clothing industry after the end of global quotas in major export markets (Box 2.11.1) The mining subsector was supported by high world copper and gold prices and foreign direct investment.

Inflation, spurred to double digits by higher prices for fuel, utilities, and food, eased later in the year as food price inflation slowed. Imports of lower-priced consumer goods from the People's Republic of China (PRC) reduced prices of clothing and footwear. Consumer inflation averaged 12.7% in 2005. Broad money growth (Figure 2.11.2) exceeded growth of nominal GDP. The Bank of Mongolia, which had been selling central bank bills to contain growth in broad money, held back from this practice in 2005. Net domestic credit continued to rise rapidly, particularly to the wholesale and retail trading, construction, and mining industries. The nonperforming loan ratio at banks increased as credit expanded, heightening concerns about related-party lending and corporate governance at banks. Nevertheless, confidence in the financial system improved, and the savings rate continued its recovery from a sharp decline after banking crises in the 1990s.

Increased corporate tax revenues, a result of the robust economic growth and higher commodity prices, swung the budget into a surplus equivalent to 2.7% of GDP (Figure 2.11.3), the first surplus in many years. Expenditure was broadly maintained as announced in the 2005 budget. An assistance program for poor families with children, which cost about 1% of GDP, was put under review to assess whether it effectively reaches the needy.

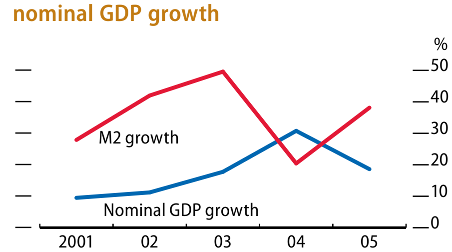
Strong copper and gold export prices also helped shrink the trade deficit to an estimated $95 million (Figure 2.11.4). Mongolia's exports comprise mainly minerals, cashmere, and clothing, with the PRC buying more than half of the total. Shipments of clothing plunged last year as predominantly foreign-owned textile companies stopped production

2.11.1 Contributions to growth (supply)



Source: National Statistical Office.

2.11.2 Money supply (M2) and nominal GDP growth



Sources: National Statistical Office; Bank of Mongolia, *Monthly Bulletin*, December 2005, available: www.mongolbank.mn/monthlybul2005.htm, downloaded 1 February 2006.

2.11.1 Loss of trading preferences—and potential growth areas

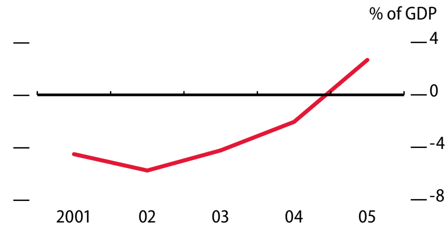
The end of international clothing quotas resulted in the closure of many clothing manufacturers and the loss of significant employment in Mongolia. This experience illustrates the risk in basing trade on preferences.

The clothing industry was built on foreign direct investment, mostly from the People's Republic of China (PRC), motivated primarily by the absence of quota restrictions on imports from Mongolia under World Trade Organization agreements. Exports, dominated by products for which quota utilization rates of the PRC were high, were aimed primarily at the United States market. Clothing exports grew rapidly over 2000–2004 to 11.3% of total exports, and the industry employed an estimated 20,000 Mongolian workers, mostly women, as well as illegal immigrants. During 2005, most of the PRC-based producers stopped production in Mongolia and almost half of the workers lost their jobs. The Government tried to support the industry by reducing clothing makers' social security contributions and exempting them from import taxes on raw materials, but these measures failed to arrest the decline. Clothing exports to the United States dropped by about 40% in value in 2005, and total clothing exports plunged by nearly 60%. The high import content (almost 70% of export value) limited the damage to the trade deficit, but the social and employment impacts were serious.

A large foreign stake in the clothing industry, in itself, does not explain this outcome, as other countries with foreign ownership were able to increase exports. A possible explanation is that investments in the Mongolian clothing industry were undertaken under an implicit time horizon that ended with the full implementation of the Agreement on Textiles and Clothing on 31 December 2004. It is likely that with most of their equipment fully depreciated and faced with the choice of renewing their investments or ceasing production and relocating to sites where costs are lower, most investors followed the latter path. This reflects the basic competitive disadvantages of Mongolia posed by its distance from major markets, reliance on imported raw materials, lack of infrastructure, and poor skills base. The sudden contraction in production and exports of clothing, and subsequent loss of jobs, have highlighted the importance of developing trade on the basis of comparative advantage, because preferences or concessions cannot be counted on in the long term to overcome basic disadvantages.

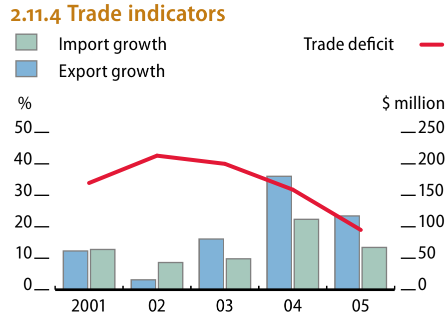
The economy may well have a comparative advantage in the resources of its remote areas, particularly the western region, which accounts for over 30% of national livestock. Most of this was raised organically, and has the potential to target niche markets in Europe and the Middle East. This region is also well positioned to supply food to the PRC, Kazakhstan, Kyrgyz Republic, and the Russian Federation. It also has considerable potential for tourism, given the area's cultural diversity and natural beauty. However, as the remote areas often have fragile natural environments, environmental protection measures that involve cooperation with neighboring economies should be part of development plans. Development will depend on establishing stronger links to these relatively nearby markets, as well as building the capacity to access distant markets. Improved transport to neighbors, combined with cross-border agreements, would be a first step. Additional transit agreements, harmonization of customs procedures, and other trade facilitation measures would reduce transaction costs that form a barrier to trade.

2.11.3 Budget balance



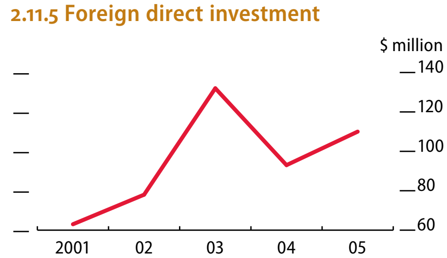
Source: Ministry of Finance.

2.11.4 Trade indicators



Source: National Statistical Office.

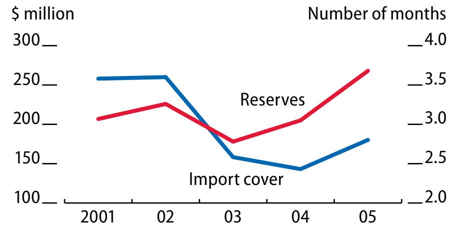
2.11.5 Foreign direct investment



Sources: Asian Development Outlook database; International Monetary Fund, *Article IV Consultation on Mongolia*, November 2005.

after the global textile and clothing trade quota system ended on 31 December 2004. The net impact on total trade was modest because most inputs for clothing manufacture are imported. The smaller trade deficit, together with capital flows into mining, remittances, and tourism receipts, narrowed the current account deficit for a third consecutive year. The togrog remained relatively stable against the United States dollar in 2005, implying a real effective appreciation of about 4%, which reflects the higher mineral export prices, remittance and foreign direct investment inflows (Figure 2.11.5), and the rebuilding of foreign reserves (Figure 2.11.6).

2.11.6 Gross official reserves



Sources: Asian DevelopmentOutlook database; International Monetary Fund, *Article IV Consultation on Mongolia*, November 2005.

Economic outlook

This analysis assumes that prices of copper and gold—the most important of Mongolia's commodity exports—will decline from the highs reached in 2005. The price of cashmere is expected to remain stable, while price increases for imported oil are expected to moderate. The baseline assumes that the Government will sustain supportive fiscal policies and that any policy changes will not be an additional constraint to private sector development. Another important assumption is that the Bank of Mongolia tightens monetary policy, resuming its sale of bills as needed to rein in inflation, and maintains confidence in the banking system.

2.11.1 Selected economic indicators

	2006	2007
GDP growth	6.0	5.0
Inflation	5.5	5.0
Current account balance (% of GDP)	-8.5	-8.5

Source: Staff estimates.

Prospects for 2006 and 2007

GDP growth in 2006 is projected at 6.0%, slowing to 5.0% in 2007 (Figure 2.11.7), as the livestock sector returns to its trend growth rate after high volume-led growth over 2004–2005. An expected easing in high global copper prices is likely to affect growth in mining. Income from tourism is expected to rise in 2006 as Mongolia holds celebrations for 800 years of statehood. Transport and telecommunications are projected to expand, with an increase in transit trade and extension of telecoms services to the growing urban population.

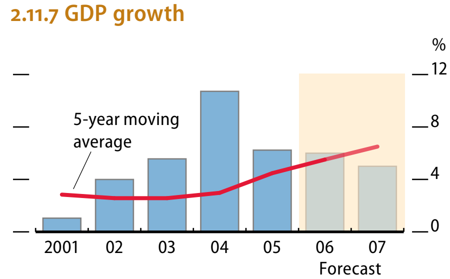
After last year's surge in prices, inflation is forecast to decelerate to 5.5% in 2006 (Figure 2.11.8) because of reduced upward pressure from oil prices and expected policy action by the Bank of Mongolia, primarily through market transactions. The current account deficit should be fairly stable at around 8.5% of GDP.

Medium-term outlook

GDP growth over 2006–2010 is forecast to average about 5%. The primary sector is likely to be a more significant contributor to growth in this period. Some medium-sized mines are expected to increase output and new mineral deposits have been discovered, though their commercial viability has yet to be established. Development of larger mineral deposits may be constrained by weaknesses in infrastructure, including power and transport, and by the capacity and commitment of some holders of exploration licenses to develop large deposits. The livestock sector is likely to maintain its trend growth.

In the services sector, tourism, transport, and telecoms are expected to expand over 2006–2010. Growth in tourism could get a lift over the medium term from private sector investments in tourist facilities for this

2.11.7 GDP growth

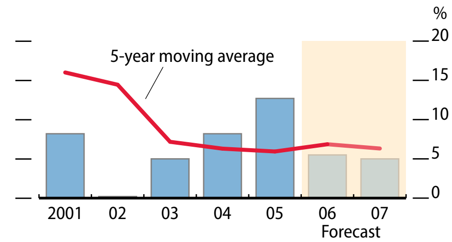


Sources: National Statistical Office; staff estimates.

year's 800th anniversary celebrations. Transit trade should be encouraged by the signing of an agreement between Mongolia, PRC, and the Russian Federation in late 2005. PRC–Russian trade that currently goes via Kazakhstan is expected to be diverted through Mongolia, provided that improvements in infrastructure are made. Development of manufacturing and other nonresource industries will depend partly on overcoming low labor productivity through education and training.

Mongolia's narrowly based economy is vulnerable to weather-related natural disasters and declines in commodity prices. Agricultural production depends heavily on the weather, which in the past has destroyed as much as 20% of the livestock herd, exacerbated rural poverty, and cut economic growth. Natural disasters also strain the budget and derail development programs, as they did in 2000–2002. The recent credit expansion and associated rise in nonperforming loans have increased the vulnerability of the banking system. As Mongolia accelerates the exploitation of its mineral resources, so the risk of environmental harm increases, particularly given that safeguards are not yet adequate.

2.11.8 Inflation



Sources: Bank of Mongolia, *Monthly Bulletin*, December 2005, available: www.mongolbank.mn/monthlybul2005.htm, downloaded 1 February 2006; staff estimates.