Mongolia

Rising global prices of minerals and strong investment in mining contributed to a return of economic growth in 2010. These factors, coupled with a surge in fiscal spending, will spur higher GDP growth this year, too. Inflation accelerated to double-digit-levels in 2010 and is expected to be even higher this year. Rapidly rising prices and fiscal discipline are near-term challenges for policy makers.

Economic performance

A 6.1% recovery in GDP in 2010 was driven by growth in the minerals sector, high prices for mineral exports (Figure 3.12.1), and support from development partners. The outcome was a turnaround from a 1.3% contraction in the economy in 2009.

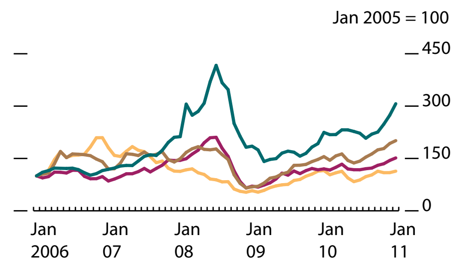
Mining benefited from a rebound in copper prices, strong external demand for coal and iron ore, and construction at Oyu Tolgoi, which will be one of the world's biggest copper and gold mines. Copper prices returned to 2008 levels early last year and rose to over $9,000 a ton in December 2010. Copper export volumes in 2010 were little changed from 2009, but their value jumped by more than 50%; export volumes of coal and iron ore more than doubled in 2010. Strong economic growth in the People's Republic of China (PRC), Mongolia's major trading partner, underpinned the increase in mineral exports.

Industry as a whole contributed nearly half the growth in GDP in 2010 (Figure 3.12.2) as construction and manufacturing expanded, along with mining. Services accounted for the rest of GDP growth: wholesale and retail trade recovered strongly as the economy bounced back.

Agriculture, however, which directly supports about one-third of the population of 2.8 million, was hit by severe winter conditions (a *dzud*) that reduced livestock numbers by about a quarter to 32.7 million. The sector's overall output contracted by nearly 17%. An estimated 10,000 households headed by livestock herders lost their livelihood and migrated to urban areas. The livestock losses also hurt the cashmere industry, reducing production of raw cashmere by 13.2% and output of cashmere sweaters by 20%.

Economic recovery was supported by an SDR 153.3 million (about $229 million) 18-month stand-by arrangement with the International Monetary Fund, completed in September 2010. Under this arrangement, Mongolia borrowed $185.4 million from the Fund and received commitments for $184 million for budget support from development partners. This financing, and associated policy actions taken by the government, bolstered both the budget and external positions and restored confidence in the currency (the togrog).

3.12.1 Global prices of main exports



Source: International Monetary Fund. International Financial Statistics online database (accessed 12 March 2011).

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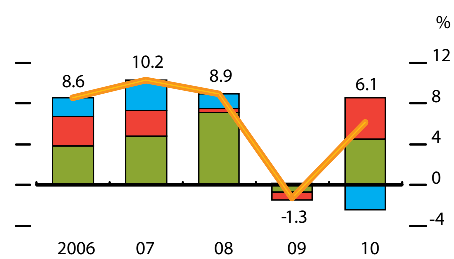
3.12.2 Contributions to growth (supply)



Source: National Statistical Office of Mongolia. 2010. *Monthly Statistical Bulletin*. December. http://www.nso.mn.

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This chapter was written by Bayasgalan Rentsendorj of the Mongolia Resident Mission, ADB, Ulaanbaatar.

External trade rebounded last year from a sharp slump in 2009. Merchandise exports and imports in US dollar terms both jumped by about 53%, exports propelled by higher copper prices and increased coal and iron ore volumes and prices. Higher imports stemmed from the need for equipment in the mining industry, as well as rising prices of oil and food.

Deficits in trade in goods and services caused the current account gap to widen to 15.3% of GDP in 2010 (Figure 3.12.3). A surge in foreign direct investment to $1.6 billion, largely into mining, and in portfolio investment boosted gross international reserves to $2.2 billion at end-2010, equivalent to about 8 months of imports. (Reserves were just $637 million at end-2008.)

Inflation accelerated to nearly 13% by end-2010 (Figure 3.12.4), and averaged 10.1%. The loss of livestock during the *dzud*, coupled with an outbreak of hoof-and-mouth disease, caused a sharp runup in food prices. Strengthening domestic demand was reinforced in October when the government raised public sector wages by 30%. M2 money supply surged by nearly 63% over the year.

Inflation would have been higher had it not been for a 13% appreciation in the togrog against the US dollar in 2010 (the country has a managed floating exchange rate). As the economy recovered and inflation quickened, the Bank of Mongolia in May 2010 raised its policy interest rate from 10.0% to 11.0%.

Higher commodity prices and cash prepayments from the Oyu Tolgoi mine contributed to a 54.5% surge in government revenue in 2010. Government spending went up by 31.7%, largely the result of cash transfers and increases in public sector wages and pensions. The budget was roughly in balance (Figure 3.12.5).

Economic recovery generated jobs and lowered the unemployment rate, though it was still high at 8.6% at end-2010. Poverty remains widespread, with about one-third of the population living below the national poverty line. There has been progress on the Millennium Development Goals related to education and health, but achievements on the poverty, malnutrition, and environmental goals are trailing.

Improvements in business optimism and in public trust in banks encouraged a recovery in lending and strong gains in togrog deposits. Nonperforming loans and loans in arrears fell to about 15% of total loans. New banking and central bank laws were approved in February 2010 to improve bank regulation and supervision. A bank-restructuring strategy, drafted by the central bank, awaits approval by Parliament.

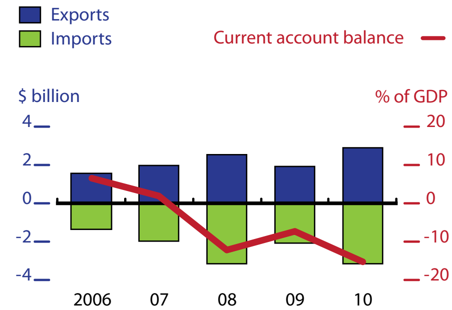
Economic prospects

Growth is expected to accelerate in 2011 and 2012, supported by high global mineral prices, development of new mines, and fiscal spending.

Mining is the key driver. Investment in the Oyu Tolgoi copper and gold mine is projected to total more than $4 billion over the next 2 years. The mine is scheduled to start production in 2013.

Preparations are being made to develop the coal deposits of one of the largest undeveloped coalfields in the world, Tavan Tolgoi. Like Oyu Tolgoi, these deposits are near the border with the PRC, a potential

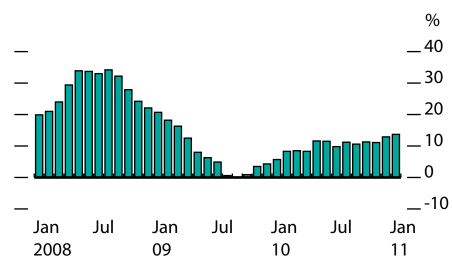
3.12.3 Current account and trade indicators



Sources: Bank of Mongolia. 2011. *Balance of Payments Report*. January. http://www.mongolbank.mn; ADB estimates.

Click here for figure data

3.12.4 Monthly inflation



Source: Bank of Mongolia. 2011. *Statistical Bulletin*. January. http://www.mongolbank.mn

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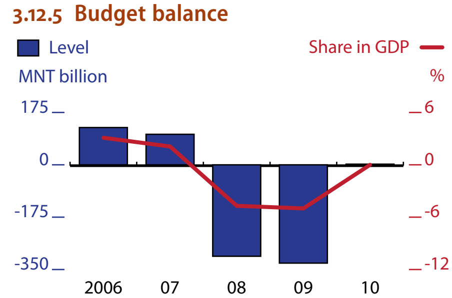
3.12.5 Budget balance



Source: Bank of Mongolia. 2011. *Statistical Bulletin*. January. http://www.mongolbank.mn

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market for the minerals. At full capacity, Tavan Tolgoi could produce 15 million tons of coal a year. A state-owned company is expected to mine in one part of Tavan Tolgoi from this year, and international mining companies are bidding to develop another part.

The government has ambitious plans for a new rail line linking into the Russian Federation's rail network and so through to its Pacific ports. It also plans to build an industrial complex, including a copper smelter, oil refinery, and facilities to process metals and produce construction materials. The aim is to reduce the country's dependence on exports of raw materials. The rail line and industrial complex would, however, require investment of more than $10 billion, and their economic viability and financing are uncertain.

Fiscal policy is highly expansionary this year. The 2011 budget, with a deficit equivalent to almost 10% of GDP, includes a 35% boost in spending. Cash allowances through the government's Human Development Fund are budgeted to almost double from 2010. Disbursements include a monthly cash allowance of MNT21,000 (about $16) for every citizen and partial tuition support for each college student. Government expenditure overall is projected to rise from 37.3% of GDP in 2010 to 52.0% in 2011, while revenue is set to climb from 37.3% to 42.0%.

Agriculture is expected to recover from the impact of last year's severe weather. The government is providing support for farm-based livestock husbandry, attempting to mitigate weather-related risks.

Taking these factors into account, GDP growth is forecast to grow by a rapid 10% in 2011. High rates of inflation and an increasingly negative real policy interest rate suggest that the central bank will tighten monetary policy. It raised the reserve requirement for banks from 5.0% to 9.0% in February 2011. Further tightening is likely to contribute to a moderation in GDP growth in 2012, projected at about 8.0%.

High food prices, hikes in government spending (notably the cash payments), and the increasing cost of imported fuel are likely to result in very high inflation in 2011, averaging 17%. On the assumption of further monetary tightening this year, inflation should decelerate in 2012, but is projected to remain elevated at 14.0% (Figure 3.12.6).

Robust mineral exports projected for 2011 will be offset by an increase in imports of supplies and equipment for mining, as well as the rising cost of imported food and fuel. The current account deficit is seen at about 15% through the forecast period. Its main sources of financing will be foreign direct investment and public and private sector borrowing from abroad.

The togrog could come under further upward pressure, undermining nonmineral industries, including cashmere and textiles.

Parliament last year enacted a fiscal stability law to improve the management of volatile revenue inflows from minerals and to help avoid the boom–bust instability that is common in mineral-based economies.

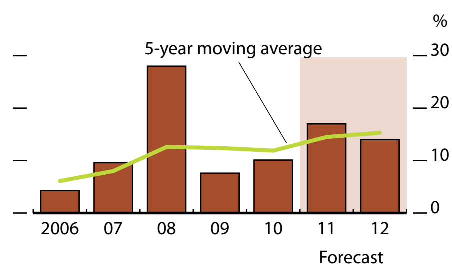
The law should foster budget discipline by effectively placing ceilings on spending growth, the fiscal deficit, and public debt. It also requires cost estimates for spending proposals to ensure consistency with the medium-term fiscal framework. A fiscal stability fund will be established to accumulate revenue saving, to be tapped during economic downturns. Most of the fiscal stability law's measures do not apply until 2013, however.

3.12.1 Selected economic indicators (%)

	2011	2012
GDP growth	10.0	8.0
Inflation	17.0	14.0
Current account balance (share of GDP)	-15.0	-14.0

Source: ADB estimates.

3.12.6 Average inflation



Sources: National Statistical Office of Mongolia. 2010. *Monthly Statistical Bulletin*. December. http://www.nso.mn; ADB estimates.

Click here for figure data

As for monetary policy, the new central bank law mandates the Bank of Mongolia to focus solely on price stability. Inflation targeting, coupled with a flexible exchange rate, should provide an appropriate monetary framework, which will take some time to establish. The monetary authorities have a tentative timetable to introduce inflation targeting in 2012.

Development challenges

The direction of fiscal policy is of increasing concern. Very high levels of government expenditure planned for 2011 are procyclical and may become a source of macroeconomic instability by fueling inflation, demand for imports, and exchange rate volatility.

Policies to develop minerals and promote economic diversification need to be balanced with sound macroeconomic management and prevention of boom–bust cycles. It is important to bring fiscal policy into line with the fiscal stability law and establish a sound medium-term budget framework.

Protecting the poor from the impact of rising prices and enabling their full inclusion in economic growth through greater employment are other objectives. Proposed measures to better target entitlement payments would mitigate the impact of high inflation.

Putting the banking system on a stronger foundation will require follow-through on the structural reforms proposed for the sector.

The "Dutch disease" risk common to mineral-based economies is likely to remain on the horizon. In this scenario, rapid increases in exports of minerals put upward pressure on the exchange rate and inflation, draw resources away from nonmineral sectors, and generate a stream of government revenue available for subsidies and handouts. The outcome can be uncompetitive nonmineral industries and overextended government budgets (particularly when global mineral prices turn down).