Mongolia

Medium-term economic prospects are excellent, with a very large mining project expected to begin production early next year and another in the initial stage of development. Growth has been driven both by the booming mining sector and by too rapidly increasing government expenditure. There are signs of overheating, reflected in double-digit inflation. As already scheduled by the government, a substantial fiscal reserve needs to be built so as to protect against contingencies, including a drop in global commodity prices.

Economic performance

The economy grew by 17.3% in 2011, driven mainly by infrastructure spending related to mining activity (Figure 3.12.1). Gross capital formation increased by about 60%, including for equipment, buildings and intermediate goods, and public infrastructure. Investment in the world-scale Oyu Tolgoi copper and gold mine is projected to total $5 billion. The mine is nearing commercial production.

Domestic consumption was another important driver, rising by 14.5% in real terms. Private consumption was up strongly, supported by rising employment and incomes.

A surge in exports, almost entirely to the People’s Republic of China (PRC), was driven by increases in the volume and value of coal output. Imports, however, surged even more, largely reflecting the equipment and machinery needs of mining. Net exports were negative and, therefore, heavily reduced the national accounts measure of overall growth.

Economic growth primarily originated in mining, but was quite broad-based (Figure 3.12.2). Domestic trade (wholesale and retail) rose by 42.5%, stimulated by large government cash payments to all citizens. Mining rose by 8.7%, manufacturing by 16.0%, and construction by 14.3%. Agriculture, which accounts for more than a third of total employment, increased by only 0.3%—disappointing progress in view of the sharp contraction in 2010. While official unemployment was less than 5%, labor force surveys indicate that the overall rate was about 9%, down from 13% at end-2010.

Macroeconomic management of the economy has been mixed. The government completed successfully a stand-by arrangement with the International Monetary Fund in October 2010 but since then fiscal policy has become more expansionary and pro-cyclical. Government expenditure in fiscal 2011 (1 January–31 December) surged by 55.6% to the equivalent of 44.2% of GDP as spending on social transfers, wages and cash transfers surged. Government revenue jumped by 40.9%, supported by sharply higher receipts from import duties on mining-related equipment and corporate and personal income taxes.

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Late in the year, Parliament amended the budget to raise revenue and expenditure—by some 20% over the initial budget estimates for both revenue and expenditure. Compounding the inflationary effects of the spending increase, 20% of total budgetary expenditures were in December. The budget deficit was the equivalent of 3.6% of GDP, compared with a small surplus in 2010 (Figure 3.12.3). While excess mineral revenues were placed in a stabilization fund, as provided for by the Fiscal Stability Law (FSL) adopted in 2010, the overall budgetary framework was inappropriate for 2011 given the inflationary pressures.

The Bank of Mongolia (the central bank) tightened monetary policy throughout the year. It increased the reserve requirement for banks from 5% at the start of 2011 to 11% in August. It has raised the policy rate four times since early 2010 by a total of 1.75 percentage points to 12.75% by year-end. Adjusting for inflation, the slightly positive real interest rate indicates a modest contractionary monetary policy stance, although insufficient to offset excessive fiscal stimulus.

The official exchange rate of the local currency (the togrog) against the US dollar depreciated by about 11% during August–December 2011, reflecting global risk aversion and declining commodity prices, which similarly affected the currencies of other emerging, mineral-rich economies. The real effective exchange rate of the togrog was broadly stable over the year (Figure 3.12.4).

The institutional framework for monetary policy has been strengthened. The broadly flexible exchange rate system adopted since 2009 helps control inflation, provides an absorber against external shocks, and facilitates the real exchange rate changes that are likely to take place over the medium term in view of the rapid growth of the mineral sector. The new Central Bank Law, enacted in early 2010, mandates the Bank of Mongolia to concentrate solely on price stability. The real effective exchange rate does not seem to be out of line with medium-term fundamentals.

Broad money supply (M2) grew by nearly 40% through December 2011, too rapidly given the need to restrain inflationary pressures. The commercial banking system in Mongolia has structural weaknesses, with weak supervision and regulation. Several small to medium sized banks are highly vulnerable. Year-on-year bank lending was up by more than 70% in December. The rapid acceleration in bank lending is fueling aggregate demand, heightening the vulnerability of banks and putting stress on the financial system.

For the year as whole, inflation was 9.2%, but varied widely with fluctuations in food prices and increased to 10.2% in December year on year (Figure 3.12.5). Inflation in Mongolia is volatile, making it hard to discern underlying inflationary pressures, which is crucial for guiding macroeconomic policy. The drop in inflation in early 2011 was largely due to a decline in meat prices through government-managed sales of meat reserves at below-market prices. (Meat constitutes about 40% of the food basket.) Core inflation (excluding food and energy) averaged 9.7%, indicating overheating of the economy.

External trade soared in 2011. The value of exports, largely minerals, rose by 64.4% to $4.8 billion, attributable to demand from the PRC (Figure 3.12.6). Imports more than doubled to $6.5 billion, driven by
purchases of equipment for mining as well as higher prices for oil and food. The current account deficit widened to $2.6 billion, which corresponded to about 30.0% of GDP in 2011 (as against 14% of GDP in 2010). The main source of financing of the current account deficit was foreign direct investment, which more than doubled to $3.7 billion. Gross international reserves by year-end totaled $2.5 billion, equivalent to 29% of GDP.

Economic prospects

The economy is forecast to continue growing at double digit rates: 15.0% in 2012 and 17.5% in 2013. The drivers of growth are expected to remain the same, notably mining-related investment and output. Commercial production from the Oyu Tolgoi mine is scheduled to begin in early 2013, accounting for the boost in growth that year. The time frame for developing the Tavan Tolgoi coal deposit, one of the world’s largest untapped reserves, is less certain. Growth is likely to be further supported by strong growth in construction and services activity associated with mining, and by rising government spending.

With an estimated budget deficit of 1.0% in 2012, fiscal policy is expected to remain pro-cyclical. Government revenue is projected to rise by about 40% and expenditure by about 32%. Contingent liabilities may also increase significantly, reflecting the government’s guarantee of bond issuances by the Development Bank of Mongolia and scheduled public–private projects. Under the amendments to the Social Welfare Law enacted in January 2012, a means-tested poverty benefit will be introduced at midyear, replacing the universal cash transfers from the Human Development Fund. This represents a major step toward setting up a fiscally sustainable social protection system while supporting the poor.

Inflation is expected to remain in double digits—15.0% in 2012 and 12.0% in 2013—owing to very high public spending and large pay rises for public-sector workers in 2012, as well as the emergence of supply bottlenecks in the mining industry and shortages in the labor market (Figure 3.12.7). Adherence to the FSL, in particular the phasing out of cash payments in mid-2012, will put the central bank in a better position to contain inflation in 2013. If, however, public spending growth does not moderate (as prescribed by the FSL), inflation may continue to accelerate beyond 2012. The recent exchange rate depreciation will further stoke inflationary pressure due to the high import content of consumer goods.

Monetary policy may need to play a more active role in countering inflationary pressures. The central bank’s target for 2012 is an inflation rate below 10%, which will require further tightening of monetary policy. Containing credit growth, which is increasing systemic risks in the banking sector, will require strict enforcement of prudential regulation.

Export growth is projected to be robust in the forecast period, based on strong demand from the PRC and continued high commodity prices. Export earnings will also be boosted when the Oyu Tolgoi mine starts commercial production.

Imports will continue to be driven by investments linked to mining and strong growth in private consumption. As new mines come on stream and mineral exports surge, the current account deficit is expected to narrow to an estimated 25.0% and 15.0% of GDP in 2012 and 2013 (Figure 3.12.8).

### Figure 3.12.1 Selected economic indicators (%)

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<thead>
<tr>
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<th>2012</th>
<th>2013</th>
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<tr>
<td>GDP growth</td>
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<td>17.5</td>
</tr>
<tr>
<td>Inflation</td>
<td>15.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Current account balance (share of GDP)</td>
<td>-25.0</td>
<td>-15.0</td>
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Source: ADB estimates.

### Figure 3.12.7 Inflation

![Source: Asian Development Outlook database.](http://www.mongolbank.mn)

### Figure 3.12.8 Current account and trade indicators

With committed investments for the Oyu Tolgoi mine and pre-operation activities related to the Tavan Tolgoi mine, foreign direct investment is set to remain high and to fully finance the current account deficit.

Downside risks to the forecast reflect Mongolia’s small, open, mining-dependent economy. Because of the heavy dependence on mineral development and exports, and associated government revenue, the current account and state finances are highly vulnerable to commodity price fluctuations. Another risk is the possibility of a sharp slowdown in the PRC’s growth, the destination for more than 90% of exports.

Domestically, weak corporate governance and regulation and supervision have resulted in the banking sector being vulnerable to external shocks; it could—as during the 2008–2009 crisis—generate severe financial stress.

### Policy challenges—institutional strengthening and public finance management

Worldwide, countries have shown that, paradoxically, an abundance of natural resources can hinder their long-term development by increasing macroeconomic volatility, thus reducing incentives to invest in physical and human capital and undermining economic and political institutions. Resource dependence often leads to widening income disparities, as resource extraction creates relatively few jobs and a small proportion of the population may secure most of the income.

Mongolia, which historically had comparatively balanced income distribution, has in recent years seen a clear trend toward increasing inequality that could undermine its social cohesion and stability. An important medium-term challenge will be to improve its economic and political institutions so as to ensure transparent, accountable and equitable management of natural resource revenue.

Macroeconomic management of an economy characterized by very rapid development of its natural resources often leads to what is called “Dutch Disease”—that is, high inflationary pressures, upward pressure on the exchange rate, crowding out of the private sector, and increasing vulnerability to external shocks. Recognizing the possible risks, the government strengthened the legal framework for fiscal policy and budget management through enactment of the FSL (in June 2010) and the Integrated Budget Law in early 2012.

The FSL aims to ensure that mining revenues are better managed by putting in place three complementary rules (Box 3.12.1). The FSL—if properly enforced—will make an important contribution to insulating fiscal policy from commodity price shocks and smoothing the economy’s adjustment to higher mineral output. In turn, conservative management of fiscal resources will facilitate development of the nonmineral economy.

While the 2012 government budget appears to be overly expansionary, the authorities are expressing their commitment to the FSL. The Integrated Budget Law is a comprehensive law which aims to reform the entire budget process, from investment planning to budget execution and auditing, and puts in place a new framework for fiscal decentralization. It is vital that both these laws be implemented in spirit and practice.

### 3.12.1 Fiscal rules for budget discipline

Good fiscal policy is critical for helping to ensure that mineral wealth contributes to sustainable economic prosperity. The Fiscal Stability Law will promote needed budget discipline through three fiscal rules:

- **Ceiling on structural budget deficit of 2% of GDP.** The structural deficit adjusts the budget deficit to take account of trends in major mineral prices (currently copper and coal) and their impact on government revenues. The structural balance is calculated using the moving average price of major minerals over 16 years (past 12 years, current year, and future 3 years). This provision takes effect in 2013.

- **Ceiling on expenditure growth.** Spending growth that is too fast leads to overheating and inflation and, from a budget perspective, is difficult to manage efficiently. The ceiling is the greater of the non-mineral GDP growth rate of the particular year or the average of the non-mineral GDP growth rate for the 12 consecutive preceding years. This provision takes effect in 2013.

- **Net present value of public debt must not exceed 40% of GDP.** This provision takes effect from 2014, with a transition period specified for the preceding years. It excludes any borrowing in which the government has agreed to contribute into the paid-in capital of a foreign mining entity and which is repayable from the future profits of the entity.