Continuing economic trends feature high growth and inflation, procyclical fiscal policy, and large current account deficits. GDP growth decelerated to 12.3% in 2012 from 17.5% in 2011, and inflation accelerated. Overly expansionary policies, including substantial off-budget spending, have caused internal and external macroeconomic imbalances. Over the longer term, sound public resource management and effective cooperation with private investors are needed to develop Mongolia’s energy sector in a sustainable and environmentally friendly way.

### Economic performance

Economic growth slowed to 12.3% in 2012, falling from 20.2% year on year in the fourth quarter of 2011 to 10.5% in the third quarter of 2012, after a slowdown in growth in the People’s Republic of China (PRC) curbed demand for coal, Mongolia’s biggest export. A driver of growth was infrastructure spending related to the mining boom, albeit to a lesser extent than in 2011, as the first phase of the Oyu Tolgoi copper and gold mine—among the five largest in the world—nearly completed. As a result, gross capital formation, including equipment, buildings, and intermediate goods, increased by 24.0%, markedly down from the 69.9% of 2011 but still the largest contributor to GDP growth, followed by consumption (Figure 3.12.1).

While economic growth in 2012 originated in the mining sector, it was quite broadly based (Figure 3.12.2). Construction continued to boom, raising concerns about another bubble as in 2004–2008. Mining grew by 8.9% to generate 89.2% of exports, 17% of government revenue, and 18.6% of GDP, while employing less than 2% of the workforce. Agriculture, which provides more than one-third of employment, finally emerged from the devastating winter of 2009/10 that had decimated the country’s livestock by nearly a fifth. However, growth in wholesale and retail trade slowed to 10.3% from 38.3% in 2011, as spending on investment and intermediate goods decelerated.

Inflation has remained high in Mongolia while declining in other Asian countries, owing mainly to rapidly rising government spending and higher food prices. In 2012, headline inflation increased to 14.3%, but core inflation (excluding food and energy prices) was more stable and averaged 10.5% (Figure 3.12.3).

Fiscal policy in 2012 continued to be procyclical, with the overall cash budget deficit rising to 7.7% of GDP from 4.8% in 2011 and the structural budget deficit rising to 8.3% from 6.9% in 2011. The initial government budget for 2012 projected revenue growth equal to 40%
of GDP, expenditure growth of about 32%, and a cash budget deficit of 1%. But cash revenues rose by only 11.2%, as value-added taxes and customs duties did not grow as expected. The government plans to issue $5 billion in bonds on the international market, of which $1.5 billion was sold in November 2012. The proceeds are expected to be transferred to the Development Bank of Mongolia (DBM), which is becoming a major source of public financing for infrastructure projects, corresponding to 3.6% of GDP in 2012. The Fiscal Stability Fund, mandated under the 2010 Fiscal Stability Law (FSL), held MNT328 billion in December 2012, which corresponds to 2.4% of GDP and is likely insufficient in case of a substantial shock (Figure 3.12.4).

Monetary policy has been mildly countercyclical in recent years. Mandated by law to pursue price stability, the central bank raised the policy rate in 2012 by 1 percentage point to 13.25%, as inflation rose substantially above the official target ceiling of 10%. This measure and a three-step increase in the reserve requirement ratio to 12% in April 2012 from 5% in February 2011 have contributed to a significant slowdown in money and credit growth. Broad money (M2) growth slowed from 37.0% in 2011 to 18.8% in 2012, and growth in bank credit almost halved in the same period. Although inflation remained above target, in January 2013 the central bank lowered the policy rate by 0.75 percentage points to 12.50%, citing a drop in inflation. Negative real interest rates and the recent cut in the policy interest rate indicate an expansionary monetary policy.

External trade slowed in 2012. The value of merchandise exports (mainly minerals) fell by 9% in response to a slowdown in PRC growth, while imports increased by 2.1%, widening the trade deficit. Meanwhile, a narrower deficit in the services account helped trim the current account deficit to 31.3% of GDP in 2012 from 31.5% in 2011. Foreign direct investment, largely in mining, decreased to 37.8% of GDP from 53.8% in 2011 (Figure 3.12.5). The resulting basic balance—the current account balance plus foreign direct investment—remained positive but smaller. At year-end, gross international reserves had accumulated to $4.09 billion, equal to 7 months of imports. These reserves included drawdowns from a swap line with the PRC, central bank deposit taking from the DBM, and the recent international bond issuance. Thus the share of borrowed reserves rose significantly.

In response to the 2008–2009 global financial crisis, the government adopted a broadly floating exchange rate regime toward instituting inflation targeting. However, during 2012, the central bank occasionally intervened to limit the togrog’s depreciation. This eroded how effectively monetary policy could control inflation and the adverse effects of the Dutch disease. The official exchange rate of the togrog against the dollar has fallen by 8% since April 2012, while the real exchange rate continues its trend appreciation caused by high domestic inflation (Figure 3.12.6).

**Economic prospects**

Mongolia’s medium-term economic prospects are favorable. The mining sector is expected to continue to be the main engine of growth in 2013 and 2014, with commercial production at the Oyu Tolgoi copper and gold mine starting in mid-2013. Growth is expected to accelerate to 16.5%
in 2013, before being trimmed to 14% in 2014 by capacity constraints in public investment planning and project management, a tight labor market and skill shortages, and some tightening of monetary and fiscal policies including lower off-budget spending financed by the DBM (Figure 3.12.7).

Until that tightening takes place, inflation is expected to remain well into double digits, reaching about 13% in 2013 (Figure 3.12.8). Assuming more prudent fiscal policy and some tightening of monetary policy in 2014, inflation could be brought down to 10%.

The 2013 government budget is the first prepared under the full effect of the FSL, which sets ceilings on the structural deficit, debt, and expenditure growth. These ceilings function as fiscal circuit breakers and work together to ensure fiscal discipline.

The 2013 budget foresees overall revenue growth at 28.9%; expenditure growth at 17.9%, mainly reflecting a sharp increase in capital expenditure; and an overall budget deficit of 1.1% in cash terms and 2% structural, which is the maximum allowed under the FSL. The revenue projections are overly optimistic, however, as they are not based on actual revenue outcome in 2012 but on the much higher revenue projections of the 2012 supplementary budget, setting the stage for a significant revenue shortfall and a deficit violating the FSL ceiling. The government is expected, however, to tighten public expenditure as needed in 2013 to comply with the FSL and constrain lending by the DBM.

Under the assumption of stable global commodity prices (Figure 3.12.9) and continued high economic growth in the PRC, Mongolia’s mineral-dominated exports will likely show very strong growth over the next 2 years, while imports will grow moderately in line with a slowdown in mining investments partly compensated by high growth in public investments, especially infrastructure. These developments are expected to drive the current account deficit down to 22% of GDP this year and 15% in 2014. The net effect of the start of Oyu Tolgoi operations on the balance of payments will be limited in 2013, as gross export proceeds will go mostly to repaying investment costs.

The outlook for 2013 and 2014 is subject to substantial risks. A renewed slowdown in the PRC, which absorbs almost all of Mongolia’s exports (92.6% in 2012), is the biggest external risk. A worsening of the global economy, in particular in the euro area, could also be damaging. Internal risks are expansionary monetary and fiscal policy, including off-budget expenditure, and the possibility of renewed problems in the banking sector. The price stabilization program announced in October 2012, through which the central bank provides loans at subsidized interest rates through the commercial banks to specified industries, aims to contain supply-side inflationary pressure but may intensify those from the demand side and create macroeconomic risks and distortions. The program amounts to about 14% of GDP over a 3-year period. The DBM’s operations undermine the integrity of the FSL and should be taken into account when judging the short- to medium-term macroeconomic impact and long-term sustainability of government spending. Without strong fiscal retrenchment, adherence to FSL requirements, and appropriate monetary management, inflation in the forecast period could be higher.

The fragile banking system has been reinforced, but vulnerabilities remain. Nonperforming loans fell to 4.3% of all loans in November 2012,
and the capital adequacy ratio for systemically important banks was raised to 14%, among other measures. However, the banking system continues to suffer from structural weakness related to corporate governance and risk management. Moreover, the rapid acceleration of bank lending in 2011 has masked growing problems in asset quality that can leave banks exposed.

**Policy challenge—energy security**

Mongolia’s growing demand for energy, heavy dependence on coal as its major energy source, and reliance on two big neighbors—the PRC and the Russian Federation—for increasingly important oil challenge its economic development. Rising demand for energy reflects rapid economic growth, the development of the mining industry, and the doubling of Ulaanbaatar’s population since 1995. Oil imports—more than 90% from the Russian Federation—have risen by 44% since 2003 (Figure 3.12.10).

Mongolia has vast proven reserves of coal and some oil, but their exploitation has been either delayed or inefficient (Figure 3.12.11). Coal fuels 70% of electricity generation and 90% of heating but with poor energy efficiency. Facilities are old, and electricity tariffs below market rates put proper maintenance and investment in new plants beyond the reach of undercapitalized plant operators. Ulaanbaatar has no spare capacity for power and heat. Many households unconnected to the grid use coal stoves, polluting the air in Ulaanbaatar and other urban areas.

The government has a two-pronged approach to energy vulnerability. In the short-term, it attempts to stabilize energy prices to protect consumers. To this end, oil imports have been exempted from custom duties and excise taxes in autumn and spring.

Over the longer term, the government is considering using public–private partnership to expand electricity generating capacity. It is preparing an energy master plan that defines long-term priorities and intends to build a 450 megawatt combined heat and power plant in Ulaanbaatar. This project, if successfully implemented, will show the government to be a credible partner of the private sector, which is important for developing energy resources. The government has announced plans to finish constructing its first oil refinery by 2015. Meanwhile, Mongolia has huge potential for renewable energy resources. The country’s first wind farm, at Salkhit, is expected to add 5% of national electricity supply while reducing carbon dioxide emissions. Solar resources are substantial, and there is potential for hydropower. Tapping these resources requires sound public planning and resource management and effective cooperation with private investors.