Economic growth rebounded in 2022 despite exogenous shocks. Inflation accelerated further to its highest since 2008, and the current account deficit continued to widen. Growth will accelerate in 2023 and 2024 as exports recover and impacts from exogenous shocks wane. Inflation will moderate on reduced risk of trade disruption, and the current account deficit will narrow in both years as exports increase. Mongolia needs investment climate reform to ensure sustainable growth.

Economic Performance

Driven by domestic demand, the economy recovered in 2022. Despite considerable stress and uncertainty arising from exogenous shocks, most notably restrictions on the border with the People’s Republic of China (PRC) and effects stemming from the Russian invasion of Ukraine, GDP expanded by 4.8% in 2022, following deep economic contraction by 4.6% in 2020 and sluggish growth by 1.6% in 2021. Domestic demand recovered following full reopening of the domestic economy in February 2022 with the lifting of all pandemic-related restrictions, as well as from continued fiscal and monetary stimulus. Cash transfers promoted household consumption, which contributed 4.8 percentage points to growth. Investment grew by 15.5% and contributed 6.9 points to growth, supported by monetary stimulus through long-term repo operations, private outlays, and 25.1% growth in budgetary capital spending. Government consumption increased by 5.4% but contributed a mere 1.1 points. Net exports dragged growth down by 8.0 points as the current account deficit increased by 25.8%, primarily on 30.0% higher imports of goods and services, outpacing export growth at 22.2% (Figure 2.10.1).

The service sector expanded for a second consecutive year with growth in 2022 at 6.4%, surpassing its pre-pandemic value and contributing 3.4 percentage points to growth.

Agriculture and industry other than mining rebounded from severe contraction in 2021 to grow by 13.0% and 7.1%, respectively, together contributing 3.1 points. However, constrained by COVID-19, mining contracted by 11.1% in 2022, dragging growth down by 1.7 points (Figure 2.10.2).
Inflation hit a 14-year high despite monetary tightening. Average consumer price inflation more than doubled from 7.3% in 2021 to 15.2% in 2022, with prices 13.2% higher in December 2022 than a year earlier. Significant drivers of inflation were high food and fuel prices. Average food price inflation soared from 13.8% in 2021 to 18.6% in 2022. Factors affecting prices included supply shocks associated with trade disruption caused by COVID-19 and the Russian invasion of Ukraine, currency depreciation, imported inflation, and, more recently, demand-pull inflation following a return to growth in private and public consumption (Figure 2.10.3).

The fiscal balance improved in 2022 with higher revenue mobilization. Expenditure growth by 16.5% was outpaced by budget revenue lifted by 30.4% with increased receipts from value-added tax, social insurance, income tax, and royalties and other receipts from the mineral industry, which benefitted from high commodity prices. The ratio of tax revenue to GDP increased significantly from 22.7% in 2020 to 29.4% in 2022, the highest since 2007. The primary fiscal balance recorded a surplus equal to 2.3% of GDP, and the overall surplus 0.8%. The structural fiscal deficit narrowed by 66.3% to equal 1.9% of GDP, less than half of the cap stipulated by parliament (Figure 2.10.4).

Public debt including central bank external liabilities decreased by 6.0 percentage points to equal 73.3% of GDP, 3.8 points lower than the ratio before the pandemic. In that time, central bank external liabilities fell by 16.6% and nominal GDP rose by 21.4%.
Monetary policy was tightened in 2022 in response to persistently high inflation and pressure on the balance of payments. The Bank of Mongolia, the central bank, increased the policy rate from 6.0% in December 2021 to 13.0% in December 2022 and tapered its liquidity support and its sectoral lending intended to ensure energy, foreign reserve, and food security. Bank credit growth slowed by 14 percentage points to 6.0% in 2022, but broad money supply increased by 6.5%. The value of nonperforming loans decreased by 2.6% but remained 11% above their 2019 value. Their ratio to all loans declined marginally to 9.0% (Figure 2.10.5).

Despite high inflation, the Mongolian togrog had depreciated in real effective terms year on year by 5.6% as of December 2022 because of 12.0% depreciation in nominal effective terms. Despite the central bank repeatedly intervening in the foreign exchange market to smooth exchange rate volatility, the togrog depreciated by 20.9% against the US dollar in 2022 (Figure 2.10.8).

Exogenous shocks intensified pressure on the balance of payments. The current account deficit expanded by 25.8% to equal 15.8% of GDP as imports of goods increased by 27.6%, outpacing 20.4% growth in exports and thus lowering the merchandise trade surplus to the equivalent of 6.9% of GDP. The service deficit expanded by 34.9%, but the deficit in income balance improved by 13.5%, mainly on lower expatriation of investment income (Figure 2.10.6). The financial account surplus remained flat in 2022, and the overall balance of payments recorded a deficit of $727 million. Foreign exchange reserves decreased by 22.1% to $3.4 billion, or cover for 3.4 months of imports of goods and services, 2.3 months less than in 2021 (Figure 2.10.7).
Economic Prospects

The economy is transitioning to post-pandemic expansion. The PRC’s recent economic reopening, robust demand for mineral commodities, and a comparatively stable outlook for coking coal and base metal prices are easing economic uncertainty, boosting economic confidence, and changing previous gloomy growth expectations despite tightened financing conditions globally and domestically. The reopening of the PRC economy will revive the Mongolian economy, notably through export and tourism recovery and lessened risk of trade disruption. Moreover, international reserves started to rise from August 2022, and the government has successfully refinanced maturing sovereign bonds and maintained access to international capital markets.

Growth is forecast to rise to 5.4% in 2023 and 6.1% in 2024, assuming no new exogenous shocks. Economic expansion will be driven by the completion of the Oyu Tolgoi underground mine development project in 2023, recovery in mining, and positive spillover to transport and other pursuits. Consumer spending will be dampened by tightened monetary policy and a resumption of home mortgage repayments since the beginning of this year. The contribution of private consumption to growth will be lower this year before increasing next year, assuming monetary tightening gives way to gradual easing as inflation recedes, and that growth in consumer credit accelerates in 2024.

The contribution of investment to growth will also be tamped down this year as bank credit to businesses will grow only moderately as bank lending becomes more cautious in the runup to expected initial public offerings of the remaining three systemically important banks by the end of June 2023. Fiscal policy will remain expansionary. The 2023 budget has capital expenditure growing by 24.5%, despite no new capital projects financed or implemented in 2023, and all expenditure growing by 14.3%. The government plans to increase spending in 2024 on the assumption of strong revenue. Net exports will contribute to growth this year and next as import growth is outpaced in both years by exports expanding on increased exports of coal, copper concentrate, iron ore, and crude oil, and on the expansion of copper production from the Oyu Tolgoi mine. Exports should be facilitated by a more efficient transport and logistics system, including new railways built for transporting coal from mines to border crossing points, automated customs clearing, and coal sales based on a competitive bidding process.

Inflation will moderate in both years, and the current account deficit is expected to narrow. Average inflation will moderate to 10.9% in 2023 and 8.7% in 2024 as supply shocks and trade disruption risk wane (Table 2.10.1). However, it will still exceed the central bank target of 6%, mainly on pass-through of togrog depreciation and revived domestic demand. More aggressive fiscal consolidation will support the external balance and reduce how much tight monetary policy crowds out the private sector. The current account deficit is projected to diminish in both years mainly as merchandise exports increase and the service deficit narrows with lesser trade disruption, consequently lower risk premiums for shippers, and lower transportation service charges.

Table 2.10.1 Selected Economic Indicators, %

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2021</td>
<td>1.6</td>
<td>7.3</td>
</tr>
<tr>
<td>2022</td>
<td>4.8</td>
<td>15.2</td>
</tr>
<tr>
<td>2023</td>
<td>5.4</td>
<td>10.9</td>
</tr>
<tr>
<td>2024</td>
<td>6.1</td>
<td>8.7</td>
</tr>
</tbody>
</table>

GDP = gross domestic product.

There are downside risks to the outlook. They include a worsening situation regarding the Russian invasion of Ukraine, new COVID-19 variants or waves, a significant commodity price correction, domestic political risks, and the adverse implications of offtake barter agreements, whereby development projects such as railway construction, for example, are financed and implemented by local contractors and foreign coal importers, who the major state-owned coal exporter repays through future coal contracts and proceeds. These contracts are insufficiently transparent and can reduce proceeds from coal exports.

Policy Challenge—Designing and Implementing Investment Climate Reform

Growth depends heavily on foreign direct investment (FDI), but this is likely to fall in 2024. Mining and the broader extractive industry has been a key driver of economic growth, but its business cycle is highly volatile because it depends on FDI and PRC demand for minerals. Indeed, 72.8% of FDI stock was in mining and other extractive industries in 2010–2022. FDI peaked at the equivalent of 43.1% of GDP in 2011, slumped in 2013–2016, and historically has been key to financing a persistent deficit in the current account. Absorbing 50%–90% of net FDI annually since 2010, Oyu Tolgoi, one of the world’s largest copper mines, will complete its underground mine project in 2023. Investment outside of mining with more potential to create jobs is insignificant, posing a major challenge to export and economic diversification.

Several major constraints degrade Mongolia’s investment climate. They include (i) macroeconomic risks in a volatile business environment in which GDP growth fluctuated from 17.3% expansion in 2011 to 4.6% contraction in 2020, as well as a deteriorating ranking for ease of doing business since 2017; (ii) policy procyclicality and instability; (iii) a lack of good governance, with a regulatory quality index historical showing negative values except in 2018 and 2019; (iv) underinvestment in infrastructure and logistics; (v) skill mismatch in the labor market; (vi) poor investment promotion and protection; (vii) an uneven playing field for businesses caused by public intervention in markets; and (viii) climate risks.

Mongolia needs to design and implement comprehensive investment climate reform. This is essential to sustain economic growth over the medium term and create an enabling environment for development led by the private sector. The government has initiated some measures to improve the investment climate. It has formed an agency to encourage foreign investment and trade and established a working group to improve the legal environment. These measures should be strengthened by a more comprehensive, practical, and targeted action plan that includes the following pillars: (i) fully operationalizing the newly established trade and investment agency to set specific targets for attracting, promoting, retaining, and protecting FDI; (ii) revising the Investment Law to improve the legal and regulatory environment and to ensure investment protection; (iii) improving Mongolia’s indicators for governance, government effectiveness, the business environment, and logistics performance; (iv) developing a credible commitment to combating corruption at all levels and ensuring that all public institutions maintain high standards of governance; (v) proactively investing in infrastructure, health, education, and the environment; and (vi) promoting industries with export potential and mobilizing green finance. Working groups should be established to thrash out the details under each of these reform headings and action plans for their implementation.