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Mongolia Quarterly Economic Update

The World Bank

The World Bank's *Mongolia Quarterly Economic Update* assesses recent economic and social developments and policies in Mongolia. It also presents findings of ongoing World Bank activities in Mongolia. The Update is prepared by a team from the World Bank's Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Region Vice-Presidency, consisting of Munkhnasan Narmandakh, Tehmina Khan, and Altantsetseg Shiilegmaa, and led by Zahid Hasnain. Copies can be downloaded from http://www.worldbank.org.mn. For further information, comments and questions, please contact Tina Puntsag (tpuntsag@worldbank.org).

Contents

Figures

Tables

Abbreviations and acronyms

bn	Billion
BoM	Bank of Mongolia
CPI	Consumer Price Index
DBM	Development Bank of Mongolia
FX	Foreign currency
FSL	Fiscal Stability Law
GDP	Gross Domestic Product
HDF	Human Development Fund
LC	Local currency
LHS	Left hand side
MFA	Mongolian Financial Association
mn	Million
MNT	Mongolian togrog
MoF	Ministry of Finance
mom	Month-on-month
mt	Metric ton
NPL	Non-performing loan
NSO	National Statistics Office
OT	Oyu Tolgoi
RHS	Right hand side
tn	Trillion
US$	United States Dollar
WPT	Windfall Profit Tax
yoy	Year-on-year
YTD	Year-to-date

Executive Summary[1]

The Mongolian economy is at the start of a huge expansion as it begins to develop its mineral wealth. The construction of the Oyu Tolgoi (OT) copper-gold mine – among the five largest in the world – lifted GDP growth above 17 percent in 2011 and the economy has since continued to grow in double-digits, albeit at a slower pace. Mongolia's medium term prospects are promising as the OT and Tavan Tolgoi (TT) mines go into production, with economic growth projected to be in the double digits, with sustained increases in exports and fiscal receipts.

The economy however, faces significant risks in the near term, as reflected in the steep drop in exports in July and August. These risks reflect an uncertain global economic outlook and slowing growth in China, and pro-cyclical fiscal policy over the past three years with large increases in government spending contributing to high inflation and pressure on the balance of payments. Any delay in commercial production at the OT mine could also impact the near term growth outlook. Mongolia has set up a stabilization fund in 2011 as required by the FSL and so far it has saved only a small amount (about 2.2 percent of GDP) which is likely to prove insufficient in case of substantial shock. The 2013 budget, being discussed in the on-going fall session of Parliament presents an opportunity to mitigate these risks by reining in spending and anchoring fiscal policy to the Fiscal Stability Law that goes into effect on January 1, 2013.

Growth slowed in Q2 to 11 percent year-on-year (yoy) from 16.5 percent in Q1, but should remain in double digits for 2012 as a whole, barring any severe negative shock. Exports fell by 39 percent yoy in August, the largest fall since mid-2009, driven mainly by a drop in exports (mostly coal) to China. The current account deficit meanwhile has continued to widen, although it currently remains funded by Foreign Direct Investment (FDI) flows. However further deterioration is possible with exports falling faster than imports. FDI flows are also expected to start easing next year as the construction of the OT mine comes to a close. Due to intermittent intervention by the Bank of Mongolia to limit the depreciation of the togrog, net foreign exchange reserves (excluding BoM borrowing from the Chinese central bank, deposits by the Development Bank of Mongolia and by domestic banks) have been declining steadily and are at a two-year low of US$ 1.4bn.

Inflation has eased slightly in recent months, but remains persistently high, due to high food prices and expansionary fiscal policy which has led to demand side pressures in an already overheating economy. The headline rate was 15.9 percent in August, with the increase in the index driven mostly by the increase in food, notably meat, prices. The prices of meat and milk products – these represent 10 percent of the consumer price index- rose by 49.5 percent yoy in August. Core inflation, excluding all food and energy prices, also remains high at about 10 percent since the start of the year.

On account of weak revenue growth due to the slowdown in exports and lower commodity prices, and sustained expenditure increases, the fiscal deficit for 2012 is projected to increase from the original target of 1 percent to 4.2 percent as per the September amended budget. The actual outturn may be worse — the International Monetary Fund recently highlighted that the supplementary budget did not take into account the full extent of the deceleration in revenue growth so far this year, particularly for VAT and customs duties— as budgeted expenditures have not been reduced significantly and growth forecasts remain overly optimistic. These numbers also do not reflect the significant off-budget

[1] The analysis is based on data until August (or latest) from the Bank of Mongolia (monthly bulletin, balance of payments, loan report and monthly consolidated banking system balance sheet), the National Statistical Office (monthly bulletin), relevant government authorities and international databases.

financing of capital expenditures by the Development Bank of Mongolia (DBM) and by construction companies on condition of repayment by the budget ("build-transfer" schemes), which will likely impact the budget next year and beyond. Including DBM spending, the deficit could reach 9 percent of GDP in 2012. Although the OT mine is expected to start producing early next year, net revenues from the mine are only expected to enter the budget with a lag (around 2015-16).

The financial market also remains vulnerable. Although monetary tightening over the past year has helped to slow the pace of credit growth from 73 percent at the end of 2011 to 37 percent in August, it is still high. Mongolia's banking system remains highly dollarized, with approximately a third of deposits denominated in dollars and easy convertibility out of the Togrog. A sharp economic slowdown or increased macroeconomic instability could cause risks to individual banks and to the overall financial system.

Given the macroeconomic risks and the expected continued slow growth of the global economy, Mongolia's policy-makers need to be cautious. The immediate requirement is a more conservative fiscal policy stance – it does not call for an austerity plan but requires that government spending does not increase faster than the GDP and is prioritized in a way that unlocks infrastructure bottlenecks and promotes long-term growth through investments in social sectors. The ongoing parliamentary budget session provides an opportunity to rein in government spending (both on and off-budget via the DBM) and to abide by the rules of the Fiscal Stability Law (FSL) that goes fully into effect in January 2013. Safeguarding the FSL will also require correcting some of the weaknesses in the Law of the Development Bank. The BoM should maintain the floating exchange rate regime with interventions in the foreign exchange market limited to smoothing out excessive volatility in the exchange rate without attempting to reverse the underlying trend. The BoM will also need to remain vigilant with respect to banking sector risks.

Real sector developments

Growth is slowing but remains high

The pace of economic expansion has slowed compared to the start of the year, but overall growth remains high. Final National Statistical Office (NSO) data released in July show that the economy grew by 11 percent yoy in the second quarter of 2012, after expanding at 16.5 percent (Fig 1) in Q1. The NSO also revised GDP growth for 2011 from 17.3 percent to 17.5 percent.

Growth was supported by strong outturns in construction and agriculture

Growth in the construction sector has rebounded, with output expanding by 40.2 percent following a contraction of 11.2 percent in Q1. Agriculture too is showing signs of finally emerging from the devastating "dzud" (severe weather conditions) that had decimated nearly a fifth of the country's livestock. The sector grew by 18 percent for the second consecutive quarter, and together with construction, added 4 percentage points (pp) to GDP growth in Q2, much larger than the growth contribution of any other sector. Communication, electricity and other services added another 4.2 pp with communication growing by 23.9 percent in Q2 following an outturn of 17.6 percent in Q1. Wholesale and retail trade sector however, grew by only 3.6 percent yoy in Q2, contributing only 0.4 pp to growth. This compares with an average growth of 37 percent and contribution of 3.5pp in the previous five quarters.

There are signs of capacity constraints, particularly with regards to the transport sector

The transport sector contracted in the second quarter by 3.1 percent, after growing by 14.1 percent in Q1. While some of this weakness can also be attributed to slower economic activity as a result of the election in June, transport bottlenecks are also contributing to increasing lead times for import shipments and negatively impacting the transport sector. Going forward, transport capacity constraints are likely to prove a significant impediment in implementing the massive road building and social housing plans announced by the government and private sector housing developments plans.

And recent industrial production data suggest that mining is set for a slowdown in the near term

GDP data show that the mining sector continued to perform well (up 9.1 percent) during the second quarter with a positive contribution to GDP growth of 1.4 pp. However, more recent industrial production data show mining sector output contracted by 6 percent yoy in August. There has been a particularly sharp contraction in coal and lignite mining and quarrying – output contracted by 50.3 percent yoy in July followed by a fall of 17.6 percent in August. With mining accounting for approximately 60 percent of total industrial output, the latter too has slowed to just 2 percent yoy in August (or 6 percent on a 3-month-moving-average basis). Manufacturing growth however remains strong, rising by 10 percent[2] and supported by manufacturing of basic metals (up 9 percent) and food and beverages (up 23 percent) in August (Fig 2).

2012 growth projections have been revised down, but the outlook should improve once the OT mine begins commercial production in 2013

With the European debt crisis continuing to simmer, growth in the US and Japan expected to remain weak for the foreseeable future and with China unlikely to provide as much support to the global

[2] On a 3 month moving average basis

economy as it did in 2009, downside risks remain large. Economic activity data from China show that its economy is continuing to cool and that Chinese demand for commodities, which had underpinned high global commodity prices, is also weakening. Indeed this is already borne out in Mongolia's export and fiscal data, both of which show sharp yoy declines in receipts since July reflecting weak commodity exports.

Accordingly growth is likely to slow further in the second half of the year and the outturn for the year as a whole is likely to be close to 12 percent barring any negative shocks to the global economy. If however, substantial downside risks to the global economy do materialize then growth could be lower, at below 10 percent. Momentum should however recover once the OT mine begins commercial production and copper and gold output and exports increase. Currently small quantities of ore are already being extracted and stock-piled from open pit operations from the OT mine. Subject to power availability from China, Phase 1 of the mining operations are scheduled to begin by the middle of next year when ore from the open-pit can be processed and made available for sale.

Table 1: Mongolia growth scenarios

Scenario	2011	2012	2013	2014
Original Baseline 1/	17.3	17.2	11.8	12.3
Current Baseline 2/	17.3	11.8	16.2	12.2
Global slowdown similar to 2009 3/	17.3	10.5	15.1	11.9
Deeper global slowdown 4/	17.3	9.0	14.4	11.5

Source: World Bank projections

Notes: A "slowdown similar to 2009" refers to a scenario where the G3 slow and major commodity prices drop. A "deeper global slowdown" adds to this projection a slowdown in China as well.

1/ Baseline projections in March and June 2012. 2/ Current baseline projections as of September 2012. 3/ Assumes severe downturn in G-3, large drop in commodity prices, but relatively robust growth in emerging market economies. 4/ Assumes severe downturn in G-3, larger drop in commodity price and also weakness in emerging market economies.

Inflation

Inflation has retreated slightly but remains high

The headline inflation rate eased to 15.6 percent in August after peaking at 17.8 percent in April (Fig 3). However, inflation has remained in double-digits since the start of the year. The BoM has responded by increasing its policy rate by 225 basis points, to 13.25 percent, and by raising the reserve requirements by 700 basis points, to 12 percent. This monetary tightening has been associated with a considerable slowdown in credit growth, from 72 percent in 2011 to 37 percent (year on year) in August 2012. However, fiscal policy has been working at cross-purposes from monetary policy, with rapidly increasing government spending largely responsible for the overheating of the economy.

Fig 1 The economy grew by 11 percent in Q2

% point contributions to GDP growth, yoy

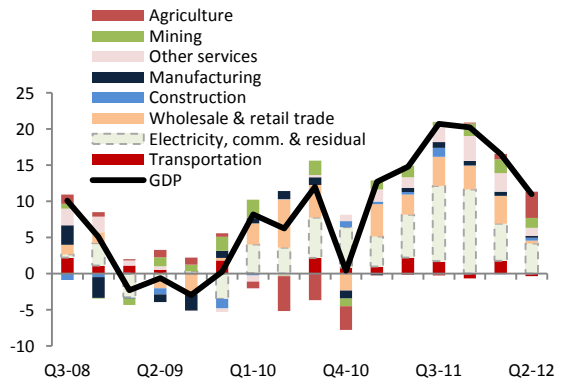


Fig 2 Growth in industrial output is slowing

Industrial output, 3 month moving average % yoy, 2005 constant prices

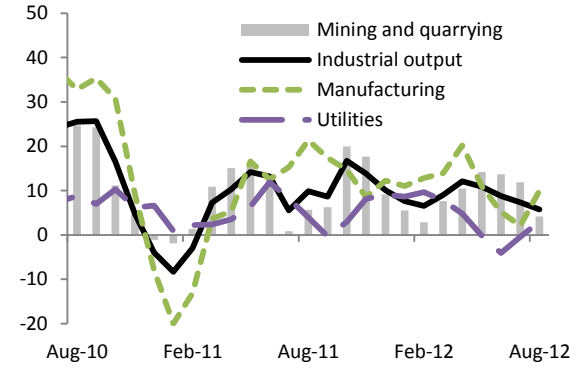


Fig 3 Inflation has eased slightly but remains high…

Percentage point cont'ns, % yoy, UB

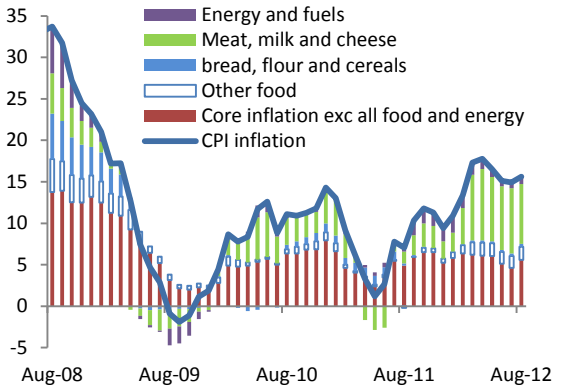


Fig 4 … reflecting rising food prices, notably of meat

% yoy

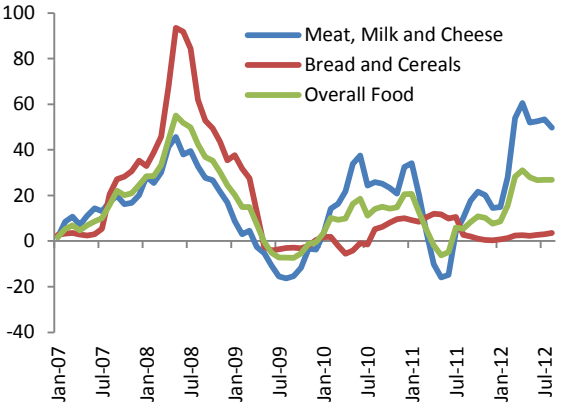


Fig 5 Real wages in informal labor markets in UB continue to increase

No of workers Av. real wages, MNT

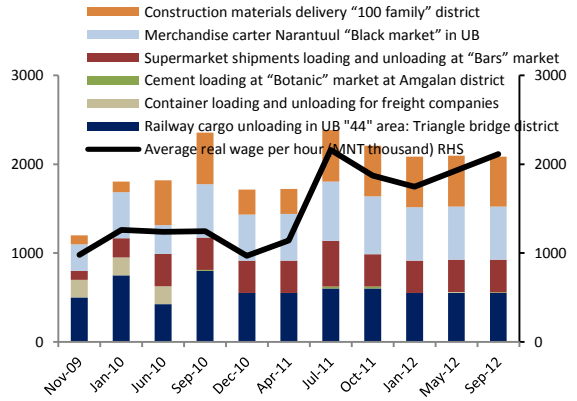
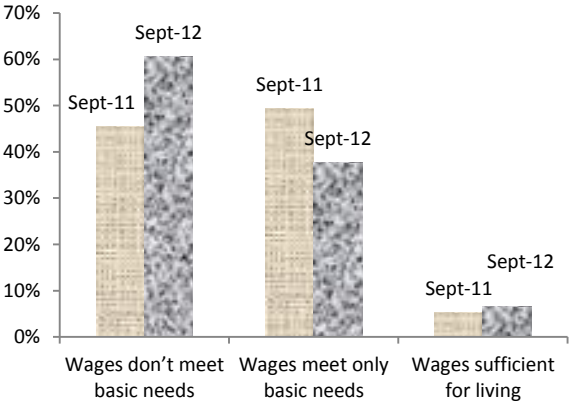


Fig 6 But nearly 60 percent of those surveyed reported that wages were insufficient to meet basic needs

% of total surveyed



Sources: NSO, BOM, WB staff estimates.

Food inflation remains high with the overall food index rising by 26.9 percent in August, slightly slower than the 31 percent in April. Food prices continue to be pushed upwards mainly by meat, milk and cheese prices (Fig 4) which rose by 49.5 percent in August and contributed 7.1 pp to the overall headline inflation rate. The rise in global food prices, and large cash transfers that have reduced the need for herders to sell their livestock for meat, have been factors. With food accounting for a third of the CPI basket (meat accounts for 10 percent), the high rates of increase in food prices only serve to undermine the real income and spending power of poorer households. Indeed as discussed below, surveys of informal workers suggest that despite rising real wages, poor households are finding it increasingly hard to meet basic needs compared to a year ago. Core inflation, meanwhile, has averaged 10.3 percent since the start of the year reflecting generalized wage and price pressures in an economy, and pass through from high food prices.

Labor Markets and Poverty

Registered unemployment is falling

Formal unemployment figures which include only those who are registered with the Labor and Social Welfare Service Center show a decrease in the unemployment rate to 3.8 percent in August, down from 4.4 percent in April 2012. The overall number of registered unemployed decreased to around 43 thousand persons from 54 thousand since April 2012. However these numbers have tended to underestimate the true extent of unemployment, which is better gauged through labor force surveys[3]. The last survey from the NSO for Q4 2011 estimated the unemployment rate at 9 percent, down from 13 percent in Q4 2010.

Real wages in informal labor markets continue to increase

Surveys conducted by the World Bank in informal labor markets in September 2012 show that, on average, real wages reported by workers are some 13 percent higher than a year ago (Fig 5). In addition, workers indicated that demand for their services remains strong so far particularly in the construction materials market where nominal wages are reported to have increased by 20 percent compared to a year ago.

However the survey also continues to show that purchasing power remains weak and finances tight. Some 60 percent of those surveyed also indicated that their earnings were insufficient to meet their basic needs, 15 percent higher compared to a year ago (Fig 6). The survey also indicated that a quarter of the survey participants were unskilled workers from rural regions (compared to 28 percent a year ago) and that nearly 40 percent of surveyed workers were working in the informal sector because of the unavailability of formal jobs (compared to 46 percent a year ago).

Fiscal developments

Government spending continues to grow rapidly despite a slowdown in revenue collections

Government spending in the first eight months of the year was 42 percent higher in nominal terms and 20 percent higher in real terms compared to the same period last year (Fig 8). Capital expenditures

[3] These also take into account those who are not officially registered as unemployed with the Labor and Social Welfare Service Centers.

grew by 82 percent yoy in August on a year-to-date (YTD) basis, contributing to two-thirds of the overall growth in expenditures. Current spending on wages and salaries[4] and the purchase of goods and services rose by 41 and 33 percent respectively (in nominal terms, YTD basis).

As highlighted in previous Quarterlies[5], the extraordinarily large expansion in capital spending is stretching the already limited capacity of the government to effectively plan, appraise, and implement projects, raising concerns about the quality of this spending. There are also signs that the construction sector has been unable to scale up to meet this rising demand resulting in rapid increases in the prices of construction materials, again pointing to the limited absorptive capacity of the economy.

Spending on transfers was some 40 percent higher in the year to August, compared to a year ago. This mainly reflects other inter fiscal transfers (mainly transfers to the private hospitals and resorts) up by 92 percent, and other current transfers up by 40 percent due to social insurance and welfare pension payments out of the SIF.

Revenues have failed to keep pace with expenditures (Fig 9) as slowing growth in China and weaker global commodity prices have resulted in a slowdown in corporate income tax, excise taxes, and VAT on imports. Revenues increased by 13 percent in nominal terms YTD in August, or declined by 3.8 percent in real terms, compared to 47 percent real increase a year ago. The slippage resulted mainly from weakness in corporate income tax (CIT) receipts which contribute slightly more than 10 percent of total revenues in Mongolia. In year-on-year terms, monthly CIT receipts have been falling since May, by an average of 30 percent. Dividends from mining companies and revenues from excise taxes have been similarly weakening in recent months, and were down 4.5 percent and 6.4 percent respectively (YTD basis). The withdrawal of customs tax and excise taxes on imported petrol and diesel fuel in May and November of last year has reduced the excise tax base and resulted in a loss of revenues (importers of petrol only pay VAT). VAT receipts on imported goods (mostly mining equipment) fell by 22 percent yoy in August as the construction of the OT mine neared completion, with equipment imports expected to fall further (these amounted to a sixth of revenues in 2011).

The fiscal deficit is likely to be higher than what is projected in the 2012 amended budget due to overly optimistic revenue projections

The experience of 2012 underscores the importance of realistic revenue targets. The original 2012 budget (passed in late 2011) was based on overly optimistic macroeconomic assumptions with regard to the growth of imports, privatization revenues, tax prepayments and signature fees associated with an agreement with foreign mining companies to develop Tavan Tolgoi's Western Block. On the basis of these assumptions, it was estimated that a 32 percent increase in spending was possible on 2011 outturns, while containing the fiscal deficit to 1 percent of GDP.

With GDP growth remaining strong, the budget was amended in February with revenues and expenditures projected to be some 2-3 percent higher than in the original budget. However, as discussed above, the revenue projections have failed to materialize: mining sector receipts (CIT, dividends, VAT on imported equipment) have been much weaker than anticipated, while income projected from the TT mine and privatization of some state owned enterprises[6] has also disappointed.

[4] Reflecting the second phase of the increase in public sector wages by a further 23 percent on May 1, 2012 following an increase in February of MNT 80,000 per worker per month

[5] www.worldbank.org/mongolia

[6] The State Bank

The revenue shortfall has in turn required a second amendment to the budget. These amendments mainly reflect revisions to revenue assumptions. For instance, under the February amendment, coal export volumes had been projected at 31.5 mn tonnes, which were revised to 22.8 mn tonnes under the second. Copper price estimates for the budget were also revised down to reflect the fall in international copper prices over the summer: previously forecast at US$ 9760.5, these are now US$ 7970. Coal (molybdenum and coking coal) export prices were also adjusted downwards by 23-29 percent compared to the budget approved in February.

Overall, the revenue intake is now projected to be MNT 694 bn (11 percent) less than in the first amendment. However, there has been no similar downward revision to expenditures which have been cut by only MNT 156 bn resulting in a fiscal deficit of over MNT 680bn or 4.2 percent of estimated GDP (Table 1 and Table 2). Although MNT 284 bn of domestic investments were cut in the second amendment, MNT 125 bn worth of subsidies and transfers were added onto the newly approved budget: indeed subsidies and transfers now account to 37 percent of the entire expenditure with an additional MNT 141 bn budgeted compared to the original 2012 proposal. Moreover, part of the reduction in capital expenditures were done by transferring the projects from the budget to the DBM (MNT 113 bn of the MNT 284 bn were transferred), an artificial reduction that will have to be financed by the budget over the next two years.

The GDP assumptions have also not changed compared to the first amended budget, despite indications the pace of economic growth has slowed since Q1. [7]

Beginning in 2011, the government has been saving excess structural revenues in a Fiscal Stability Fund. Allocations to the fund amounted to MNT 241 bn or 2.2 percent of GDP. However, due to lower than anticipated revenues, allocations for 2012 have been substantially cut in the second amendment to only one-third of the level in the February amendment (from MNT 322 bn to MNT 101 bn).

The fiscal space is constrained in the near term and the government will have to significantly control expenditure growth to achieve the fiscal targets of the Fiscal Stability Law. Net revenues from the OT project will enter the budget with a lag (primarily on account of the government's investment share borrowing and tax prepayments from the mining conglomerate). The budget should take into account that any delay in the OT project could (for example, due to delays in power supply from China needed to process the copper ore) undermine public balances which are already stretched.

The deficit will also be higher because of significant off-budget financing from the Development Bank of Mongolia and build-transfer (BT schemes)

Mongolia learned from the 2008-09 crisis and passed the Fiscal Stability Law (FSL) to smooth the effect of mineral price volatility, limit expenditure growth to avoid over-heating of the economy, and to ensure long-term fiscal solvency through caps on public debt. The experience so far in 2012 underscores the importance of strictly adhering to the FSL in 2013, when it becomes fully operational. There is a risk however, that excessive lending by the DBM, in particular for non-revenue generating public infrastructure projects; and, to a lesser extent "build-transfer" (BT) projects in the roads and energy sectors that were financed by construction companies themselves on the condition of repayment from the budget at a later date will undermine the logic of the FSL. Such off-budget capital spending is

[7] The 2012 GDP projection was not changed from the first amendments and remains at MNT 16133 bn in the second amendment.

projected to be approximately 4 to 5 percent of GDP in 2012, thereby increasing the fiscal deficit to 9 percent, and likely to be higher in 2013 as per the current plans.

The regulatory framework for the Development Bank of Mongolia's law needs to be strengthened

The lending operations of the DBM are not covered under the structural balance or the expenditure rule of the FSL (DBM borrowings are covered under the debt rule). This implies that the logic of the FSL —to smooth volatility and to prevent over-heating of the economy from excessive infrastructure spending — is undermined. These risks are particularly high given both the scale of DBM lending and the nature of the projects that the lending is going to. In 2012, the DBM plans to disburse US$ 600 million in lending to projects in roads, railways, utilities, urban housing, the Sainshand Industrial Park, and urban housing. This US$ 600 million is equivalent to about half of the disbursement from the state capital budget. A number of these projects, in particular roads which makes up US$ 150 million of the loans, are social benefit projects that will not generate revenues, and for which funding from the state budget will be needed to repay principal and interest.

It is imperative that there be a clear policy from the government that: (a) there are some limits on the aggregate lending of the DBM to ensure alignment with the principles of the FSL, in particular the expenditure rule; (b) that the DBM only funds revenue-generating projects; or (c) if it is to fund social benefit projects then the amount of lending to such projects (e.g. the US$ 150 million for the roads) would be reflected in the state budget and so would be capped by the expenditure limit of the FSL. Experience in other countries has shown that without such a clear policy there is a real risk that the DBM will be used as a non-transparent way to finance non-priority or non-viable infrastructure projects, or to bypass fiscal limits, which ultimately requires costly budget-funded bailouts as the projects financed by the DBM do not generate sufficient cash to pay back the creditors.

Implementing such a policy to ensure that the DBM can meet the long-term infrastructure needs of Mongolia in a manner that is macro-economically sustainable will also require correcting several weaknesses in the Law on the Development Bank. When the Law is compared to good examples of development banks from other countries, such as Brazil, South Africa, Canada, Korea, and Turkey, several problems are apparent (Box 1):

Box 1: Weaknesses in the Law of the Development Bank of Mongolia

The DBM's regulatory framework has the following main weaknesses that need to be urgently addressed:

- Insufficient clarity on the mandate: Article 8.1 of the Law sets the mandate of the DBM as to finance large-scale development projects and programs approved by the parliament, with Article 10.1.3 elaborating that these projects should enhance economic growth and be oriented towards value-added goods. The mandate makes no explicit reference to cost recovery, implying that the DBM can fund projects that should ideally be funded through tax revenues.

- An imbalance in the authority of the parliament vis-à-vis the DBM board on the choice of projects to finance: Article 8.1 of the Law states that the DBM must finance projects approved by the parliament, and that this list will be approved by the parliament annually in its spring session. This requirement compromises the DBM's independence. While the Government, as shareholder, can certainly establish priorities for DBM lending, specific projects should be technically evaluated by the DBM and approved by its management or the board of directors.

- Lack of sufficient independence of the board from the government: Article 17 states that the board will be selected and dismissed by the Government, and independent members will be in a minority (3 of 9). Article 22.1.10 further specifies that board members can be appointed for a period "up to 3 years" and that the Government has authority to dismiss a board member prior to the completion of his/her turn. In order to preserve independence, the more successful development banks provide stronger tenure protections, with board members appointed for a fixed tenure, ideally with the tenure not coinciding with the electoral cycle, and with a due process specified for their termination. Article 22.1.5 allows the government to "have a direct contact with the bank and other authorities regarding credit policy of the Development Bank and its implementation, and express its stand". This potentially opens the DBM to political interference, and is contrary to the stated principle in Article 6.1.2 of the DBM's independence.

- An insufficient oversight role for the MoF: It is often recommended that the Ministry of Finance has a strong presence in the board to minimize fiscal risks. This presence of the MoF is particularly recommended for the DBM given the huge increases in capital expenditures going forward and the particular risks associated with mineral price volatility.

- Lack of a clear supervision function: Good practice in the regulation and supervision of development banks requires the state to separate its ownership and supervisory roles. The supervisory function should aim to protect the state against credit risk and the private sector from unfair competition, and to ensure that the institution is transparent, and undertakes sufficient risk management, monitoring, and evaluation of its projects. The supervisor should have the appropriate legal capacity to take remedial action when the institution fails to meet requirements. The Law on the DBM does not clearly specify the role of the supervisor. The MoF has oversight responsibilities on the issuance of loan guarantees, and the DBM is required to provide the central bank of Mongolia (BOM) with financial reports. However, this falls far short of the necessary supervision function. Ideally, the DBM should be supervised by the BOM.

- Excessive authority to lend: Article 24 sets the maximum loan-to-equity ratio at 50:1, implying a capital ratio of 2 percent, and Article 13 allows the DBM to issue loan guarantees to third parties. These are very lax standards that can create undue fiscal risks for the Government. Capital ratios of between 12 percent and 30 percent are more common among the better-performing development banks.

It is advised that the government issue and implement a clear policy on the DBM along the lines outlined above and amend the Law on the Development Bank to address these weaknesses.

"Build-Transfer" Schemes should be discontinued

In 2008, a Mongolian parliament resolution allowed "build-transfer" (BT) projects in the roads and energy sectors that were financed by construction companies themselves on the condition of repayment from the budget at a later date. The number of such schemes increased from 3 percent of the total cost of budget-funded projects in 2008 to over 25 percent in 2009 and 2010, and remains sizeable today. These BT schemes weaken the FSL as spending on them is not reflected in the budget in the current fiscal year, even though the construction activities are taking place, and shows up later when repayments are due. The BT schemes for rural roads are also a particularly expensive financing option as construction companies need to borrow at commercial rates to finance them rendering these projects an estimated 25 percent to 30 percent more expensive than the equivalent budget-funded project. These schemes involve very little transfer of risk from the government to the private sector partner, and the increase in the financing costs of the project — which will eventually be passed back to the budget

— is not compensated with any efficiency gains in delivering the services involved. Therefore, it is important that the government discontinue these BT schemes as they are a bad practice and finance such projects from the budget, following proper feasibility studies, design, and competitive bidding process.

Table 1 Aggregate indicators for the Budget Framework under the MTBF in comparison (% of GDP)

	MTBF 2011	MTBF 2012	MTBF 2013	2012 First amendment	**2012 Second amendment**
Floor on total budget revenue	35.4	35.4	30.3	37.2	**34.3**
Ceiling on total budget expenditure	40.4	39.4	32.3	40.1	**39.1**
Ceiling on total budget deficit	-5.0	-4.0	-2.0	-2.9	**-4.8**
Floor on capital expenditure	6.3	6.0	4.7	12.4	**10.7**

Source: World Bank , MOF Budget document

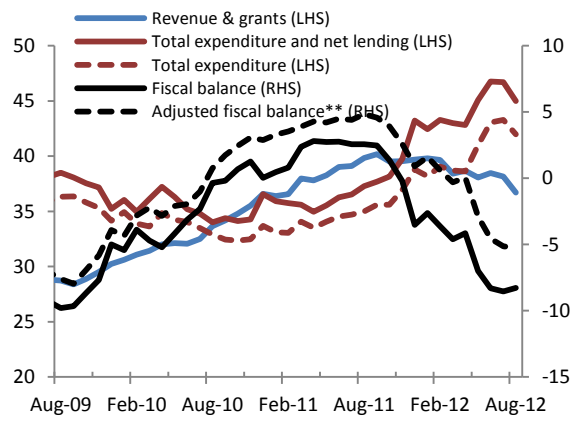
Table 2: 2012 Budget Amendments (% of GDP)

	2011 Actual	**2012 Feb Amend**	**2012 Sep Amend**	**% change from 1st Amend**
Total revenues and grants	44.0	39.2	34.9	-11%
Structural revenues and grants	41.6	37.2	34.3	-8%
Tax revenues	36.1	30.6	30.5	0%
CIT	5.4	4.1	4.1	0%
PIT	2.3	1.7	1.8	4%
Non-Tax Revenues	5.4	6.6	3.7	-44%
Mining-related revenues	11.7	11.4	10.9	0%
Total Expenditure & net lending	49.2	40.1	39.1	-2%
Current Exp	31.9	28.0	28.6	2%
Wages &Salaries	7.9	7.6	7.6	-1%
Goods & Services	6.9	5.4	5.4	1%
Subsidies & Transfers	1.2	0.7	0.7	9%
Capital Exp	15.5	13.2	13.9	5%
Domestic Investment	10.1	10.5	8.7	-17%
Capital Repairs	0.5	0.3	0.3	6%
Non-mining balance	-16.5	-12.3	-15.2	28%
Primary balance	-9.6	-1.7	-3.9	
Overall Bal inc grants	-5.2	-0.9	-4.2	
Structural balance	-7.6	-2.9	-4.8	
Revenue allocated to Fiscal Stability Fund	2.2	2.0	0.63	-69%

Source: World Bank, MOF Budget document

Fig 7 Fiscal balances have deteriorated in recent months …

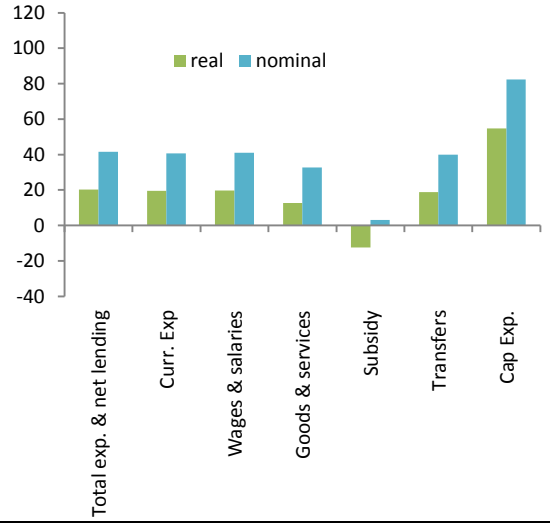
% of GDP* % of GDP*



Note: *GDP interpolated using actual GDP data until 2011 and WB estimates thereafter ** Adjusted fiscal balance excludes net lending from expenditure, leaving current and capital expenditure only.

Fig 8 … as government spending remains high, mostly on capital projects

% yoy increase in expenditures, YTD August 2012



Sources: MoF, NSO, World Bank staff estimates

Fig 9 While revenues have been weakening

% yoy increase in revenues, YTD August 2012

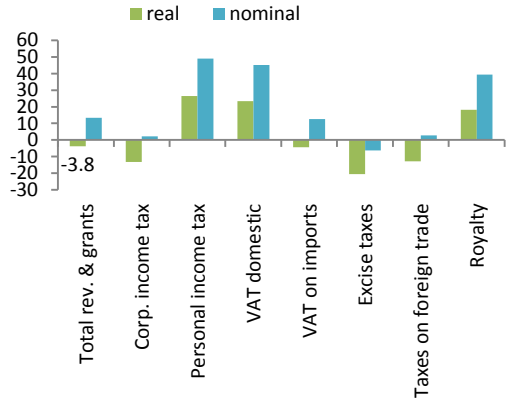
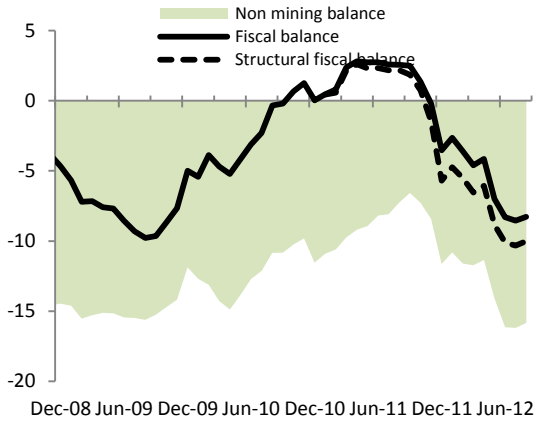


Fig 10 The structural balance reached minus 10 percent of GDP in August

Jan 2010=100



Sources: NSO, BoM, Haver, Datastream, WB staff estimates.

External sector: balance of payments and the exchange rate

The trade deficit continued to widen even though imports are now falling

The trade deficit increase to US$ 2.2 bn in August 2012 (on a 12 month rolling sum basis[8]), up from US$ 1.5 bn a year ago (Fig 11). This increase was largely on account of the surge in equipment imports for OT construction that were fully financed by FDI; strong domestic demand that drove the import of consumption goods; and the slowdown in the exports of coal to China. Imports have slowed down in recent months on a yoy basis, transport and machinery equipment imports were down by 29 and 8 percent respectively as imports related to the development of the OT mine (these accounted for 70 percent of total imports in 2011) are winding down (Fig 12). August data show an overall decrease of 8 percent yoy in total imports. This likely reflects base effects, namely the surge in equipment, fuel and transport imports last year as the construction of the OT mine gathered pace, and also the effect of growing lead times to import goods, which have increased considerably due to the transportation bottlenecks.

Exports however fell even more than imports, mainly due to declining coal exports to China fell

Exports dropped unexpectedly by 39.1 percent yoy in August, following a drop of 21 percent in July. These are the largest declines in more than 2 years and further weakness is likely as the Chinese economy continues to cool (Fig 13).

Mongolia's exports over the past year have been supported almost entirely by exports to China which account for 93 percent of the total (mostly coal). Total Chinese coal imports for August shrank by 15 percent on the month and in yoy terms, grew by just 4.2 percent. This led to a contraction of 30.4 percent yoy in Mongolia's exports to China, mostly of coal (Fig 14). On a year-to-date basis, coal exports are still 9 percent higher than a year ago, reflecting weak growth in both unit prices and volumes. Copper exports were down by 16 percent on a YTD basis, due to a 17 percent drop in unit prices, while exports of gold also performed poorly mainly due to a 48 percent drop in volumes.

Non-mineral exports however seem to be doing well. Exports of greasy cashmere were up by 20 percent on YTD basis in August, with volumes up by 40 percent. Chinese buyers currently dominate the market for cashmere, with local dehairers and spinners remaining on the sidelines. However, combed goat down export volumes have fallen significantly since March, resulting in a 21 percent decline in value. With global economic prospects looking dim as the euro area crisis drags on, global commodity prices are becoming increasingly volatile. Meanwhile the momentum of global trade is slowing, and with China trying to engineer a soft landing for its housing market and its economy, the risks only lie to the downside. Renewed volatility in global financial markets or any shift in risk appetite, in both domestic and overseas investors, suggests that demand for Mongolia's commodity exports is unlikely to remain robust. Indeed, as the discussion above shows, this is already being borne out in the export data.

Table 3 2012 Value, volume and unit price changes of major export commodities, YTD

	% change in $ value	% change in volume	% change in unit price	% of total exports

[8] Monthly trade data tends to be highly volatile and also is affected by seasonal factors. For this reason, 12-month rolling sums are illustrated.

Copper concentrate	-16	1	-17	19.4
Gold	-52	-48	-6	2.1
Coal	9	5	4	43.9
Combed goat down	-21	-9	-13	0.9
Greasy cashmere	20	40	-83	4.8
Zinc concentrate	-27	-6	-22	2.5
Crude petroleum oils	38	44	-4	7.9

Source: NSO

The balance of payments is likely to remain under pressure in 2013

Second quarter data show that the current account deficit has continued to widen, reaching US$ 3.1 bn (on a 4 quarter rolling sum basis, Fig 15). Both the merchandise and services trade deficit are at record levels. The current account deficit is currently fully funded by high levels of FDI inflows, which amounted to US$4.1 in Q2 (albeit down from US$4.4 bn in Q1) on a 4 quarter rolling sum basis (Fig 16). FDI inflows have been spurred by the construction of OT and should begin to ease next year, once completed. Net remittances declined to US$ 52 mn in Q2 2012 from US$ 116 mn in Q2 2011 mainly due to rising outflows from the private sector.

With the construction phase of the OT coming to a close, mining equipment imports should drop off. However, this decline is likely to be offset by rising imports relating to the large levels of public infrastructure works planned for the next year. These include the planned disbursement this year by the DBM to the tune of US$600 million (more than half of on-budget capital spending) in lending to projects in roads, railways, utilities, and urban housing. Moreover, the start of OT operations will have a relatively limited positive impact on the balance of payments in 2013 as the bulk of the gross export proceeds will be used for the repayment of investment costs.

Fig 11 The trade deficit continues to widen

US$ mn, 12-month rolling sum*

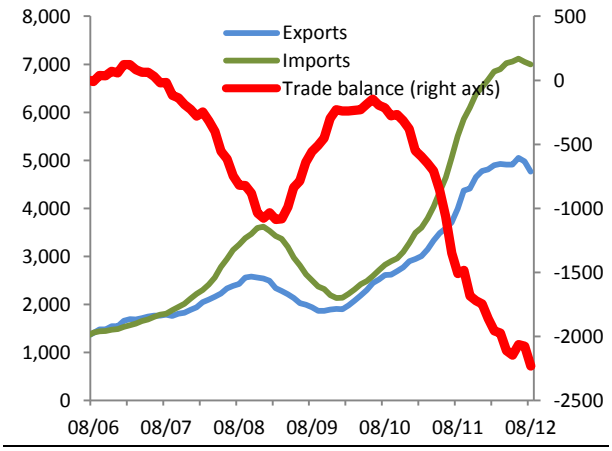


Fig 12 although imports are now contracting

Percentage point contributions to year-on-year growth

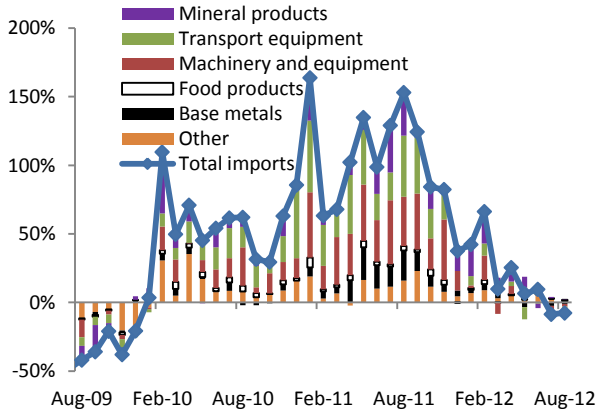
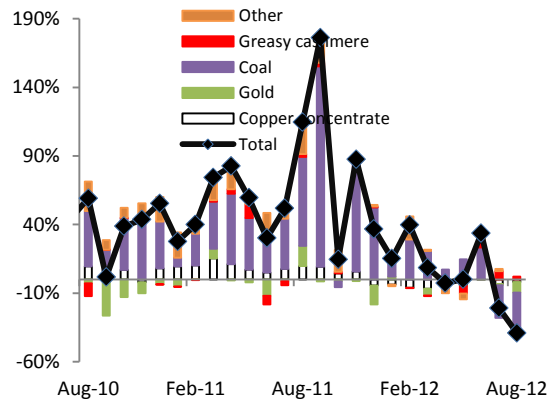


Fig 13 Exports are falling sharply

Exports, percentage point contributions to year-on-year growth

Fig 14 …reflecting weak demand in China

Exports, percentage point contributions to year-on-year growth



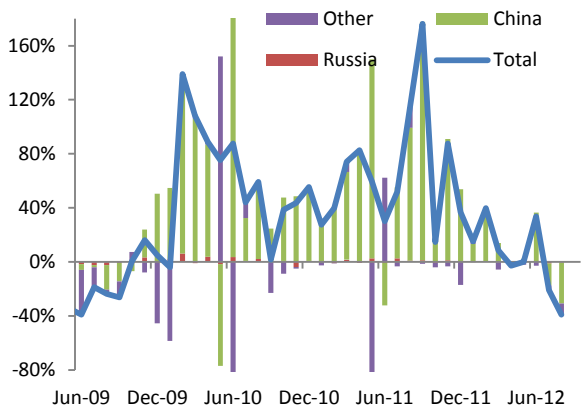


Fig 15 Although the current account widened…

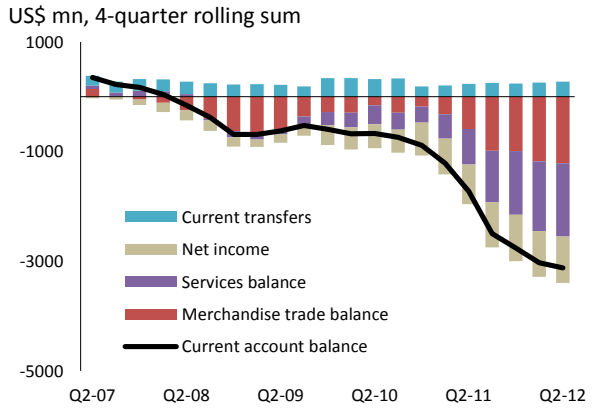
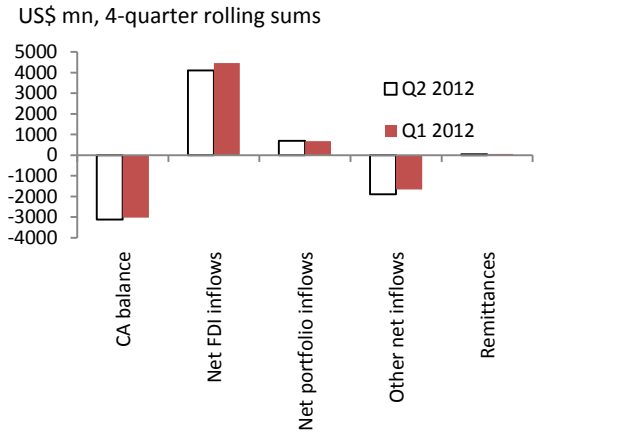


Fig 16 …it remained fully funded by FDI inflows



Sources: BoM, MoF, NSO and WB staff estimates.

Net FX reserves have dropped off and, excluding BoM borrowing from the Chinese central bank, deposits by the DBM and domestic banks, are at a two-year low

The sharp drop in exports and rising trade balances is being felt mainly in the international reserve holdings of the central bank. The togrog has depreciated by 7 percent since October 2011 (Fig 17), with further depreciation offset by a loss in reserves. In July and August, net international reserves (NIRs) fell by US$ 254.4 mn -- excluding commercial banks' NIR -- after hitting new highs at US$ 2.7 bn in June (Fig 18). To stem volatility in currency markets the Bank of Mongolia (BoM) sold some US$ 470 mn in the currency exchange auction.

Excluding borrowing by the BoM from the Chinese central bank (US$ 0.2 billion), foreign currency deposits by the DBM at the BoM (US$ 0.5 billion) and commercial banks (US$ 0.2 billion), net reserves are even lower than the headline rate at about US$ 1.4bn which is a two-year low. In parallel, the outstanding stock of central bank paper has fallen considerably compared to the start of 2011. As a result, the BoM has been injecting liquidity into the financial system through the net redemption of central bank paper.

Fig 17 The Togrog has depreciated since April

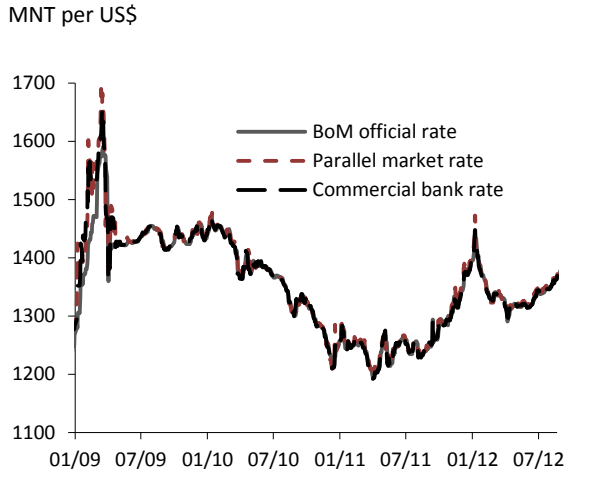
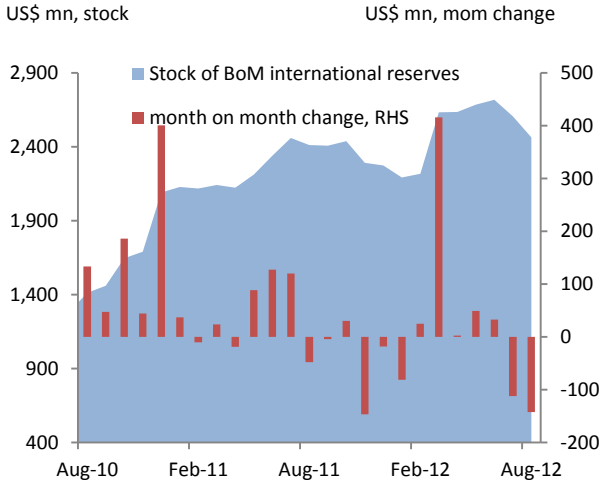


Fig 18 FX reserves have fallen in recent months, as the central bank has sold FX to stem currency volatility



Sources: BOM, World Bank

Banking sector

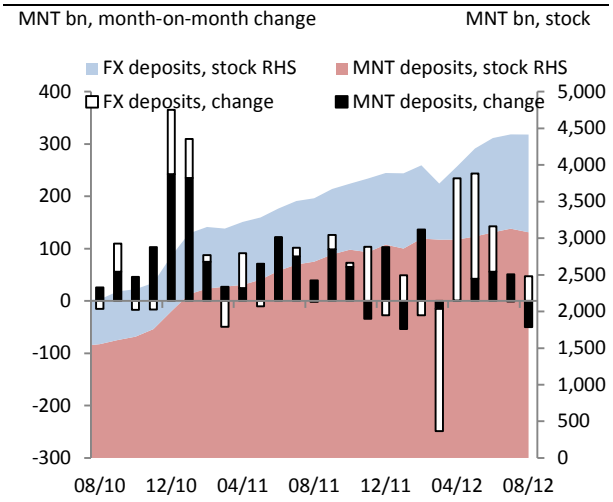
After leveling off in April, deposit inflows into the banking continue to grow but at a much slower pace compared to the middle of last year

The total volume of deposits in the banking system reached a new peak in July, as net inflows of both domestic and foreign currency deposits have been growing on a yoy basis (Fig 19). However, domestic currency deposits fell slightly in August by about 1.6 percent on mom basis as pressure on exchange rate increased. Interest rates offered on these deposits tend to be highly sticky, but have edged up since the start of the year. The average weighted interest rate on local currency deposits has for instance stood at 11.4 percent in August, compared to 10.3 during 2011. The weighted average rate on FX deposits, meanwhile, has risen from an average of 4.7 percent in 2011 to 6.0 percent in August, with the maximum rate on offer rising from 14 percent to 15.2 percent.

Domestic lending rates have correspondingly increased, from about 15-16 percent at the end of last year to 18.3 percent in August. However with inflation still high, real deposit and lending rates have trended lower – the former are now sharply in negative territory at minus 4.2 percent and the latter are still positive at 2.4 percent (Fig 20). Given the recent tightening of interest rates and reserve requirements by the BOM and with growth in deposit funding sharply down compared to the middle of last year, lending growth is sharply down to 37 percent in nominal terms (22 percent in real terms) compared to the end of last year when lending growth rose above 70 percent (Fig 21). Lending continues to be highly concentrated with the 50 largest borrowers in the banking system still accounting for more than a quarter of all loans (Fig 22).

Fig 19 Deposit inflows are increasing with local currency deposit tapering off in August

Fig 20 while real rates of returns on local currency deposits are still negative



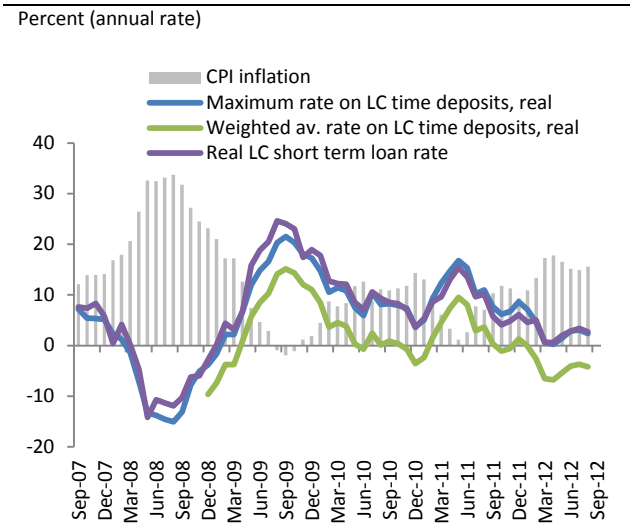


Fig 21 Credit growth has decelerated after peaking in November of last year, and is likely to slow down further

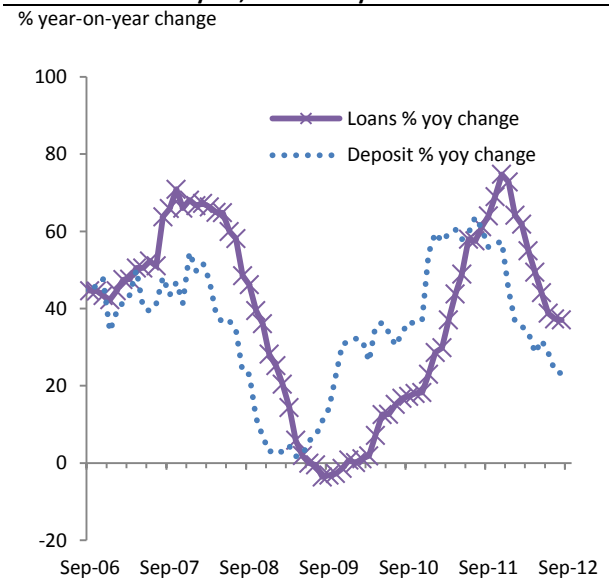
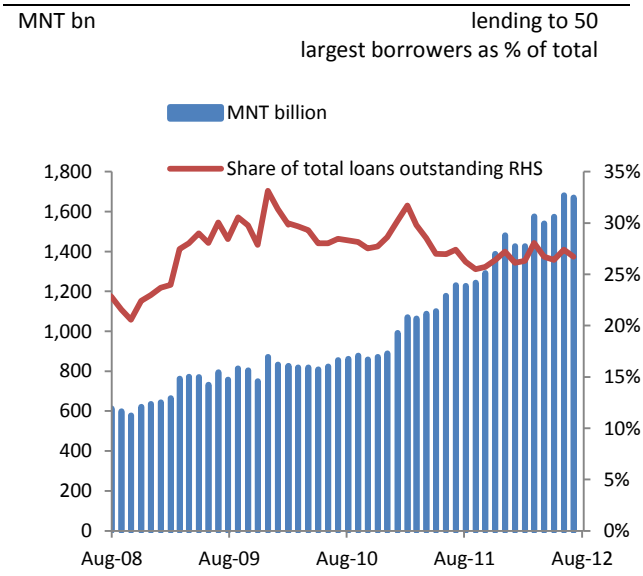


Fig 22 … while lending remains highly concentrated



Source: BoM, World Bank

Continued vigilance on financial sector risks remains important

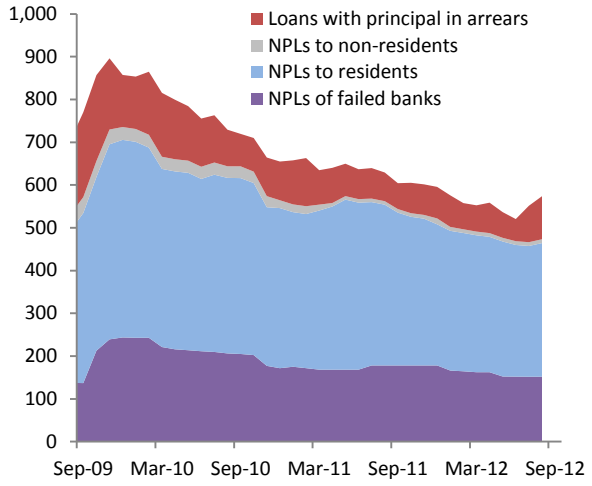
As emphasized in the previous Quarterly, compared to other countries in the region, Mongolia has some of the lowest Tier 1 capital buffers in the East Asia region and also some of the highest NPL ratios that date back to the banking sector crisis from 2008-09 when 2 large banks failed. Admittedly, the ratio of NPLs to gross loans has fallen to 4.1 percent (excluding the NPLs of the two failed banks) in August from 5.8 percent a year ago. But this improvement is mainly due to the continued growth of loan

Fig 23 and the overall volume on NPLs on bank balance sheets remains large

MNT bn

portfolios, while the total stock of outstanding NPLs has in fact increased from MNT 235 bn at the end of April 2012 to MNT 270 bn in August 2012 (Fig 23) while principal in arrears also picked up sharply from MNT 71 bn in April to MNT 100.6 bn in August.

In addition, the banking system remains highly dollarized with about a third of deposits denominated in dollars and easy convertibility between local and foreign currency deposits.



Economic outlook

Mongolia's medium term prospects are promising as the OT and TT mines go into production, with economic growth projected to be in the double digits, with sustained increases in exports and fiscal receipts. The economy however, faces significant risks in the near term, as reflected in the steep drop in exports in July and August. These risks reflect an uncertain global economic outlook and slowing growth in China and pro-cyclical fiscal policy over the past three years with large increases in government spending contributing to high inflation. A further commodity price shock could result in a rapid worsening of the external and fiscal balances. Given the macroeconomic vulnerabilities and the expected continued slow growth of the global economy, Mongolia's policy-makers need to be very cautious. The immediate requirement is a more conservative fiscal policy stance. The upcoming parliamentary budget session provides an opportunity to rein in government spending (both on and off-budget via the DBM) and to abide by the rules of the Fiscal Stability Law that goes fully into effect in January 2013. The BoM should maintain the floating exchange rate regime with interventions in the foreign exchange market limited to smoothing out excessive volatility in the exchange rate without attempting to reverse the underlying trend. The BoM will also need to remain vigilant with respect to banking sector risks.

Table 4 Mongolia: Key Indicators

	2008	2009	2010	2011	2012f	2013 f	2014f	2015f
Output, Employment and Prices								
Real GDP (% yoy change)	8.9	-1.3	6.4	17.3	11.8	16.2	12.2	8.0
Industrial production (% yoy change)	2.7	-3.3	10	9.7	8.0	51.0	35.0	44.0
CPI Ulaanbaatar (% yoy change, average)	23.2	1.9	14.3	11.1	13.0	12.0	12.0	12.0
Public Sector								
Government expenditures (as % of GDP)	37.6	35.2	36.6	44.2	36.5	31.4	29.9	31.7
Government revenues (as % of GDP)	33.1	30.2	36.6	40.6	41.5	32.4	31.2	33.1
Government balance (% of GDP)	-4.5	-5	0	-3.6	-6.0	-1.0	-1.3	-1.4
Non-mineral govt balance	-14.1	-12.4	-10.5	-16.0	-28.7	-13.1	-8.0	-9.1
Public Sector Debt (% of GDP) (1)	31	46.6	42.2	47.1	47.6	39.8	33	28
Foreign Trade, BOP and External								
Exports of goods (US$ mn)	2534.5	1903	2899	3825.0	3978.0	5529.4	6524.7	6864.0
(% yoy change)	30	-25	52	31.9	4.0	39.0	18.0	5.2
Imports of goods (US$ mn)	3147	2131	3278	4874.0	5290.0	5348.2	5674.4	6026.2
(% yoy change)	57.1	-32.3	53.8	53.4	8.0	1.1	6.1	6.2
Current account balance (US$ mn)	-690.1	-592.0	-886.7	-2586.9	-2663.6	-269.4	435.3	623.9
(% of GDP)	-12.3	-12.9	-14.3	-15.1	-18.0	-1.5	3.0	4.3
Foreign direct investment (US$ mn)	838.5	1037.6	1629.7	5309.5	1500.0	1995.6	842.0	609.7
External debt (% of GDP) (2)	31	43.3	30.2	21.7	17.0	13.9	12.5	12.6
Gross official reserves, net (US$ mn)	658	1328	2288	2984.0	3302.0	3679.0	3976.0	4850.0
In month of next year's imports of g&s	3.0	4.0	4.2	4.9	5.8	6.2	6.7	7.5
Financial Markets								
Domestic credit (% yoy change)	59.11	-9.33	26.69	72.8	40.0			
Base policy rate (eop)	9.75	10.00	11.00	12.3	13.25 (Sep)			
Exchange rate (MNT/USD, avg)	1267	1443	1257	1264.8	1360.0			
REER (real effective exch rate) (% yoy eop, +app)	13.7	-15.5	26.9	-4.6	…			
Stock Market Top 20 index (2000=100, eop)	1182	1229	2931	4059.0	…			
Memo:								
Nominal GDP (MNT bn)	6556	6591	8414.5	11087.7	13946.1	17593.1	19352.4	21287.6
Nominal GDP (US$ mn)	5174	4567	6694	8766.5	10254.5	14508.2	14509.2	14510.2
GDP per capita (US$)	1946	1685	2434	3139.9	3623.5	5126.6	5126.9	5127.3

Source: Bank of Mongolia, National Statistical Office, Ministry of Finance, IMF and World Bank staff estimates
Notes: 1) IMF (2012) Post Program Monitoring Report. (2) On public and publicly guaranteed debt