This Economic Update assesses recent economic developments and policies in Mongolia. The Update was prepared by a team comprising Altantsetseg Shiilegmaa (Economist), Khandtsooj Gombsuren (Consultant) and Davaadalai Batsuuri (Consultant), led by Taehyun Lee (Senior Country Economist for Mongolia) under the overall guidance of Chorching Goh (Lead Economist for Mongolia, China and Korea). Contributions were gratefully received from Zahid Hasnain, Marius Vismantas, Andrey Milyutin, Jigjidmaa Dugeree, Trang Van Nguyen, Juan Feng and Young Hwan Cha. This Economic Update also greatly benefited from advice and contributions from Coralie Gevers (Country Manager) and Deepak K Mishra (Lead Economist for Economic Policy). Copies can be downloaded from http://www.worldbank.org.mn. For further information, comments and questions, please contact Tina Puntsag (tpuntsag@worldbank.org).
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<td>BoM</td>
<td>Bank of Mongolia</td>
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<tr>
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<td>Development Bank Mongolia</td>
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<td>Human Development Fund</td>
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<td>Mongolian Financial Association</td>
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<td>Mongolia Togrog</td>
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<td>MoF</td>
<td>Ministry of Finance</td>
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<td>MoM</td>
<td>Month-on-month</td>
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<td>MMA</td>
<td>Moving month average</td>
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<tr>
<td>Mt</td>
<td>Metric ton</td>
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<tr>
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<td>Non-Performing Loan</td>
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<td>National Statistics office</td>
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<td>Oyu Tolgoi</td>
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<td>QoQ</td>
<td>Quarter-on-quarter</td>
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<td>Yoy</td>
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Executive Summary

In 2013, the Mongolian economy is expected to maintain double digit growth thanks to the start of copper production of the Oyu Tolgoi (OT) mine and expansionary economic policies. Yet, the economy is facing a significant challenge from growing balance of payments pressures as the FDI inflow declines and the mineral exports remain weak. A substantial balance of payments imbalance stems from a weakening minerals market but also largely reflects the consequences of pro-cyclical economic management over the last two years. Mongolia may also face a downside risk from an uncertain global economic environment and further dampening of minerals market. Macro-economic and financial vulnerabilities are growing due to continuous expansionary fiscal and monetary policies reflected in significant off-budget spending and rapid credit growth. The Government took a series of positive measures in recent months to address the challenges including the adoption of the new Investment Law, announcement of a fiscal consolidation plan, and subsequent amendment of the 2013 budget to tighten budget spending. Yet, further efforts are needed to shift the growth-oriented economic policies toward economic stability and rebuilding macro-economic policy buffers, in light of uncertain prospects in the external environment and the balance of payments situation.

Real Sector Development

The Mongolian economy will likely show another double digit growth in 2013 but is exposed to downside risks. The economy is expected to maintain double digit growth in 2013, due to expansionary fiscal and monetary policies and the increasing mineral production from the OT mine. Robust performance in agricultural production and strong expansion in construction led the growth so far. The World Bank is revising its baseline growth forecast for 2013 to 12.5 percent from its previous forecast (13 percent) of the April Economic Update, reflecting the softer growth in China than we had previously projected in April and lower-than-expected pace of recovery in mining. Economic growth is expected to remain in double digits in 2014, led by an expected ramp-up of mineral production from the OT mine. However, the economic prospect is subject to downside risks from uncertain external environment and the continuation of expansionary economic policies amidst the growing balance of payments imbalances.

Inflation

Inflation remains at a single digit level but shows growing inflationary pressure in recent months. The national headline inflation picked up to 9.4 percent in August and further to 9.9 percent in September on year-on-year basis, after a steady downward trend earlier this year. The Bank of Mongolia has been containing inflation at single digit level by curbing prices with the Price Stabilization Program. However, a sliding exchange rate in recent months has been putting increasing pressure on the cost of imported goods, making it difficult for suppliers to keep sales prices in check. Given the recent exchange rate trends and pressures from expansionary macro-economic policies, the monetary authorities will likely face increasing difficulties keeping inflation at single-digit level.

Fiscal Development and Outlook

Rising off-budget spending remains a concern as large portion of the Chinggis bond proceeds have been used to finance public investment projects outside the budget, mainly through the Development Bank of Mongolia (DBM). The Government spent about $0.7 billion – equivalent to around 6 percent of GDP – of the bond proceeds through September and will likely spend another $ 0.2-0.3 million in the remainder of the year. The DBM has become the main financier of off-budget spending since 2012 and its total off-budget spending will likely reach 10 percent of GDP in 2013 including the Chinggis bond projects. In spite of the large fiscal burden and likely macro-economic impact of the off-budget spending, no official reports have been released on the disbursement of the Chinggis bond proceeds and the operations of the DBM in 2013, raising another concern on the transparency and efficiency of the off-budget projects.

The fiscal consolidation plan is a positive step toward more sustainable fiscal path, however the fiscal policy remains highly expansionary in 2013 due to the large off-budget spending. The execution of official budget spending – which excludes the spending by the DBM – has been cautious reflecting the revenue stream weaker than the budget projections. In this light, the budgetary authorities announced a fiscal consolidation plan to meet the structural deficit ceiling of 2 percent of GDP of the Fiscal Stability Law (FSL) and subsequently amended the 2013 budget to cut budget spending by 11 percent. However, the large off-budget public investment (equivalent to 10 percent of GDP) will put fiscal policy in a highly expansionary path, pushing the fiscal deficit including the off-budget spending to over 12 percent of GDP. Government spending is projected to reach over 47 percent of GDP in 2013, a jump from 36.6 percent in 2010.
**Monetary and Banking Sector**

The monetary authorities have embarked on monetary easing programs in 2013 to offset the slowing credit growth early this year. The monetary easing has been carried out through policy lending programs on discounted terms: (i) provision of discounted loans of MNT 718 billion to select industries under Price Stabilization Program to address supply side constraints on prices; (ii) liquidity injection of MNT 900 billion to banks in the form of one-year deposits since March in order to counter slowing credit growth; and (iii) additional construction and housing development programs including MNT 1.1 trillion of low-interest rate mortgage lending and MNT 430 billion for construction companies since June. Reflecting the policy lending programs, the outstanding central bank loan to commercial banks jumped by MNT 3.4 trillion (20 percent of GDP) since November 2012 when the Price Stabilization Program had been launched.

Loose monetary policy has led to accelerating credit growth in recent months, particularly in construction and housing sector. Private sector credit growth rose from 23.9 percent in January to 48 percent in September. Due to the rapid credit growth, the loan to deposit ratio picked up to 128 percent, from 99 percent at the end of 2012. The credit growth has been concentrated on the construction industry. The growth of bank loans to construction sector picked up to 67.7 percent in the second quarter from a year ago and its share of total bank loan also rose to 37.7 percent. Around 60 percent of the liquidity provided by monetary easing programs has been used to support the construction and housing sectors.

The recent acceleration of credit growth needs close attention from the monetary authorities. The monetary easing contributed to maintaining double digit economic growth and revamped credit growth amidst the declining FDI inflows. However, the recent economic indicators suggest that the rapid acceleration of credit growth in recent months has begun to exacerbate external and internal imbalances, reflected in the recent volatile exchange rate movement and rising inflation. The banking sector is increasingly vulnerable to a possible economic downturn amidst the rising credit growth, particularly given the concentration of credit growth on construction sector. The prudential regulatory forbearance given to various policy loans will likely add to growing vulnerability of banking sector as it will increase moral hazard and reduce the transparency of banking system.

**External Sector**

Mounting balance of payments pressures pose a significant challenge to the economy as FDI inflows decline and mineral exports remain weak. While the weakening global minerals market weighs on mineral exports, the import demand — that had more than doubled in 2011 amidst the large FDI inflows — remains substantial due to domestic aggregate demand far exceeding the supply capacity of domestic industries. Expansionary fiscal and monetary policies also have been intensifying the balance of payments pressure by stimulating domestic demand over the last three years. Foreign capital inflows declined reflecting the growing concerns over the investment regime and the completion of the investment in the OT mine. Declining capital inflows amidst the large current account deficit creates a large external financing gap, which will be equivalent to around 10 percent of GDP. The growing balance of payments pressures have been reflected in the international reserves and foreign exchange market. The local currency’s value has been under growing pressure from the deteriorating external position and it experienced volatile fluctuations since July.

Recent volatile exchange rate fluctuations underscore the importance of proper economic policies to address mounting balance of payments pressure and to attract new capital inflows. The foreign exchange market does not have the significant risk of abrupt capital flight due to limited short-term borrowing and foreign portfolio investment, but it became vulnerable to “headline risk” that could be triggered by a series of negative news stories. The recent adoption of the new Investment Law will likely provide a positive momentum to improve the fragile market sentiment. The composition of the current foreign assets and liabilities shows no likelihood of significant adverse impacts from the capital reversal that recently affected several other emerging economies in the region. As of June 2013, outstanding foreign direct investment stood at $15 billion. Outstanding foreign portfolio investment in Mongolia was only $2.7 billion, most of which was long-term bond investment.

**Overall Assessment and Policy Recommendations**

The current loose economic policies are not sustainable given the mounting balance of payments pressure and will undermine macro-economic stability going forward. The Government has recently taken a series of positive measures to address increasing external imbalances and financing gap of the budget. Yet, under the current
economic policy framework, the large balance of payments pressure will unlikely ease significantly in the near future, given the persistent large import demands and uncertain prospects of minerals market recovery. Compared with peer countries in the region, Mongolia’s economic management has been highly expansionary and resulted in larger current account deficit and higher inflation (Box 9). If the current expansionary and loose economic policies were to continue, growing balance of payments pressure would likely become unsustainable and may lead to a harsh economic adjustment process in the medium term.

The downside risk will likely be exacerbated if the Mongolian economy faces growing headwinds from an unfavorable global economic environment. A rebalancing of the Chinese economy from the investment-led growth to more consumption-based growth could further dampen China’s growth. In advanced economies, the likely tapering of the aggressive quantitative easing would weaken capital inflows to emerging economies and raise borrowing costs. The global minerals market will also likely remain weak in the near future amidst the abundant supplies and growing competition among exporters of major minerals. Under the current policies, policy buffers to cope with these possible external shocks will likely be highly limited amidst the growing balance of payments pressure, increasing fiscal deficits and public debt, and rising inflation.

- **In light of the growing external imbalances and uncertain global environment, the growth-oriented economic policies need to be tightened toward economic stability.** Priorities of macro-economic management need to lie in: (i) easing the balance of payments pressures from domestic factors; (ii) addressing potential macro-economic and financial risks stemming from expansionary policies; (iii) replenishing policy buffers to maintain sustainable and stable growth in the long term.

- **Fiscal policy should be further tightened and start rebuilding fiscal space.** The recent announcement of tightening spending is a noticeable progress; yet significant off-budget spending remains uncontrolled. A priority is to recognize the off-budget spending as part of the budget and put it under the control of the FSL. Then the consolidated budget should adhere to the rules of the FSL based on realistic revenue assumptions and rational spending plans. A medium term fiscal consolidation strategy would provide a good anchor to reduce the consolidated fiscal deficit including the off-budget spending to the 2 percent ceiling of the FSL in a targeted year. In the longer-term, fiscal policy needs to start building policy buffers for precautionary purpose. The sovereign wealth fund legislation currently under development would provide a good institutional foundation.

- **Fiscal policy should focus more on “spending well”.** The pace of scaling up infrastructure spending needs to be adjusted to the Government’s planning and implementation capacity and the economy’s absorptive capacity. A proper medium-term public investment plan is needed to guide the national development strategy on a sustainable fiscal path. In a country at an early development stage, everything looks important but prioritization is essential for successful long-term development given limited fiscal resources.

- **Monetary policy should be adjusted toward economic and financial stability.** The rapid credit growth and growing external and internal imbalances in recent months underscore the needs to re-assess the macro-economic impact of monetary easing and to curb the rapid growth of credit. There are recent indications that the monetary authorities are assessing the current situation, yet the monetary easing will remain in a substantial scale given the likely continuation of large policy lending programs. The policy lending programs need to be phased out and they should be implemented through the budget if they are considered necessary.

- **Supervision and monitoring of the banking system should be strengthened.** Good progress was made early this year in strengthening capital adequacy and establishing the Deposit Insurance Corporation. To prevent rapid credit growth from raising financial sector vulnerability, further strengthening of the regulatory and supervisory framework is needed, especially in the capital adequacy of systemically important banks and the prudence of lending practices and internal controls. Heightened monitoring is needed of the construction and housing sectors, given their recent rapid credit growth. The prudential regulatory forbearance given to the policy loans needs to be terminated as it could exacerbate the credit risk placed onto the banking system.

- **Continuous improvement of investment climate is important.** The recent adoption of the new Investment Law will help to build investors’ confidence by providing a more business friendly environment to foreign and domestic investors. Continuous improvements in investment-related regulations and consistent policy implementation would further this positive momentum.
Recovery is gaining momentum in the major advanced economies in recent months

Global growth prospects have become more promising as recovery is picking up momentum in the major advanced economies. For the first time since mid-2010, the Euro area, Japan, and the United States have all reported positive growth (quarter-on-quarter in seasonally adjusted terms) during the second quarter of 2013 (Figure 1). After a record 18 months in economic contraction, the Euro area emerged from recession in July 2013 and Japan’s economy has expanded at a higher than expected rate for the third straight quarter after its government decided to pursue more accommodative monetary and fiscal policies. The U.S. economy, which slowed during the second half of 2012 and earlier this year, appears to have bounced back in the second quarter of 2013.

Growth momentum is strengthening in some of the large developing countries, as well (Figure 2) China’s quarterly growth rate picked up to 7.5 percent in the second quarter and 7.8 percent in the third quarter from 6.3 percent in the first quarter. Similarly, growth accelerated in several major developing economies including Brazil (6 percent annualized), South Africa (3 percent), and Turkey (8 percent) among others. However, not all large developing countries are experiencing a growth rebound (for example, India, the Russian Federation).

The global economy is broadly on track to meet growth expectations this year—2.4 percent, slightly lower than last year’s 2.5 percent. The modest acceleration in growth among the advanced economies in the second quarter is expected to continue through the year. The gradual strengthening of quarterly growth in the high-income countries will show up in the whole-year growth of 2.1 percent in 2014 and 2.3 percent in 2015. Developing country growth is expected to improve from 4.8 percent this year to 5.3 percent in 2014 and 5.6 percent in 2015. Global growth should hit 3.1 percent in 2014 and 3.4 percent in 2015. Even then, the forecast global growth rates for 2014 and 2015 will remain below the pre-crisis growth rates of 4.0 percent in 2006 and 2007.

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1 This section summarizes “East Asia and Pacific Economic Update, The World Bank (Oct 2013)".
Despite the gaining growth momentum, economic growth in the developing economies in the region will likely soften in 2013

While growth momentum accelerated in the second and third quarters in many East Asia and Pacific countries, year-on-year (y-o-y) changes continue to show a decline. (Figure 3) China’s growth rate is expected to be lower as the economy transitions from a credit-fueled and investment-led boom to a more sustainable consumer- and services-oriented growth path. Lower global commodity prices have dampened export receipts and slowed private investment in the capital-intensive resource sectors of the Indonesian economy, depressing overall growth. Thailand’s growth sharply decelerated in the second quarter of 2013, as post-flood reconstruction drew to a close and some of the stimulus measures were removed. Malaysia’s economy expanded less than expected in the second quarter, and lower growth of exports dragged down growth.

Domestic demand, which has been the main driver of growth in the EAP region in the post-global financial crisis period, is slowing. Robust growth in private consumption and investment, supported by large stimulus programs, has contributed to more than 90 percent of growth in developing East Asia since 2009. But as stimulus programs are being phased out, domestic demand is weakening. China is likely to seek further rebalancing of its economy by slowing credit growth and investment, although the pacing is likely to depend on overall growth. Since mid-2012, the Indonesian economy has been affected by lower global commodity prices and a slowdown in private investment. Higher private sector debt has reduced the ability of Malaysia and Thailand to further reflate their economies.

The decision by the U.S. Federal Reserve (Fed) to delay tapering of quantitative easing (QE) has restored capital flows to emerging markets, giving the authorities a second opportunity to take measures to lower risks from future volatility. The speculations about withdrawal of quantitative easing led to stock market selloffs, depreciation of currencies, and a sharp rise in domestic bond yields. Indonesia was affected most, followed by Thailand, the Philippines, and Malaysia. Countries in the region that experienced comparatively larger fund withdrawals were the ones that had larger foreign participation in their financial markets, putting them at risk to further volatility. The financial markets have stabilized after the Fed decided to delay the withdrawal of QE— giving EAP countries a much needed respite and a second opportunity to better prepare for eventual tapering. Measures to lower risks from tapering include reducing excessive reliance on short-term and foreign-currency denominated debt, accepting a weaker exchange rate when growth is below potential, and building policy buffers to respond to changing global liquidity conditions.
Subdued global commodity markets have hurt the region’s resource exporters. Metal and mineral prices have declined the most—46 percent from their post-crisis high in February 2011 to July this year (Figure 4). Resource exporters in the region were adversely affected by the weak minerals market, particularly in Indonesia and Mongolia. Indonesia’s terms of trade has deteriorated sharply since mid-2012. Malaysia and Vietnam’s terms of trade has deteriorated sharply since mid-2012, largely affecting Mongolia and Lao PDR. Yet, compared to other resource exporters in the region, Mongolia’s current account deficit (over 30 percent of GDP) is highest, followed by Lao PDR (around 20 percent), Papua New Guinea (around 12 percent) and Indonesia (3.4 percent).

Strengthening of global growth momentum will help developing East Asia maintain a growth rate in excess of 7 percent, retaining its status as the global growth leader. The World Bank revised its earlier regional growth forecast for developing East Asia downward to 7.1 percent this year and 7.3 percent in 2014. (Table 1) Growth in China is expected to meet the official indicative target of 7.5 percent in 2013. In the medium term, China’s growth is expected to remain range bound between 7.5 and 7.7 percent as the authorities emphasize productivity and innovation, and rebalance demand from investment-led to consumption-based growth. Notwithstanding the modest decline in growth in 2013, the East Asia Pacific (EAP) region will contribute nearly two-fifths of global growth and one-third of global trade—higher than any other region in the world.

Table 1. East Asia and Pacific: GDP Growth Projections

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Assumptions about the external environment:

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Source: The World Bank, East Asia and Pacific Economic Update, October 2013

2 Fuels were 33 percent of Indonesia’s total exports in 2012; and ores and metals, 6 percent.
3 Fuel exports were 20 percent of Malaysia’s total exports in 2012, and 9 percent of Vietnam’s.
4 Ore and metal exports were 53 percent of Laos’s total export in 2012.
Headline risks are on the downside to the economic growth in the region

A greater than expected slowdown of investment in China would adversely affect the suppliers of capital goods and industrial raw materials that have benefited from China’s industrial expansion, infrastructure spending, and real estate development. Restructuring an economy as enormous and diverse as China’s is inherently complex and difficult. The base case scenario of the World Bank assumes that the transition away from an export and investment-led growth pattern and to a consumer- and services-based growth path will be gradual and orderly. However, because rebalancing involves the reversal of long-standing policies (low interest rates for manufacturers, state-owned enterprises, and property developers, for instance) that have successfully underpinned growth over three decades, the adjustment could be sharp and disorderly. An abrupt reduction in investment would drag down growth because of the large share of investment in output and the limits to which consumption could rise high enough and fast enough to offset the downturn. A slower-growing China will affect commodity exporters the most. Countries with less well-diversified economics and with a disproportionate reliance on China for exports – e.g., Mongolia and Lao PDR – would likely be more heavily affected by slowing growth in China. (Figure 5)

Although the normalization of monetary policy in the United States should ultimately benefit developing countries, the adjustment could be disruptive. The withdrawal of monetary stimulus will signify a firm recovery in the United States, benefiting countries integrated in trade and finance with the world’s largest economy. The adjustment, however, can turn out to be disruptive, as shown by the recent volatility in the financial markets of many developing countries at the time when tapering of QE became more likely. Since the U.S. Federal Reserve first signaled its intent to gradually withdraw monetary stimulus, interest rates have risen, portfolio flows have reversed, and asset prices have taken a fall in East Asia and in other developing areas. Although the postponement of tapering in September brought some relief, volatility in financial markets is likely to persist for some time to come.

The countries in the region reporting comparatively larger fund withdrawals have had comparatively larger foreign participation in their financial markets, putting them at risk to further volatility. They have also had either large current account deficits (Indonesia) or sharp credit expansions (Thailand and Malaysia). Economic imbalances and financial vulnerabilities put these economies at risk of a tightening of global financial conditions. Capital outflows and increases in long-term rates have real economic consequences. Higher interest rates, for one, may hurt fixed investment, and consequently, potential growth. Countries with less foreign participation in the financial market – e.g., Mongolia – will likely be less affected by the volatile short-term capital movement but will likely suffer more from slowing foreign direct investment and rising international borrowing costs.

Figure 5. Mongolia and Lao PDR are most exposed to a slowdown in China.

Exports to China, in percent of total country exports, 2012

Source: WB and IMF database, World Bank staff estimates.
Part II. Mongolian Economy – Recent Developments and Prospects

Real Sector Development and Outlook

Mongolia’s economic growth slowed in the first half of 2013 due to the weak minerals market, but it maintained double digits due to policy stimulus and the weather favorable to agriculture. The economy grew at 11.3 percent in the first half of 2013, down from 12.4 percent in 2012 and its peak of 17.5 percent in 2011. The double-digit growth in the first half was possible due to the strong rebound of growth in the second quarter (14.3 percent, year-on-year basis) from 7.1 percent in the first quarter (Figure 6). The mineral GDP expanded a moderate 6.1 percent in the first half amidst the weak minerals market. Non-mineral GDP (which excludes mining industry) grew at 12.3 percent in the first half of 2013, slight down from 13.3 percent and 13.2 percent in the first half and second half of 2012. Construction sector that more than doubled in the first half thanks to the active support from fiscal and monetary policies largely helped fueling the double-digit economic growth. Steady and strong growth in agriculture also helped the growth in the first half (Figure 7).

Construction output jumped by 129 percent in the first half from the same period last year, fueled by supportive measures from fiscal and monetary policies. Despite the low share of the gross domestic output (2 percent), the construction growth accounted for over 10 percent of the GDP growth (11.3 percent). The impact of construction growth is likely to be larger given its multiplier effect as the growing construction activities tend to translate into related sectors including transportation and manufacturing.

After displaying a moderate 8.3 percent growth in the first quarter, the construction sector expanded by 154 percent in real term in the second quarter, buoyed by the monetary and fiscal stimulus measures. The Bank of Mongolia (BoM) has been providing a substantial amount of...
discounted policy loans – up to MNT 1.8 trillion – to construction and housing sectors under the Price Stabilization Program and the Construction and Housing Development program (Box 6). The construction boom was also driven by the off-budget public infrastructure projects. The Development Bank of Mongolia has been disbursing the Chinggis bond proceeds to public infrastructure projects largely focused on road construction since April. As a result of the active policy support, constructions of residential and commercial buildings as well as roads significantly expanded during the second quarter (Figure 8). Capital maintenance only grew two percent from a year ago in real terms in marked contrast to the strong growth in new construction, reflecting a bias towards new projects and underspending on maintenance.

The agricultural sector expanded 20.6 percent in the first half due to favorable weather this year. Agriculture has maintained strong growth – over 20 percent – for six consecutive quarters, after contractions in 2010 and 2011 in the aftermath of the harsh winter (Dzud). Accounting for almost 16 percent of GDP, agricultural production contributed a quarter of total growth. Detailed data on sectoral output composition is not yet available, but the quarterly agricultural GDP was estimated largely based on the number of young livestock in 2012 that will reach productive age in 2013. The agricultural output data will be revised based on surveys later this year. Livestock accounts for roughly 80 percent of agricultural production, according to the NSO.

Manufacturing industry and the wholesale/retail sector grew 6.6 percent and 3.1 percent respectively in the first half. The manufacturing sector accounted for 5 percent and the wholesale/retail sector accounted for 11 percent of gross domestic production in the same period. Due to the limited and undiversified capacity of domestic industry, manufacturing in Mongolia was largely dominated by food and beverages and textiles – accounting for half (food and beverages) and 10-15 percent (textiles products) of manufacturing production. In the second half, food and beverage production grew at 6.7 percent and textile production increased by 6.8 percent, leading the overall manufacturing growth.

Mineral production expanded at a moderate pace, registering 6.1 per cent growth (yoy) in the first half amidst a drop in coal production, but it will likely pick up in the latter half thanks to the ramp-up of copper production in the Oyu Tolgoi mine.

- **Coal production declined by 3.5 percent to 18.2 million tons over the nine months from 18.9 million tons from a year ago.** The drop in coal production reflects the weakening coal exports amidst the increasing competition and abundant coal supply in China: the exports of coal declined by 45 percent for the first nine months from a year ago. The coal industry has been experiencing difficult condition including the suspension of coal production in some major coal mines early this year and the downgrade of credit rating of a major mining company.

- **Coal production is expected to remain weak in the face of likely continuation of low prices and strong global competition.** However, recent industrial production data indicates a possible moderate recovery of coal production. Between July and September, coal production increased by 18 percent (yoy), a turnaround from contracting for the seven consecutive months. Should the plan to ramp up production from the Erdenes Tavan Tolgoi mine be realized, it could contribute to the recovery of coal production in the second half of the year.

- **Metal ore production growth turned robust from June, largely due to the start of production in the OT mine.** After contracting for the first five months, the metal ore production growth turned positive in June and displayed 44 percent growth between July and September. Production of copper led the growth by expanding 92 percent in the third quarter and 30 percent in the second quarter, from 13 percent growth in the first quarter. The OT mine produced 13.1 thousand tons of copper in
concentrates in the second quarter and it further picked up to 30.6 thousand tons of copper in the third quarter, which accounted for 19 percent of total production of copper in concentrate in the third quarter. The production is likely to increase further in the latter half of the year as the mine plans to ramp up its production.

- **Strong crude oil and gold production helped maintain the positive minerals growth.** Crude oil production increased 39 percent from a year ago between January and September. The production of gold also increased by 67.8 percent over the nine months.

![Figure 9. Non-mineral GDP drove the double-digit growth while mineral sector expanded moderately](image1)

![Figure 10. Mineral production has picked up in recent months](image2)

*Source: NSO Bulletin, World Bank staff estimates*

In the expenditure side, the high growth was fueled by domestic consumption driven by strong stimulus measures. Final consumption increased by 16.5 percent (yoy) in the first half of 2013, led by a 25.8 percent growth in the second quarter – the highest quarterly growth since 2008 – from 6.6 percent growth in the first quarter (Figure 11). Meanwhile, domestic investment – which led high growth over the last two years – lost its momentum due to declining foreign investment. Domestic investment dropped by 16 percent in the first half despite the large increase in construction during the second quarter, as the first phase investment of OT mine was completed early this year. In 2011 and 2012, strong domestic investment growth led double digit growth by expanding at 64 percent in 2011 and 24 percent in 2012.

The consumption-led double digit growth buoyed by the construction boom raises a concern on the stability and sustainability of the economic growth as it came with growing balance of payments pressure. Given the low supply capacity of domestic manufacturing industries, increasing domestic demand amidst the weak mineral export leads to an inevitable consequence – a large current account deficit. Since 2011 when the economy grew double digits, the current account deficit mounted to over 30 percent of GDP as the imports ramped up while the growth of mineral exports could not catch up with the elevated import level (Figure 12). The current high growth trend may not be sustainable in the medium- and long-term, should the large current account deficit continue without significant recovery in foreign investment capital inflow or global minerals market.
Economic growth is expected to remain in double digits in 2013, yet the economic prospects are exposed to downside risks from unfavorable external environment and mounting balance of payments pressure. The World Bank is revising its baseline growth forecast for 2013 to 12.5 percent from its previous forecast (13 percent) of the April Economic Update. The downward revision for 2013 reflects the softer economic growth in China than we had previously expected in April and the slower pace of recovery in coal production. Despite the downward adjustment, the economy is expected to maintain double digit growth in 2013, due to expansionary fiscal and monetary policies and the increasing mineral production from the OT mine. Economic growth is expected to be one of the highest in the East Asia and Pacific region. (Figure 13) The economic growth is expected to remain in double digits in 2014, thanks to the ramp-up of mineral production from the OT mine and continuous stimulus from off-budget spending using the Chinggis bond proceeds. However, the mid-term prospects are subject to the following substantial downside risks:

- **Further dampening of the global minerals market.** While recent minerals production indicates the signs of a moderate recovery, abundant global supplies and growing competition pose uncertainty over the prospect of Mongolia’s major mineral production and exports.

- **Moderating economic growth in China.** The reform efforts of Chinese authorities to curb excessive credit growth and to rebalance to more consumption-based economy may dampen investment and further soften economic growth in China. The Mongolia economy is the most exposed economy to the economic cycle in China as it exports almost 90 percent of exports to China (Figure 5).

- **Adverse impact from tapering of global quantitative easing.** Tightening of monetary policies in the advanced economies may lead to declining capital inflows and increasing borrowing costs to
emerging economies. This could slow the resumption of foreign capital inflows to Mongolia as many potential investors may have to adjust their business plans to the changing global liquidity situation.

- **Continuation of expansionary economic policies.** Despite the promising long-term economic prospects thanks to vast mining resources, strong domestic demand buoyed by the expansionary fiscal and monetary policies is adding to the substantial balance of payments pressures. Should the current large current account deficit continue with the continuation of weakening foreign investment, the economy would have to undergo a harsh adjustment process to absorb the balance of payments imbalance eventually, likely through an exchange rate depreciation and abrupt slowing of domestic demand.

**Box 1. Poverty rate down to 27.4 percent in 2012**

A recent poverty analysis by the NSO, with World Bank technical support, finds that the national poverty headcount rate declined from 38.7 percent in 2010 to 33.7 percent in 2011 and further declined to 27.4 percent in 2012, an annual reduction of 5 to 6 percentage points. The poverty reduction occurred in both urban and rural areas. In urban areas, the poverty rate dropped 9.9 percent points over the two years. Rural areas displayed faster decline in poverty rate by 13.5 percentage points. Data from the Household Socio-Economic Survey indicates that per-capita household consumption of food and almost all nonfood categories increased.

The official 2010-2012 poverty estimates allow for monitoring Mongolia’s progress in reducing poverty. They are comparable over time, based on a poverty line constructed from the 2010 Household Socio-Economic Survey data. This series incorporated several methodological revisions. First, total household consumption included imputed values of heating fuels that were collected by households. This better approximates heating consumption, especially for rural households, in light of Mongolia’s long, cold winters. Second, the new estimates rely on more accurate information about the current population distribution than what was possible previously. Survey sampling weights were improved to reflect the changing urban-rural and aimag population distributions from the 2010 Census. Third, the new estimates use the new official CPI series (released in 2012) to adjust the nonfood poverty line from the base year of 2010 to later years. The Fisher food price index continues to be used to adjust the food poverty line.

This methodology for poverty analysis follows the international standard practice for consistent poverty estimation over time. These revisions reflect recent demographic changes and improve the accuracy of household consumption estimation. These improvements provide policy makers with more accurate indicators for monitoring social progress and evaluating the impacts of growth and public policies on poverty.

Source: World Bank Staff

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5 The Fisher price index is an index formula used in price statistics for measuring the price development of goods and services, on the basis of the baskets from both the base and the current period. It is defined as the geometric average of the Laspeyres price index (which only uses the base period basket) and the Paasche price index (which only uses the current period basket). For this reason, the Fisher price index (named after American economist Irving Fisher) is also known as the “ideal” price index (Eurostat. http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Glossary:Fisher_price_index).
Inflation

Inflation remained at single digits throughout the year but there are signs of mounting inflationary pressures. After a downward trend to 8.3 percent in July from 13.0 percent in January, the national headline inflation picked up to 9.4 percent in August and further to 9.9 percent in September on a year-on-year basis. The inflation in the capital city also accelerated to 8.4 percent in August and September after it slowed down to 7.0 percent in July from 12.7 percent in January. (Figure 15)

Food price inflation accelerated to 9.7 percent in September from 5.6 percent in August, a turnaround from the steady slowing trend in earlier months. (Figure 16) Meat prices contributed to the accelerating food price inflation by rising 9.6 percent in September from 5.1 percent in August. Price increases of most major non-meat food items also accelerated in August and September. The price of bread and cereals – another key indicator – rose by 12 percent in August and 14 percent in September, up from 10.9 percent in July. The price of milk, cheese and eggs also rose by 9.7 percent in August and further accelerated to 18.5 percent in September from 6.7 percent in July.

Core inflation in recent months also indicates the growing inflationary pressures. Core inflation on year-on-year basis eased to 9 percent in September after picking up to 9.8 percent in August from a 7.9 percent in July. The recent rise in core inflation reflects that the prices of consumption goods are adjusted to the exchange rate depreciation since July as well as mounting demand side pressures from expansionary macro-economic policies. Accelerating price increases were observed in most core inflation items between July and September including: transport services (to 3.6 percent from 1.6 percent) housing goods (to 11.8 percent from 3.9 percent), education expenses (to 28.4 percent from 16.1 percent). Electricity prices were also raised by 11.4 percent from the price level that had been frozen since May 2012 (Figure 17).

Housing rental prices also picked up in recent months, calling for close attention from the authorities. The housing rental price index rose by 20.1 percent in August and 16 percent in September from a year ago. (Figure 18) Given the current construction boom supported by policy lending programs, the recent hike in housing rental price needs attention as it may indicate a sign of growing asset prices going forward. Close monitoring and further data collection on the housing market (e.g., housing price indicators) both by the Government and the monetary authorities are needed.
Inflation will likely be on an upward trend in the coming months. Despite the expanding credit and monetary easing, the Bank of Mongolia has been containing inflation at a single digit level throughout the year. The Price Stabilization Program – that had been launched by the BoM last November – contributed to the stable price trend by controlling key prices in return for providing financial support to suppliers at discounted terms. However, a sliding exchange rate in recent months has been putting increasing pressures on the cost of imported goods, making it difficult for suppliers to keep domestic prices in check. Given the recent exchange rate trends and additional pressure from expansionary macro-economic policies, the monetary authorities will likely face increasing difficulty to keep inflation at single digit levels.

Box 2. Poverty rate down to 27.4 percent in 2012

Consumption Basket. The CPI market basket based on 2010 year prices is derived from expenditure information collected from 11,323 households, using the Household Socio-Economic Survey (HSES) that began from 2007 by the NSO. In addition to the HSES, NSO analyzes import and industrial production data to define a representative basket of goods and services for Mongolian households according to their income level. NSO updates the basket every 5 years. The current basket comprises 329 goods and services with 12 groups: food and beverages, housing, apparel, transportation, medical care, recreation, education and communication and other goods and services.

Imported Consumption Goods. Among the food CPI basket, 52.7 percent are imported and 47.3 percent are domestically produced in terms of number of items. Among the 235 non-food consumption items, 55 percent are imported. These imported items are purchased in Chinese RMB or other currencies and are sold to local customers in local currencies. This reliance of consumption on imported goods reflects the limited capacity of domestic industries and explains why increasing economic growth is likely to be easily translated into growing trade deficit when mineral export growth is not strong enough. This also suggests that imported inflation will likely continue to put growing upward pressure on inflation in light of the rapid depreciation trend in recent months, especially considering the time lag between the currency depreciation and the actual adjustment of sales price of imported goods.

Administered Price. The Government raised heating, electricity and water fees from August, 2013. Electricity and water fees are called “base price” in Mongolia and the Governments tend to be reluctant to raise these prices due to a concern that rises in electricity and water prices would be followed by price increases of other goods. Before the recent decision, the Government had raised the base prices only twice since 2010; in June 2010 by 16.6 percent and in May 2011 by 5.5 percent to reflect the increasing cost of production. Given the impact of these base prices increases on the production costs of other products (both industrial and agricultural), they will likely translate into increases of prices of other consumption goods in the coming months.

Source: WB staff

6 Household income, expenditure and living standards measurement surveys were merged and re-named as household socio-economic survey.
Employment

The Labor Force Surveys data shows a decline in unemployment in the second quarter. Formal unemployment figures – which include only those who are registered with the Labor and Social Welfare Service Center – show a decline in the unemployment rate to 3.0 percent in August down from 3.4 percent in January 2013. However, these numbers have tended to underestimate the true extent of unemployment as some people are reluctant to be registered as unemployed to the authorities. In this context, the Labor Force Survey (LFS) data gives better indications of the unemployment rate.

The latest LFS data by the NSO estimated the unemployment rate for the second quarter at 7.3 percent, down from 9.3 percent in the first quarter. (Figure 19) Total labor force is estimated at 1.2 million people and the female labor force was estimated at 602 thousands, about a half of total labor force. The unemployment of female labor force was estimated at 7.6 percent down from 9.7 percent while that of male labor force was 6.9 percent.

The composition by employment types indicates the possibility of deteriorating quality of jobs despite the declining unemployment rate. The share of self-employed workers – usually small scale and family-based businesses including kiosks, small vendors – rose to 22.2 percent of the total employed in the second quarter from 16.5 percent during the previous quarter. The share of unpaid family workers also rose to 3.3 percent from 1.7 percent over the same period. Meanwhile, the share of paid employees declined to 47.5 percent from 51.6 percent over the same period and the size of paid employees also fell by around three thousand people. This indicates growing labor force was more absorbed by small family stores or self-owned businesses (e.g., kiosks and vendors) as the employment capacity of bigger and more formal business entities are limited due to weakening business prospects.

Sectoral composition of employment shows the shifting labor force into non-agricultural sectors and the difficulty of mining industry. Agriculture employed 29 percent of total employment in the second quarter but its share of total employment has been on a downward trend from 42 percent in 2007. The share of mining sector has been around 4 percent of total employment since 2010 (Figure 21), but the size of employment of the mining sector declined 20.7 percent (quarter-on-quarter) and 11 percent (year-on-year) during the second quarter, indicating the weak business prospects. The coal industry's

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7 The LFS reflects both registered and unregistered unemployed.
work force was reduced by 120 workers between January and September. Growth of employment in the metal ore sector that includes the copper industry also slowed: the number of employees in the metal ore industry increased by over 4,700 workers for the first seven months in 2013. However, the size of employment in the industry increased at a slower pace in August and September, adding only by 165 workers over the two the last months.

**Employees in construction, manufacturing and the wholesale/retail sectors increased during the second quarter (figure 22).** Construction workers increased 17 percent (quarter-on-quarter) and 20 percent (year-on-year) during the second quarter reflecting the strong construction boom observed over the period. Manufacturing and the wholesale/retail sectors also employs increasingly more workers, which may reflect the growing self-employed workers.

Due to limited data availability, the official data may not accurately reflect the labor market condition. While the official data points to an improving unemployment rate, there is an increasing concern about the impact on the labor market from the struggling mining industry. As the prospects of the coal market remain weak, some coal companies seem to work on plans to reduce operational costs, which could cut employment further. In July, it was reported that the Oyu Tolgoi mine would need to lay off around 1,700 workers due to delays in the underground investment in the mine. Another incident that affected the labor market was the fire at the “Narantuul” black market in September, which caused unpredictable loss to many in the market who had uninsured and unreliable working conditions, the majority of whom are reported to be women. The tightening labor market condition in some industries may not appear in the aggregate labor data should increasing temporary employment (e.g., through growing construction activities and public maintenance work) absorb the unemployed.
Fiscal Development and Outlook

Fiscal policy remained expansionary in 2013 due to large off-budget spending. The fiscal performance in 2013 sent mixed and possibly misleading signals on the true fiscal policy stance. On the one hand, the official budget execution has been cautious given weaker-than-projected revenues. Meanwhile, off-budget spending through the Development Bank of Mongolia (DBM) ramped up, using the proceeds of the Chinggis bond that had been issued in November 2012. While the official disbursement data of the DBM expenditures is not publicly available, the overall fiscal policy remained expansionary due to the off-budget spending and the fiscal deficit including the DBM’s off-budget spending will likely reach over 12 percent of GDP, above the last year’s level (10.9 percent).

Official budget spending – which excludes spending by the DBM – has been cautious as the revenues were significantly smaller than budget projections. Due to the low execution of budget spending, the official budget balance remained in surplus through May but turned to deficit from June. Between January and September, the overall budget deficit remained only MNT 93 billion – significantly down from MNT 531 billion from a year ago.

- Despite relatively robust growth, the budget revenue outturn has been much weaker than projections. Total budget revenue (MNT 3.5 trillion) over the first nine months was only 55 percent of the budgeted annual revenue (MNT 7.3 trillion). At the current pace, the annual budget revenue shortfall is expected to reach around 15-20 percent of projected budget revenue, which is in line with the revenue projection of the last Mongolia Economic Update (April, 2013). The revenue shortfall was mainly due to weaker-than-expected receipts from trade and mining related taxes (Figure 23).

- The revenue shortage was anticipated as the budget revenue projections had been prepared based on optimistic and unrealistic assumptions. The 2013 budget overestimated tax revenues based on optimistic assumptions on trade, which led to significant shortfalls in import VAT and customs duties. The inclusion of extra revenues (MNT 445 billion) from the Oyu Tolgoi company – which was uncertain and controversial at the time of budget preparation – led to inevitable revenue shortages due to the prolonged negotiations over major issues including the tax payment.

- Budget execution was low compared to the past pattern as the budgetary authorities remained cautious in anticipation of the weak revenues. The cautious execution of the budget was more evident in capital spending: the capital spending execution between January and September was only 32 percent of the annual budget spending plan. Meanwhile 65 percent of recurrent spending was executed for the nine months (Figure 24).
Facing a significant revenue shortfall, the Government announced a fiscal consolidation plan and adopted a subsequent amended budget for 2013 in October to meet the two percent of GDP structural deficit target of the Fiscal Stability Law (FSL). To meet the two percent structural deficit target of the budget, the amended budget included these measures:

- **The amended budget projected that revenue shortage would reach MNT 1.1 trillion** (14 percent of the original projection). The amended budget plans to reduce the revenue shortage to 920 billion through extra tax mobilization efforts from various sources (e.g., excise tax, property tax and social insurance contributions).

- **Reduction of budget spending by 10.9 percent (MNT 814 billion).** Capital spending was adjusted downward by MNT 620 billion by cutting: (i) MNT 459 billion on public investment projects that failed to show noticeable progress; (ii) MNT 156 billion on projects that were planned to be financed by foreign loans but had been delayed; and (iii) MNT 5 billion on maintenance expenses. Additional MNT 234 billion will be cut from recurrent spending through tightening operational expenses and downward adjusting interest payments for foreign loan disbursements that have been delayed. The size of spending reduction is lower than the original proposal of the fiscal consolidation announcement (MNT 945 billion).

The consolidation plan represents progress toward a more sustainable fiscal framework. The significant spending adjustment plan also shows its commitment to adhere to the discipline of the Fiscal Stability Law. The new revenue projections reflect the current revenue outturn trends and seem more realistic. Yet, the authorities would have to tighten spending further should the plan to raise additional tax revenues not be successful given the current weak revenue outturn.

Despite tightening the budget to meet the requirements of the FSL, a large amount of government spending is outside the budget. A significant share of the Chinggis bond was used to finance off-budget investment projects, mainly through the Development Bank of Mongolia (DBM). There is no official data on disbursements of the Chinggis bond proceeds, but according to a press conference by the Prime Minister the Government used about $0.7 billion—equivalent to around 6 percent of GDP—of the Chinggis bond revenues ($1.5 billion) during May through September, 2013. Assuming around $0.2-0.3 billion will be spent during the last four months of the year, total spending of the Chinggis bond is estimated to be around 8 percent of the GDP in 2013.
The Development Bank of Mongolia has been executing off-budget projects since 2012. The main source of financing includes the proceeds from the five-year Euro bond\(^8\) (580 million USD) that was issued in 2012 and the proceeds from the Chinggis bond. The World Bank estimates that the Development Bank spent about 60 percent of the proceeds of the Euro bond ($580 million) issued in 2012 and has been using the rest of the Euro bond proceeds in 2013. The total off-budget spending through the DBM (including the Chinggis bond financed projects) in 2013 will likely reach around 10 percent of GDP. Considering all spending, the overall fiscal deficit will likely reach over 12 percent of GDP. Mongolia’s fiscal deficit has been markedly high compared with other peer developing countries in the region (Figure 28).

The continuous deterioration of the fiscal balance and the rapid government spending increase have added to aggregate demand and put pressure on the balance of payments and domestic prices. The government spending share of GDP (including the DBM expenditures) has been on a steep rise since 2010: it jumped from 36.6 percent in 2010 to 46.7 percent in 2012. In 2013, the government spending share of GDP is projected to reach over 47 percent of GDP in 2013 (Figure 29). Meanwhile, the GDP share of government revenue remained below 40 percent of GDP and is expected to be around 35-40 percent of GDP in 2013.

The large off-budget spending may give misleading signals on the government's fiscal stance. Contrary to the official budget consolidation plan that shows a commitment to fiscal discipline, the off-budget spending puts overall fiscal policy on an overly expansionary fiscal path for the third consecutive year (Figure 26). Even the downward-revised official budget does not mean the fiscal policy is contractionary should the off-budget spending be included; capital spending will increase by over 30 percent from last year’s level, which will far exceed the nominal GDP growth rate. The Chinggis bonds are financed by direct external borrowing of the Government and the spending using the bond proceeds should increase the budget deficit by an equivalent amount. The current fiscal management of excluding the off-budget spending of the DBM (especially with Chinggis bond proceeds) is not consistent with the Fiscal Stability Law and international principles of budget management. It is also important to publish monthly reports on projects financed by the Chinggis bonds and the DBM in the same way that the detailed official budget data is released, given their fiscal burden and potential impact on the macro-economy.

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\(^8\) The DBM issued its five-year Euro bond (580 million USD) in March 2012 at 5.75 percent, following the first Euro bond issuance of 20 million USD (one-year bonds at 6 percent) in December 2011.
Box 3. Off-budget spending and the Chinggis bond

Off-budget spending. Off-budget spending can be defined as government expenditures that are not recorded in the official budget. In principle, all government expenditures – that are funded by the government’s tax/non-tax revenues and borrowing – needs to be recorded as budget expenditures. When budget expenditures exceed the Government’s total revenues (and grants) in a fiscal year, it creates a budget deficit. The deficit is usually financed by borrowing from domestic (e.g., domestic government bonds or central bank loans) or external sources (e.g., external sovereign bonds). Government’s borrowing is not recorded as government revenue (above the line) but as financing transactions (below the line) in the same way that individuals would not regard money borrowed from banks as part of their incomes.

Recording all the expenditures, revenue receipts and financial transaction in the budget is important as it shows how the government operations (or fiscal policy) affect the economy through the budget and how the government’s financial obligations change as a result. In principle, if the government spends more than its revenues (i.e., budget deficit), it means the government stimulates the economy by borrowing. Therefore, if a government expenditure financed by borrowing is not recorded in the budget, it underestimates the impact of the government’s activities on the economy by reducing the actual spending (and budget deficit) financed by borrowing and may also make the fiscal policy seem less expansionary than it really is.

Chinggis bond. In Mongolia’s case, the Chinggis bond has been at the center of the controversy of off-budget spending. Chinggis bond was issued directly by the Government in November 2012 and will have to be repaid by tax payers’ money when the bonds are due in 2017 and 2022. Therefore, the Chinggis bond proceeds are treated as a financial transaction (with an increase in government’s foreign liability and a corresponding increase in the government deposit at the Central Bank) when the government receives the proceeds. As the government starts using the proceeds to fund certain projects, the bond proceeds need to be withdrawn from the government deposit and the corresponding amount should be recorded as budget expenditure – either direct expenditure (if it is spent directly by the government) or net lending to the Development Bank of Mongolia (if it was transferred to the DBM so that the DBM can finance public investment projects). The bond issued by the DBM in 2012 has similar issues as the DBM bond was issued under the direct guarantee by the government. The DBM bond proceeds would have to be repaid by tax payer’s money when it’s due should the DBM fail to raise enough financial return for repayment from projects it invested in. Therefore, excluding projects financed by the Chinggis bond and the DBM from the official budget effectively underreports the size of government expenditure and the budget deficit.

Source: WB staff

Source: NSO Bulletin, World Bank staff estimates
Public debt has been on the rise. (Figure 30) Mongolia’s public debt reached MNT 8.8 trillion – equivalent to 63 percent of GDP – at the end of 2012. This is a significant increase from MNT 4.3 trillion or 39 percent of GDP in 2011. External debt more than doubled from $2.2 billion in 2011 to $4.8 billion in 2012, accounting for 77 percent of total public debt and 48 percent of GDP, reflecting the large external bond issuance last year including the Chinggis bond ($1.5 billion) and the DBM bond ($580 million). As a result, a significant change has occurred to the composition of external debt. Until 2012, the majority of public external debt has been concessional loans – it accounted for 56 percent of total public external debt in 2011. The share of external loans on concessional terms from multilateral creditors (e.g., WB, ADB and IMF) significantly fell to 26 percent in 2012 and the share of commercial external debt jumped to 43 percent in 2012 from 0.2 percent a year ago. Official bilateral loans accounted for 24 percent of total external loans. Domestic debt rose from MNT 1.2 trillion to MNT 2 trillion mainly due to a rise in government bond stock that was issued to finance budget deficit. The public debt to GDP ratio will increase further in 2013 in light of the increasing domestic debt issuance for deficit financing and the depreciating exchange rate.

In light of the fast rising public debt level, the authorities need to pay more attention to effective debt management strategy. Increasing external loans on commercial terms call for close monitoring and planning to manage cost and risk profile of public debt in the forward looking manner. The authorities need to ensure that further external financing decisions are taken within a published formal debt management framework through stronger coordination between related ministries. Public spending financed by the external commercial loans need to be prioritized to revenue-generating projects given the significant financial burden of the commercial loans. Macro-economic policy framework also has a significant implication on the public debt management in the medium-term. The continuation of the current loose fiscal policy based on further external debt financing and off-budget spending scheme will significantly add to rising public debt level and raise debt distress risk in the medium- and long-term.

Rapid spending increases in recent years have been concentrated in capital spending. Nominal capital spending increased over 27-fold during the decade 2002-2012 while the nominal GDP increased nine-fold. As a result, the percentage of capital spending in GDP jumped from 4.4 percent in 2002 to 13.4 percent in 2012. The pace of capital spending increases accelerated over the last two years: the capital spending level in 2012 stood three times the size in 2010. In 2013, capital spending is expected to nearly
double from the 2012 level due to off-budget public investment, reaching over 20 percent of GDP (Figure 31).

Scaling up public investment is important in developing countries with poor infrastructure. Yet, the rapid pace of spending increases also raises several concerns:

- **The rapid growth in capital spending is likely to have exceeded the production capacity of the economy, adding to the balance of payments pressures and to construction cost inflation.** Over the last two years, imports of construction materials have almost doubled as the capacity of the domestic industry to supply the materials could not match surging demands. A recent World Bank study\(^9\) found that of the 186 registered road construction companies, only 59 are active, and of these 59 only 10 have the capacity to build roads longer than 50 km in one construction season in 2011. The lack of domestic capacity also translated into the steep rise in prices of major construction materials over the last three years (2010-2012); iron concrete by 82 percent, bricks by 80 percent and cement by 64 percent, according to the World Bank’s estimation.

- **Rapidly scaling up public investment projects is likely to strain the Government’s limited capacity to properly prepare and implement them.** As the growing number of new projects exceeds the Government’s project preparation capacity, there is a growing tendency to use direct contracts rather than competitive tendering. While no public data is available, most off-budget projects seem to be using direct contracts. Significant under-execution of the 2013 on-budget capital spending indicates that capital spending already exceeds the capacities of the Government and of the productive economy to deliver the new investments. Given that the Chinggis bond has been financing significant off-budget projects, it is also likely that construction capacity was absorbed more by off-budget projects in larger scales, crowding out on-budget projects which impose more transparent public procurement processes.

- **Another concern is that many projects are inserted during Parliamentary review and a significant number of them will likely lack proper project preparation and appraisals.** A recent World Bank study\(^3\) found in 2008 that Parliament increased the number of new projects by 60 percent and the annual capital budget by 25 percent, an intervention that is unusually high by both developing and OECD country standards. The study also suggested that these projects are generally less well prepared than line ministry schemes, and often lack even basic documentation such as technical drawings and cost estimates.

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\(^9\) Mongolia: Improving Public Investments to Meet the Challenge of Scaling-up Infrastructure", January 2013, The World Bank
Monetary and Banking Sector

The Bank of Mongolia has pursued expansionary monetary policy to support economic growth and revamp private credit growth that showed signs of slowing in early 2013. As domestic credit growth slowed in late 2012 and early this year, the monetary authorities adopted a series of accommodative policy measures from January 2013: (i) rate cuts in January, March, April and June from 13.25 percent to 10.5 percent by 275 bps; (ii) significant monetary easing of over MNT 3 trillion (equivalent to 20 percent of GDP) through various policy channels.

Monetary easing has been carried out through the following policy lending programs: (i) provision of discounted loans of MNT 718 billion to select industries under the Price Stabilization Program to address supply side constraints on prices since November 2012; (ii) liquidity injection of MNT 900 billion to banks in the form of one-year deposits to counter slowing credit growth since March; and (iii) a construction and housing development program including MNT 1.1 billion for low-interest rate mortgage lending and MNT 430 billion for construction companies since June (Box 4 and Box 5). As a result of these measures, outstanding central bank loans to commercial banks jumped by MNT 3.4 trillion since November 2012 when the Price Stabilization Program had begun – from MNT 181 billion in last November to MNT 3.6 trillion in September 2013 (Figure 32).

The loose monetary policy led to accelerating growth in domestic and private credit. The year-on-year growth of total outstanding domestic credit including claims to general government has been steadily rising to 61.6 percent in September from 29.4 percent last December. The growth of bank credits to private sector has also picked up from 26 percent at the end of 2012 to 48.6 percent in September. The speed of Mongolia’s credit growth in recent months is the highest among the major economies in the region (Figure 33). The outstanding domestic credit now reached 67.8 percent of GDP in September, up from 48.6 percent in March (Figure 34).
Due to the rapid credit growth, the loan to deposit ratio picked up to 128 percent in September, from 99 percent at the end of 2012. (Figure 35) The rising loan to deposit ration deflects the growing gap between the growth of bank loans and deposits. While total private loan growth of banks reached over 48 percent in September, total deposits continued to grow moderately around 20 percent in August and September. Total outstanding private sector loans of banks reached MNT 10.2 trillion in September while the total bank deposit (except for government deposit) was MNT 7.9 trillion.

The currency composition of bank deposits shows the recent fragile market sentiment over the local currency amidst rising external imbalances. The growth of local currency denominated bank deposits has been stagnant, declining by 1.1 percent in August and slightly rose by 2 percent in September on month-on-month basis. The foreign currency bank deposits rose significantly in July (11.5 percent) and August (13.9 percent) – a turnaround from the continuous decline for the first four months of the year, reflecting weakening confidence in local currency. The foreign currency deposit fell by 11.4 percent in September as the exchange rate stabilized from mid-September. Total foreign currency accounts took up 23 percent of total bank time deposits and 30 percent of total bank account (including current account deposit) in September. (Figure 36)

The rapid credit growth needs close attention from the monetary authorities. The monetary easing contributed to the double digit growth amidst the weak minerals market and maintained robust domestic credit growth through liquidity support to industry. However, the economic indicators suggest that the rapid credit growth in recent months may have begun to translate into exacerbating external and internal imbalances; the recent volatile exchange rate movement and rising inflation. Given the private credit growth now reaching close to 50 percent, the monetary authorities need to be cautious to minimize adverse impacts on the mounting balance of payments imbalance and inflationary pressures. Authorities should closely watch macro-economic indicators including the balance of payments, exchange rate, inflation rate, and the banking sector soundness.

Recent monetary aggregates indicates some signs of slowing pace of monetary easing, yet the monetary easing will remain in a substantial scale given the likely continuation of large policy lending programs. After picking up to 59.3 percent (yoy) in July from 30.5 percent last December, the reserve money growth decelerated to 33.9 percent (yoy) in August and 22.4 percent in September. (Figure 37) The BoM absorbed excess liquidity from commercial banks of MNT 771 billion through its open market operations using Central Bank bills in August and September. The MNT 900 billion that was
deposited at commercial banks as short-term deposits by the central bank is planned to be returned to the Bank of Mongolia in late 2013. However, a large portion of the monetary easing program will remain as long as large policy lending programs are being implemented. The Price Stabilization Program is planned to be implemented for two more years and the construction and housing development program including the low rate mortgage lending will also likely remain for a while given the program’s popularity from the general public. The two programs account for over 70 percent of the monetary easing programs.

The monetary easing measures contain risk factors that could create distortions and vulnerabilities in the banking system. Along with reassessment of the overall monetary stance, these risks need to be closely monitored and addressed going forward:

- **Banks’ capability to price credit risks is limited due to the rate cap imposed on the policy lending.** The policy lending programs provide discounted loans to beneficiaries (petroleum, meat wholesale companies, construction material producers, construction companies, individual mortgages) through commercial banks. While credit risks associated with policy lending reside on banks’ balance sheets, banks cannot fully price the credit risks of individual borrowers in their lending rates due to the rate cap.

- **Regulatory forbearance.** Some policy loans (e.g., Price Stabilization Program) are given forbearance from some prudential regulations, which could lead to increasing moral hazard and adverse selection in bank’s lending operations and weaken the soundness of banking system.

- **Refinancing risks.** BoM’s funding is intended to be temporary, at most three years. This creates refinancing risks once the BoM withdraws from policy lending and banks have to refinance the low-rate BoM financing. The lack of a similarly priced funding source in the market indicates that the current policy lending may have to be rolled over for a significant period, especially in the case of the low-rate mortgage program.

**Credit growth has been concentrated in construction industries.** In the second quarter of 2013, bank loans to most industries showed robust growth due to the policy loans. On a quarter-on-quarter basis, loans to construction industries jumped by 67.7 percent, followed by wholesale industry loans (22.8 percent). (Figure 38) Loans to the mining industry increased by 10.2 percent and manufacturing industry lending grew 12 percent. As a result, the share of construction and real estate related loans accounted for 37.7 percent in the second quarter, a gain from 33.5 percent at the end of 2012. The wholesale industry took up 24.1 percent of industrial loans. Loans to the mining sector accounted for 14.7 percent, a stable trend over the last three years. (Figure 39) The increasing exposure to construction and the real estate sector reflects the concentration of policy lending programs in these sectors. Around 60 percent of the total policy lending has been planned to target the construction and housing sectors, including the Price Stabilization Program and the additional measures for construction and housing development that were launched in June. (For more details, see Box 6.)
Bank supervisory authorities need to closely monitor the development of construction and real-estate sectors as well as the quality of loans to these sectors. A significant portion of construction loans likely have been used to finance residential construction which increased by 287 percent in current terms in the first half of the year from a year ago. The construction and real-estate sectors are known to be more vulnerable to economic downturns and the boom-bust cycle of the economy, especially when the construction and real-estate boom is buoyed by speculative motives or excessive policy stimulus. Increasing lending exposure to these sectors implies that the banking sector may become more vulnerable to a possible downturn in the construction and real-estate sectors. The recent housing rental CPI indicates that the construction boom may have begun translating into rising housing prices: the actual rental rates for housing rose 20.1 percent in August and 16 percent in September from a year ago.

Banks’ non-performing loans (NPLs) have been rising. The NPL ratio (excluding past due loans) jumped to 4.97 percent in July from 3.68 percent in June as the bad loans of the Savings Bank were added. The NPL ratio further rose to 5.29 percent in September – the highest level since April 2012. (Figure 40) The NPL ratio including the past due loans displayed a similar trend, reaching 6.8 percent in September from 6.7 percent in July and 6.66 percent in August. The volume of non-performing loans increased by 15.6 percent in September from August – the highest month-on-month increase since July 2009, except for last July when the bad loans of Savings Bank were added. The volume of past due loans declined by 17 percent in September from a significant increase of 15.6 percent in August. (Figure 41) While the overall soundness of bank loans remains stable, the growing size of non-performing loans may indicate tightening financial situations of some borrowers. Continuous vigilance is needed in light of the fast-growing credits and rising size of past due and non-performing loans.
The swift action of the Bank of Mongolia and the Ministry of Finance in managing the degrading situation of Savings Bank successfully maintain the stability of the banking system. Yet, the recent failure of Savings Bank highlights the importance of a transparent and accountable banking system as well the necessity of closely monitoring of loan quality. Strengthened supervision and proper enforcement of prudential regulations are needed, especially in light the recent rapid credit expansion. In addition, the cost of recapitalizing State Bank following the failure of Savings Bank will likely put an additional fiscal burden on the government. (Box 4)

Box 4. The Recent Failure of Savings Bank

The Bank of Mongolia (BOM) intervened in Savings Bank’s insolvency in July 2013. Privately-owned Savings Bank accounted for 8 percent of total banking assets (fifth-largest in the country and the smallest of the five systemic banks). The bank appears to have failed as a result of poor corporate governance and defaults on insider loans to affiliated companies. The related-party loans exceeded capital by more than 2 times (compared to the 20 percent of capital limitation on loans to any related parties, and the 5 percent limitation on loans to related parties of the bank). Savings Bank had been operating under a special supervisory program of the BOM for the past two years, yet was not able to reduce the insider/problem exposures and restore its capital adequacy.

Savings Bank was put into receivership. Except for about MNT 160 billion of non-performing loans to related parties and MNT 20 billion of other problem credits (which remained with the receiver), all Savings Bank’s assets and liabilities, together with staff, IT systems and other intangible assets were transferred to State Bank in a purchase & assumption transaction arranged jointly by the BOM and the Ministry of Finance.

The resolute approach by the authorities largely prevented a confidence shock to the system. Deposits in the banking system remained intact in the initial post-transaction period. However, the speed of the arrangement came at a cost of State Bank inheriting the assets and liabilities of Savings Bank without the supporting financial injection from the Mongolian Deposit Insurance Corporation or the state as the owner. It is estimated that State Bank needs around MNT 205 billion to reach the 18% CAR State Bank reported prior to the P&A. The authorities are currently deliberating options for State Bank recapitalization (Table 2).

Table 2. The Balance Sheet of State Bank: Before and After the Transfer of Savings Bank’s Operation

<table>
<thead>
<tr>
<th></th>
<th>State Bank pre-transaction</th>
<th>Savings Bank at transaction</th>
<th>State Bank post-transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets ( billion MNT*)</td>
<td>330</td>
<td>~1,070</td>
<td>~1,400</td>
</tr>
<tr>
<td>Assets ( million US$)</td>
<td>~200</td>
<td>~640</td>
<td>~840</td>
</tr>
<tr>
<td>Number of Staff</td>
<td>~400</td>
<td>~3,300</td>
<td>~3,700</td>
</tr>
<tr>
<td>Number of Branches</td>
<td>30</td>
<td>510</td>
<td>540</td>
</tr>
<tr>
<td>CAR</td>
<td>18%</td>
<td>Negative capital,</td>
<td>Below required minimum of 14%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>asset-liability gap of 120b MNT</td>
<td></td>
</tr>
</tbody>
</table>

Source: WB staff estimates
*US$ 1 = MNT 1.675 (September 17, 2013)

Savings Bank’s failure underscores the need for strong banking supervision. The bank, similarly to other Mongolian banks, experienced very significant loan growth in recent years. The rate of growth in the banking sector is likely to have posed a challenge to prudent underwriting practices, corporate governance, and internal controls. Additionally, the unseasoned nature of sector portfolios and shared exposure to a small number of corporate borrowers, in combination with dependence on mining and government spending for this growth, continues to present vulnerability to the banking system. In addition, credit risk is heightened due to recent currency depreciation and given that approximately 30 percent of total loans were in foreign currency in June 2013. Continuous vigilance will be required from the BOM as the banking regulator in the coming months towards systemic and bank-by-bank capital adequacy and maintaining macro-financial stability.

Source: WB staff
The Price Stabilization Program started in October 2012 when government and the central bank signed a Memorandum of Understanding on “Joint implementation of medium term program to stabilize the prices of key commodities and products”. The program (PSP) consists of four sub-programs: i) price stability of staple food; ii) fuel retail price stability; iii) reducing the cost of imported consumption goods; and iv) promoting the construction sector and achieving stable housing prices.

The program aimed to address structural bottlenecks by addressing supply shortages in select goods that have been viewed as drivers of seasonal price volatility. Yet, the PSP is an unconventional inflation measure as it provides discounted loans to select industries in return for their promises to keep prices stable. In this context, the PSP has been a major tool of injecting money into the economy while it contains key consumption prices through de-facto price controls.

The actual disbursement of the PSP program reached MNT 642 billion (excluding the mortgage lending program) since last November through September. The construction industry received MNT 292 billion for construction material production and import, followed by petroleum industry (MNT 192 billion), meat industry (MNT 87 billion) and flour industry (MNT 49 billion).

- Oil price stabilization under the PSP aims to keep petroleum prices stable by lowering financing cost of imported retail oil products. As of September, MNT 192 billion was provided to 11 local oil importers in 15 tranches, at 3.8% interest rate. Forward agreements to sell $82.5 million in 2-6 months through participating banks were signed between the central bank and the 11 companies on favorable terms. Consequently, local oil importers were able to finance their retail oil products at low interest costs and exchange rate risks. This sub-program does not aim to keep the price fixed over the long-term period but requires firms to delay upward adjustment of retail prices in return for financial support.

- The sub-program on meat and flour – that accounts for 20 percent of total CPI and over 60 percent of food CPI – is to increase the meat and flour reserves. Under this sub-program, MNT 122 billion with one year maturity at 3.8 percent interest rate was granted to three meat companies (MNT 87 billion) and 24 flour companies (MNT 49 billion) as of September. As a result, 11,446 tons of meat reserve was prepared by contracted meat producers. Under the flour price stabilization program, a set of measures were implemented to create flour reserves and to control the quality and trading of flour reserves, through discounted loans to 24 flour producers. Through September, the meat companies have fully repaid their loans and flour producers have paid MNT 4.1 billion back to the central bank through commercial banks.

- As the sub-program of the PSP “to stabilize prices of key construction materials”, MNT 292.1 billion has been disbursed, of which MNT166.7 billion was issued to 68 companies that produce construction materials and MNT 125.4 billion to 55 companies to reduce seasonal price volatility of imported prices of construction materials (cement, installed metal). Business entities that were provided financial support by the PSP kept prices in a stable range: the cement price between MNT132-138 thousand and the price of installed metal between MNT 1,100-1,130 thousand during the 2nd and 3rd quarters of 2013. However, the contract terms of the PSP are now increasingly difficult to observe due to increasing production and import cost with the sliding exchange rate. In August, the cement price rose to MNT 140-145 thousand and the installed metal (armature) price went up to MNT 1,150-1,170 thousand.

Source: WB staff
Box 6. Construction and Housing Development Program

Overview. In 2013, the Government has been implementing massive support measures to construction and housing sector. The support measures include the Price Stabilization Program to stabilize the prices of construction materials and additional measures to provide financial support to construction companies and real estate developers and to provide low-rate mortgage loans to households. On top of the MNT 292.1 billion provided to construction sector under the Price Stabilization Program (see Box 5 for more details), the Government and the BoM launched additional supportive measures to construction and housing sector in late June. The measures include (i) MNT 1,125 billion provided to the commercial banks for subsidized mortgage lending and (ii) MNT 430 billion provided to commercial banks for housing construction on-lending with a 7% interest rate and 18 months maturity.

As a result of these comprehensive measures, the construction sector-related policy lending is estimated to reach around MNT 1.8 trillion, over 60 percent of total credit (MNT 3.1 trillion) provided by various policy lending programs.

Mortgage financing program. The MNT 1,125 billion intended for mortgage finance reaches commercial banks from Bank of Mongolia (BOM) at 4% interest rate and is lent to individual borrowers as 20-year mortgages with an interest rate between 7% and 9%, depending on the inflation. The market-based rates in early 2013 reached 27% per annum. These subsidized mortgages are to be packaged to the residential mortgage backed securities (RMBS) by the Mongolian Mortgage Corporation (MIK), which will be subsequently sold to the BOM and the Social Insurance Fund (SIF). The Program additionally includes a provision to allow refinancing of the existing mortgages at the same subsidized rate, which can be seen as a portfolio credit risk management measure. Property eligibility criteria set a limit on the square area of the collateralized apartment at 80 m², which is significantly more than the average property size of the current mortgage portfolio of 50 m². People who have permanent jobs and have income higher than MNT 1 million are eligible for the loan application.

The mortgage financing program follows a series of less than successful prior initiatives, but aims to adopt a comprehensive approach for the development of the mortgage market. The program is very complex with many actors (BOM, a number of Ministries, SIF, capital market regulator, MIK, and major lenders) and transactions, which have been untested in the Mongolian context (mortgage loan sales with full risk transfer, RMBS structuring, issuance and trading, SIF investment, etc.). It is in a large scale that exceeds the existing outstanding portfolio by 32% and is equivalent to 5-6 years of normal mortgage originations in terms of volume. It also requires significant legal and regulatory developments, particularly in the area of the secondary mortgage market operations and MIK institutional capacity.

The Program may not only pose implementation challenges but also has a potential to significantly distort the market. If the large amount of heavily subsidized mortgage credit is made available to the population without rigorous targeting and appropriate eligibility criteria, the real estate prices would likely rise rapidly and significantly. Also, without such criteria on eligibility, mortgage lenders may be left without business opportunities in non-subsidized mortgages even after the program closure as the population may expect further subsidies. However, the fact that ¾ of the mortgage financing was earmarked for refinancing of the existing portfolio indicates that the BOM intended to reduce credit risks to the mortgage industry and to minimize the extent of potential real estate price appreciation.

Between June and mid-September, MNT 448 billion of existing mortgages (53% of the existing portfolio at the time and 40% of the Program) were refinanced and MNT 411 billion (36% of the Program) of new mortgages were issued. The new subsidized lending volume is significant – approximately double the annual originations at market rates – and thus is likely to put the upward pressure on the real estate prices. Overall, ¾ of the Program funding has been utilized and ½ of the Mongolian mortgage portfolio was refinanced and now carries a subsidized interest rate.

The capital market component of the Program, which includes issuance of sophisticated RMBS instruments, is yet to be implemented and would likely require substantial legal, regulatory and institutional efforts. Furthermore, given such a quick disbursement timeframe, there may be social pressure on the BOM and the Government to provide continued subsidized resources for mortgage lending, which will likely lead to a negative effect on the commercial banks’ profitability and their capacity to maintain market-based mortgage lending business. Additionally, BOM is advised to minimize further new subsidized lending by the banks in order to reduce the potential house price growth.

Source: WB staff
External Sector

Amidst the weak global minerals market and strong domestic demand, a large trade deficit continues in 2013, following a record deficit of $2.4 billion (23 percent of GDP) in 2012. The trade deficit for the first nine months reached $1.72 billion, slight down from $2.0 billion a year ago. (Figure 42) While the weakening global minerals market weighs on mineral exports, the import demand – that had more than doubled in 2011 thanks to large FDI inflow – remains large due to domestic aggregate demand far exceeding the capacity of domestic industry. Total imports currently stand at 1.6 times the total exports.

Total exports for the first nine months dropped by 4.1 percent from a year ago, reaching $3.1 billion. A significant drop in coal exports was a main driver behind the weakening exports while other major export commodities displayed relatively robust performance.

- Coal exports – that accounted for 43 percent of total exports in 2012 – declined by 45.3 percent from a year ago, down to $783 million from $1,432 million (Figure 43). The decline in coal exports was mainly driven by a sharp drop in coal exports to China which had absorbed 98.5 percent of Mongolia’s coal exports in 2012.

- Abundant coal supplies in China and growing competition with other major coal exporting countries put heavy pressures on both coal prices and volumes. Despite Mongolia’s significant geographic advantage to the major coal market compared to competitors, the lack of cost-efficient transport and shipment systems constrains the competitiveness of Mongolian coal in China. Reflecting the unfavorable coal market situation, the coal export volume for the first nine months dropped by 20.4 percent, to 11.3 million tons from 14.3 million tons a year ago. The realized unit sales price of coal export per ton between January and September also fell by 31.4 percent (Figure 44).
Copper exports – that accounted for 19 percent of total exports in 2012 – increased by 8.4 percent (yoy) for the first nine months after a decline of 13 percent in 2012. After contractions for three consecutive months, copper export growth turned positive in July and accelerated to 27.1 percent in August and 68.9 percent in September as the Oyu Tolgoi mine started shipping its copper concentrates from July. Copper export volume growth picked up from 10.8 percent in July to 49.4 percent in September (Figure 45). The copper export volume is likely to pick up in the coming months as the Oyu Tolgoi mine is expected to increase its production and export going forward.

Non-mineral exports – that accounted for 8 percent of exports in 2012 – displayed a robust growth of 32.3 percent for the first nine months thanks to strong exports of cashmere products. Growth of cashmere product exports picked up to 29.1 percent from 10.2 percent in 2012. Textile exports including cashmere, leather, wool and hide products rose by 26.1 percent, a significant rise from a 5.8 percent decline in 2012. For the first nine months, the non-mineral exports accounted for 12 percent of total exports and cashmere product accounted for 48 percent of total non-mineral exports.

Total imports declined by 8.0 percent for the first nine months, falling to $4.8 billion from $5.2 billion a year ago. Total imports have been slowing down since 2012 as the mining investment related imports dropped due to the completion of large investments in the Oyu Tolgoi mine. Despite the slowdown since 2012, strong import demand persists exceeding the total exports by 1.6 times in 2013 after it had doubled in 2011 buoyed by the significant foreign direct investment and expansionary fiscal policy.

The slowdown of imports was most prominent in machinery and equipment imports that account for a quarter of total imports, reflecting slower domestic investment demand including the completion of the first phase of the OT mine. Machinery and equipment imports dropped by 17.8 percent through September from a year ago following a 7.3 percent decline in 2012.

Imports of food and basic construction materials grew robustly. Basic construction materials (e.g., cement and red bricks) rose by 11.4 percent in August from a year ago. It reflects the strong demands in road and buildings driven by the strong construction activities in public infrastructure and residential buildings. Food product imports – that account for 6 percent of total imports – also grew at 7.3 percent from a year ago.

Figure 45. Copper export has been rising fast in recent months

![Copper Export Volume and Price (year-on-year, % change)](source: NSO, WB staff estimates)

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Our definition of non-mineral export excludes gold materials that are regarded as non-mineral export in the NSO bulletin. According to the NSO classification, non-mineral export (including gold materials) accounted for 19.9 percent of total exports, up from 10.8 percent in 2012.
The current account had a $2.4 billion deficit for the first eight months of 2013 due to large trade deficit and continuous deficits in service and income accounts. (Figure 46) In addition to the large trade deficit, the service account balance and the income account balance recorded continuous deficits. The service account balance recorded a deficit of $0.9 billion mainly due to a deficit in railway freight services. The income balance also recorded a deficit of $0.6 billion due to increasing deficits in compensation to employees and investment income.

The current account deficit remained close to last year’s level, but foreign capital inflows significantly declined in 2013, putting the balance of payments into a large imbalance. The total financial and capital account recorded a net inflow of $1.3 billion for the first eight months, only 51 percent of the net capital inflow a year ago. The lack of capital inflow led to an external financing gap of $1.1 billion in the balance of payments, putting pressure on local currency value and foreign exchange reserves.

The large decline in foreign capital inflows occurred in both FDI and portfolio investments. (Figure 47) The net foreign direct investment (FDI) for the first eight months in 2013 reached $1.8 billion, only 53 percent of the level between January and August last year. At the current trend, the annual FDI inflow is expected to be only around a half of the FDI levels of the last two years: $4.6 billion in 2011 and $4.4 billion in 2012. The portfolio investment in 2013 recorded a net outflow of $22 million for the first eight months of the year. In 2012, the net portfolio investment inflow recorded $2.3 billion due to a series of external bond issues by a private mining company ($0.6 billion), the Development Bank of Mongolia ($580 million) and the sovereign bond ($1.5 billion).

Growing external imbalances have been translated into pressures on the foreign exchange market and international reserves. (Figure 48) The exchange rate has been on a moderately depreciating trend throughout the year until June. The local currency value against the U.S. dollar depreciated 7.7 percent between January and June. The depreciation accelerated from July – the currency value dropped by 10.4 percent between July and September due to deteriorating market sentiment over the balance of payments prospects.

The international reserve level steadily declined reflecting the growing balance of payments deficits. The gross reserve level peaked at $4,125 million at the end of 2012 due to the proceeds of the Chinggis bond ($1.5 billion). Since then, the reserve level steadily declined throughout the year, dropping to $2,679 million in September 2013. Despite the downward trend, the international reserve level is adequate for precautionary purposes: the gross reserve level is equivalent to about four month’s import.
With the composition of Mongolia's current foreign assets and liabilities, there is no likelihood of significant adverse impacts from capital reversal that recently affected several other emerging economies in the region. As of June 2013, outstanding foreign direct investment stood at $15 billion (Figure 49). Outstanding foreign portfolio investment in Mongolia was only $2.7 billion, most of which was long-term bond investments including the $1.5 billion of Chinggis bonds and $580 million of DBM bonds that were issued last year. Existing foreign loans are also mostly long-term liabilities, and short-term loans accounted for only 9 percent ($347 million) of total foreign loans ($3.9 billion) as most of external loans are concentrated on concessional lending to the government.

Recent sharp exchange rate fluctuations show the fragility of market sentiment. The value of local currency plunged by 9 percent over two weeks between late August and early September. The recent volatility reflects the underlying market forces from the large external imbalances, yet it was also driven by deteriorating confidence in the strength of local currency. Large external imbalances from the trade deficit and declining capital inflows due to a drop in FDI have put continuous pressure on the local currency value throughout the year. Expansionary fiscal and monetary policies have added to the pressure on the balance of payments by providing excessive stimulus to the economy. The prolonged debate over OT issues and remaining high uncertainty over the regulatory framework for foreign investment further weakened the market sentiment.

The recent episodes in foreign exchange market underscore the importance of sound policies to address balance of payments pressures and to attract new capital inflows. The foreign exchange market does not have the significant risk of abrupt foreign capital flight due to limited short-term borrowing and foreign portfolio investment, but the market is vulnerable to headline risks that could be triggered by a series of negative news. In this light, structural changes in macro-economic policy management and the investment regime are important to prevent avoid future currency fluctuations.

Against this backdrop, the recent adoption of the new Investment Law will likely send a positive signal to the market and will help stabilize the market sentiment. The new Investment Law aims at providing a level playing ground to both foreign and domestic investors and ensuring stability of investment over the medium (Box 7). Continuous improvement in related legal environment in the coming months would help further the positive momentum provided by the adoption of the new Investment Law.

Sound macro-economic policies are critical to address the underlying causes of the balance of payments pressure. While continuous improvements of the investment environment including the recent
adoption of the Investment Law will help attract foreign investment going forward, it would take some time for foreign investors to adjust their investment plans and commit to new investments in Mongolia. Meanwhile the strong aggregate demand fueled by the expansionary fiscal policies and monetary easing would likely continue to stimulate imports in excess of exports; a large current account deficit would likely continue despite the increased exports from OT mine unless the strong aggregate demand is eased. In this regard, macro-economic policies need to be adjusted to address the rising current account deficit.

The Mongolian authorities also need to pay close attention to how the international financial market views Mongolia’s economic and political developments. A good indicator is the secondary market bond yields of the Chinggis bonds and the DBM bonds. The Chinggis bonds were issued in December 2012; a $500 million of five-year bonds at 4.125 percent and a $1 billion as ten-year bonds at 5.125 percent. The five-year DBM bonds of $580 million were issued in March 2012 at 5.75 percent.

The sovereign bond market yields followed a steady upward trend throughout the year and began to accelerate in mid-June, reflecting growing concern on the fiscal strength and the economic prospects. The yield to maturity of the 10 year Chinggis bond peaked at over 8.1 percent on Sep 9 amidst the rapid depreciation of exchange rate. It began stabilizing since mid-September following a series of positive news including the stabilizing exchange rate and the announcements of the adoption of the new Investment Law and the fiscal consolidation plan for 2013 and 2014.

The market acceptance of the sovereign bonds means that Mongolia is now a part of the global financial market. The volatile fluctuation of the bond yields indicates that the global financial market is monitoring Mongolia’s economic development and the sustainability of its economic policies. Higher sovereign bond yields also indicate that future sovereign external financing may not come in the favorable terms that we saw in late 2012 when the emerging bond market experienced an extra-ordinary boom due to surging global liquidity and the growing tendency of hunting for higher yields by international investors amidst the aggressive quantitative easing in the US.

A series of comments from international credit rating agencies could provide useful indications on what has been driving sovereign bond yields fluctuation from international investors’ perspective. All the credit rating agencies have agreed that Mongolia has a great growth potential thanks to the vast mineral resources. Yet, the key risk factors that are commonly pointed out by various international credit rating agencies are worth attention. They include: (i) the vulnerability of the economy to the boom-bust cycle caused by the volatile global minerals market cycle; (ii) the growing external imbalances exacerbated by the expansionary macro-economic policies; (iii) pro-cyclical fiscal policy based on off-budget spending and debt financing despite the fiscal disciplines of the Fiscal Stability Law; (iv) unpredictable investment regime; and (v) banking sector vulnerability and transparency in light of rapid credit growth and the recent Savings Bank event.

11 Moody’s (September 5), S&P (May 15), Fitch (July 29)
Box 7. Key Features of the New Investment Law

Investment sentiment over Mongolia has been deteriorating since 2012, especially after the adoption of the Law on Foreign Investment in entities operating in strategic sectors (May 2012) known as SEFIL and amidst the uncertainties over negotiations on the OT agreement. As the foreign investment declined noticeably in 2013, the Government of Mongolia recognized the importance of revamping the investor confidence by improving the investment regulation and started working on a new investment law that would replace SEFIL and outdated Law on Foreign Investment (1993). The preparation of the law underwent rigorous consultation process with investors and under technical advice from international financial institutions including the World Bank Group and the IMF.

The Investment law intends to protect legal rights and interests and to stabilize tax environment to both foreign and domestic investors. Key features of the law include:

- **Streamlining of investment approval process.** The law replaced the SEFIL and streamlined the investment approval or registration process. The definition of strategic sectors was taken out of the law. Private foreign investors are not required to get approval from the government or the Parliament but only have to be registered to a state agency.

- **Investment by foreign government owned legal entities.** A special process is required if a foreign government owns 33 percent or higher shares of an investor. For those investments, an application should be made to a state agency, which will be reviewed for its possible impact on (i) national security, (ii) competition in the market, (iii) government budget and other policies. The decision has to be made by the state agency with 45 days after application.

- **Tax stabilization.** The law introduces tax stabilization clauses for four types of taxes: CIT, Customs tax, VAT and royalties. For the purpose of tax stabilization, stabilization certificates will be issued to investments that meet certain criteria, e.g. investments that will create new vacancies or introduce new technologies for example. The tax stabilization will ensure the four tax rates will not be raised for the duration of the certificate but the investors with the certificates will be able to benefit from tax rate reduction. The duration of stabilization certificates varies by sectors, sizes of investment and locations divided into five regions. Mining, heavy industry and infrastructure sectors will get the tax stabilization up to 18 years depending on the size of investment (from MNT 30 billion), and regions. Investment in other sectors will get the tax stabilization up to 15 years depending on the size of investment (from MNT 10 billion), and regions. The duration of tax stabilization will be 1.5 times longer for investments that meet certain criteria, for instance an investment that will produce import substitute or export oriented products or an investment over MNT 500 billion.

- **Tax and non-tax incentives.** Tax exemptions and incentives will be provided but the details of tax incentives will be further stipulated by related tax laws. Imported technical equipment may be exempted from the customs duty and VAT rate, may be zero-rated during the construction works. Non-tax incentives will also be provided by the related legislations.

- **Investment contract and protection.** The Government of Mongolia shall conclude an investment contract with the investor who is to invest more than MNT 500 billion at the investor’s request with the purpose of stabilizing the environment of business activities. The Law also includes almost all standard investor guarantees and is in this respect more elaborated than the Law on Foreign Investment (1993). In addition it does establish a right to international and domestic arbitration.

The law is a positive progress from the SEFIL as it significantly streamlined the process and provides a stable environment in terms of tax burden and investor protection. Continuous and consistent improvement in ensuing investment related legislations would help add to the positive momentum provided by the new Investment Law.

Source: The World Bank staff
Box 8. Mongolia advances in its ease of doing business rank in the Doing Business 2014 report


These areas are covered by two types of indicators. The first type indicators measure the complexity and cost of regulatory processes—assessing the efficiency with which a local entrepreneur can complete a common transaction, such as incorporating a company or getting an electricity connection, while complying with all relevant rules and regulations. Second type indicators measure the strength of legal institutions—assessing specific features of local business laws such as those relating to protecting investors or getting credit. In both these examples, a higher score is assigned for features providing stronger protections of investors or secured lenders.

Ten topics are included in the aggregate ranking on the ease of doing business. The ease of doing business index ranks economies from 1 to 189. For each economy the ranking is calculated as the simple average of the percentile rankings on each of the ten topics included in the index in Doing Business 2014.

Mongolia is ranked the 76th of the ease of doing business ranking among 189 countries in Doing Business 2014 report, an improvement by four ranks from the 2013 report. The report recognized three regulatory reforms Mongolia made to make business easier between June 2 2012 and June 1 2013: (i) starting a business, (ii) dealing with construction permits, and (iii) Getting electricity. Mongolia made starting a business easier by eliminating the requirement to get company statutes and charters notarized as well as the requirement to register a new company with the local tax office. And it made dealing with construction permits easier by eliminating the requirement for a technical review of the building plans by the state for low- and medium-risk construction projects. In addition, Mongolia made getting electricity easier by increasing the efficiency of the utility’s internal processes, enforcing time limits at different stages of the connection process, and eliminating the fees for testing the installation.

Thanks to the three business regulatory reforms, Mongolia’s distance to frontier indicator for Mongolia also improved from 60.2 to 61.6. The distance to frontier measure, introduced in Doing Business 2012, assesses how much the regulatory environment for local entrepreneurs improves in absolute terms by showing the distance of each economy to the “frontier,” which represents the best performance observed on each of the Doing Business indicators across all economies since 2003 or the first year in which data for the indicator were collected. The measure is normalized to range between 0 and 100, with 100 representing the frontier.

Singapore has the highest global ranking on the ease of doing business, followed by Hong Kong SAR, China. New Zealand, Malaysia, and the Republic of Korea are also among the top 10. The Philippines is among the global top 10 improvers this year—the economies making the biggest improvement in business regulation over the past year. Among the 25 economies in East Asia and Pacific region, Vietnam and China implemented most business regulatory reforms. Vietnam implemented the most number of reforms in the region with 21 reforms during this period, followed by China with 18. Fifteen of 25 economies in East Asia and the Pacific implemented at least one regulatory reform making it easier to do business in the year from June 2, 2012, to June 1, 2013—25 reforms in total. China is among the 20 economies worldwide that have narrowed the gap with global good practices the most since 2005. The Lao People’s Democratic Republic, Timor-Leste, Malaysia, Cambodia, and the Solomon Islands are among the top 50 narrowing this gap the most.

The economy is facing a challenge from mounting balance of payments imbalance and uncertain economic environment...

The Mongolian economy has achieved remarkable progress over the last two years and its medium-term prospects are promising. It has emerged as one of the fastest growing economies in the world over the last two years and rising incomes have helped to reduce the poverty rate by 11.3 percentage points during the period. The economy is expected to show double digit growth again in 2013 despite the unfavorable external environment. The medium-term prospects are also promising, given the expected ramp-up of major mineral production including copper, coal, and gold.

The economy has become more susceptible to volatile minerals market cycles and more reliant on capital inflows. The 17.5 percent growth in 2011 was fuelled by the surge in foreign capital inflows and expansionary fiscal policy. The high double digit growth also came with increasing vulnerability to external shocks. Imports nearly doubled over the year, far exceeding the growth of exports even though the exports grew at over 65 percent thanks to robust minerals market at the time. It meant that a substantial trade deficit would be highly likely in times of abrupt minerals market downturn and that the trade deficit could only be sustained with continuous large foreign capital inflows. The heightened external vulnerability became more visible in 2012 when the global minerals market weakened rapidly. Total exports declined amidst the sharp downswing of the global coal market, and the strong import demands that had been buoyed in 2011 led to a surging current account deficit in 2012, equivalent to over 32 percent of GDP. Yet, the mounting current account deficit was not considered an imminent risk as the large foreign capital inflow enabled the economy to fully finance the current account deficit.

In 2013, the Mongolian economy is facing a challenge from growing external imbalances as the FDI inflow declines and the mineral exports remain weak. The declining capital inflow will likely be able to finance only half the current account deficit. The growing balance of payments pressures have been reflected in the international reserves and foreign exchange market. The international reserves fell by around 30 percent from the peak at the end of 2012. The value of the local currency has been under growing pressure from the deteriorating external position and it has experienced volatile fluctuations since July.

The balance of payments problem also reflects the consequences of pro-cyclical economic management that has been spurring domestic aggregate demand since 2011. A trade deficit can be anticipated to some extent in a country at an early stage of development in massive mines as it requires growing imports of mining investment equipment. The full potential of the vast Oyu Tolgoi mine – which is expected to provide a third of total economic growth once it’s fully developed – will not be realized until the investment in the underground mine is completed. Yet, the pro-cyclical economic management over the last two years has pushed the aggregate demand to the extent that it could lead to substantial
external imbalances that may not be sustainable in the medium and long-term in the event of a prolonged minerals market downswing.

**Macro-economic policies are still focused on economic stimulus and growth, adding to pressures on the balance of payments and inflation.** After the continuous accumulation of budget deficits over the last two years, the fiscal policy remains highly expansionary in 2013 because of significant off-budget public investment spending that will push the fiscal deficit to over 12 percent of GDP. Monetary policy turned accommodative in 2013 and has injected liquidity equivalent to over 20 percent of GDP to industry in the form of subsidized central bank lending. These expansionary policies have helped maintain economic growth at double digits in the first half, but the high growth was driven by strong domestic consumption growth and construction boom that are largely reliant on imports, which have been intensifying the balance of payments pressure. Compared with other countries in the region, Mongolia’s economic management has been highly expansionary and resulted in larger current account deficit and higher inflation (Box 9).

- **The current loose economic policies are not sustainable given the mounting balance of payments pressure and will undermine macro-economic stability going forward.** The Government has recently taken a series of positive measures to address increasing external imbalances and financing gap of the budget. Yet, under the current economic policy framework, the large balance of payments pressure will unlikely ease significantly in the near future, given the persistent large import demands and uncertain prospects of minerals market recovery. Compared with peer countries in the region, Mongolia’s economic management has been highly expansionary and resulted in larger current account deficit and higher inflation (Box 9). If the current expansionary and loose economic policies were to continue, growing balance of payments pressure would likely become unsustainable and may lead to a harsh economic adjustment process in the medium-term. **Under the current economic policy framework, the large balance of payments pressures will likely continue:** (i) import demands – currently 1.6 times the size of exports – will remain strong and may grow further if consumption and construction activities accelerate due to the rapid credit growth and increasing off-budget DBM spending; (ii) coal exports will likely remain weak for the coming months due to the excess of supply and growing competition in China despite the plans to ramp up production in major coal mines; (iii) the balance of payments impact from OT mine will be limited in the coming years as the full potential of the mine will be realized only after the second phase development is completed and a significant portion of the export proceeds will have to be used to repay the cost of surface mine development; (iv) the resumption of significant foreign capital inflows may take some time despite the adoption of the new Investment Law before potential investors adjust their business plans and commit to new investment plans.

- **Continuous deterioration of balance of payments would put growing pressure on the international reserves and the foreign exchange market.** While the foreign exchange reserves remain adequate, the current rate of decline in the reserves may not be sustainable in the medium term. The current depreciation would help moderate import demands and improve export competitiveness to some extent, but it could also add to inflationary pressures given the reliance of domestic consumption on imports and pose a downside risk to the banking sector’s soundness.

- **With the mounting fiscal deficit and public debt, the fiscal policy space to cope with possible external shocks and further dampening of minerals markets is narrowing.** The public debt to GDP ratio rose significantly from 35 percent in 2010 to 63 percent in 2012 due to the issuance of large external debt in 2012 and accumulation of domestic debt. Deteriorating
fiscal strength also implies that the capacity of the Government to resort to external financing would also be more constrained in an economic downturn as the international financial markets would likely price the weakening fiscal soundness into higher borrowing costs.

- **While it helped maintain credit growth amidst declining FDI, further monetary easing will likely translate into growing vulnerability of the banking system and add to economic imbalances.** With private credit growth accelerating to 48 percent in September, the banking sector becomes increasingly susceptible to a possible economic downturn, particularly given the concentration of credit growth on construction and housing sector and its vulnerability to the economic cycle. Meanwhile, adverse impacts of rapid credit growth on macro-economic stability seem to be emerging as the exchange rate’s depreciation accelerates and inflation rises. The prudential regulatory forbearance given to various policy loans under the monetary easing program will add to banks’ vulnerability as it will increase moral hazard in banks’ lending and weaken the transparency of the banking system.

**The downside risk will likely be exacerbated if the Mongolian economy faces growing headwinds from an unfavorable global economic environment.** Under the current policies, policy buffers to cope with these possible external shocks will likely be highly limited amidst the growing balance of payments pressure, increasing fiscal deficits and public debt, and rising inflation. Should the rebalancing of the Chinese economy from the investment-led growth to more consumption-based growth occur in an unfavorable way, it may further dampen the economic growth in China. In advanced economies, tapering of the aggressive quantitative easing in recent years is likely in the near future, which would weaken capital inflows to emerging economies and raise borrowing costs. Some emerging countries – especially with large current account deficits and heavy reliance on foreign capital – have already experienced adverse impacts from sharp capital reversal and currency depreciation over the recent months and are preparing to cope with changing global liquidity conditions by building macro-economic policy buffers and improving their investment climates. The global minerals market will also likely remain weak in the near future amidst the abundant supply conditions and growing competition among exporters of major minerals including coal and copper.

**Box 9. Macro-economic Policies in Mongolia and Peer Countries in the EAP Region**

Indicative assessment of economic policies, Mongolia’s economic policy stance can be compared with those in other peer countries in the region. This box compares key economic parameters and policy variables between Mongolia and other countries in the East Asia and Pacific countries (Figure 51).

Mongolia displays the highest growth in the region but also shows persistent large external and internal imbalances compared with peer countries in the region.

- The current account balance to GDP ratio has been the highest over the three years compared with all other countries in the region. Lao PDR and Papua New Guinea shows high current account to GDP ratio ranging from 15-20 percent of GDP. Other resource export countries (e.g., Indonesia and Myanmar) displays deteriorating current account balances but their sizes relative to GDP are significantly small compared with that of Mongolia or other two countries.

- Mongolia’s inflation rate also has been one of the highest in the region except for Vietnam. However Vietnam’s inflation rate has been on a downward trend over the last two years. Indonesia will likely have significant inflation at 9.8 percent in 2013 as the government raised subsidized fuel prices for the first time since 2005.

- Mongolia experienced largest decline in the foreign investment inflows over the last three years. The Mongolia also shows the largest share of FDI inflows compared with the GDP but the GDP share of FDI is expected to drop from 58 percent in 2011 to below 20 percent in 2013.
Fiscal and monetary policy variables indicate that expansionary policies have been underlying forces behind the higher growth rates and the larger external and internal imbalances in Mongolia. The fiscal deficits of Mongolia have been highest in the region over the last two years and continue to grow in 2013. Most of other countries have been experiencing fiscal deficits due to their policy measures to cope with the global financial crisis, yet their size relative to GDP has been much smaller than that of Mongolia. The regional comparison of economic parameters and policy variables indicate that Mongolia has been achieving the highest economic growth by running more expansionary economic policies. As a result, the Mongolia economy has been experiencing larger external imbalances and higher inflation rates than most peer countries in the region.
Economic policies need to shift toward ensuring economic stability and sustainable growth in the long-term...

In light of the uncertain global economic prospects and growing economic vulnerabilities, the current growth-oriented economic policies should be tightened toward economic stability. Priorities of macro-economic management should lie in: (i) easing the pressures on the balance of payments from domestic factors; (ii) addressing potential macro-economic and financial risks stemming from expansionary policies; (iii) replenishing policy buffers to maintain sustainable and stable growth in the long-term.

1. Fiscal policy should be tightened further and start rebuilding fiscal space. The Fiscal Stability Law (FSL) that became effective in 2013 provides fiscal discipline to curb excessive spending (e.g., 2 percent ceiling in structural deficit to GDP) and insulate fiscal policy from volatile minerals market cycle. The recent announcement of tightening spending is a noticeable progress; yet significant off-budget spending remains uncontrolled. A priority is to recognize the off-budget spending as part of the budget and put it under the control of the FSL. Then the consolidated budget should adhere to the rules of the FSL based on realistic revenue assumptions and rational spending plans. Restoring fiscal space is also important for the fiscal policy to secure flexibility (e.g., proper public debt level and build-up of fiscal savings) for future counter-cyclical policies in times of abrupt external shock in the future.

- The recent announcement to tighten budget spending for 2013 and 2014 is a noticeable progress toward a more sustainable fiscal path. Yet, the consolidation plan is limited to the official budget, and significant off-budget spending will continue pushing the overall fiscal deficit to over 12 percent of GDP.
- Off-budget spending should be recognized as part of the budget. The Government planned to slow the spending through the DBM in the remainder of the year, which is a positive signal. Yet, a significant amount of off-budget spending mainly financed by the Chinggis bond will be implemented next year outside the budget, and it will undermine the effectiveness of fiscal planning and of the Fiscal Stability Law. The off-budget spending should be included in a fiscal consolidation plan that would put a ceiling of the FSL on the comprehensive fiscal deficit including the off-budget spending.

- A medium term fiscal consolidation plan would be useful to provide a credible and realistic road map. The best economic scenario would be to reduce the fiscal deficit – including off-budget spending – to the 2 percent target of the FSL this year. However, the task may be politically challenging given the political commitment to infrastructure investment. In this light, a medium term fiscal consolidation strategy would provide a good anchor to gradually reduce the consolidated (on- and off-budget) fiscal deficit to the 2 percent ceiling of the FSL by a targeted year – e.g., after three years. Macro-economic assumptions would need to be conservative and realistic to avoid optimistic revenue projections and aggressive spending plans. The Ministry of Finance’s annual Medium Term Budget Framework is a good platform for a mid-term fiscal consolidation plan, but it should be improved to serve the purpose because it does not include DBM spending and its revenue projections have proven to be too optimistic. Legislative action could also help to consolidate off-budget spending into the budget by requiring that the DBM’s spending or projects financed by sovereign bonds be recognized as spending that is subject to the FSL.
Revenue projections need to be based on realistic assumptions, insulated from political influence. The revised revenue projections of the current fiscal consolidation plan and the preliminary 2014 budget proposal by the Cabinet seem to be in line with realistic economic prospects. Yet, past experiences suggest that the revenue projections submitted by the Cabinet tend to be raised on an ad-hoc basis during Parliament’s review process along with upward adjustment of spending via insertions of extra budget programs. This year’s harsh experience – the revenue shortfall of 15-20 percent of budget – underscores that too optimistic revenue projections could jeopardize the credibility of fiscal plans and misguide overall economic management of the year.

In the longer-term, fiscal policy needs to build policy buffer to cope with possible economic downturns. Budget savings allow the government to address economic downturns with active, counter-cyclical fiscal policies without resorting to borrowing – which is usually more difficult when an economy is in a downturn. The sovereign wealth fund legislation being developed by the Ministry of Finance would provide a good institutional foundation for effective mineral revenue management and fiscal savings. In this regard, tightening of the 2 percent ceiling of structural deficit to structural balance (i.e., no structural deficit) should be considered in the longer-term to provide a better anchor by securing budget savings when mineral revenues are above structural revenues.

2. Fiscal policy needs to more focus on “spending well”. The rapid increase of public investment spending – twenty-seven fold increase over the last decade – has raised concerns about the quality of public investment projects. It is undeniably important to scale up infrastructure spending in developing countries, yet the pace should match the Government’s planning and implementation capacity and the economy’s absorptive capacity. All projects approved by the budget need to be equipped with proper project documentations including their feasibility, design, and accurate cost estimations. Ad-hoc insertion of new projects during the Parliament review process needs to be avoided unless they are proven urgent and feasible by rigorous analysis and convincing documentation.

In this context, a proper medium-term public investment plan needs to be established to present national and sectoral development priorities and a road map to achieve them. The plan needs to specify development targets to be achieved within a given time line. The public investment plan should be realistic under an affordable and conservative midterm revenue prospect stipulated by a medium-term fiscal plan under the FSL. In a country at an early development stage everything looks important, and prioritization is essential for successful long-term development given limited fiscal resources. Strategic priorities proposed by the public investment plan would provide a good anchor for strategic allocation of fiscal resources.

The fragmented public investment planning system needs to be improved. The system has two pillars: (i) official capital expenditures under the budget and (ii) extra public investment spending through the DBM. While the Ministry of Economic Development is effectively in control of both pillars, the second channel of public investment through the DBM will likely create problems in terms of effective planning and transparency. While the DBM became the main financier of large public investment projects, there is no national development plan that comprises both the budget and the DBM. The lack of transparency in the DBM also raises a concern about the quality of public investment. The DBM has not been publishing either its annual investment plan or its progress, and its projects are not subject to the rigorous procurement and monitoring requirements imposed on on-budget investment projects. Without
transparency and regulation, there are risks that the DBM’s investment projects will be more vulnerable to political influence and include uneconomic, pork-barrel projects.

3. Monetary policy should focus on macro-economic and financial stability. The monetary easing contributed to countering signs of credit slowdown early this year, but the rapid private credit growth in recent months underscores that the monetary authorities need to re-assess the impact of monetary easing on key economic indicators, particularly on the balance of payments and inflation.

- **Given the recent balance of payments pressures and inflation trends, the authorities should start reinig in credit growth.** Policy lending programs implemented by the monetary authorities have fueled the credit growth as the policy loans were directly provided to commercial banks at discounted terms. These policy lending programs need to be gradually phased out and eventually terminated.

- **There are indications that the monetary authorities may be slowing the pace of monetary easing, yet the monetary easing will remain in a substantial scale given the likely continuation of large policy lending programs.** The MNT 900 billion that was deposited at commercial banks as short-term deposits by the central bank is planned to be returned to the Bank of Mongolia in late 2013. However, a large portion of the monetary easing program will remain as long as large policy lending programs are being implemented, including the Price Stabilization Program and the construction and housing development program. The size of two programs account for over 70 percent of liquidity provided by monetary easing programs.

- **Going forward, policy lending with social objectives should be managed under the budget if they are considered priority programs by the Government.** Many of the policy lending programs with social objectives were initiated by the line ministries of the Government and have been implemented by the central bank as the limited budget revenue could not finance those projects. These programs include the Price Stability Program and the construction and housing development program. These quasi-fiscal spending programs implemented through the central bank shift the fiscal burden to the monetary authorities, thus creating a large monetary easing effect while the government budget avoids additional deficit.

4. Stronger supervision and monitoring of the banking system's soundness is essential. Good progress has been made in strengthening capital adequacy and establishing the Deposit Insurance Corporation early this year. To prevent rapid growth of credit from creating new financial sector risks, further strengthening of the regulatory and supervisory framework is needed, especially in the capital adequacy of systemically important banks and the prudence of loan underwriting practices and internal controls.

- **Given the rapid growth of credit to construction and housing sector, strong monitoring is needed of the soundness of the banking system.** Over 60 percent of the credit provided by monetary easing programs has supported construction. The resulting strong growth in residential construction and rising housing rental prices indicate the risk of asset price bubbles. Given the potential impacts on the banking sector soundness, close and continuous monitoring of construction and housing prices is important. The authorities also need to monitor the household debt burdens given the increasing mortgage borrowing of the middle income families.

- **The prudential regulatory forbearance given to the policy loans needs to be terminated as it could exacerbate the credit risk placed onto the banking system.** The prudential regulatory
forbearance was introduced as an incentive to encourage commercial banks’ participation in policy lending programs. However, it may provide misleading information on the financial capacity of banks to cope with possible financial stress and weaken the credibility and transparency of overall banking system. The recent Savings Bank failure also underscores the importance of proper enforcement of prudential regulation.

- **In light of the depreciating exchange rate, close monitoring is also needed of possible risks stemming from foreign currency denominated loans.** Detailed data is not publicly available on the size and composition of foreign currency loans, but increased foreign currency loans amidst the depreciating trend of local currency could turn into growing currency mismatches and financial burden of (un-hedged) private sector borrowers.

5. **Continuous improvement of the investment climate is important.** Reforming the investment regime – that has been regarded as a major obstacle to increasing FDI – has important implications in: (i) improving the fragile market sentiment in the near-term; and (ii) easing the growing balance of payments pressures in the longer-term. The significant decline of FDI has been one a driving force behind deteriorating market confidence this year. Credible and realistic improvement of investment regulations would be a signal to foreign investors that the Mongolian economy seeks to provide a stable and predictable business environment for the long term investment.

**Recognizing the importance, the Government has adopted the new Investment Law in October, a significant progress.** The new investment law provided a good momentum to regaining investors’ confidence through providing a more business friendly environment. It may take time to readjust investment plans and commit to new investment in Mongolia as investment decision takes time and resources and investors' confidence has been weakening for over a year. Yet, the positive momentum established by the new Investment law will help gaining the investor’s confidence and building the foundation for stable and strong foreign investment inflow going forward, especially if the positive environment provided by the new law is further strengthened by continuous improvements in investment-related regulations and consistent policy actions.
# Key Economic Indicators Tables

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<td>-10.9</td>
<td>-12.3</td>
<td>-7.6</td>
<td>-5.9</td>
</tr>
<tr>
<td>Public Debt (% of GDP)</td>
<td>36.7</td>
<td>63.0e</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td><strong>Balance of Payment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports of goods (US$ mn)</td>
<td>4,817</td>
<td>4,384</td>
<td>4,261</td>
<td>5,113</td>
<td>5,883</td>
</tr>
<tr>
<td>(% yoy change)</td>
<td>65.6</td>
<td>-9.0</td>
<td>-2.8</td>
<td>19.9</td>
<td>15.0</td>
</tr>
<tr>
<td>Imports of goods (US$ mn)</td>
<td>6,598</td>
<td>6,738</td>
<td>6,522</td>
<td>6,910</td>
<td>7,193</td>
</tr>
<tr>
<td>(% yoy change)</td>
<td>101.3</td>
<td>2.1</td>
<td>-3.2</td>
<td>5.9</td>
<td>4.1</td>
</tr>
<tr>
<td>Current account balance (US$ mn)</td>
<td>-2,758</td>
<td>-3,362</td>
<td>-3,259</td>
<td>-2,198</td>
<td>-1,856</td>
</tr>
<tr>
<td>(% of GDP)</td>
<td>-31.7</td>
<td>-32.8</td>
<td>-29.7</td>
<td>-23.0</td>
<td>-18.0</td>
</tr>
<tr>
<td>Foreign direct investment (US$ mn)</td>
<td>4,620</td>
<td>4,407</td>
<td>1,951</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Gross official reserves (US$ mn)</td>
<td>2,630</td>
<td>4,126</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td><strong>Financial Markets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Domestic credit (% yoy, eop)</td>
<td>72.3</td>
<td>24.6</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Base policy rate (% eop)</td>
<td>12.3</td>
<td>13.3</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Exchange rate (MNT/USD, eop)</td>
<td>1,395.4</td>
<td>1,392.1</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>REER (% change, period average)</td>
<td>8.6</td>
<td>2.9</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td><strong>Memo</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nominal GDP (MNT bn)</td>
<td>11,088</td>
<td>13,944</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
</tbody>
</table>

Source: National data sources, World Bank staff estimates

e = estimate
f = forecast