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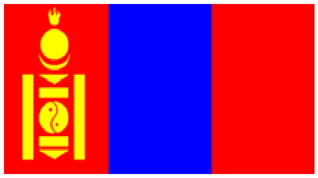


MONGOLIA QUARTERLY

WORLD BANK

October 2008

The recent worsening of the financial crisis in the US and the contagion to the world real economy are adding pressures for Mongolia to address macroeconomic imbalances. In particular, the fall in copper prices and the shortage of liquidities worldwide will imply a slowdown of global economic growth, lower copper prices, and reduced FDI. The implications for Mongolia—a larger current account deficit, much lower government revenues, and continued large investment needs—will pose significant policy challenges for the new government to maintain growth while lowering inflation. Fiscal tightening will be key to prevent inflation from permanently affecting expectations and to reduce the current account deficit. This includes no further increase in public wages, no further increase in universal cash transfers, and a prioritized investment program limited to what the absorptive capacity of the economy can bear. Fiscal space should be kept for a targeted social safety net to protect the most vulnerable. Reducing inflation is always painful, but the slower the authorities react, the more protracted the process is, with deeper impact in economic activity, employment and poverty.

The World Bank's *Mongolia Quarterly* provides an update on recent economic and social developments and policies in Mongolia. It also presents findings of ongoing World Bank work in Mongolia. The Mongolia Quarterly is produced by a team from the World Bank's Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Region Vice-Presidency, with key inputs from other members of the Mongolia Country Team. Questions and feedback can be addressed to Altantsetseg Shiilegmaa (ashiilegmaa@worldbank.org).

TABLE OF CONTENTS

Page No.

BOXES

FIGURES

TABLES

1. RECENT ECONOMIC DEVELOPMENTS

ECONOMIC GROWTH

1. ***GDP real growth accelerated over the 2nd quarter of 2008, reaching 11.3 percent over the last 12 months***. The main engines of growth were services and agriculture, contributing 4.2 and 3.8 percentage points respectively to GDP growth. By contrast, as of July, real gross industrial output increased by only 2.3 percent year-on-year (yoy), with mining production even recording a decline of 1.9 percent in real terms. Reasons for this decline despite high world prices are: (i) an inelastic copper extraction due to depleted resources in Erdernet copper mine and (ii) a marked slowdown of official gold production by 17.3 percent yoy, as a result of the windfall tax. Although the direct contribution of mining to economic growth is small or even negative, this remains Mongolia's main foreign exchange earner, with large export revenues from high world metals prices and sustained FDI flowing into the sector over the first half of the year.

Table 1: In the second quarter of 2008, economic growth accelerated further …

	Gross Domestic Product	Agriculture	Industry, construction	Services	Net taxes on products
2006	8.6%	1.6%	2.1%	2.2%	2.6%
2007	9.9%	3.4%	2.1%	3.2%	1.2%
I -2008	10.2%	3.4%	1.7%	3.5%	1.6%
II - 2008	11.3%	3.8%	1.0%	4.2%	2.2%

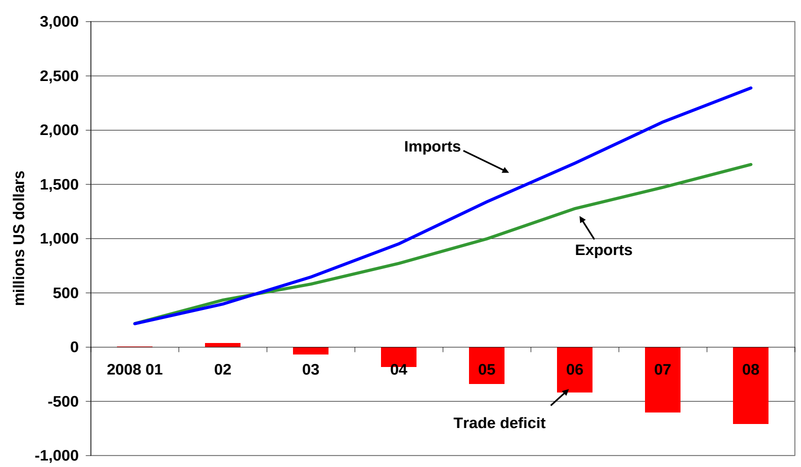
Note: Quarterly figures are annualized growth figures over the previous 4 quarters

Source: National Statistical Office

BALANCE OF PAYMENTS

2. ***Despite sustained export growth, the trade deficit has widened sharply due to a rapid expansion of imports.*** Exports increased by 47 percent, in large part due to high world prices of copper and gold (above $8,000/mt and $900/toz respectively over the first 8 months of 2008). As of September, mineral products accounted for more than 84 percent of total export earnings and contributed to more than 90 percent of their incremental earnings over the previous 12 months. Copper, gold, zinc, coal and crude oil contribute respectively 40, 22, 7.1 and 6.9 percent of total export earnings in the first 9 months of 2008. Imports expanded by 90 percent yoy as of September 2008, but this expansion might be overestimated.[1] Imports were driven by petroleum (25 percentage points), and equipment purchases (14 percentage points). Four factors contributed to this rapid expansion: higher world oil

Figure 1: Trade deficit is widening



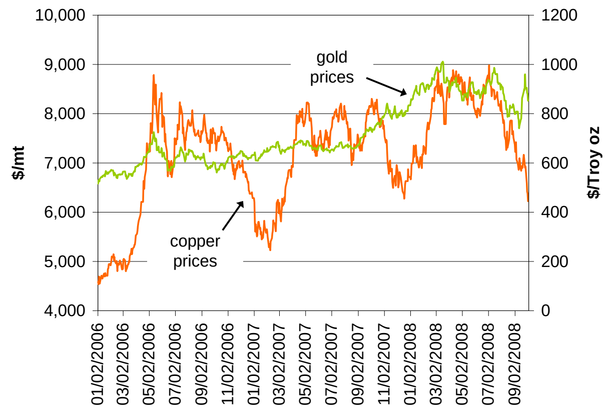
Note: Cumulated monthly flows from January 2008.
Source: Bank of Mongolia monthly statistical bulletin

[1] The category "cellulose and related products" includes items which need to be re categorized in the capital account of the balance of payments.

and food prices; excess liquidity in the domestic economy which pushes up aggregate demand; a relatively rigid nominal exchange rate; and large imports of mining equipment associated with growing FDI in that sector.

3. ***The capital account remained robust at the end of the second quarter, thanks to growing foreign direct investment*** which reached US $195 million, up from US $52 million yoy. Overall, the balance of payments recorded a slight decrease in reserve assets by US $28 million at end-July.

Figure 2: Copper prices are falling while gold prices are holding up

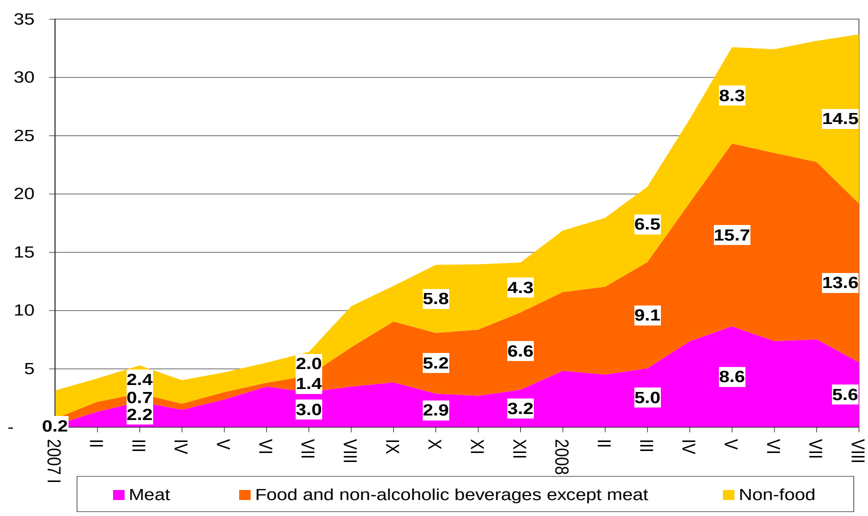


Source: World Bank Prospect Group

4. ***Copper prices fell recently on weak demand,*** especially from sagging global construction activity and higher inventories, with prices plunging sharply in early October on concerns about global growth. From August to early October, the total drop exceeded 40 percent; from $7600/mt to below $5,000/mt. Gold prices remained above $800 per ounce as of the end of September. Further declines in copper prices are expected in the coming months, caused by a slowdown of demand in high-income countries as a consequence of the financial crisis, as well as in China. China's economic growth is 9.7 percent yoy as of end September, down from 10.1 percent at the end of the second quarter.

INFLATION

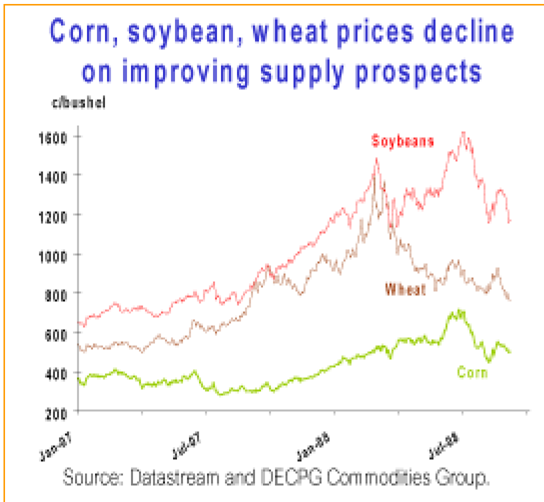
Figure 3 – Inflation shifted of drivers over the summer from food to non-food.



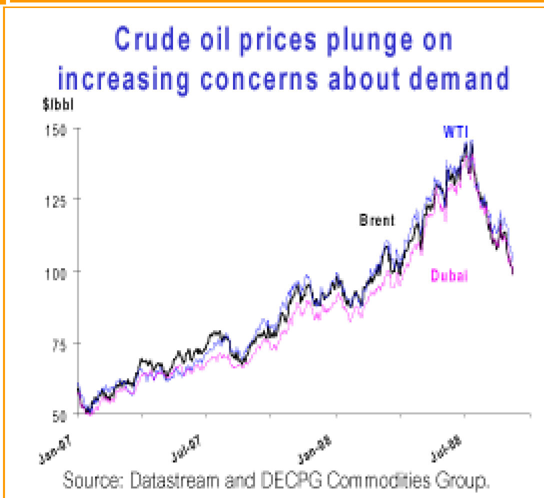
Note: Percentage points of inflation; Source: National statistical office

5. ***Inflation accelerated further over the summer, up to 34.2 percent yoy as of August 2008, but started declining in September down to 31.7 percent yoy.*** Inflation drivers shifted over the summer from food to non-food items. Since May 2008, food inflation slowed down to 19.6 percent yoy, as a result of declining world food prices, the impact of a tighter monetary policy, and the announcement of a relatively good harvest. World food prices started falling over the summer (see box 1). At the border, prices of sugar, wheat (highest grade), potatoes, and rice all started declining in May 2008. In addition, hay harvest and gathered potatoes recorded 29 and 23 percent yoy increases respectively at the end of August.

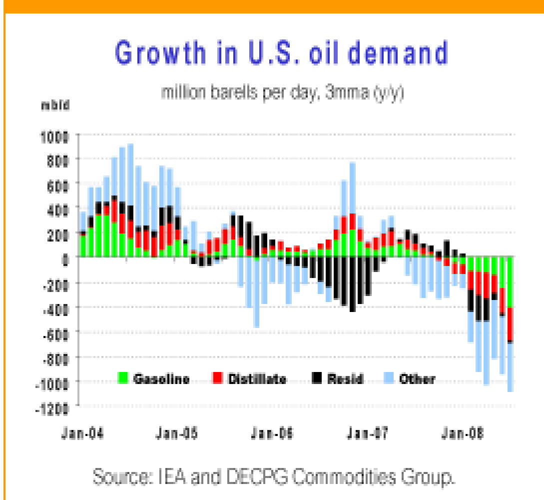
Box 1: World food and oil prices are on the decline



Agriculture prices fall sharply. Agriculture prices slumped 8.5 percent in August, the second monthly decline following 15 consecutive monthly gains. The largest drop was in fats and oils, down 15.5 percent on the back of reduced consumption due to earlier skyrocketing prices, and increasing supplies. Palm oil prices fell more than 20 percent on much higher production in Indonesia and Malaysia and rising stocks. The entire soybean complex fell some 12-13 percent tied to weak demand amid cancelled import orders from China, and improving supply prospects. Wheat prices are down due to expectations of a large increase in global output, while corn prices continue to sag on an improving production view of the United States.



Oil prices drop with focus on slowing demand. Crude oil prices dropped 30 percent, or more than $40/bbl, since peaking on July 3rd. While fears of supply shortages helped drive prices to record levels earlier this year, concerns have shifted to slowing OECD demand and improving global supply prospects. OPEC production continues to edge upward, with Saudi Arabia starting to pump oil from its new 0.5mb/d Khursaniyah field. OPEC met September 9th and agreed to adhere to production targets announced in September 2007, which they judge would require 0.52mb/d to be taken off the market, although it appears a larger cut is needed. Prices have continued to weaken, as Saudi Arabia has said it will produce whatever its customers want.

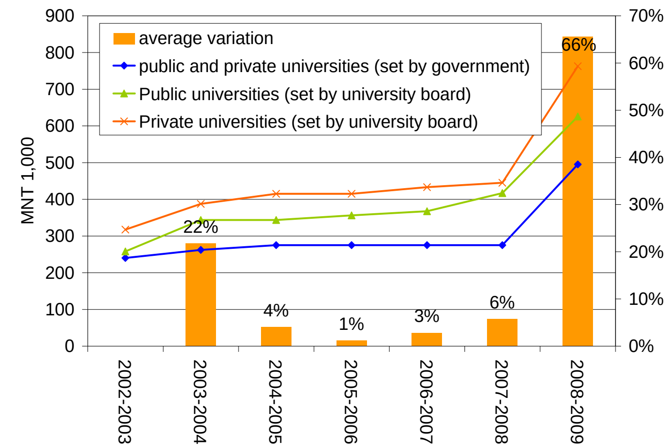


Fall in demand accelerates. OECD oil demand has declined on a quarterly basis for nearly three years, with much of that falloff in the United States. The pace of decline has been picking up in 2008, with June data revised sharply lower and July recording a fall of 1mb/d. Preliminary August data show a drop of 0.7mb/d, bringing the year-to-date decline to 0.85mb/d or 4.1 percent. The fall in transport fuels has become larger of late, with gasoline demand down 2 percent. European oil demand is also slowing and there are concerns that demand in China will also ease after pre-Olympic buying boosted stocks. Higher prices have also slowed demand in other Asian countries, notably Indonesia and Vietnam.

Source: World Bank Global Economic Monitor

6. ***Non-food prices have soared, contributing 14.5 percentage points of yoy inflation at end August, due to the sharp adjustments of administered prices and higher oil prices at the pump***. Bus and taxi fares increased by 50 and 39 percent respectively in August, while tertiary education fees were also sharply adjusted upwards by an average of 66 percent, adding another 1.6 percentage point to inflation (figure 4).

Figure 4: Adjusting higher education fees upwards



Source: Ministry of Education and Labor

7. ***Adjustment in energy tariffs and fuels contributed another 2.2 percentage point of yoy inflation.*** Electricity and heating tariffs were raised by the Energy Regulatory Authority (ERA) by 28 and 39 percent on average starting from July 2008, after 3 years of stability (figure 5b). In addition, price discrimination was introduced between Ulaanbaatar apartment residents, ger areas residents, aimag and local residents, and firms & organizations. Similarly, regulated producer coal prices were also pushed up by 28 percent in May 2008.

Table 2: Introducing differentiated heating tariffs

	Monthly consumption (MNT/Kbt)			
Ulaanbaatar	Base price	<150 kbt	<150-250 kbt<	250 kbt<
Apartment resident	60	60	64	68
UB ger area resident	58	58	62	66
	Base metering	Differentiated metering MNT/kbt		
		6am-5pm	5pm-10pm	night
Firms and organizations	68	68	114.4	39

Source: Energy Regulatory Authority

Figure 5a: Coal prices

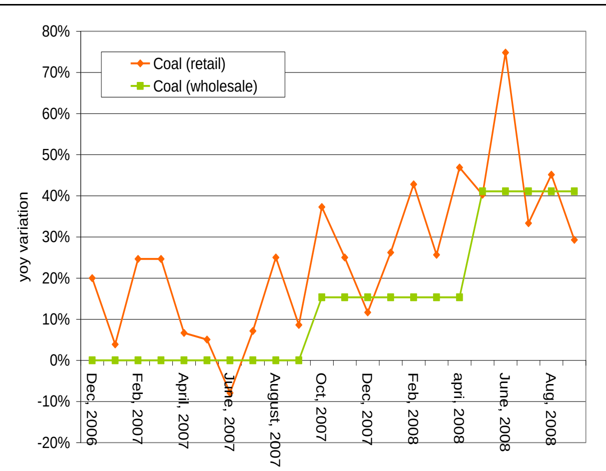
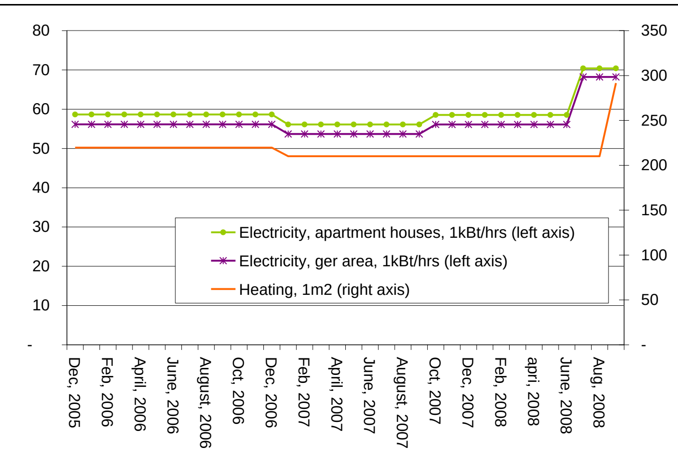


Figure 5b: Energy tariffs



8. ***These administrative adjustments constitute an important attempt to address the long–standing issue of energy tariffs in Mongolia.*** Electricity and heat tariffs had not changed since February 2005, despite much needed annual adjustments to keep up with inflation and eventually reach cost recovery levels. The tariff issue had been passed on from energy distribution companies to energy generation companies and on to coal companies, with a consequent accumulation of arrears. As Figure 5a illustrates, retail coal prices have been rising at much faster rates than producer prices,

providing lucrative opportunities for fuel traders (Box 2). On the consumer side, the poorest households living in ger areas are neither connected to the grid nor benefit from central heating. AS a result of this, they pay the highest energy prices and devote the largest share of their income to energy consumption compared to any other population group. Because poor households are cash-constrained, they are unable to take advantage of lower energy prices over the summer to stock up for winter months.

Box 2: Fuel traders in Mongolia

In Mongolia, the fuel trade is run by formal and informal distributors of various types of fuel, largely coal and firewood. Animal dung is sold privately and/or is available only among the herding communities. Aside from the formal traders of fuel (small, medium and large-scale companies), there are many independent individual traders of coal and firewood who, in the absence of other income generating opportunities, were driven into this business in search of more reliable incomes.

Fuel trade provides lucrative opportunities mainly due to the permanently high demand for and availability of coal in Mongolia. Coal is sold all year around with the highest prices during winter months and the lowest prices during the summer. As a result, non-poor households buy coal in the summer in large amounts (i.e. in trucks of coal which usually equals to 4-5 tons) while the poor cannot afford to do so, and thus spend considerably more than non-poor households do. Single and small purchases of coal (i.e. 1 sack of coal that equals 20-25 kg) are much more costly.

Source: Mongolia heating sector social impact assessment (World Bank, 2005)

9. ***Oil prices at the pump increased by 40 percent over the summer***, prompted by the announcement that the Russian export tax would be further increased by 20 percent starting in August 2008 and by a further rise in world oil prices (until July). Since then, domestic oil prices have started to decline by 2 percent in September, as world crude oil prices dropped from US$147 per barrel to US$90 (early October). In addition, Russia announced at the end of September a plan to cut taxes from US $486 per ton to $372 starting from October, in an attempt to stimulate its domestic oil production. As of end of September, Russia's oil production fell for the ninth consecutive month as producers struggle with rising costs and maturing fields.

Box 3: Public attitudes toward inflation: What do Mongolians say?

Inflation is a serious issue for households, and the issue is even more serious in aimags, among elderly, and among the poorest. Ninety-two percent of interviewed households say that the recent price increase is a problem for their family budget. The situation is worse for people over 50 and those who cannot meet their basic needs. Forty-three percent of households declare that they cannot adjust their consumption to higher prices in 2008, as inflation already constitutes a significant problem in their budget. The issue is more salient in aimags, among elderly groups and the poorest families.

Households are significantly cutting their food consumption as a result of higher prices. Fifty-eight percent of interviewed households declare that their general food consumption has decreased because of higher food prices, in particular meat consumption. The reduction in food consumption among UB dwellers, the elderly and poor families is more widespread.

When it is explained that direct cash transfers are inflationary, households are willing to give up cash transfers to the extent that this would lead to less inflation. Forty-seven percent of those who provided an answer declared that they prefer "some transfers for some inflation (1 digit)" and 43 percent prefer "less transfers and less inflation."[2] Only ten percent chose "high transfers, high inflation." The better-off with savings are relatively more in favor of less transfer for less inflation, which is expected to be as they rely less on transfers.

Source: World Bank commissioned household survey – June 2008

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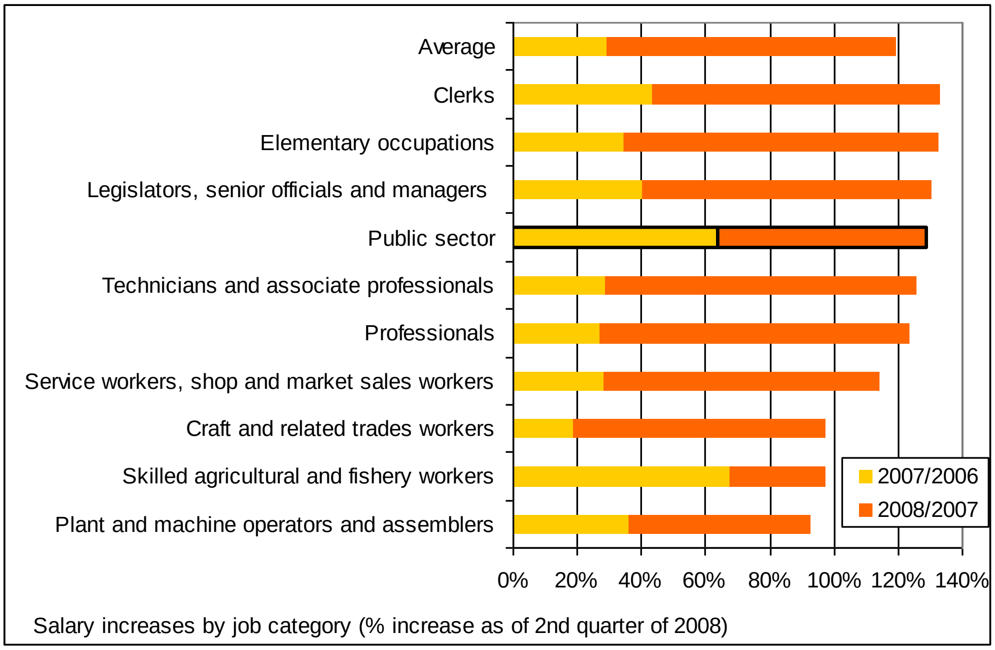
[2] Only 58 percent of respondents were able to provide an answer, which is still significant given the technical nature of the question.

10. ***There is evidence of second round effects of inflation, notably through rising demand for larger nominal wage increases***. Wages and salaries are increasing in all parts of the economy and showed a rapid increase of 69 percent in the first semester of 2008 (yoy), and of 119 percent over the last 2 years (Figure 6). Public sector wages were increased by 129 percent over the same period. The share of wages and salaries in household incomes has increased rapidly, from 40 percent in the 3rd quarter of 2007 to 46 percent in the 2nd quarter of 2008. A key concern is that inflation expectations may become entrenched, as higher nominal wages in response to price increases could well lead to a wage-price spiral that would then prove politically difficult to stop. Such second round effects may well keep inflation elevated over the medium term even if commodity prices are easing, unless the authorities take strong actions to control any build-up of inflation.

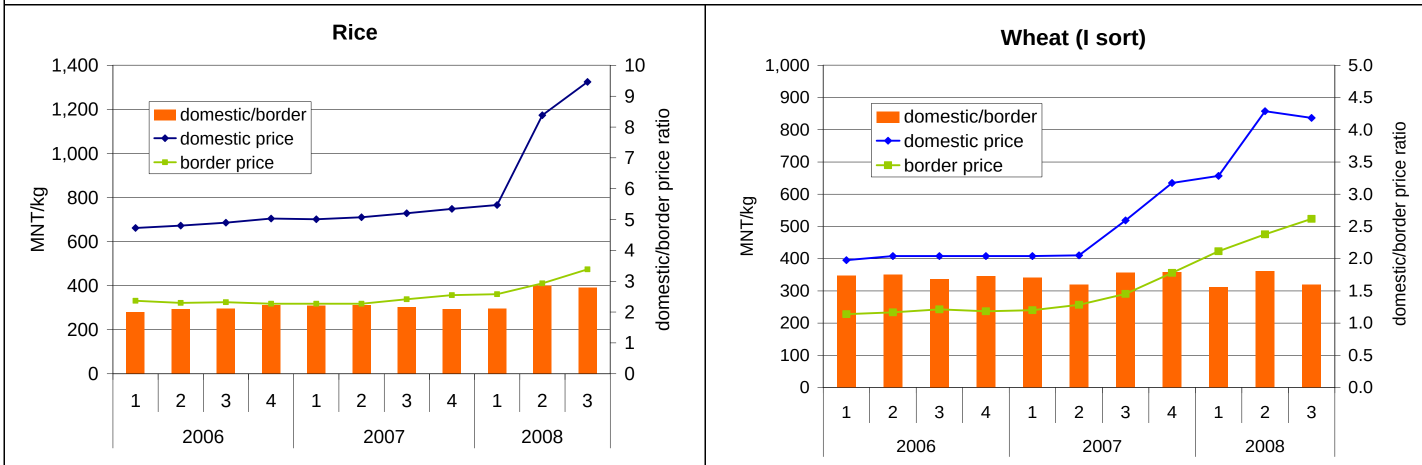
Figure 6: Wages and salaries have more than doubled in two years



Source: National Statistical Office Monthly Bulletin

11. ***Against the backdrop of declining world oil and food prices, it becomes increasingly evident that inflation in Mongolia is to a large extent domestically induced, as opposed to imported from abroad***. Several pieces of evidence support this conclusion: First, domestic prices of imported goods have increased faster than their international prices. Figure 7 plots quarterly border and domestic prices of wheat and rice since 2006. If inflation was caused by higher international prices of imported goods, the magnitude of domestic price increase should be proportional to border price increases. Domestic rice prices increased over the 2nd and 3rd trimester much faster than border prices. Similarly, domestic wheat prices have increased much faster than border prices starting from the 3rd trimester of 2007. Second, some non-tradable goods have seen their prices rising rapidly. A good example is meat, which is not traded abroad because of sanitary and hygienic international standards which domestic supplies do not meet. Meat prices have contributed to domestic inflation to a great extent, up to 8.6 percent in spring and still 5.6 percent at the end of August (Figure 3). But neither higher world prices nor higher production costs in the meat sector can explain such a price increase, while increased demand through expansionary domestic macroeconomic policies can. Finally, as explained above, wages have been increasing quickly, which is further evidence of inflation induced by domestic factors.

Figure 7: Domestic factors caused domestic prices to increase at a faster rate than imported prices

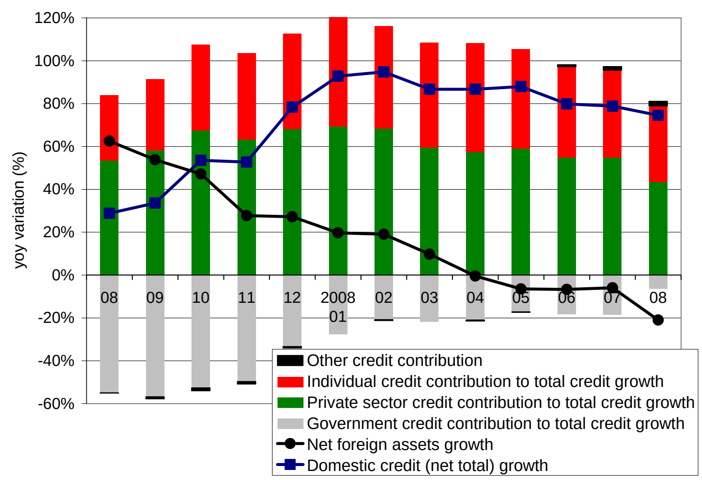


Source: National Statistical Office

MONETARY AND FINANCIAL DEVELOPMENTS

12. ***Monetary growth has slowed, responding to tightening financial conditions and the Togrog appreciation against the dollar*.** Money (M1) was growing at 17.3 percent yoy at the end of August, down from 50 percent at the beginning of 2008**.** The Bank of Mongolia has: (i) raised its policy rate by 0.5 percentage points in September. to 10.25 percent, (ii) increased required reserves for the banks to 5.6 percent, and (iii) let the exchange rate appreciate by 3.2 percent yoy against the dollar as of end -September. As a result, the growth of the money supply and credit to the private sector slowed down to 26 percent and 56 percent respectively yoy as of August 2008. Net foreign assets accumulation has also slowed, because of the widening of the deficit of trade payments combined with the Bank of Mongolia's purchase of domestic currency to reduce the volume of money circulating in the economy. As a result, official net international reserves went down by about $150 million in two months to about $860 million in September due to greater sales of foreign reserves.

Figure 8: Credit growth is slowing down along as a result of Bank of Mongolia selling foreign reserves



Source: Bank of Mongolia monthly bulletin

13. ***The combination of a relatively rigid exchange rate and increasing commercial access by domestic banks to foreign financial markets has undermined the effectiveness of monetary policy as an instrument to manage inflation***. As of September 2008, monetary authorities let the exchange rate appreciate slightly (by 3.2 percent yoy) against the dollar to limit inflationary pressure on domestic prices. This appreciation still corresponded to a nominal depreciation of the domestic currency against the Euro and the Chinese RMB of 4.8 and 7.2 percent respectively (Figure 9b). In Mongolia, 75 percent of settlements are done using the US dollar but an increasing share is done using Chinese RMB. From a policy standpoint, letting the exchange rate appreciate would be the most efficient way to curb inflation and would increase the effectiveness of monetary policy.

14. ***Domestic prices continue to rise faster than foreign prices,*** as evidenced by the real appreciation of the exchange rate by 24 percent since January 2006. Most of this real appreciation is happening through domestic prices, while the nominal exchange rate has been stable against a depreciating US dollar.

Figures 9: Real appreciation and a fixed exchange rate against a depreciating dollar has translated into higher domestic inflation

Figure 9a

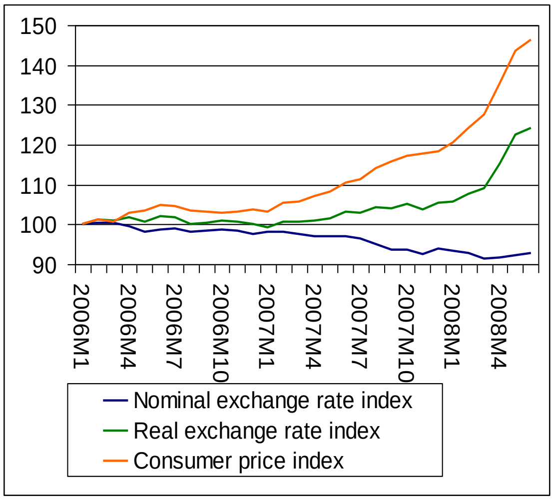
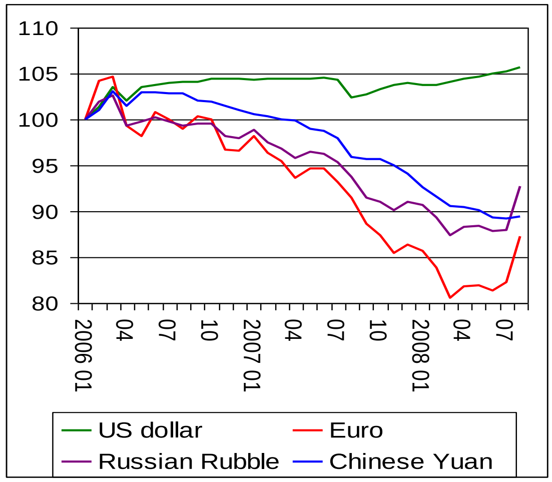


Figure 9b



Source: Bank of Mongolia

15. ***Key indicators of the soundness of the financial system appear stable, but close supervision may be required given the fast growth of credit, high inflation and the likely slowdown of economic activity due to the fall of copper prices and world economic slowdown***. The capital adequacy of the banking system is well above the BOM requirement of 10 percent. Non-performing loans (NPL) have increased by 16 percent yoy at end August, but with the fast growth in credit the NPL ratio has fallen below 2.8 percent as of August 2008. Even so, it is important to be cautious because the rapid growth of credit can often result in banks lending to less credit worthy borrowers. The growth of credit is relatively concentrated in a few banks. For example the 3 largest banks account for 2/3rd of credit growth yoy ending August 2008 (figure 10b). Portfolio quality and financial performance vary among banks and close supervision of the banking system will be important to identify any emerging problems early, especially among the relatively performing banks. Looking at sector allocation of loans, new credit over the 2nd quarter of 2008 went primarily into trade services, construction, and manufacturing. A significant share has also gone to real estate (figure 10c). The mortgage portfolio of banks has been rising rapidly over the past couple of years but is still not a significant proportion of the total lending portfolio. But new credits to agriculture have declined over the 2nd quarter of 2008 which is surprising at a time when agriculture's contribution to economic growth is still significant. Finally, one should note that individual credit has become almost as high as credit to the private sector (41 and 57 percent of total loans respectively). Credit to individuals consists essentially of consumer credit. Mortgages have risen rapidly in recent months but still represent a small fraction of total credit (7.4 percent as of September 2008).

Figure 10a: Rapid credit growth…

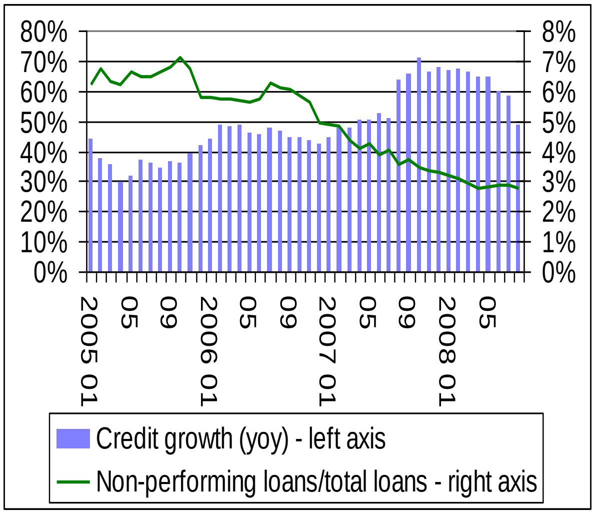


Figure 10b: … is concentrated in three banks

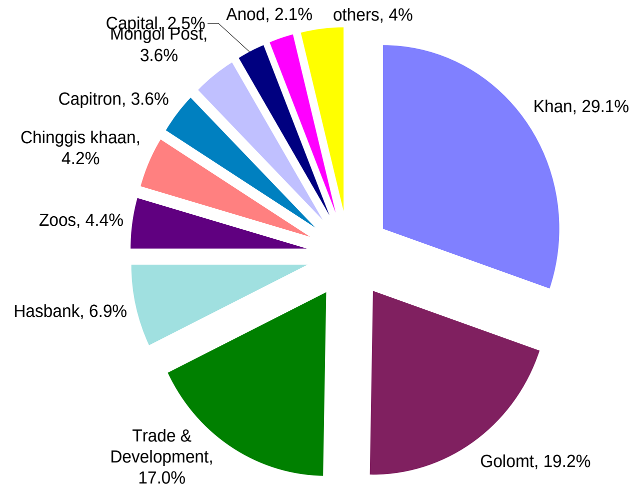
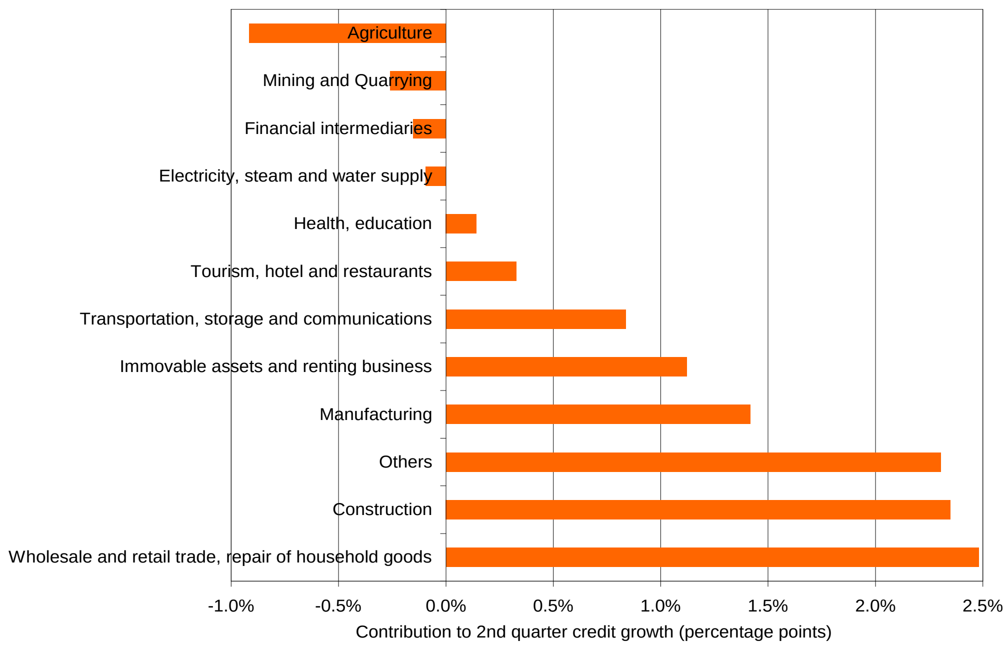


Figure 10c:… and is going primarily into services and construction



Source: Bank of Mongolia

FISCAL POLICY

16. ***At the end of September, the government budget recorded a deficit of 3.1 billions togrog, while more than half of planned domestic investment expenditures remained undisbursed.*** Total revenue and grants of the General Government budget fell short of planned amounts by 1.8 percent. Reasons for this include: (i) a lower than planned (by 18.4 percent) corporate income tax revenue due to lower than usual collection of tax arrears; (ii) lower than planned value-added tax revenue (by 24 percent) due to the initial assumption that the Oyu Tolgoi and Tavan Toilgoi mining projects would start in 2008 and generate additional VAT on imports, and VAT exemptions on domestically sold petroleum products; and (iii) lower than expected dividend revenues. On the expenditure side, September fiscal outturns report a significant under-spending of planned budget expenditures by 20.6 percent. In particular domestic capital expenditures fell short by more than 54 percent of the planned

amount, due to difficulties in executing a much larger investment program. The investment program has almost tripled over the last 2 years, reaching 689 billion togrog in 2008 (579 million US dollars).

17. ***The government is proposing to amend the 2008 planned budget to restrain spending and its inflationary impact***. The 2008 planned fiscal impulse was significant, with expenditures growth outpacing revenue growth by 20 percent. As of August, 2008, goods and service expenditures increased yoy by 39 percent, wages and salaries expenditures by 100 percent, social insurance contributions by 57.8 percent and domestic investment by 70 percent. The amended budget is being revised according to new economic conditions prompted by the world financial turmoil, and in particular will take into account the rapidly falling copper prices.

Table 3: The investment budget underperforms significantly

General government budget outturns (end September)

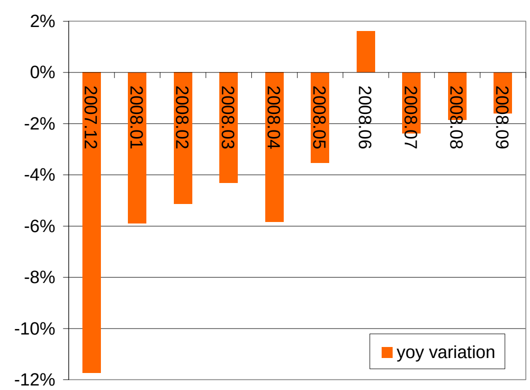
bln. tog.	2007 Plan	2007 Actual	2007 %	2008 Plan	2008 Actual	2008 %
TOTAL REVENUE AND GRANTS	**1,161**	**1,231**	**106**	**1,649**	**1,619**	**98.2**
TOTAL EXPENDITURE AND NET LENDING	**1,041**	**873**	**84**	**2,042**	**1,622**	**79.4**
CURRENT EXPENDITURE	792	706	89	1,368	1,226	90
Goods and services	474	411	87	793	699	88
o.w. Wages and salaries	194	180	93	417	388	93
Interest payments	15	12	80	15	14	92
Subsidies and transfers	302	283	94	560	512	91
CAPITAL EXPENDITURE	203	117	58	602	281	47
From domestic sources	185	102	55	553	268	49
o.w. Domestic investment	154	83	54	504	231	46
Foreign financed	18	15	82	49	13	27
NET LENDING	46	50	109	72	115	159

Source: Ministry of Finance and National Statistical Office

EMPLOYMENT

18. ***Job creation continues to slow***. The 2.4 percent July yoy decrease is the lowest of 2008 so far, as illustrated by Figure 11. Mongolia does not produce employment statistics by sector. Only industrial employment statistics are available, making it difficult to identify the specific sectors which are creating jobs in the economy. Jobs in industry record a marked decline of 3.2 percent yoy at end-August. This decline is primarily driven by jobs in metal ores mining which account for 2.7 percentage points of the decline, and in fur manufacturing (4.7 percentage points).

Figure 11: Unemployment decreases, but less rapidly



Source: National Statistical Office

19. ***Unemployment seems to be concentrated in upper-secondary and higher education.*** Looking at unemployment statistics by degree of education suggest that people with lower secondary education attainment or below are more likely to find a job. One explanation might be skills mismatch and educational overqualification.[3] Mongolia produces a large number of school graduates—77 percent complete lower secondary school or higher—relative to labor market demands. This naturally leads to mismatches between labor demand and supply, with many graduates doing jobs requiring less education than they have.

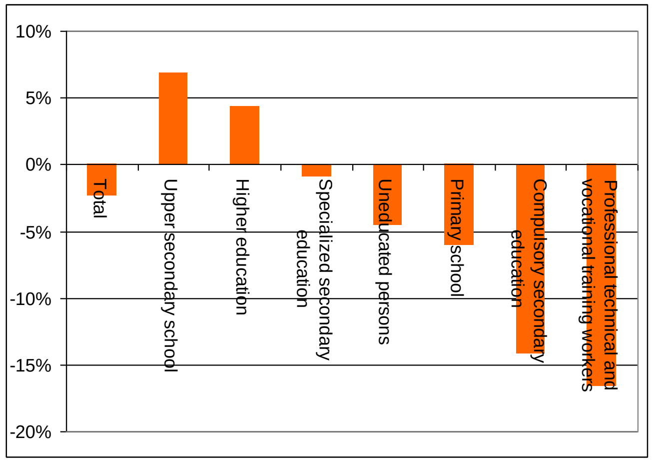
[3] See World Bank report "Mongolia: Building the skills for the new economy" – June 2007.

POLITICAL DEVELOPMENTS

20. ***A new bi-partisan Cabinet was established on September 19, ending a protracted period of negotiation in the wake of the June 29 parliamentary elections*** and ensuing riot and declaration of a 4-day state of emergency. However, although the Mongolian People's Revolutionary Party (MPRP) had won a solid majority (39 vs. 25 seats), formation of a new government was blocked when Democratic Party parliamentarians refused sit in Parliament. The MPRP then formed a coalition government with the DP in a 60:40 power sharing agreement.

Figure 12: Vocational and lower secondary perform best, while higher education lags behind

(unemployment yoy variation by education attainment as of July 08)



Source: National Statistical office

21. ***The newly announced government action plan includes measures which could be hard to deliver without putting at risk Mongolia's macro-stability and economic growth.*** These include among other measures the distribution of 1,500,000 togrog (1,311 US dollars) to every Mongolian using expected mining revenues, which would represent around US$3.5 billion or 60 percent of GDP. The action plan also comprises the tripling of wages and pensions within the next 4 years, while continuing other cash transfer programs. Wages already doubled in the last 2 years and cash transfers reached almost 5.2 percent of GDP in 2007.

TO CONCLUDE

22. ***Looking forward, the key challenge for Mongolia's policymakers will be to tighten fiscal policy enough to bring down inflation at single digit levels.*** This would increase domestic saving and in turn reduce the current account deficit. Further cash injections into the economy could lead to even higher inflation given the strong inflationary pressures in Mongolia today and the already expansionary stance of current fiscal policy. This includes no further increase in public wages, no further increase in universal cash transfers, and a prioritized investment program limited to what the absorptive capacity of the economy can bear. Fiscal space should be kept for a targeted social safety net to protect the most vulnerable. Reducing inflation is always painful, but the slower the authorities react, the more protracted the process is, with deeper impact in economic activity, employment and poverty.

2. SPECIAL FOCUS – AN ANALYSIS OF THE PROPOSED 2009 BUDGET

23. This note provides a brief analysis of the 2008 amended budget and the 2009 plan budget. At the outset it should be stated that given Mongolia's high fiscal dependence on mineral revenues, the realism of these budgets has been significantly affected by the recent sharp decline in world copper prices, and the possibility of a global economic slowdown in the wake of the financial crisis. Copper prices are now $5000/ton, 40 percent below their July level of $8500/ton. The original 2008 plan was based on a price assumption of $6800/ton, which was revised upward to $7500/ton in the amended budget, and the 2009 budget is based on an assumption of $6700/ton. Therefore, and noting the inherent uncertainty in these estimates, these price projections, particularly for 2009, appear overly optimistic.

Amendments to the 2008 Budget

24. ***In the amended budget the overall deficit has been reduced to 1.5 percent of GDP, on account of higher than planned mineral revenues and lower than planned capital expenditures***. The 2008 plan budget was expansionary, calling for the overall deficit to increase from 0.4 percent of GDP in 2007 to 2.5 percent of GDP (Table 4). As compared to the outturn for 2007, revenues are projected to increase to a record 42.1 percent of GDP from 41.3 percent of GDP, an annual growth of 29 percent in nominal terms from Tg.1880 billion to Tg.2432 billion, based on higher minerals prices, on-going improvements in tax administration, and strong economic growth. Overall expenditures are expected to be 43.6 percent of GDP, down from 46.9 percent of GDP in the planned budget but 33 percent higher in nominal terms than the outturn for 2007. This growth in spending is associated with large nominal increases in the wage bill (81 percent growth over 2007), social welfare spending (70 percent growth over 2007), and capital expenditure (38 percent increase). However, this growth in capital expenditure is considerably less than projected in the planned budget, reflecting continued problems in the execution of the public investment plan.

25. ***Overall income tax revenues have been revised upwards, on the account of higher than planned windfall tax***. Tax revenues are Tg.916 billion or 15.8 percent of GDP in the amended budget, as compared to 14.8 percent of GDP in the planned budget, and Tg.648 billion or 14.2 percent of GDP in 2007, representing a nominal increase of 41 percent. This increase over the plan is entirely driven by the Windfall Profit Tax, which is projected at 8 percent of GDP as compared to 6.6 percent in the planned budget, due to the higher than expected mineral prices—copper prices are projected at $7500/ton as compared to $6800/ton in the planned budget—and underlining the difficulties in, and the continued need to improve, the forecasts of these volatile sources of Mongolia's public revenues.

26. ***The biggest decrease in revenues in the amended budget is in domestic and imported VAT collections,*** which is projected at 6.5 percent of GDP as compared to 8.3 percent of GDP in the plan. This reduction is due to the exemptions on petroleum products, some food items, wheat, and agribusiness equipment introduced by the government in May in an attempt to lower domestic food prices, particularly in the run-up to the elections.

27. ***Current expenditures are projected at 31.6 percent of GDP in the amended budget as compared to 32.1 percent in the plan and 30 percent in 2007***. In nominal terms, current expenditures are 4 percent higher in the amended as compared to the plan budget, with the major categories of increases being those associated with the government's response to the food and fuel price increases, which includes a public transportation subsidy of Tg.7 billion; Tg.11 billion additional funding for the wheat subsidy program; and Tg.19 billion in increased electricity, heating, and fuel expenses of public offices.

28. ***Implementation of the public investment plan continues to be problematic***. Of the planned capital expenditures of Tg.689 billion, actual outturns as of July 2008 stood at Tg.198 billion, or 29 percent of the budget. As a result of this low utilization, the amended budget has been reduced to Tg.617 billion, which is also likely to be an ambitious target. The structural reasons for this poor implementation include lack of strategic prioritization or formal linkage with sector strategies, limited inter-ministerial coordination in project selection, and limited capacity to effectively implement the key steps in the project cycle.

The 2009 Budget

29. ***In contrast to the previous years, the government has prepared a balanced draft budget for 2009 with more moderate spending plans.*** Based on projected real GDP growth of 14.1 percent and inflation of 12 percent, overall revenues are expected to increase modestly by 8 percent in nominal terms over the amended 2008 budget, and decline to 37.7 percent of GDP, while overall expenditures are budgeted to increase by 6 percent in nominal terms. The moderate increase in revenues comes mostly from assumed increases in VAT, excise and personal income taxes, while other categories

such as the corporate income and windfall taxes are forecasted to decline by 5 and 9 percent respectively. Expenditures will increase on account of (i) higher intergovernmental fiscal transfers by Tg.137.2 billion, which include the creation of local funds (Tg.50 billions) and (ii) transfers to students through various programs (lunch program, tuition grants, and living allowances). These relatively more modest fiscal targets are based on controls over wage increases, and a sharp reduction in the growth of capital expenditures compared to the trend over the past four years.

30. ***However, this budget is supported by very optimistic macroeconomic assumptions unlikely to materialize in 2009***. In particular, revenue projections are based on a 14.1 percent economic growth, in conjunction with an assumed decline in average copper prices from $7,500/ton in 2008 to $6,700/ton in 2009. As noted at the outset, the price of copper has already reached levels below $5,000/ton as of October 2008 and is therefore very likely to be lower in 2009 than the projected $6700/ton. Lower metal prices combined with a world economic slowdown and tightened financial conditions will have significant implications for economic growth in Mongolia in 2009 and the government revenue targets.

31. ***As a consequence, the 2009 proposed budget does not appear realistic enough in light of the world economic turmoil and much lower copper prices.*** The budget presents a more prudent fiscal stance characterized by a balanced budget, restrained current expenditures and cut capital spending, which is commendable given the expansionary fiscal policy of the past two years, and the continued problems of high inflation. But this planned fiscal stance does not seem realistic with copper prices falling below $5,000. The fall in copper prices can be expected to have a direct impact on revenue through much reduced revenues from the windfall and corporate income tax, and dividends transferred from the government-owned Erdenet copper mine. For example, a fall of copper prices of 25 percent from 6,700 to 5,000 would imply shortfall of revenue in the 2009 budget of [2.2 percent-3.5 percent] of GDP (Box 4). A revision of revenue projections based on more realistic price and economic growth forecasts would strengthen the credibility of the budget.

Box 4: How sensitive is the windfall tax to copper prices?

The windfall has become an important fraction of the government budget, contributing 7.8 percent of total public revenues in 2007, and is the main source of revenue of the government development fund. It is imposed on sales of copper ore and concentrate extracted and levied at a rate of 68 percent on the difference between actual copper prices on the London Metal Exchange and the sum of a base price (set at US$2,600 per ton) and smelting costs.

Given its contribution to the budget and the current rapid decline in copper prices, a key question is therefore how sensitive the windfall tax is to a fall of copper prices. The elasticity of the windfall tax to copper prices according to various levels of smelting costs was estimated at the following levels:

Smelting costs ($ per ton)	500	1000	1500	2000
Elasticity of the windfall tax to copper price	1.7	1.9	2.2	2.6

This means that a decline of copper price of 25 percent, from $6,700 to $5,000 per ton would lead to a decline of the windfall tax revenues between 42 and 65 percent That would translate into a decline in revenue, of between 2.2 and 3.5 percent of GDP in the 2009 budget, everything else kept constant. This decline does not include the likely decline in other taxes such as corporate income and value added taxes as well as dividends that would be induced by domestic economic slow down.

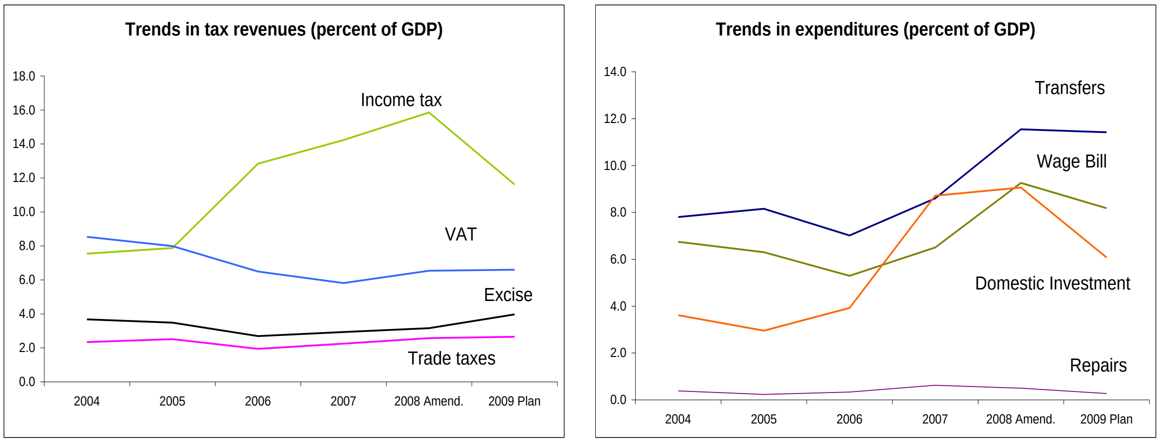
Of course, these calculations should be regarded with caution, as they rely on assumed smelting costs. These costs appear could be used as a variable of adjustment to determine the level of the windfall tax to be paid between the government and Erdenet.

Source: World Bank staff calculations

32. ***The government's reliance on mining has increased since 2005 with the introduction of the windfall tax and reductions in the VAT***. Figure 13 provides trends in taxes and expenditures over the past five years. Income tax revenues have increased from 7.5 percent of GDP in 2004 to 14.2 percent of GDP in 2007, and are projected at 11.6 percent for 2009, while VAT receipts declined from 8.5 percent of GDP in 2004 to 5.8 percent in 2007, and are estimated at 6.6 percent for 2009. The

resources from this minerals boom have been used to finance increases in social transfers, public sector wages, and domestic investment, which grew from 7.8 percent to 11.5 percent, 6.7 percent to 9.3 percent, and 3.6 percent to 9.1 percent of GDP respectively between 2004 and the amended plan for 2008.

Figure 13: Trends in tax revenues and expenditures, 2004-2009



Source: Ministry of Finance

33. ***These increases in transfers and wages have increased the rigidity of the budget.*** The implication therefore, is that the projected decline in revenue receipts for 2009 requires a concomitant reduction in capital expenditures. Domestic investment is projected to decline from 9.1 percent of GDP in 2008 (Tg.520 billion) to 6.4 percent of GDP in 2009 (Tg.452 billion). Maintenance and repairs continues to remain an area of neglect, expenditures dropping from an already low 0.6 percent of GDP in 2007 to a projected 0.3 percent in 2009. With the emphasis on capital investment, there is a need to increase the share of maintenance expenditures to between 7 and 10 percent of capital costs as per international best practice.

34. ***The projected decline in income tax revenues in 2009 underscores the urgent need to adopt fiscal rules that smooth the fiscal stance over time and enable the government to maintain fiscal discipline***. The Government is exploring a variety of mechanisms to redefine the fiscal policy framework, such as adopting binding fiscal rules, an establishing a stabilizing and saving fund, to avoid these swings in capital expenditures.