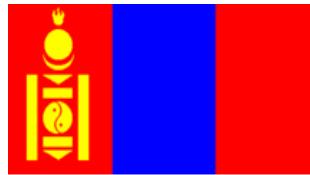


52558



MONGOLIA MONTHLY ECONOMIC UPDATE

WORLD BANK

November 2009



The World Bank's *Mongolia Monthly Economic Update* 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 Monthly* 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). Copies can be downloaded from <http://www.worldbank.org.mn>.

Table of Contents

	Page number
Sections:	
1. Executive Summary.....	3
2. Budget Developments.....	5
3. External Sector.....	8
4. Inflation.....	13
5. Banking Sector	13
6. Real Activity.....	19
7. Labor Markets.....	20
Tables:	
1. Highlights of the 2010 budget.....	6
2. Daily wages of unskilled workers in selected informal labor markets in UB.....	21
3. Mongolia: Key Indicators.....	24
Figures:	
1. The 12-month rolling fiscal deficit shows some improvement.....	5
2. The trade deficit has narrowed further as imports have fallen faster than exports.....	8
3. Monthly export contraction is moderating.....	9
4. Copper and gold prices have continued to increase.....	10
5. ....and exports to other counties picked up in October.....	10
6. Imports contraction bottoming out.....	10
7a. The current account deficit improved by a narrowing trade and services deficit.....	11
7b. ...and FDI and other net inflows picked up while net portfolio inflows dropped.....	11
8. Exchange rate remains stable, with some recent minor appreciation.....	12
9. Bank of Mongolia is accumulating international reserves.....	12
10. Inflation has fallen rapidly from its peak, mainly because of the domestic slowdown.....	13
11. Real deposit and loan rates continue to rise as inflation falls and nominal rates remain stable.	14
12. Real borrowing costs in Mongolia are extremely high relative to comparator countries	14
13. MNT deposits increasing due to still high deposit rates.....	14
14. NPLs and loans in arrears have risen strongly, as key sectors in the economy slowed down...	15
15a. Largest increases in NPLs and loans in arrears occurred in consumer loans and construction sectors.....	16
15b. And these sectors now account for the majority of NPLs and loans in arrears.....	16
16a. The construction sector has the highest NPLs and loans in arrears relative to outstanding loans.....	17
16b. ... and construction accounted for the largest part of the increase in NPLs and loans in arrears.....	17
17. Concentration of lending to the largest 50 borrowers by loan size rose during the crisis period.....	17
18a. Large decreases in loan issuance to wholesale and retail, mining, construction and manufacturing..	18
18b. Loan portfolio exposed to sectors that suffer from NPLs and loans with principal in arrears.....	18
19. Small signs of new lending to individuals	19
20. Wholesale and retail trade was a primary driver of the recent fall in GDP growth.....	20
21. Industrial production remains weak.....	20
22. Poverty has declined substantially in Mongolia.....	22
23. Livestock headcount increased significantly and especially among the poorest households....	22
Boxes:	
1. Focus on the Civil Service	7
2. Progress in Poverty Reduction in Mongolia.....	22

1. Executive Summary¹

On November 27, 2009, Parliament approved the 2010 budget which projects a 5 percent of GDP deficit. However, Parliament had to increase the copper price assumption to achieve the deficit target. A significant increase in total social spending was also approved, including that under a newly created Human Development Fund (HDF) which is earmarked to pay pension and health insurance, housing, education and health services, and cash transfers to Mongolian citizens. Since budget allocations to the “old” cash transfers to newlyweds, newborns, and child money programs, approved during the mining boom years, have been cut, analysts hope that creation of the HDF will pave the way for implementation of comprehensive social welfare reform with the view of moving towards a targeted new poverty benefit, using objective allocation criteria.

With respect to the budget outturn for this year, the 12-month rolling deficit improved somewhat in October, reflecting both reduced expenditures and stabilization of the revenue decline. However, it remains high, at around 9 percent of GDP. While the long-term fiscal outlook looks good, because of future large increases in revenues from the mining sector, the medium-term scenario until 2015 looks more uncertain. In particular, 2011 will see the Windfall Profits Tax disappear and, in the absence of continued donor funding, a series of large fiscal deficits would be difficult and costly to finance.

On the external sector, the trends of recent months have continued—narrowing of the trade deficit and accumulation of international reserves and stability of the nominal exchange rate. Indeed the export contraction seems to be bottoming out and the imports decline moderating. Preliminary balance of payment figures for Q3 indicate a narrowing of the current account deficit to US\$470 million (10.9 percent of GDP), after it peaked in the first quarter of 2009.

In banking sector developments, Zoos Bank was taken into receivership at the end of November 2009. Anod Bank was also, finally, put under receivership. To date, the Zoos Bank situation does not seem to have had an adverse impact on overall confidence levels, likely in part reflecting the blanket deposit guarantee which was put in place in November, 2008, in response to the failure of Anod Bank. However, non-performing loans continue to increase across key sectors of the economy including individual lending, construction and agriculture, and banks remain exposed to the failure of large individual borrowers. Real deposit and borrowing rates also continue to be at extremely high levels. Average real loan rates of almost 25 percent are very high by international standards.

¹ The analysis is based on the most recent data (October 2009) from the Bank of Mongolia (monthly bulletin and monthly consolidated banking system balance sheet), the National Statistical Office and the Ministry of Finance.

Third quarter real GDP data, down by 3.7 percent year-on-year after growth of 0.7 percent in the second quarter, along with recent industrial production figures, highlight the continued weakness in the real sector. The latest World Bank commissioned survey of the daily wage of unskilled workers in key informal labor markets in Ulaanbaatar in December 2009 also shows no improvements in real income relative to September 2009, pointing to continued economic stagnation and the on-set of winter.

New analysis by the World Bank of poverty trends between 2002/3 and 2007/8 using the national household survey data from the NSO, but using the same, absolute poverty line in both years, shows a sharp reduction in poverty during that period of high economic growth. Recall that the official consumption-based poverty headcount in 2007/8 was 35.2%, as estimated by the NSO. Working backwards from that benchmark and using a consistent poverty line over time, World Bank staff calculations indicate that the poverty headcount in Mongolia declined from 66.2% in 2002/3. This finding of substantial poverty reduction over this period is robust to the choice of the poverty line used.

Finally, a recently released analysis of the civil service in Mongolia suggests three main challenges to improving its efficiency. First, the civil service grading and compensation system requires significant changes in order to be able to attract and retain high caliber staff. Second, movement in a phased manner towards centralized payroll administration is required in order to increase control over staff numbers and personnel expenditures. Third, the personnel management regime needs to be improved as it presently does not fully protect civil servants from undue political interference.

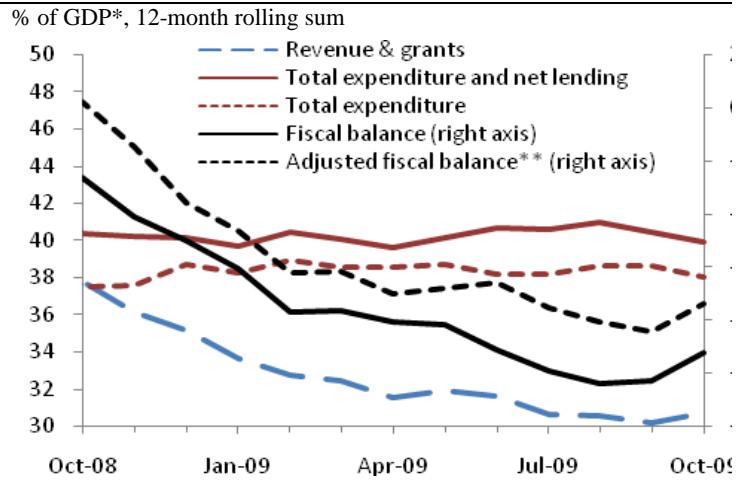
2. Budget developments

On a twelve-month rolling basis the fiscal deficit improved slightly in October, reflecting a combination of reduced expenditures and a stabilization of the decline in revenues.

There was some positive news on the fiscal balance in October as the 12-month rolling deficit showed some sign of improvement. However, the overall fiscal balance on this basis remains high, at around 9.2 percent of GDP, compared with 10.3 percent in the 12-months to September (Figure 1). The fiscal balance in the first ten months of 2009 was MNT 336 billion, compared with a full-year budget target of MNT 364 billion. Further continued fiscal adjustment will be required in order to reverse the deterioration of the past year and to place the fiscal position on a sustainable footing.

Total fiscal revenues and grants (rolling 12-month) increased by 1.7 percent in October relative to September. This was due primarily to a rise in windfall tax revenues. On the expenditure-side the fall on this basis from October to September was 1.3 percent. Reduced purchases of goods and services were the main driver of this fall.

Figure 1. The 12-month rolling fiscal deficit shows some improvement



* GDP interpolated using actual 2008 GDP (MNT 6,130 billion) and projected 2009 GDP (MNT 6,209 billion). ** Adjusted fiscal balance excludes net lending from expenditure, leaving current and capital expenditure only.

Source: Ministry of Finance, World Bank.

Table 1. Highlights of the 2010 budget

	2010 budget		2009 budget June Amendment	
	MNT billion	(% of GDP)	MNT billion	(% of GDP)
Total revenue & grants	2,427	(33.8%)	2,055	(32.6%)
Total expenditure & net lending	2,785	(38.8%)	2,419	(38.4%)
of which				
Wages & salaries	600	(8.4%)	586	(9.3%)
Domestic investment	443	(6.2%)	423	(6.7%)
Purchase of goods & services	455	(6.3%)	347	(5.5%)
Interest payments on foreign loans	29	(0.4%)	51	(0.8%)
Fiscal balance	-358	(-5%)	-364	(-5.8%)
Copper price assumption (US\$/t)	5,800		3,995	
Nominal GDP assumption	7180		6304	

Source: Mongolian authorities, World Bank.

Parliament passed the 2010 budget projecting a 5 percent of GDP deficit.

On November 27, 2009 Parliament approved the 2010 budget projecting a 5.0 percent of GDP deficit. However, it had to change the copper price assumption from US\$5,187 to US\$5800/tonne to achieve this. Parliament also approved a significant increase in total social spending (by around MNT150 billion), including spending under a newly created Human Development Fund (HDF). In 2010, the HDF will receive MNT346.7 billion from the budget, earmarked to be used to pay pension and health insurance, housing, education and health services, and cash transfers to Mongolian citizens. The latter are to make good on campaign promises made by both parties in the

coalition to distribute cash to the citizenry in an effort to share the mining wealth of the country.

Since the budget allocations to the “old” cash transfers to newlyweds, newborns, and child money programs (approved during the mining boom years, both monthly and quarterly) have been cut, analysts hope that the creation of the HDF will pave the way for the implementation of comprehensive social welfare reform with the view of moving towards a targeted new poverty benefit, using objective allocation criteria.

While the long-term outlook for Mongolia’s budget looks good, because of the large increases in revenues coming from its mining sector in the future, the medium-term scenario until 2015 looks more uncertain. In particular, 2011 will see the Windfall Profits Tax disappear. In the absence of continued donor funding, a series of relatively large fiscal deficits will be difficult and costly to finance, both from domestic as well as foreign sources. This is why it would be important to continue the fiscal effort, and use the existing resources to more effectively protect the poor from the current downturn.

Around 22 percent of total expenditures and net lending in the 2010 budget are allocated to the payment of wages and salaries, down slightly from 24 percent in the 2009 budget. Ensuring that such expenditures are used to finance an effective and efficient civil service remains a challenge, despite the significant transformation over the past two decades and the relatively strong levels of service provision in areas such as health and education. Box 1 highlights three main areas of weakness which are particularly challenging – civil service grading and compensation, payroll administration and personnel management. This area of reform forms part of the wider fiscal reform agenda in Mongolia, different aspects of which have been discussed in previous monthly Updates (e.g. the counter-cyclical management of fiscal mineral revenues in the September 2009 update).

Box 1: Focus on the Civil Service

An efficient and high-performing civil service is a key to a high performing public sector, and an important component of the menu of reforms needed to meet the challenge of translating Mongolia's natural resources into sustainable long term growth. The World Bank recently released an analysis of the challenges that Mongolia's civil service faces. The Mongolian civil service has undergone a rapid and deep transformation since the transition from socialism in 1990. The number of civil servants has been reduced dramatically as the state's role in the economy has diminished, and a whole new legal framework has been introduced. And there are many achievements that the civil service can be proud of. The education and health bureaucracies have been able to deliver a standard of service that is higher than many countries at similar levels of development, overcoming the challenges posed by Mongolia's geography. The legal framework has emphasized merit-based recruitment, and the skill level in the civil service is higher than in many developing countries.

There are however, three main areas of weakness that require reforms if the management and performance of the civil service is to improve. First, the civil service grading and compensation system requires significant changes in order to be able to attract and retain high caliber staff. The present grading structure creates inequities between staff who work in the ministries or in Ulaanbaatar compared to those that work in the aimags. For example, directors in ministries are graded higher than directors in aimag and soum administrations, and doctors in UB hospitals are at a higher grade than doctors in aimag hospitals or soum clinics. The pay structure is highly complex, consisting of basic pay, allowances, and extra payments which exacerbate the grading inequities. Combined with the considerable managerial discretion in setting pay, it results in a non-transparent compensation regime. There are also very limited increases in the pay scale for key service delivery staff like teachers and nurses whose careers are confined to one or two grades. What is required is a simplification of pay through merging the many allowances and extra payments into basic pay, and the development of a new grade structure and basic pay scale based on job evaluations and a pay survey.

Second, Mongolia needs to move in a phased manner towards centralized payroll administration in order to increase control over staff numbers and personnel expenditures. Presently payroll administration is conducted by each budget entity — and there are over 5000 budget entities — using non-standardized procedures which, combined with the complexity of the pay structure, significantly limits the controls of the Ministry of Finance. This system also renders impossible accurate simulations of wage increases, thereby weakening budgetary planning, a deficiency that has been dramatically highlighted in the current economic crisis and the urgent requirement for fiscal adjustment. A feasible first step in the sequenced transition to centralized payroll administration is the creation of a centralized human resource database within the Ministry of Finance with information on posts, personnel, and pay for all budget entities.

Third, the personnel management regime needs to be improved as it presently does not fully protect civil servants from undue political interference. Civil servants need to be protected from being arbitrarily terminated from employment, and this tenure protection is one of the defining features of civil services across countries. This is required for depoliticized management and is what sets apart the legal regime for civil servants from that of the private sector. The Mongolian civil service however, is characterized by a high degree of staff turnover, particularly after elections, and this churn disrupts management and negatively impacts overall civil service performance. This problem needs to be addressed by removing some of the loopholes in the current legislation and developing an institutional mechanism to manage staff transfers.

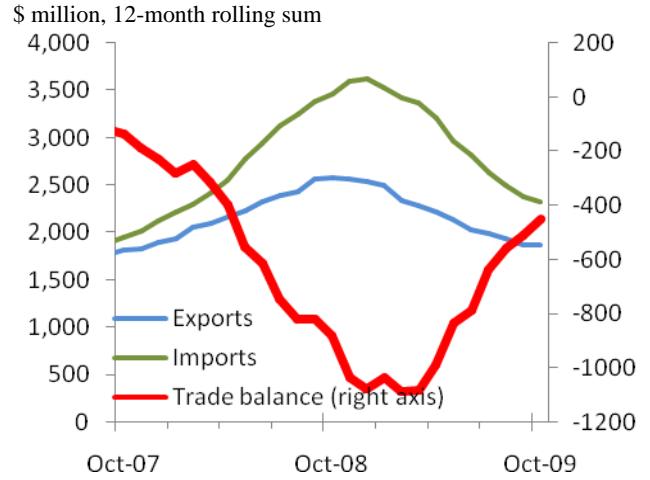
Source: World Bank (2009), Mongolia: Towards a High Performing Civil Service, available on line at www.worldbank.org/mn.

3. External sector

The 12-month rolling trade deficit continues to narrow—it reflects the continued economic slowdown.

The 12-month rolling trade deficit narrowed to US\$451 million in October, from US\$511 million in September. This represents an almost halving of the US\$1090 million deficit reached in February 2009. The adjustment has been driven by the faster pace of import compression relative to the contraction of exports (Figure 2), reflecting the continued slowdown of the economy.

Figure 2. The trade deficit has narrowed further as imports have fallen faster than exports²



Source: National Statistical Office, World Bank

² Monthly trade data is strongly affected by the seasons in Mongolia, and has strong month-to-month fluctuations. For this reason, 12-month rolling sums are illustrated.

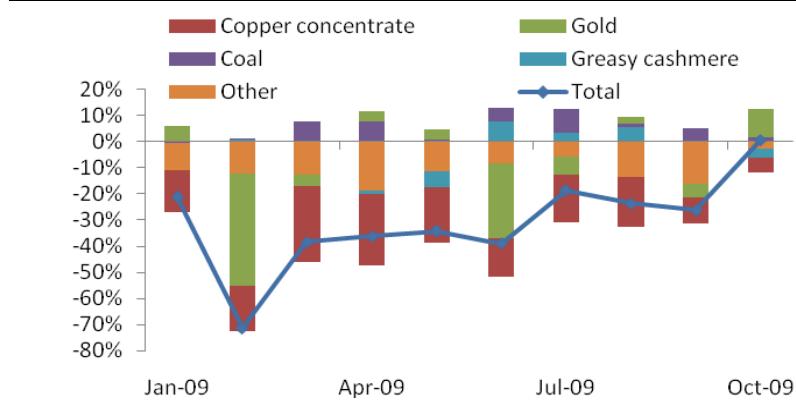
The contraction in exports seems to be bottoming out – in October the year-on-year growth in total exports was positive for the first time since October 2008, buoyed by gold exports.

In October total exports of US\$193 million were up slightly on their value a year earlier. This was driven primarily by an increase in gold exports to US\$35 million, compared with US\$13 million in October 2008. The volume of monthly gold exports doubled. However, the unit price also increased (by around 25 percent), reflecting the rise in international gold prices to about US\$1100/toz in November (Figure 4).³ Most of the gold exports went to the European Union.

However, total goods exports over the period January to October continue to be down by 31.2 percent in dollar terms from a year earlier with declines across most commodities due to lower prices, rather than volume. The strong economic growth in China continues to be supportive for Mongolia's export recovery with the annual contraction in exports to China falling in recent months (Figure 5).

Figure 3. Monthly export contraction is moderating

Contributions to monthly year-on-year growth

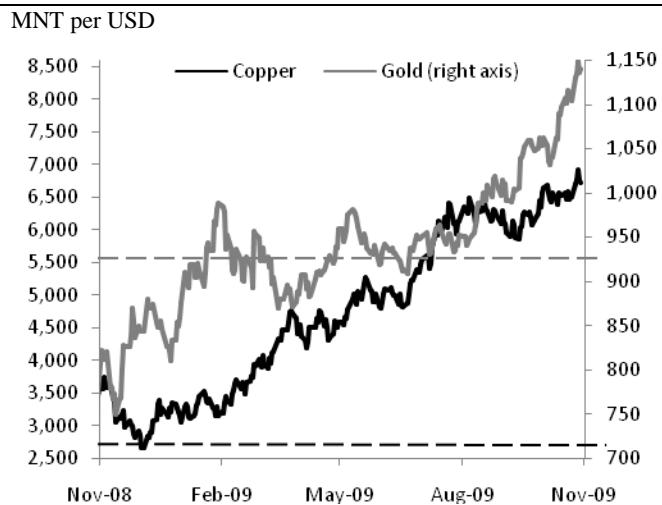


Note: Gold: unwrought or in semi-manufactured forms. Combed goat down and greasy cashmere are intermediate cashmere products.

Source: National Statistics Office, World Bank

³ World Gold Council quarterly report, 3Q 2009.

Figure 4. Copper and gold prices have continued to increase...



Note: the dashed lines indicate the US\$2600/tonne and US\$850/ounce thresholds for copper and gold respectively for the WPT.

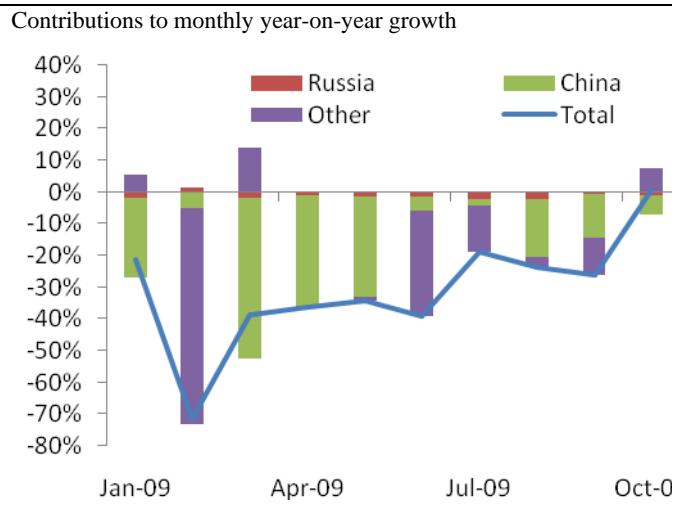
Last observation: November 23, 2009.

Source: London Metal Exchange, World Bank.

The decline in imports also appears to be moderating

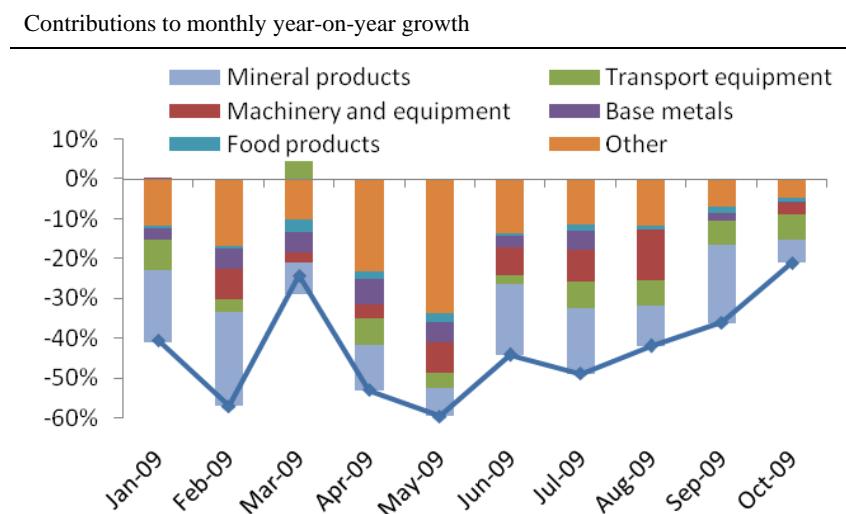
In October the dollar value of goods imports was down by around 20 percent year-on-year, compared with contractions of over 50 percent in the first half of 2009. In the first ten months of 2009 goods imports were down by 37 percent on the corresponding period of 2008 (Figure 6).

Figure 5. ... and exports to other counties picked up in October



Source: Bank of Mongolia, monthly bulletin, World Bank

Figure 6. Imports contraction bottoming out...



Source: National Statistics Office, World Bank

The narrowing of the goods trade deficit led to a narrowing of the current account deficit⁴

The current account of the balance of payments—recording the balance of goods and services trade, net investment income, remittances and grants to the government—came in at US\$470 million deficit in the third quarter of 2009 (10.9 percent of GDP). The deficit has narrowed, after it peaked in the first quarter of 2009 (Figure 7.a). The main driver of the narrowing of the current account deficit was the goods trade deficit. The services balance, another key driver, improved due to a surplus of US\$30.2 million in the third quarter of 2009 as transportation and tourism revenues eased. Throughout, net income flows were negative, due to dividends paid to foreigners.

The current account deficit was primarily financed by net capital inflows in the financial account,⁵ which amounted to US\$689 million (16 percent of GDP) in the third quarter of 2009. Direct investment by foreign companies (FDI), mainly in the mining sector, has increased compared with the second quarter of 2009. Net borrowing from abroad by both government and the private sector jumped in the third quarter of 2009, due to the donor disbursement and loans to the commercial banks. Other capital inflows, such as trade credits and short-term lending to the private sector fell from their peaks in the fourth quarter of 2008

Figure 7.a. The current account deficit improved by a narrowing trade and services deficit...

% of GDP, 4-quarter rolling sum

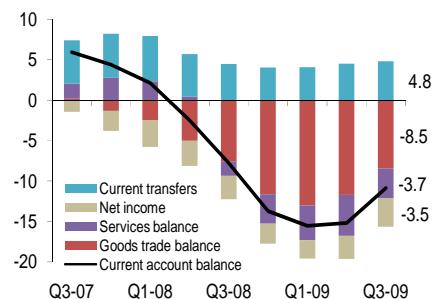
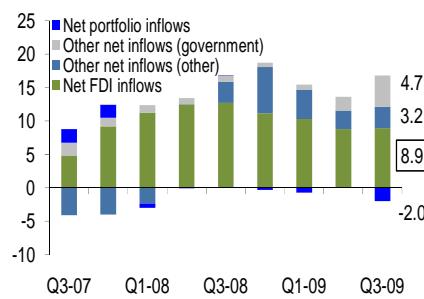


Figure 7.b. ... And FDI inflows and other net inflows picked up while net portfolio inflows dropped

% of GDP, 4-quarter rolling sum



Note: Numbers on the right are the values of major balance of payments components as a % of GDP on a 4-quarter rolling basis. The 4-quarter rolling sum nominal GDP in the denominator has been estimated using publicly available data on quarterly real GDP, CPI, trade and commodity prices (copper, gold and coal).

Source: Bank of Mongolia, National Statistical Office, World Bank

⁴ All balance of payments data in this section are on a 4-quarter rolling basis, this means they have been summed over the previous four quarters. This reduces the strong effect of Mongolian seasonal cycles on the data. For notational simplicity, the term 4-quarter rolling has been dropped.

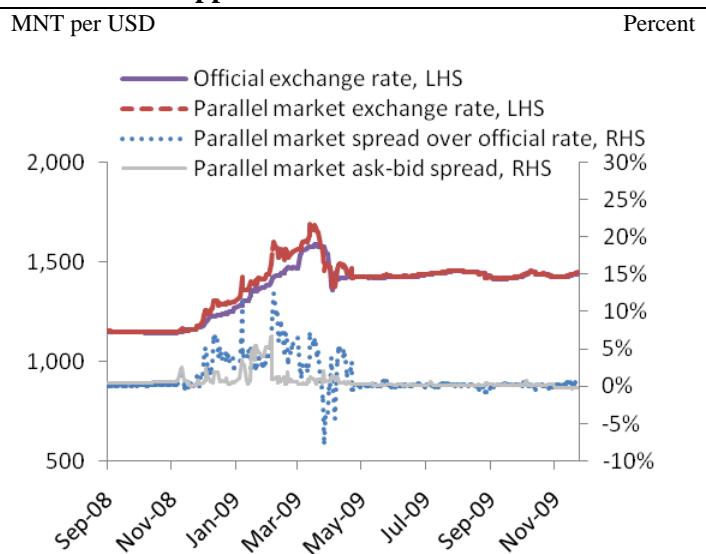
⁵ The financial account records all transactions between a domestic and foreign resident that involves a change of ownership of an asset. It is the net result of public and private international investment flowing in and out of a country, such as FDI, portfolio investment, and lending and borrowing.

(Figure 7.b). The remaining portion of the current account deficit was financed by a disbursement from the IMF under the SBA (\$24.6 million), FX purchases through the BoM's auction, and gold purchases from domestic producers. This also allowed the BoM to rebuild its net international reserves to US\$1062.6 million at the end of September 2009 (Figure 9).

The exchange rate against the USD remains stable

The exchange rate against the USD has been stable since April (Figure 8), when the BoM raised its policy rate substantially and introduced an auction system. In addition, the spread between the ask and bid rates in parallel and commercial bank foreign exchange markets, which is often a good indicator of the liquidity, has remained low, after the sharp spikes in late 2008 and early 2009. In November, the average monthly exchange rate against the USD appreciated slightly, by 0.4 percent, compared with October. This stabilization of the exchange rate has allowed the Bank of Mongolia to bring its international reserves back to the levels prior to the collapse of the copper price in mid-2008 and the Bank's attempts to support a de facto peg against the US dollar by selling its reserves into the market. However, in November, the BoM sold US\$19.5 million of foreign exchange in its regular auctions, with no foreign exchange purchases. Instead, reserves were boosted by the receipt of the pre-payment from the OT agreement.

Figure 8. Exchange rate remains stable, with some minor recent appreciation

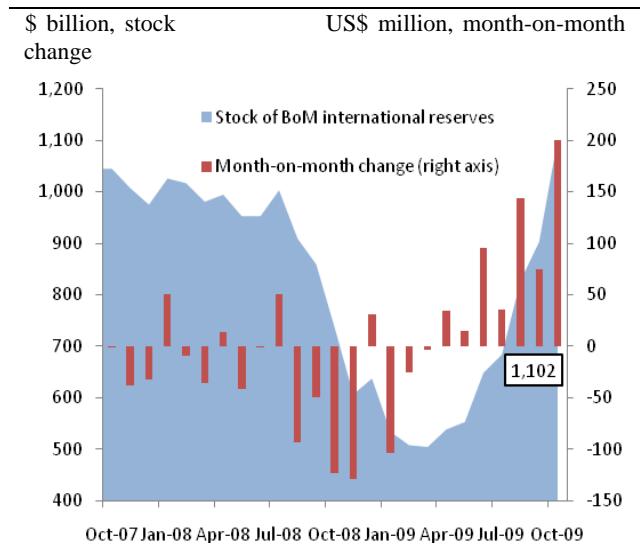


Note: Parallel market rate is mid-point of bid and ask rates. Positive spread over official rate indicates relative depreciation. Ask-bid spread measured as percentage of mid-point of the two.

Last observation: November 23, 2009.

Source: Mongolian Financial Association, World Bank.

Figure 9. BoM is accumulating international reserves



Note: Number in box is end-October stock of BoM international reserves in US\$ million.

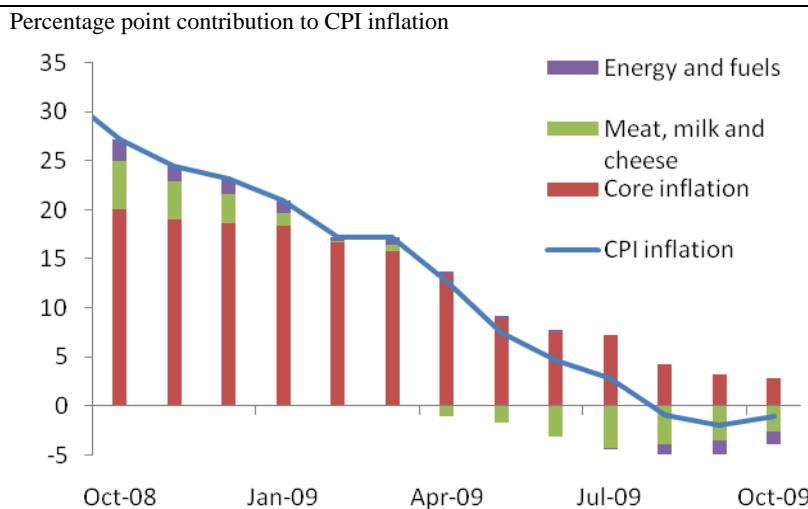
Source: Bank of Mongolia, World Bank

4. Inflation

The decline in economic activity continues to depress domestic prices - core inflation continued to fall in October and the overall inflation rate remained in deflation.

The overall CPI inflation rate was minus 1.1 year-on-year in October, compared to minus 1.9 percent in September. While core inflation remains positive, it fell to 3.9 percent year-on-year in October (Figure 10).

Figure 10. Inflation has fallen rapidly from its peak, mainly because of the domestic slowdown



Note: This is the UB city CPI.

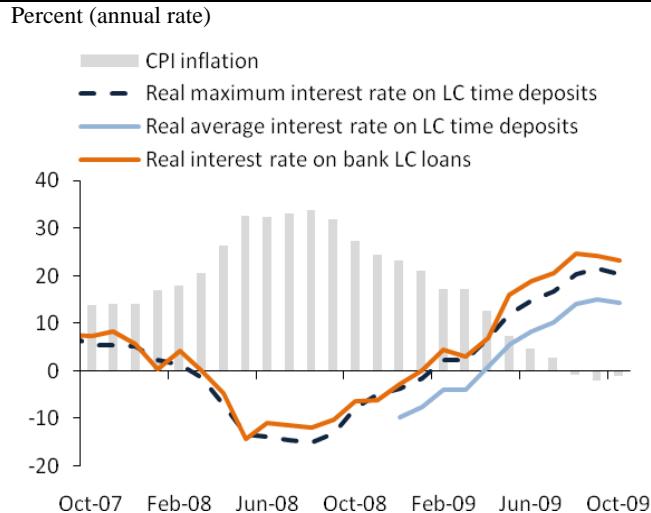
Source: National Statistical Office, World Bank

5. Banking sector

Real interest rates on both loans and deposits are now extremely high.

Despite the Bank of Mongolia having cut its official policy rate from 11.5 to 10 percent in September, nominal interest rates on both local currency deposits and loans have barely moved. But, with inflation having fallen sharply and turned negative in recent months, real economy-wide borrowing costs have soared (Figure 11). As a result, real borrowing costs are close to 25 percent in Mongolia, which is extremely high compared to real interest rates in comparator countries (Figure 12), and poses a constraint to the recovery in private sector activity. Such high rates also constrain the room the Mongol Bank has to raise rates even further, if macroeconomic conditions would seem to warrant this.

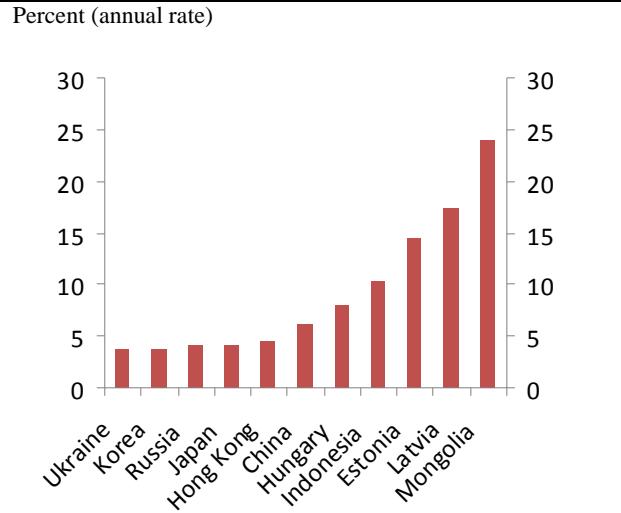
Figure 11. Real deposit and loan rates continue to rise as inflation falls and nominal rates remain stable



Note: Real interest rates are calculated as nominal rate less annual CPI inflation.

Source: Bank of Mongolia, World Bank.

Figure 12. Real borrowing costs in Mongolia are extremely high relative to comparator countries



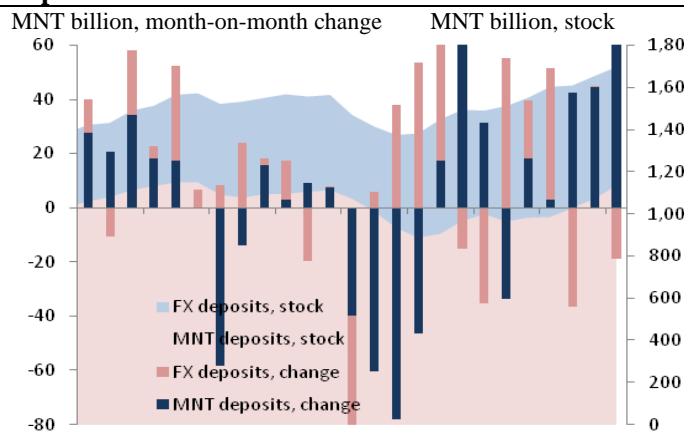
Note: Real borrowing costs are calculated as nominal prime lending and commercial rates less CPI inflation for September 2009. For Mongolia, the MNT loan rate was used.

Source: Datastream, Bank of Mongolia, World Bank.

MNT deposits are continuing to increase ...

The high real interest rates cause MNT deposits to continue to rise. Indeed, at MNT 1,134 billion in October 2009, local currency deposits are now only slightly below their peak of MNT 1,149 billion in March 2008. While the weighted average interest rate stayed the same on the month for MNT deposits, it was reduced for foreign currency deposits in October to 6.3 percent from 7.0 percent in September.⁶ This contributed to the reduction in foreign currency deposits over October by US\$13 million to US\$391 million

Figure 13. MNT deposits increasing due to still high deposit rates



Source: Bank of Mongolia, World Bank

⁶ In comparison, real returns even in those countries which are the target of carry traders are not as high. For instance, real interest rates in Australia are 2.5 percent while in Brazil, Indonesia and the Philippines, they average close to 4.5 percent. Real returns on investing in US 3month t-bills are meanwhile around 1.5 percent.

at end-October. Still, these are US\$115 million higher than corresponding level in October of 2008 (Figure 13).

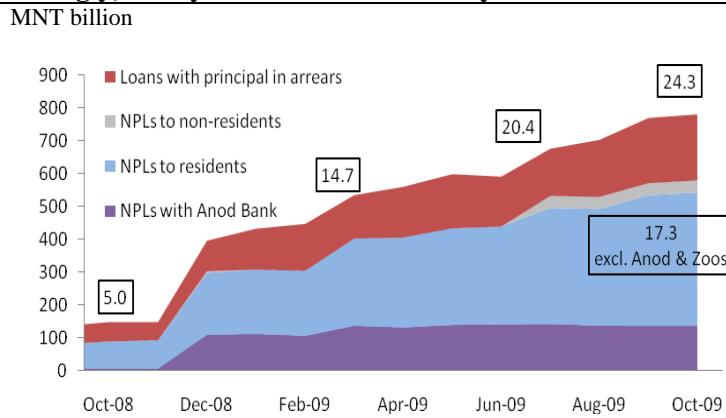
Non-performing loans continue to increase

Following the failure of Anod Bank at the end of 2008, which was taken into conservatorship by the Bank of Mongolia, a second bank in Mongolia was now taken into receivership at the end of November 2009. Earlier, rumors about the insolvency of this publicly-traded bank did not seem to have much adverse impacts on overall confidence levels. For instance, its

share price was relatively stable (at around MNT 2,000 compared with around MNT 2,500 at the beginning of the year) prior to the suspension of trading on the Mongolian Stock Exchange. Recall that the government put in place a blanket deposit guarantee since November, 2008 to avert any possibility of a bank run when Anod Bank failed last year. This safety net would explain why the second bank failure has so far not had obvious knock-on effects, such as an outflow of MNT deposits at the time Anod failed. The blanket deposit guarantee is, however, a rather crude measure to ensure continued confidence. It also has several disadvantages, including providing an incentive to the banks for excessive risk-taking in lending.

On average, the banking system remains weak as loan quality, in particular to the private sector, continues to deteriorate. Non-performing loans (NPLs) to residents and nonresidents rose to MNT 443 billion or 16.7 percent of outstanding loans in October, slightly up from 16.3 percent in August 2009. Loans with principal in arrears⁷, which, if the borrower does not improve repayment, will eventually turn into NPLs, reached MNT 201 billion in September (7.7 percent of outstanding loans). As a result, non-performing loans and loans with their principal in arrears now stand at 24.3 percent of all loans. Excluding the two failed banks, the number is still 17.3 percent, or MNT 402 billion (Figure 14).

Figure 14. NPLs and loans in arrears have risen strongly, as key sectors in the economy slowed down



Note: The numbers in boxes are the sums of NPLs to residents and non-residents and loans with principal in arrears as a percent of total loans outstanding.

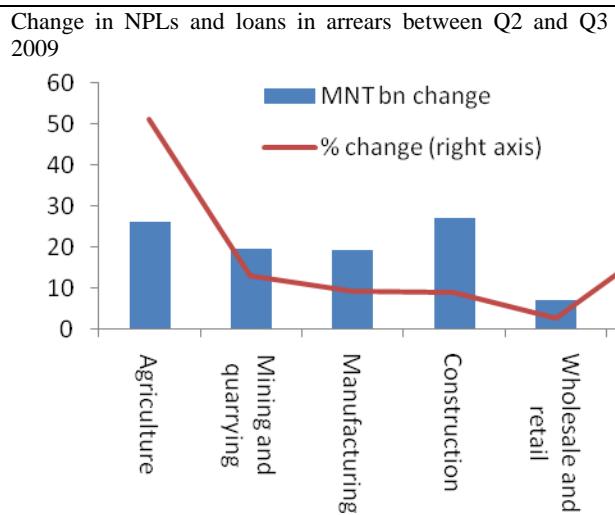
Source: Bank of Mongolia, World Bank

⁷ These are loans of which the principal is 1 to 90 days in arrears. After 90 days, they become non-performing loans.

... and credit quality deteriorates across key sectors of the economy including individual lending, construction and agriculture.

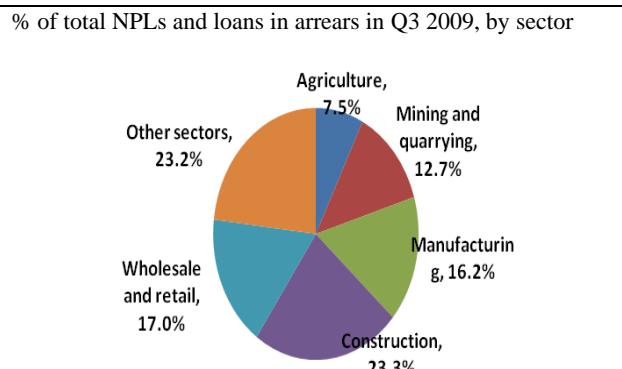
A comparison of the sectoral composition of the changes in NPLs and loans with principal in arrears between the third quarter of 2009 and the second quarter of 2009 shows that the largest increases were recorded in the “other sectors” (MNT 49 billion) which comprises mortgages, salary and pension advances.⁸ The second highest increase was in construction (MNT 27 billion) followed by agriculture sector (MNT 26 billion) (Figure 15.a). These three sectors also account for 54 percent of the total NPLs (to residents) and loans with principal in arrears at the end of the third quarter of 2009, with “other sectors” amounting to MNT 138 billion, construction MNT 139 billion and agriculture 45 billion (Figure 15.b).

Figure 15.a. The largest increases in NPLs and loans in arrears occurred in consumer loans and construction sectors



Note: “Other sectors” mainly comprise lending to consumers e.g. mortgages, pension and salary advances
Source: Bank of Mongolia, World Bank.

Figure 15.b. ... And these sectors now account for the majority of NPLs and loans in arrears



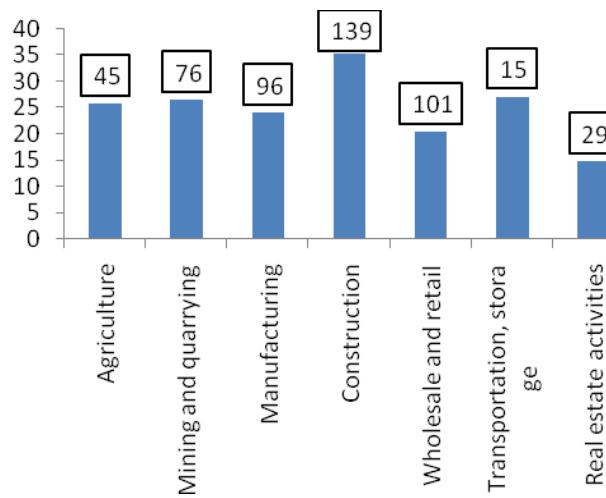
Note: “Other sectors” mainly comprise lending to consumers e.g. mortgages, pension and salary advances
Source: Bank of Mongolia

The construction sector has the highest sector ratio of NPLs and loans in arrears to total loans at 35.5 percent, with mining and quarrying second at 26.4 percent (Figure 16.a). Between the third quarter of 2008 and the second quarter of 2009, NPLs and loans in arrears increased by around 350 percent. The construction sector alone accounted for 100 percentage points of this increase, i.e. almost one third, with wholesale and retail a distant second at 55 percentage points (Figure 16.b).

⁸ The source of the sectoral data on loans is the Bank of Mongolia’s Q3 2009 loan report.

Figure 16.a. The construction sector has the highest NPLs and loans in arrears relative to outstanding loans

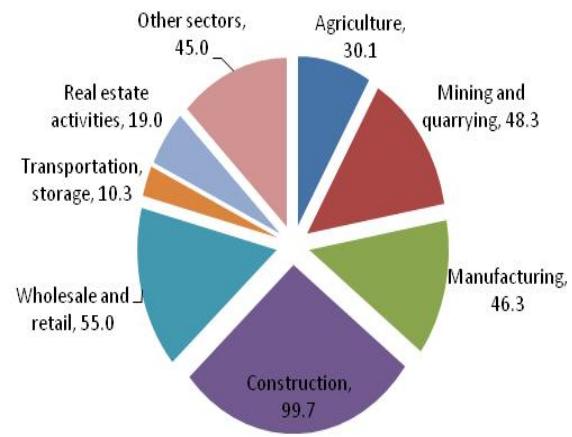
NPLs and loans arrears as percentage of outstanding loans in sector



Note: Number in box is MNT value of NPLs and loans in arrears
Source: Bank of Mongolia, World Bank

Figure 16.b. ... And construction accounted for the largest part of the increase in NPLs and loans in arrears

Percentage point contribution to 353.6% increase in NPLs and loans in arrears between Q3 2008 and Q3 2009



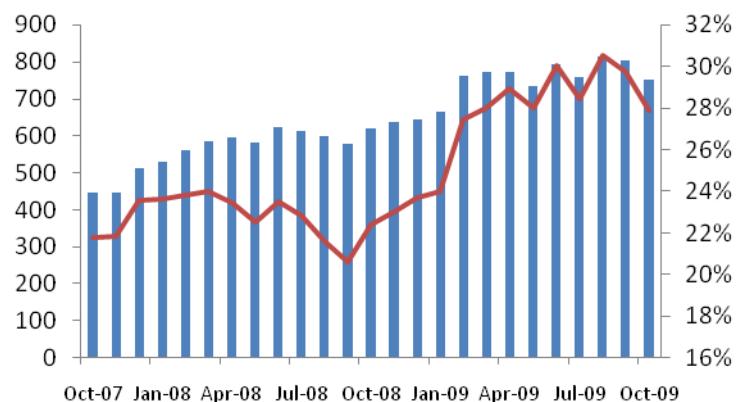
Source: Bank of Mongolia, World Bank

Concentration of lending has increased the exposure of banks to debt servicing difficulties of individual clients in these key sectors.

During the crisis period from mid-2008 there was a sharp rise in the share of loans accounted for by the top 50 borrowers by loan size, increasing from around 20 percent of total loans to just over 30 percent. Whilst this ratio has fallen slightly in recent months, the concentration of credit exposures

Figure 17. The concentration of lending to the largest 50 borrowers by loan size rose during the crisis period

■ MNT billion ■ Share of total loans outstanding



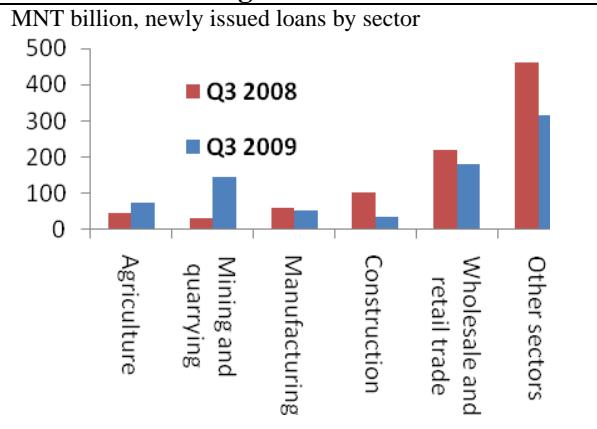
Source: Bank of Mongolia, World Bank

remains high (Figure 17). These figures are on an aggregate basis and individual banks may well have higher exposures. This concentration increases the impact on the health of a bank's loan portfolio of shocks hitting individual creditors.

Newly issued loans continued to decline in the major segments of the private sector.

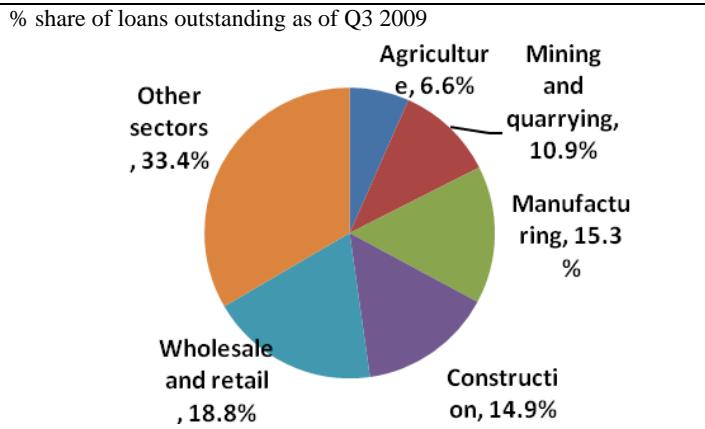
Newly issued loans dropped 13 percent to MNT 802 billion in the third quarter of 2009 from MNT 921 billion in the third quarter of 2008. The largest decreases in newly issued loans occurred in the “other sector”, i.e. primarily lending to individuals, at MNT 315 billion, with the wholesale and retail sector a second at MNT 180 billion (Figure 18.a). However, around 48 percent of the loan portfolio remains exposed to the “other sector” and the wholesale and retail sectors (Figure 18.b), the two sectors which recorded the highest increases in NPLs from the second to the third quarter of 2009.

Figure 18.a. Large decreases in loan issuance to wholesale and retail, mining, construction and manufacturing ...



Source: Bank of Mongolia

Figure 18.b. The loan portfolio is exposed to sectors that suffer from NPLs and loans with principal in arrears



Source: Bank of Mongolia

Banks continue to purchase less risky central bank bills and deposit their foreign exchange with the central bank, but there are some emerging signs of new lending to individuals .

Total loans outstanding to individuals in October increased slightly over September. However, total loans outstanding to the private sector continued to decrease by 21.5 billion MNT in October.

Aggregate losses of commercial banks increased to MNT 112 billion from an aggregate profit of MNT 64 billion a year ago⁹.

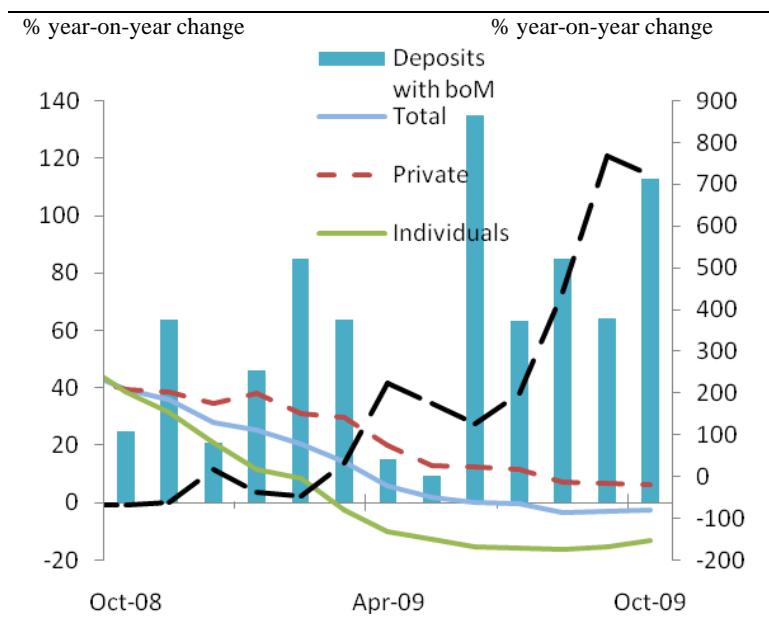
Given the worrying signs in the banking sector, the BoM has been intensifying its partnership with Mongolia's development partners, including USAID, the IMF, the ADB and the World Bank Group, to ensure continued confidence in the banking sector and implement a range of banking sector reforms to help strengthen the system. A key measure is to complete audits by internationally reputable firms of the majority of the banks to allow for the formulation and implementation of a strategy tailor-made for the Mongolian situation.

6. Real Activity

The contraction in economic activity in the third quarter GDP figures, along with recent monthly industrial production figures, highlights the continued weakness in the real sector.

According to the Mongolian National Statistics Office (NSO), real GDP contracted by 3.8 percent yoy in the third quarter of 2009, in sharp contrast with growth of 0.7 percent in the second quarter. Looking at the first three quarters of 2009, real GDP contracted by 2.2 percent compared with the corresponding period of 2008. As in the preceding quarters of 2009, the wholesale and retail trade sector made the greatest contribution to the contraction in the third quarter whilst the transport and communication sector

Figure 19. Small signs of new lending to individuals

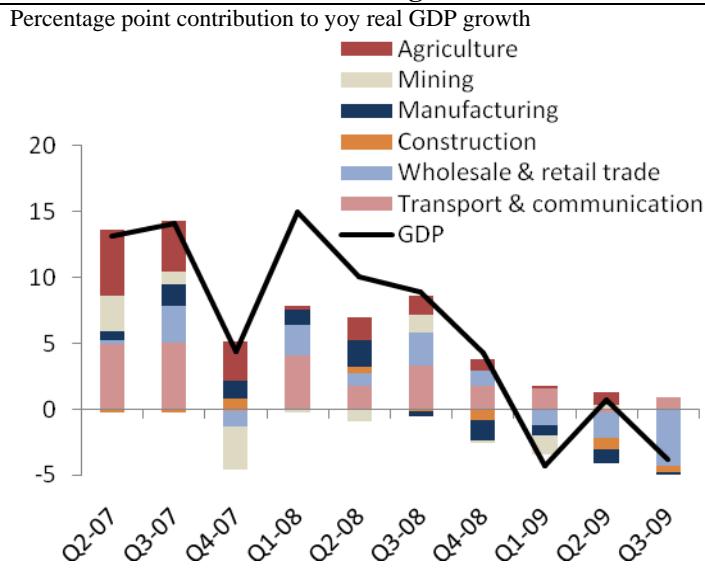


Source: Bank of Mongolia, World Bank

⁹ Consolidated Loan Report, October, 2009, Bank of Mongolia

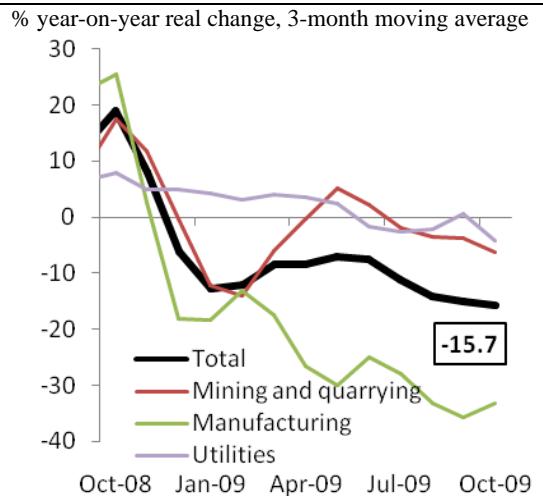
showed positive growth. The agriculture, mining, manufacturing, and construction sectors also declined (Figure 21).

Figure 20. Wholesale and retail trade was a primary driver of the recent fall in GDP growth



Source: National Statistical Office, World Bank

Figure 21. Industrial production remains weak



Note: Number in box is October growth.

Source: National Statistical Office, World Bank

Industrial production (on a three-month moving average basis to smooth fluctuations) contracted by 15.7 percent yoy in October 2009, continuing the downward trend since the middle of 2009. Manufacturing activity was hit especially hard, with two output in two key sectors (manufacturing of textiles and basic metals) contracting by 30 to 60 percent yoy. After a brief rebound in May and June 2009, mining and quarrying have also returned to a contraction (Figure 20).

7. Labor Markets

In line with seasonal patterns observed in recent years, registered unemployment decreased marginally in October ...

Registered unemployment fell by 0.1 percentage points in October, down to 3.6 percent of the labor force. However, this reduction likely reflects the influence of seasonal patterns with the 12-month moving average rate continuing to rise.¹⁰ The impact of the crisis on registered unemployment underestimates the labor market impact of the crisis, both in terms of the impact on actual unemployment and on real wages, particularly in the informal sector (as discussed in previous Updates). These adverse effects threaten to reverse some of the gains in poverty reduction in poverty seen over the past few years due to high

¹⁰ However, the officially registered unemployment figures grossly underestimate actual unemployment, which according to plausible, **unofficial** estimates could be a much higher percentage of the labor force.

economic growth. The scale of these reductions in poverty is highlighted in recent World Bank analysis detailed in Box 2.

...while informal wages seem to have improved slightly in recent months.

The World Bank commissioned another survey to get a snapshot of the daily workers' wages in several major unskilled labor markets in Ulaanbaatar in December, 2009 (Table 2). Recall that the results of the September survey suggest a slight improvement between April and September. In the markets surveyed, first, the number of workers decreased by about 24 percent compared to September, 2009 due reduced activity in construction related markets. Second, on average workers' real wages have stayed about same from September to December 2009. The average wages would have been lower if wages in the supermarket shipments didn't pick up due to holiday season.

Table 2: Daily wages of unskilled workers in selected informal labor markets in UB

Informal labor market	Total number of workers in the market (estimated)			Daily wages (MNT thous.)			Average real wage per hour (MNT thous.)		
	Apr-09	Sep-09	Dec-09	Apr-09	Sep-09	Dec-09	Apr-09	Sep-09	Dec-09
Railway cargo unloading in UB "44" area: Triangle bridge district	500	700	500	3.0-7.0	4.0-5.0	3.0-5.0	0.4	0.4	0.3
Container loading and unloading for freight companies	200	300	200	8.0	8.0-9.0	6.0-7.0	0.9	1.1	0.9
Cement loading at "Botanic" market at Amgalan district	100	20	0	8.0-30.0	2.7-2.9	n.a.	1.3	0.4	n.a.
Supermarket shipments loading and unloading at "Bars" market	25	100	100	5.0-10.0	6.0-10.0	10.0-15.0	0.8	0.9	1.6
Merchandise carter Narantuul "Black market" in UB	400	400	300	5.0-6.0	7.0-8.0	8.0-10.0	0.4	0.6	1.0
Construction materials delivery "100 family" district	30	50	100	5.0-10.0	10.0-15.0	5.0-10.0	0.7	1.3	1.8
Total (estimated)	1255	1570	1200	Average			0.7	0.8	0.9

Notes: Data from special surveys conducted in April, September and December 2009.

Box 2. Progress in Poverty Reduction in Mongolia

Mongolia's economy experienced significant growth in GDP per capita during the 2002-2008 period. How much of this growth translated into a reduction in poverty?

The answer to this question depends on what measure of poverty is used to compare poverty in 2002/3 and 2007/8, the years in which the National Statistical Office (NSO) conducted nationally representative household surveys.

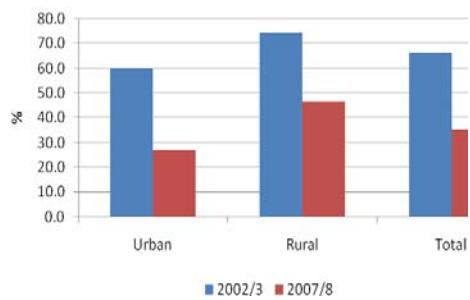
The official consumption-based poverty headcount in 2007/8 is 35.2 percent (NSO). If we now use this benchmark and a consistent poverty line over time, we can calculate the poverty headcount in 2002/3: 66.2 percent, which points to a large reduction in poverty (Figure 22). Rural poverty declined from 74.2 to 46.6 percent during this period, while urban poverty declined from 59.9 to 26.9 percent.

We also analyzed what happened to poverty, starting with the NSO's 2002/3 poverty line as the benchmark. In 2002/3, this measure generated a poverty rate of 36.1 percent. Using this same poverty line consistently, we found that poverty fell to 11.6 percent by 2007/8. This finding would be consistent with the high economic growth, the considerable increase in national herd size and increases in several real commodity prices. Changes in inequality, inflation, or the consumption aggregate itself do not contradict the findings. Real consumption increased across different wealth quintiles.

Figure 22. Poverty has declined substantially in Mongolia

% of population

Poverty headcount by region

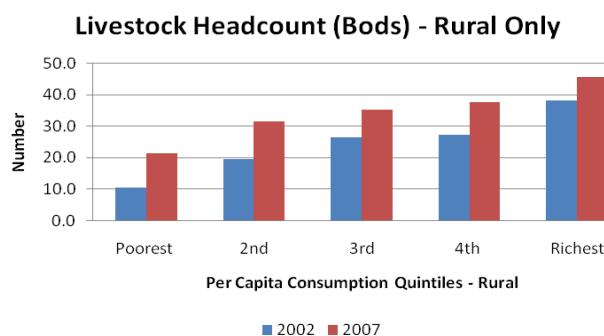


Source: World Bank staff calculations using the official 2007/8 poverty line as a benchmark and using a comparable poverty line for 2002/3.

We also analyzed what happened to poverty, starting with the NSO's 2002/3 poverty line as the benchmark. In 2002/3, this measure generated a poverty rate of 36.1 percent. Using this same poverty line consistently, we found that poverty fell to 11.6 percent by 2007/8. This finding would be consistent with the high economic growth, the considerable increase in national herd size and increases in several real commodity prices. Changes in inequality, inflation, or the consumption aggregate itself do not contradict the findings. Real consumption increased across different wealth quintiles.

Figure 23. Livestock headcount increased significantly and especially among the poorest households

Headcount in bod scale



Note: Bod scale - 1 horse is assumed to be the same as one cattle (cow or yak), 0.67 camels, six sheep or eight goats.

Source: World Bank staff calculations from 2007/8 household survey.

line, usually after a long period and some structural change a country's poverty benchmark outweighs the need to maintain comparability. The NSO adopted this approach in an effort to improve its estimation of the poverty line. However, this approach makes it difficult to compare poverty numbers over time, even though its formula to recalculate the poverty line for each given year is generally well-accepted.

In addition, examination of key non-consumption measures of well-being between 2002/3 and 2007/8 also provides evidence consistent with falling poverty. On the most essential input to Mongolia's rural economy, both macro and micro data show that the livestock headcount increased significantly and especially among the poorest households (Figure 23). Increases in livestock size may be one of the driving factors for poverty reduction among the rural poor in Mongolia. The country also experienced progress along various social indicators such as access to savings, educational attainment, illness incidence, and access to solar energy and telecommunications.

Why do these findings seem different from those of the NSO? The answer lies in the poverty lines used in 2002/3 and 2007/8. There are two possible approaches:

- One approach is to recalculate the poverty line in the economy, when the need to re-adjust a country's poverty benchmark outweighs the need to maintain comparability. The NSO adopted this approach in an effort to improve its estimation of the poverty line. However, this approach makes it difficult to compare poverty numbers over time, even though its formula to recalculate the poverty line for each given year is generally well-accepted.

- A second approach is to adjust the poverty line for changes in the cost of living and thus maintain the same benchmark in real terms. This method is often used for comparison over the short-to-medium term. Using this approach, i.e. using comparable poverty lines in both periods, we find that consumption-based poverty has declined in Mongolia.

Source: World Bank staff calculations and NSO's report of the 2007/8 household survey, July 2009. Further details are provided in World Bank presentations available at <http://www.worldbank.org.mn/>.

Table 3. Mongolia: Key Indicators

	2003	2004	2005	2006	2007	2008e	2009f
Output, Employment and Prices							
Real GDP (% yoy change)	7.0	10.6	7.3	8.6	10.2	8.9	0.5
Industrial production index (% yoy change)	.. ..	.. ..	.. ..	100.0	110.4	113.4	..
Unemployment (%)	3.4	3.6	3.3	3.2	2.8	2.8	..
Consumer price index (% yoy change)	4.6	10.9	9.6	5.9	14.1	23.2	8.5
Public Sector							
Government balance (% of GDP)	-3.7	-1.8	2.6	3.3	2.8	-5.0	-6.5
Non-mining balance (% of GDP) ⁽¹⁾	-5.9	-5.8	-1.3	-7.3	-13.4	-15.3	-12.1
Domestic public sector debt (% of GDP)	3.1	1.4	0.1	1.0	0.5	0.0	0.0
Foreign Trade, BOP and External Debt							
Trade balance (\$ mn)	-199.6	-99.2	-99.5	136.2	-52.4	-612.6	-183.0
Exports of goods (\$ mn) (% yoy change)	627.3 19.7	872.1 39.0	1066.1 22.2	1543.9 44.8	1950.7 26.4	2534.5 29.9	1830.0 -27.7
Copper exports (% yoy change)	..	..	14.7	94.8	27.7	3.0	..
Imports of goods (\$ mn) (% yoy change)	826.9 21.6	971.3 17.5	1165.6 20.0	1407.7 20.8	2003.1 42.3	3147.0 57.1	2013.0 -35.7
Current account balance (\$ mn) (% of GDP)	-102.4 -7.1	24.1 1.3	29.7 1.3	221.6 7.0	264.8 6.7	-721.9 -13.9	-291.0 -6.9
Foreign direct investment (\$ mn)	131.5	128.9	257.6	289.6	360.0	585.5	517.0
External debt (\$ mn) (% of GDP)	1240.3 87.3	1311.8 73.7	1360.0 59.7	1413.9 44.3	1528.7 38.9	1600.5 33.1	1860.0 46.5
Short-term debt (\$ mn) ⁽³⁾	0.0	0.0	0.0	0.0	0.0	0.0	..
Debt service ratio (% of exports of g&s) ⁽³⁾	13.4	9.4	7.6	5.4	4.3	3.5	4.3
Foreign exchange reserves, gross (\$ mn) (month of imports of g&s)	203.5 2.3	207.8 1.8	333.1 2.5	718.0 4.6	1,000.6 5.0	656.7 2.1	822.1 3.7
Financial Markets							
Domestic credit (% yoy change)	157.3	25.8	18.8	-3.1	78.4	60.6	..
Short-term interest rate (% per annum) ⁽⁴⁾	..	15.8	3.7	5.1	8.4	9.8	..
Exchange rate (MNT/USD, eop)	1168.0	1209.0	1221.0	1165.0	1170.0	1267.5	..
Real effective exchange rate (2006=100) ⁽⁵⁾ (% yoy change)	94.2 -4.8	93.9 -0.4	99.6 6.1	102.8 3.2	104.8 1.9	127.4 21.5	..
Stock market index (2000=100) ⁽⁶⁾	151.5	120.8	203.6	382.0	2048.0	1181.6	..
Memo:							
Nominal GDP (MNT bn)	1,660	2,152	2,780	3,715	4,600	6,130	6,209
Nominal GDP (\$ mn)	1,448	1,814	2,307	3,156	3,930	5,258	..
GDP per capita (\$)	583	722	900	1,214	1,491	1,960	..

(1) Non-mining balance excludes revenues from corporate income tax and dividends from mining companies, the Windfall Profits Tax and royalties. (2) The 2008 data for the balance of payments are based on the final revision. (3) On public and publicly guaranteed debt. (4) Yield of 14-day bills until 2006 and of 7-day bills for 2007. (5) Increase is appreciation. (6) Top-20 index, end of year, index=100 in Dec-2000.

Source: Bank of Mongolia, National Statistical Office, Ministry of Finance, IMF and World Bank staff estimates