

# Mongolia Quarterly Economic Update

The World Bank



The World Bank's *Mongolia Quarterly Economic Update* assesses recent economic and social developments and policies in Mongolia. It also presents findings of ongoing World Bank activities in Mongolia. The Update is prepared by a team from the World Bank's Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Region Vice-Presidency, consisting of Munkhnasan Narmandakh, Tehmina Khan and Altantsetseg Shiilegmaa, and led by Rogier van den Brink. This Update also received contributions from Alexander Pankov and Michele Zini. Copies can be downloaded from <http://www.worldbank.org.mn>. For further information, comments and questions, please contact Sunjidmaa Jamba ([sjamba@worldbank.org](mailto:sjamba@worldbank.org)).

## Contents

Executive Summary.....	5
Real sector developments .....	7
Labor Markets and Poverty.....	9
Inflation.....	9
Fiscal developments.....	14
External sector .....	21
Banking sector.....	25
Economic outlook .....	28

## Figures

Fig 1 The economy is expanding at a furious pace .....	10
Fig 2 But there are growing risks of a construction bubble .....	10
Fig 3 Manufacturing continues to grow at a healthy rate .....	10
Fig 4 Registered unemployment.....	10
Fig 5 Real wages declining in informal labor markets due to inflation erosion.....	10
Fig 6 while more laborers struggle with inadequate wages to buy basic needs .....	10
Fig 7 inflation is trending up once more, suggesting that the economy is overheating .....	13
Fig 8 Over the past year inflation has mostly been sustained by rising core prices (ex all food and energy) .....	13
Fig 9 But as the effects of the govt. meat subsidy have worn off, food inflation is accelerating once again .....	13
Fig 10 and with Mongolian food inflation lagging Chinese food inflation by 3 months, prices look set to rise further .....	13
Fig 11 which will hurt the poor the most.....	13
Fig 12 The Bank of Mongolia tightened policy in August to curb inflationary pressures .....	13
Fig 13 Fiscal balances have improved strongly in recent months.....	14
Fig 14 ... in line with revenues.....	14
Fig 15 Rising mineral receipts including VAT on mining equipment imports are more than compensating for.....	15
Fig 16 ... the loss in Windfall Profits Tax revenues in 2011.....	15
Fig 17 .. Expenditures are much higher than a year ago.....	15
Fig 18 ...with current transfers and wages and salaries constituting the bulk of the increase .....	15

Fig 19 The 2011 budget amendment and 2012 proposal aim to raise spending sharply.....	20
Fig 20 supported by mining sector revenues as production from Oyu Tolgoi is brought forward.....	20
Fig 21 with large increases planned in transfers and subsidies relative to the original 2011 budget.....	20
Fig 22 .. and on wages and salaries.....	20
Fig 23 ...as well as on capital expenditures .....	20
Fig 24 The overall balance will deteriorate sharply .....	20
Fig 25 The trade deficit is close to record levels.....	23
Fig 26 driven mostly by transport equipment and machinery imports.....	23
Fig 27 Exports are growing strongly as well driven by large coal exports to China .....	23
Fig 28 But copper exports are not doing so well and unprocessed cashmere and gold even worse.....	23
Fig 29 Commodity prices have experienced large fluctuation in recent months and... ..	23
Fig 30 ...Mongolia is the most exposed in East Asia to volatility in commodity prices.....	23
Fig 31 Global trade is losing momentum rapidly, reflecting fragile demand in advanced economies.....	24
Fig 32 ...and it is unclear to what extent China will act as a “growth pole” for its neighbors .....	24
Fig 33 The exchange rate* has appreciated sharply since the start of 2010.....	26
Fig 34 while FX reserves have stabilized at close to record levels.....	26
Fig 35 Issuance of central bank bills has fallen in recent months.....	26
Fig 36 The CA deficit continues to grow, pushed up by rising mineral sector imports .....	26
Fig 37 Net FDI inflows remain strong in contrast to portfolio inflows which have dropped to zero.. ..	26
Fig 38 .. reflecting global flight to safety flows as the global economic environment has deteriorated ...	26
Fig 39 Both local and foreign currency deposits continued to reach new highs in September .....	27
Fig 40 Real economy-wide interest rates fell as inflation picked up .....	27
Fig 41 Credit continues to surge .....	27
Fig 42 ... directed mostly to a small number of borrowers.....	27
Fig 43 Loan to deposit ratios are close to 100 percent.....	27
Fig 44 .. while the volume of NPLs remains high .....	27

## Tables

Table 1 Budget execution, Year to Date, MNT mn .....	16
Table 2 Aggregate indicators for the Budget Framework under the MTBF in comparison to 2011 Budget and Budget Amendments (% of the projected GDP) .....	17
Table 3 Headline numbers from the 2012 Proposed Budget compared to 2011 Approved Budget .....	18

Table 4 Capital expenditure composition, MNT mn .....	18
Table 5 Mongolia: Key Indicators.....	30

## Boxes

Box 1 Construction material .....	7
Box 2 The Bank of Mongolia's response to inflationary pressures: a comparison between 2007/08 and 2011 .....	11
Box 3 What Next? Proposed Social Welfare Changes as per the 2012 draft budget .....	21

## Abbreviations and acronyms

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

## Executive Summary<sup>1</sup>

---

The economic rebound in recent quarters has been stronger than expected and the economy is showing signs of overheating. These signs are show up in rising inflation, especially of those goods and services which are in strong demand, but cannot easily be imported or whose local supply cannot readily be increased to meet the growing demand.

GDP growth reached 20.8 percent year-on-year (yoy) in Q3, following an outturn of 17.3 percent in Q2. Growth for the year as a whole will likely hit 15 percent, if not more, up from 6.4 percent in 2010, and is being pushed by infrastructure spending as Mongolia develops its vast mineral wealth.

Mining and manufacturing output are both rising at a healthy rate but there are growing fears of another construction bubble similar to the previous boom in 2004-08. Unemployment is trending down, but overall levels remain high at around 9 percent and October survey results from selected informal labor markets indicate that, on average, real wages have fallen (due to inflation) since the July survey. Almost half of those surveyed indicated that their earnings did not meet their basic needs, which confirms the negative impact of inflation on the poor.

Inflation continues its upward trend. Headline inflation in Ulaanbaatar accelerated to 11.9 percent yoy in September from 9.9 percent in August. Note that core inflation, which excludes all food and energy, has now continuously kept rising throughout the year, reflecting generalized wage and price pressures from a booming economy and large government cash handouts. With food prices rising and the government expected to ramp up spending sharply, inflation will likely rise further.

The trade deficit is close to record levels (US\$ 1.4 bn in September using 12-month rolling sums) driven by a surge in mining-related equipment and fuel imports. Exports are growing strongly too, driven by large coal shipments to China. Nevertheless, copper exports are barely growing in volume terms, and cashmere exports are doing even worse. The Togrog has depreciated against the US\$ since August in line with other currencies in the region due to rising global risk aversion, but this has been relatively small (about 4.8 percent), as FDI inflows to develop the OT mine have remained strong.

Although bank capital buffers are in much better shape compared to 2009 when two banks failed, nevertheless, continued vigilance on financial risks is necessary on a number of counts. High lending growth in the banking sector is focusing attention on asset quality in the banking system. Credit growth of 52 percent yoy in real terms in September is higher than the underlying real growth in the economy and is also highly concentrated, while the volume of non-performing loans remains high. And although deposits in the banking system are hitting new peaks, the loan to deposit ratio (excluding government deposits) has risen to about a 100 percent, implying growing liquidity risks. Ensuring financial stability will require close monitoring and pro-active implementation of macro-prudential norms and regulations such as higher capital ratios and limits on loan to value ratios.

The Bank of Mongolia raised its interest rate by 0.5 percentage points to 12.25 percent in October. This is the third rate increase this year, complemented by two increases in the reserve requirement ratio, in response to the rising trend in core inflation. Given long policy lags, and with inflation continuing to rise, more action will be needed. However, monetary policy's effectiveness in fighting inflation is undermined by expansionary fiscal policy, as is currently the case.

---

<sup>1</sup> The analysis is based on the Q3, 2011 data from the Bank of Mongolia (monthly bulletin, loan report and monthly consolidated banking system balance sheet), the National Statistical Office, National Tax Authority and the Ministry of Finance.

With government revenues boosted by mining sector receipts and a booming economy, public sector finances are in relatively good shape. On a 12-month rolling basis, the fiscal balance amounts to 2.5 percent of GDP in September.

In September, the government submitted to Parliament an amended 2011 Budget Law for consideration alongside the 2012 budget. Recall that the original 2011 budget already raised expenditures by 32 percent over 2010 outturns. While excess mineral revenues are saved in a stabilization fund as required by the Fiscal Stability Law (FSL), this is not required for above-trend non-mineral revenues. It is these that the government is proposing to spend under the 2011 budget amendment. This would raise expenditures by another 20 percent on top of 2011 plans, with a deficit target of 9.8 percent of GDP.

The 2012 Budget continues this fiscal expansion and targets a 74 percent increase in expenditures (mostly on wages and social transfers). In absolute terms, the proposed fiscal expenditure in the 2012 budget is double total expenditures in 2010 and is only slightly lower than total GDP in 2010. At the same time, based on optimistic revenue and GDP projections, the 2012 budget deficit is estimated at 4.1 percent of GDP.

Increased spending on wages and transfers creates the risk of setting in motion a wage price spiral, if higher inflation expectations become entrenched. Aside from the negative impact on the poor, this will undermine the competitiveness of exporting (agriculture) and import-competing businesses (mostly small and medium sized enterprises). Fortunately, the draft 2012 budget plans for the introduction of proxy means tested benefits targeted to the poorest in the second half of next year, replacing the current universal cash transfers. Twelve percent of the budget is allocated for this purpose.

Revenue, expenditure and GDP forecasts underlying the 2012 budget proposal are optimistic. High GDP forecasts are based on (i) continued strong flows of foreign direct investment, which has more than doubled between 2010 and 2011; (ii) continued rapid expansion of the mining sector, including coal; (iii) public investment being raised by a multiple, with second-round effects on economic growth due to multiplier effects; and (iv) an upsurge consumer demand due to the final disbursements of cash to the citizenry ahead of the 2012 elections, in order to fulfill the political promises made during the 2008 elections.

There are risks that these optimistic forecasts would not materialize. For instance, revenues could discontinue or reverse their current trends if the global economy deteriorates, coal exports could run into transport capacity constraints, large public investment projects could be delayed due to capacity constraints in preparation, contracting and execution, and OT production could be affected by delays in obtaining power from China.

Risks in the global environment have increased with heightened uncertainty in international financial and debt markets, and a slowdown of growth in developed countries. Indeed, commodity prices have already started falling. Accordingly, pro-active, prudent and risk-averse economic management is now needed, as the economy shows signs of overheating against a backdrop of rising global risks.

---

## Real sector developments

---

### The economy is expanding at a furious pace

The economy grew at a furious pace in the third quarter with data showing GDP growth of 20.8 percent year-on-year (yoy), following an equally remarkable outturn of 17.3 percent in Q2 (Fig 1). This means that even if the pace of growth weakens in the fourth quarter – to say 10 percent yoy – the overall outturn for the year as a whole will hit close to 15 percent, if not more. This is more than double GDP growth in 2010 of 6.4 percent, and well above the average 9 percent outturns during the previous mining boom in 2004-08.

Overall growth is being driven by infrastructure spending related to the mining sector boom, as the economy gears up for the Oyu Tolgoi mine to become operational. Expansionary fiscal policies of the government are adding additional pressure to domestic demand. The transport sector grew by 35.1 percent, contributing 4.4 percentage points to overall growth. Meanwhile, the wholesale and retail trade sector grew by 50.5 percent (contributing 4.3 pp to overall growth), up from 24.7 percent in Q2 reflecting very strong consumer spending and sentiment. Manufacturing is continuing to grow at a healthy pace (Fig 3): in September, output rose by 17 percent yoy on a 3 month moving average (3mma) basis—the same as average growth since May.

The mining sector itself is growing at a somewhat slower pace: output rose by 6 percent yoy (3mma) basis in September, down from 15 percent in May—due to a number of bottlenecks and constraints. These include: increased fuel prices and fuel shortages during the operational summer season; increasingly expensive equipment and parts due to the increase in global steel prices over the past year; several hikes in electricity tariffs over the past year that have raised input costs; and growing demands on existing rail and transport networks as mining imports surged.

### Fears of a construction bubble are mounting

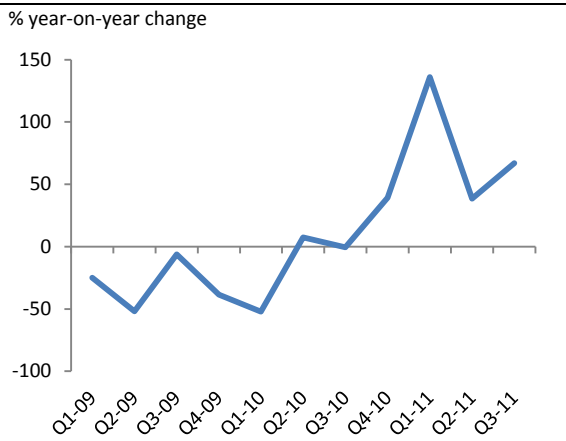
There are growing fears of another construction bubble fuelled by the inflow of money into the economy from currently high mineral prices, similar to the previous boom in 2004-08 (Fig 2). Currently, the sector is growing at 67 percent yoy, up from 38 percent in Q2. Housing prices are soaring, while the prices of key construction materials have also climbed sharply since last year (Box 1). However, because the share of construction in overall GDP is tiny—only 1.4 percent in 2010—its contribution to overall growth amounted to only 0.9 percent.

#### Box 1 Construction material

Cement consumption in Mongolia increased more than tenfold in the past 10 years, with supply struggling to meet the increasing demand. A booming domestic economy and the development of Mongolia's mineral deposits (notably Oyu Tolgoi, which is expected to start production in late 2012) is spurring demand for roads, buildings, and infrastructure.

Quarterly GDP growth of Mongolia's construction sector surpassed 130 percent year-on-year in the first quarter of 2011 and has remained high since then (Box Figure 1). The recent growth spurt comes on top of a decade of already high growth: total cement sales increased by an average of over 35 percent annually since 2001 (Box Figure 2). According to unofficial statistics, the total current consumption in Mongolia is approximately 1.5 mn tons a year. Cement demand is projected to reach 2.0 mn tons in the near future, due to the massive infrastructure projects planned by the government.

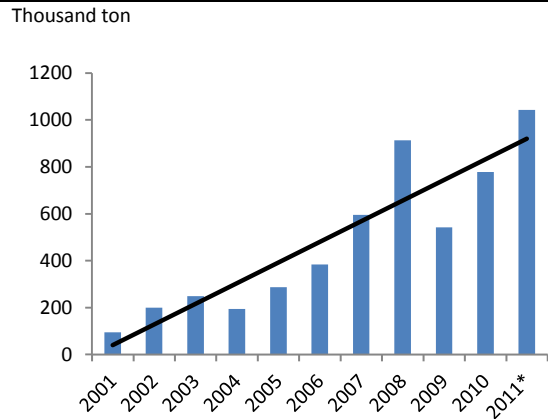
**Box Figure 1 Construction sector growth**



Mongolia’s own cement production has been unable to cope with the increased demand, and prices for locally produced cement have shot up since 2010. On average, prices tripled in the last 5 years. Imports have only partially been able to offset the price rises, because Mongolia imports the bulk of its cement from China (unofficial estimate: about 90 percent), which itself struggles to meet local demand. Since the first quarter of 2011, these pressures resulted in sharply rising cement prices in Mongolia and a widening gap between local and import prices, as imports were not able to meet local demand and local supply is not growing fast enough.

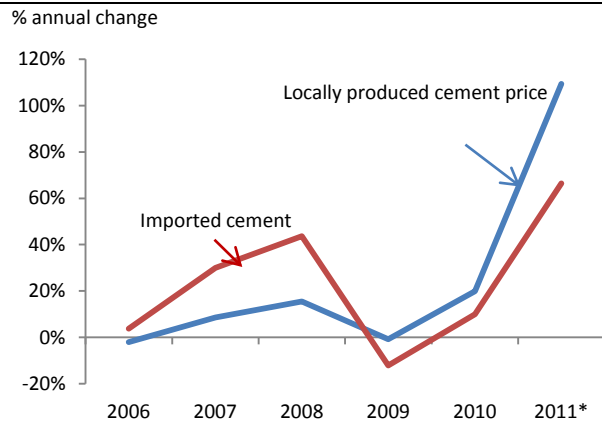
Source: NSO, Mongolian Customs Agency, World Bank Staff

**Box Figure 2 Official statistics for cement sales (locally produced and imported)**



\*estimate based on 10-year average growth. The actual outcome is likely to be higher due to the construction sector boom in 2011.

**Box Figure 3 Official statistics for cement prices**



\*Current price. The average outcome for 2011 is likely to be higher due to the construction sector boom.

## Labor Markets and Poverty

---

### Unemployment is falling

Labor force surveys (LFS) show that unemployment has been gradually trending down, although the overall level is still high at around 9 percent<sup>2</sup>. The LFS take into account workers who are not officially registered as unemployed with the Labor and Social Welfare Centers. Accordingly, they provide a more accurate picture of unemployment in the country compared to official estimates, which only count those registered with these Centers as unemployed. Indeed, according to the latter data, unemployment stood at just 3.6 percent in September (Fig 4).

### Real wages in informal markets are decreasing as inflation picks up

The October survey results from selected informal labor markets indicate that on average real wages fell since the July survey, as rising inflation is eroding purchasing power. The workers' real wages declined by 13 percent compared to July, while the number of laborers declined by 9 percent as students went back to school. The remaining workers are concentrated mostly around the cargo loading and unloading areas, and construction sites, as the job opportunities for carrying carts, transporting small shipments and cleaning activities have increased in these markets due to the fast growing economy. However, almost half of those surveyed indicated that their earning did not meet their basic needs, which would confirm the inflation problem the poor are facing. This number is up almost 24 percent from July 2011. The survey also indicated that most of these unskilled laborers have recently migrated from rural regions.

## Inflation

---

### With food prices and government spending increasing, inflation could rise further

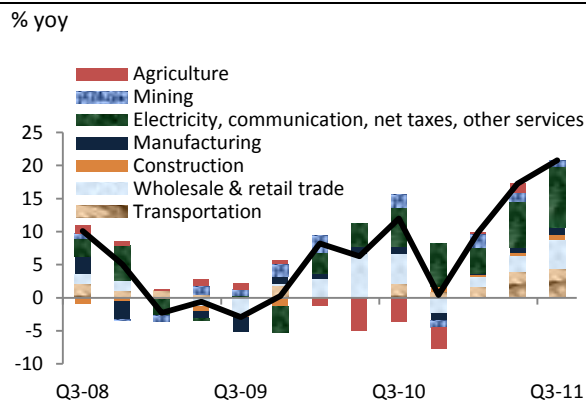
September data show headline inflation accelerating to 11.9 percent yoy in Ulaanbaatar, up from 9.9 percent the previous month (Fig 7). Recall that core inflation (which excludes food and energy, because they are typically more volatile) has kept increasing throughout the year (Fig 8). This continuously rising trend reflects the combination of a booming economy and the expansionary fiscal policy stance. Core prices rose by 12.7 percent in September, up from 11.9 percent in August.

Headline inflation has been less than anticipated for a number of reasons. First, government policy has successfully kept food price inflation under control. In the spring, government-coordinated releases from meat storage facilities were able to put downward pressure on meat prices. However, this intervention is now over. Meat prices reflect open market forces. Because Mongolia imports the bulk of its non-meat food from China, Mongolia's food inflation typically follows China's with a lag of three months or so (Fig 10). In September, China's food inflation stood at 13.4 percent. Currently, Mongolia's food inflation seems set to catch up with the higher levels in China. (Fortunately, China's food prices are stabilizing: September data showed that Chinese food inflation stayed constant from August.) The bottom line: all food prices are once again rising in Mongolia (Fig 9).

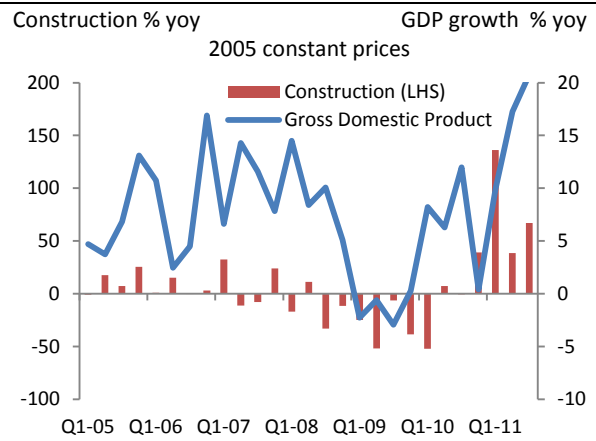
---

<sup>2</sup> The Q1 2011 Labor Force Survey shows unemployment at 8.7 percent

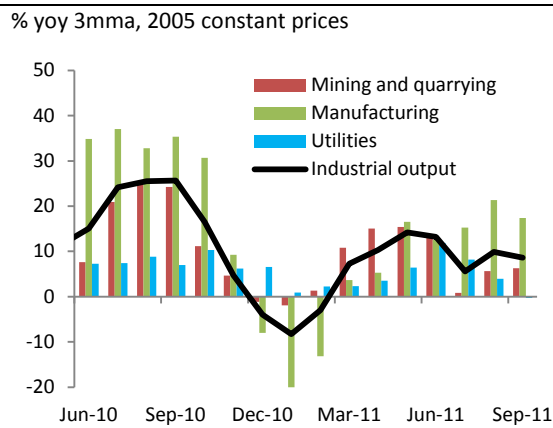
**Fig 1 The economy is expanding at a furious pace**



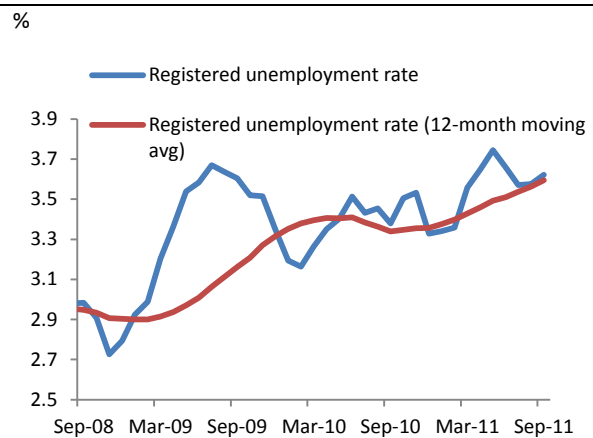
**Fig 2 But there are growing risks of a construction bubble**



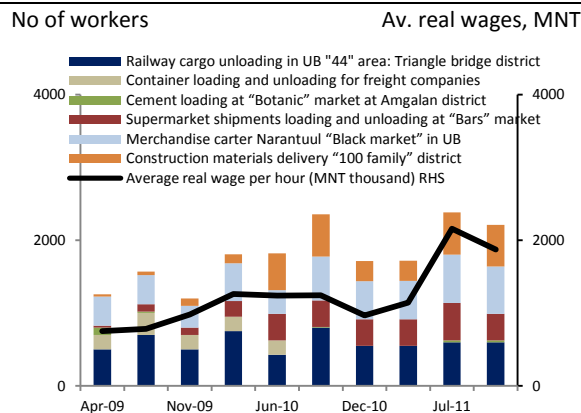
**Fig 3 Manufacturing continues to grow at a healthy rate**



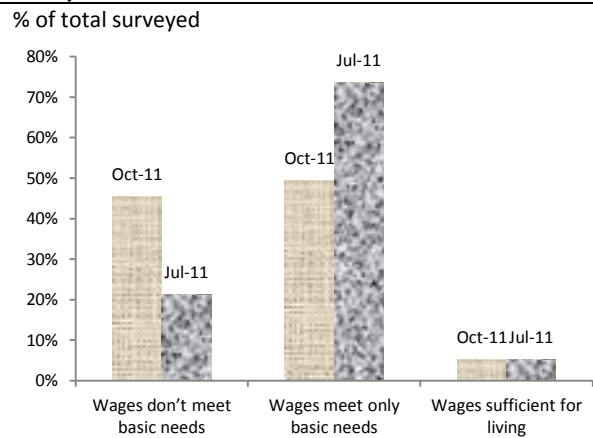
**Fig 4 Registered unemployment**



**Fig 5 Real wages declining in informal labor markets due to inflation erosion**



**Fig 6 while more laborers struggle with inadequate wages to buy basic needs**



Sources: NSO, WB staff estimates.

Rising food prices hit the urban poor (roughly 22 percent<sup>3</sup> of the UB population) extremely hard, as the poor spend most of their income on food, mostly meat (Fig 11).<sup>4</sup>

The second reason why current inflation is high, but less high than anticipated last year, is the response by the Bank of Mongolia to earlier inflation predictions, including its own. The Bank has been quick to raise its benchmark interest rate twice this year, by a total of 75 basis points to 11.75 percent in August. And in October it raised this further by 50 basis points to 12.25 percent (Fig 12). In addition, in order to curb credit growth, it also raised the banking sector reserve requirement ratio twice this year, by a total of 900 basis points to 11 percent.

However, with headline inflation at 11.1 percent, real economy-wide interest rates still seem low (the real policy rate turned negative in September), suggesting that more tightening would have been appropriate. In addition, there can be long lags between the time that policy is changed to when it has an effect on the real economy—these are typically estimated at around 12 months or more for monetary policy. More importantly perhaps, monetary policy will be ineffective in fighting inflation if fiscal policy is working in the other direction, as is currently the case. Government spending on a year to date basis is 41 percent higher, while the proposed 2012 budget seeks to ramp up spending to extraordinarily high levels.

### **Box 2 The Bank of Mongolia's response to inflationary pressures: a comparison between 2007/08 and 2011**

In the run-up to the 2008/9 crisis, the Bank of Mongolia's policy was much looser than it is today. Reserve requirement ratios had been sharply cut from 14 percent to 5 percent in Feb 2007, so that real lending was growing at over 50 percent yoy at the end of 2007. Meanwhile, the Bank of Mongolia's policy rate was only gradually raised in response to rising inflation. Even though inflation doubled from 14 percent yoy in Dec 2007 to over 33 percent in Jul 2008, the BoM raised its policy rate only by 285bp over the period to 10.25 percent in August 2008. As a result, real interest rates remained negative for most of 2008.

This time round, the Bank of Mongolia has been quicker to raise reserve requirement ratio and its policy rate in order to curb inflation and lending growth. The reserve requirement ratio was raised twice this year, by 500bp in the first half of 2011 and more recently in August by 200bp so that it currently stands at 11 percent. The policy rate was also raised twice this year (by a total of 75 basis points) and currently stands at 11.75 percent. Clearly, then, the Bank of Mongolia has taken the lessons from the previous boom-and-bust episode into account.

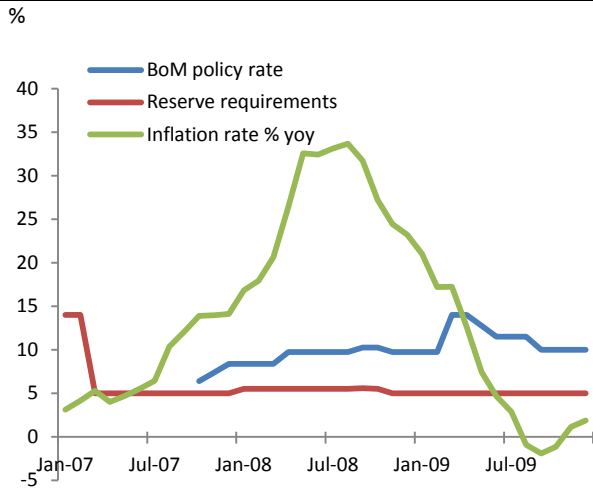
However, current trends demand further vigilance on the part of the Bank. The real policy rate turned negative in September as inflation trended higher. And real lending growth accelerated further in recent months, reaching a staggering 52 percent yoy in September, up from 46 percent in July.

---

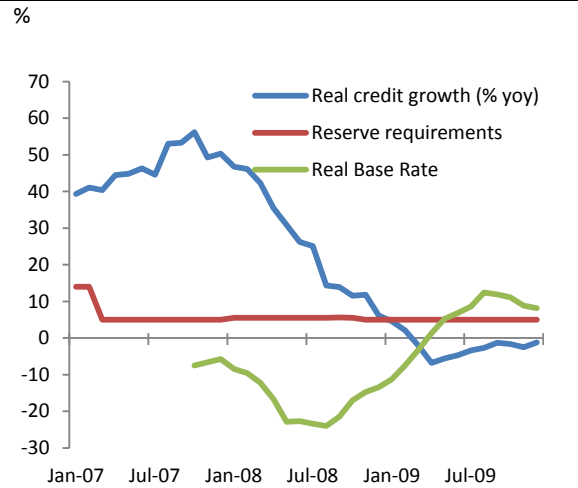
<sup>3</sup> Mongolian National Statistics Office, Poverty Headcount 2007-08

<sup>4</sup> Food consumption patterns from the 2007/8 household survey show that the median household below the poverty line allocates more than 80 percent of its food expenditure to meat and dairy products (46 percent), and to flour and bread (36 percent).

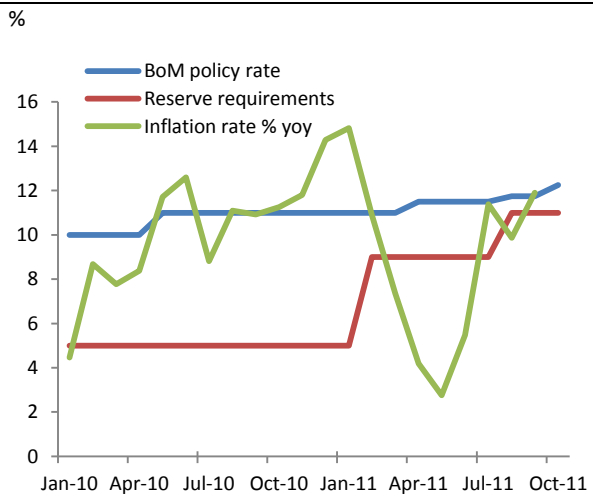
**Box Figure 4 Policy was extremely loose policy in the run-up to the previous bust**



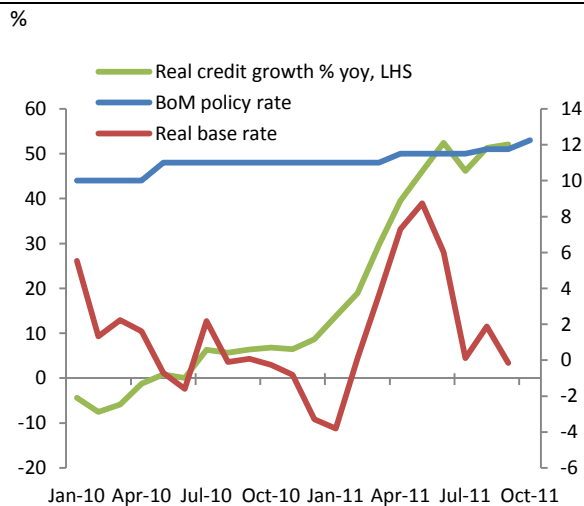
**Box Figure 5 with the result that there was a lending boom**



**Box Figure 6 The BOM has moved faster to tighten policy this time round**



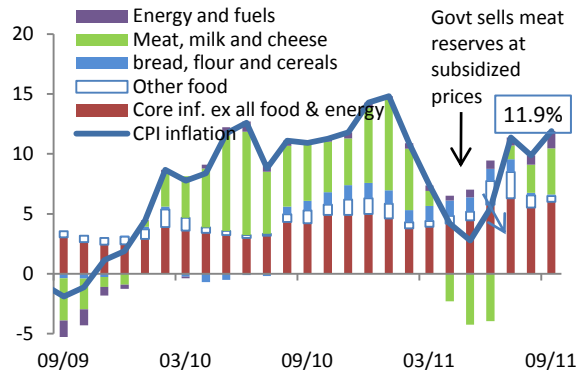
**Box Figure 7 But real interest rates are still extremely low**



Source: NSO, BoM, WB staff estimates.

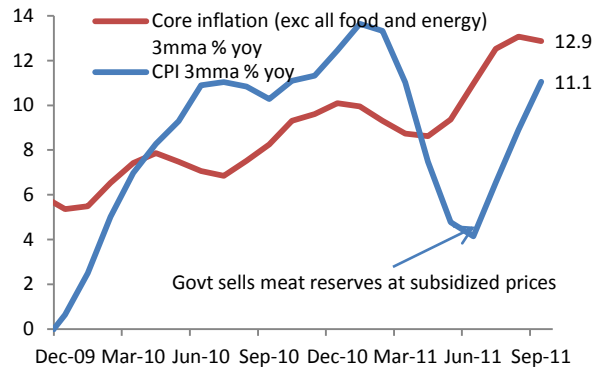
**Fig 7 inflation is trending up once more, suggesting that the economy is overheating**

% yoy, UB



**Fig 8 Over the past year inflation has mostly been sustained by rising core prices (ex all food and energy)**

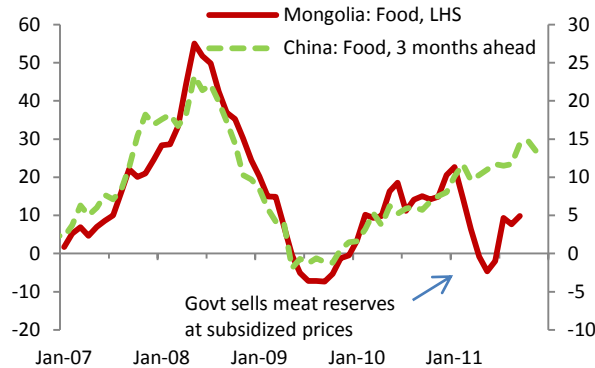
% yoy 3mma, UB



**Fig 9 Mongolian food inflation lagging Chinese food inflation by 3 months, prices look set to rise further...**

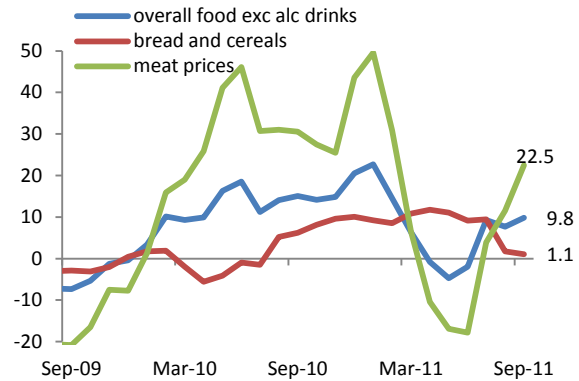
%

%



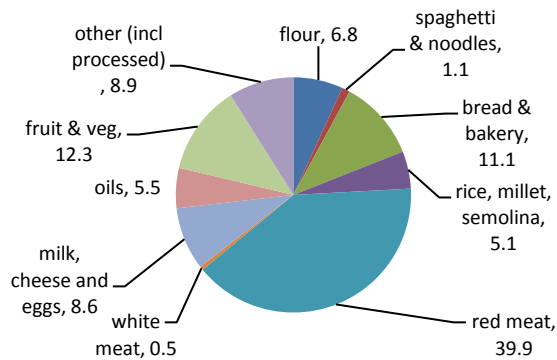
**Fig 10 ...as the effects of the gov't. meat subsidy have worn off, food inflation is accelerating once again**

% yoy



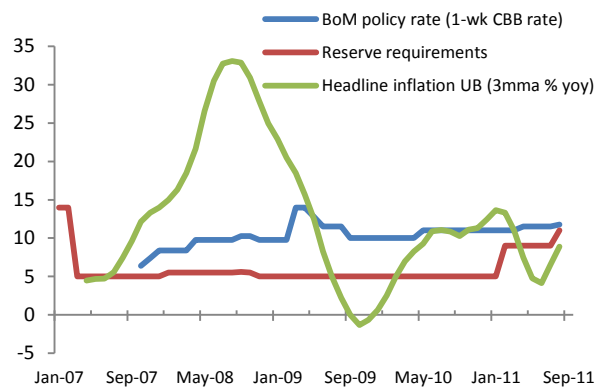
**Fig 11 hurting the poor the most**

CPI food basket, % of total



**Fig 12 The Bank of Mongolia tightened policy in August to curb inflationary pressures**

%



Sources: NSO, BoM, WB staff estimates.

## Fiscal developments

### 2011 budget outturns are in good shape, supported by mineral sector revenues and a booming economy

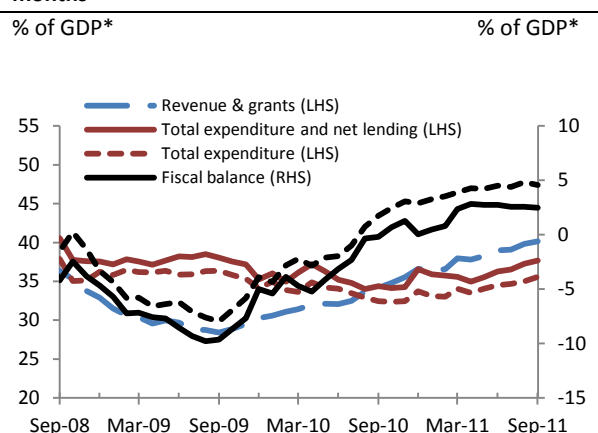
With government revenues boosted by receipts from the mining sector and a fast growing economy, public sector finances are in relatively good shape. On a 12-month rolling basis, the fiscal balance is in surplus, and reached 2.5 percent of GDP in September (Fig 13). This is only a slight deterioration compared to April, when it amounted to 2.8 percent of GDP. Excluding net lending, the budget balance amounted to a surplus of 4.6 percent of GDP in September.

Government revenues have been steadily climbing higher in step with the recovery in global commodity prices since 2009. On a 12-month rolling basis, total revenues amounted to 40.1 percent of GDP, up from a low of 28.4 percent in September 2009. On a year-to-date (YTD) basis, revenues were 53.8 percent higher in nominal terms (42 percent in real terms, Fig 14), boosted mainly by growing receipts from royalties (up 38.8 percent) and dividends (up 269.7 percent).

Although the withdrawal of the Windfall Profits Tax (WPT)<sup>5</sup> at the start of the year resulted in a substantial loss to government revenues (the WPT contributed 13.7 percent of total revenues in 2010), this has been more than compensated for by VAT receipts on mining related equipment imports (Fig 15 and Fig 16).

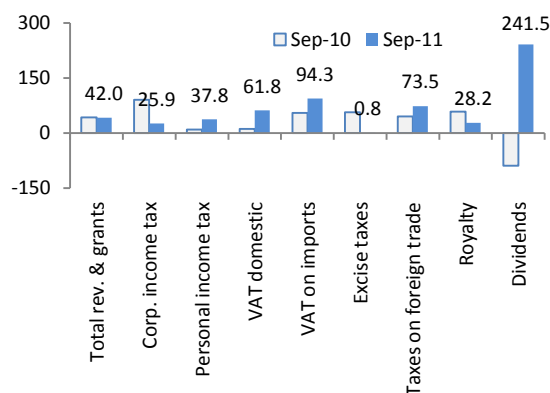
These imports have surged in the past year as the Oyu Tolgoi mine has come closer to starting operations. VAT receipts from imported goods, which are non-refundable for mining equipment, rose sharply, as imports were 110 percent higher (YTD basis) in September compared to the same period last year. Meanwhile, with the economy booming, corporate and personal income tax receipts are also buoyant (up 36 and 49 percent respectively YTD), as are VAT receipts on domestic goods and services (up 75 percent).

**Fig 13 Fiscal balances have improved strongly in recent months**



**Fig 14 ... in line with revenues**

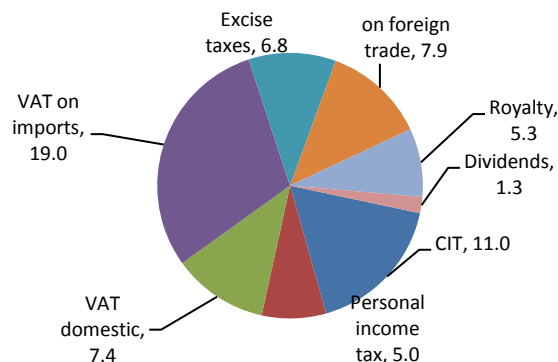
YTD % real change in revenues in Sep 2011 vs Sep 2010



<sup>5</sup> A 68 percent tax applied to revenues from prices exceeding base prices of \$2600/tonne for copper and \$850/ounce for gold until December 31, 2010.

**Fig 15 Rising mineral receipts including VAT on mining equipment imports are more than compensating for..**

% contribution to YTD increase in total revenues

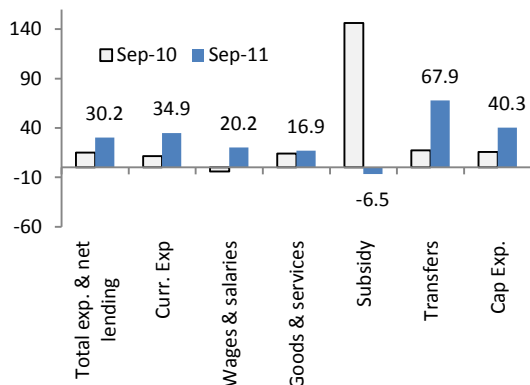


**Fig 16 ... the loss in Windfall Profits Tax revenues in 2011**



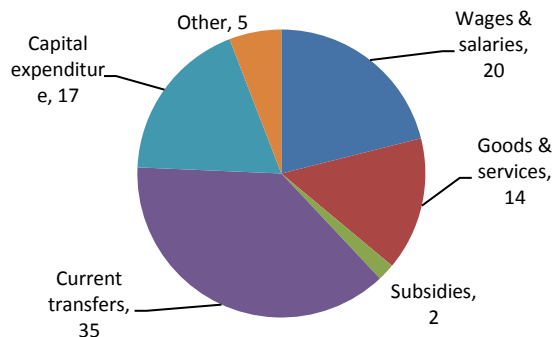
**Fig 17 ...Expenditures are much higher than a year ago...**

YTD % real change in expenditures in Sep 2011 vs Sep 2010



**Fig 18 ...with current transfers and wages and salaries constituting the bulk of the increase**

% contribution to YTD increase in total expenditures



Sources: MoF, NSO, WB staff estimates. \*GDP interpolated using actual 2008, 2009, 2010 and 2011 GDP data \*\* Adjusted fiscal balance excludes net lending from expenditure, leaving current and capital expenditure only.

### But spending is at record levels, spurred by rising expenditures on cash handouts

Expenditures have also increased sharply: on a 12 month rolling basis, total expenditures amounted to 38.8 percent of GDP. This is the highest level since September 2008, when Mongolia was hit by the 2008/9 global financial crisis, and found that it could not sustain spending in the face of falling revenues, but had instead to resort to painful policy actions, supported by the IMF and other development partners.

On a YTD basis, total expenditures were 40.9 percent higher in September compared with the same period last year (Fig 17). More than half of the increase up till September is accounted for by spending on social transfers. This includes the MNT 21,000 cash transfer to every citizen out of the Human Development Fund (HDF) and tuition fee support to students. Another quarter of the increase is accounted for by current government spending on wages and salaries, and the purchase of goods and services (Fig 18). Increased spending on capital expenditures accounted for most of the remaining amount.

### The 2011 budget amendment aims to increase expenditures beyond the already substantial increase envisaged in the original 2011 budget

The total revenue intake as of September was 20 percent higher than projected under the 2011 budget (Table 1). Instead of saving some or all of this extra revenue, the government plans to spend it all. Under the amendment, total expenditure is set to increase by 20 percent on top of the 2011 approved budget.

**Table 1 Budget execution, Year to Date, MNT mn**

	YTD Sep	Original 2011 Budget YTD Sep (projected)	Difference
Total revenues	3,100,254	2,478,461	20%
Tax revenues	2,675,712	2,173,060	19%
Income taxes	560,886	509,800	9%
Taxes on G&S	1,040,060	816,977	21%
Non tax revenues	411,537	296,458	28%
Total Exp	2,929,195	3,063,086	-5%
Current exp	2,226,765	2,359,794	-6%
Goods & services	984,640	1,069,078	-9%
Subsidies & transfers	1,213,279	1,262,077	-4%
Capital exp	504,020	633,667	-26%

Under the original 2011 budget, the government had planned MNT 627.7 bn in public investment projects. This amount is now being increased by 46 percent to MNT 914.8 bn. Out of this additional spending, MNT 197.6 bn is being used to fully fund a number of large projects which had been underfunded in the original budget due to lack of budget financing. The expectation is that these additional funds will be fully disbursed, as many of these projects are road projects pre-financed by the private sector. Also, MNT 34 bn is being added in order to implement the Air Pollution Law approved by the parliament, which includes the subsidization of improved stoves for gher households.

An additional MNT 366.6 bn of current expenditure is being proposed (the biggest item under the amendment) for the Ministry of Agriculture. Out of this amount, MNT 50 bn is being used to finance sheep and camel wool production, MNT 100 bn for subsidized credit lines to cashmere production, and MNT 150 bn for subsidized credit line to SMEs. To finance these schemes, the government has so far issued MNT 130 bn in domestic bonds out of MNT 300 bn planned.

### ...but the budget amendment is inconsistent with the Medium-Term Budget Framework

Expenditure and revenue estimates in the 2011 budget amendment are much higher than that of the MTBF baseline scenario, which laid out binding ceilings on expenditure and the deficit (Table 2). Under the 2011 amendment, budget expenditure will exceed the MTBF ceiling by 8 percent, the deficit by 4.8 percent, and the floor on capital expenditure target by 5.4 percent.

Both the original and the 2011 budget amendments are inconsistent with the Medium-Term Budget Frameworks of 2010 and 2011, and hence in contradiction with the Fiscal Stability Law. However, while the MTBF passed in 2010 was a parliamentary resolution, not a law, the MTBF passed in 2011 was a law. The MTBF law will now also need to be amended in order to accommodate the increased spending if the 2011 Budget amendments are approved. Such retro-active adjustments undermine the usefulness of the MTBF concept: to allow for sustainable multi-year budgeting within the limits of a sound macroeconomic framework.

**Table 2 Aggregate indicators for the Budget Framework under the MTBF in comparison to 2011 Budget and Budget Amendments (% of the projected GDP)**

	MTBF	MTBF 2011			2011 Approved	2011 Budget Amendments
	2010	Guidelines for budget for given year as % of GDP*				
	2011	2011	2012	2013		
Floor on total budget revenue	35.4	35.4	35.4	30.3	42.2	38.6
Ceiling on total budget expenditure	40.4	40.4	39.4	32.3	52.1	48.4
Ceiling on total budget deficit	-5.0	-5.0	-4.0	-2.0	-9.9	-9.8
Floor on capital expenditure	6.3	6.3	6.0	4.7	10.8	11.7

Source: World Bank , MOF Budget document.\* Budget Assumptions for GDP

### **The 2012 Budget proposes raising spending (mostly on wages and transfers) by 74 percent over the original 2011 Budget**

The 2012 Budget proposes expenditure of MNT 7,093 bn, which is a 74 percent increase from the original 2011 budget. In absolute terms, the proposed fiscal expenditure doubles from 2010 expenditure levels and comes close to total GDP in 2010. Meanwhile the government projects an increase of 92 percent in revenues on 2011 levels and forecasts nominal GDP in 2012 at MNT 18 trillion. The overall deficit under these spending plans and revenue and GDP forecasts amounts to 4.1 percent in 2012 (Table 3, Fig 19 and Fig 20).

The increase in spending is largely directed towards current spending with wages (up 57 percent) and current transfers (up 40 percent) constituting about 50 percent of the total expenditures in the budget (Fig 21 and Fig 22).

### **It ramps up spending on large public works projects but under-prioritizes the maintenance of existing public infrastructure**

Capital expenditures under the proposed 2012 budget are 143 percent higher than the 2011 approved budget (Table 4 and Fig 23). These are to be directed towards infrastructure development— notably on upgrading road and rail networks to the tune of UD\$1bn, necessary for getting Mongolia's mineral wealth out of the ground and to market.

However given capacity constraints in the economy, in particular a shortage of skilled labor, it is uncertain to what extent ambitious infrastructure plans can be planned and implemented in such a short span of time without compromising project quality, appraisal and implementation.

The budget for capital repairs increased by 146 percent, but given the low base as a starting point, total capital repairs will only amount to 2.5 percent of total capital expenditures, down from 5.5 percent in the 2011 approved budget. This indicates that, as before in the previous boom period from 2005-08, the government's priorities lie towards new investment spending, rather than maintaining the existing infrastructure which is in significant need of repairs.

**Table 3 Headline numbers from the 2012 Proposed Budget compared to 2011 Approved Budget**

	2011 Budget approved MNT mn	% of GDP	2012 Budget proposal MNT mn	% change from 2011 approved	% of GDP est.
<b>TOTAL REVENUES &amp; GRANTS</b>	<b>3,304,614.9</b>	<b>30%</b>	<b>6,352,199.1</b>	<b>92%</b>	<b>35%</b>
Current revenue	3,292,690.4	30%	5,166,847.0	57%	29%
1. Tax revenue	2,897,412.7	26%	5,166,847.0	78%	29%
2. Nontax revenue	395,277.7	4%	1,104,568.1	179%	6%
<b>TOTAL EXPENDITURE AND NET LENDING</b>	<b>4,084,114.4</b>	<b>37%</b>	<b>7,093,099.6</b>	<b>74%</b>	<b>39%</b>
Current expenditure	3,146,391.7	28%	4,637,061.4	47%	26%
1. Goods and Services	1,425,437.2	13%	2,111,064.1	48%	12%
1.1 Wages and salaries	789,538.4	7%	1,235,808.5	57%	7%
1.2 Purchase of g & s	635,898.8	6%	875,255.5	38%	5%
2. Interest payment	38,185.1	0%	191,921.3	403%	1%
3. Subsidies and transfers	1,682,769.3	15%	2,334,076.1	39%	13%
3.1 Subsidy	93,870.4	1%	110,595.3	18%	1%
3.2 Current Transfers	1,588,898.9	14%	2,223,480.8	40%	12%
<b>Overall Deficit</b>	<b>779,499</b>	<b>-7%</b>	<b>740,900</b>		<b>-4.1%</b>
GDP assumptions MNT tn	11.1				18.0

Source: MOF Budget document.

**Table 4 Capital expenditure composition, MNT mn**

	2009 Actual	2010 Actual	2011 Approved	2011 Amendment	2012 Planned
Domestic Investment	396,581	502,374	688,256	971,608	1,672,061
% annual increase		27	37	93	233
Capital Repairs	11,784	24,417	46,673	52,510	60,094
% annual increase		107	91	115	146
Other capital expenditures	25,543	28,970	16,858	69,808	79,101
% annual increase		13	-42	141	173
Road fund financed by project loan	26,657	8,951	93,103	93,103	579,693
% annual increase		-66	940	940	6376

Source: World Bank , MOF Budget document. \* Increase relative to 2011 Approved Budget

**And is based on highly optimistic revenue and GDP forecasts...**

The main sources of revenue that will support the increase in spending are VAT (35 percent of total tax revenues) and income tax (20 percent), while corporate income tax is expected to increase 84 times. Such high expectations of revenue increases are mainly based on OT production being brought forward

to start in the second half of 2012, which is also expected to raise real GDP growth substantially in 2012, and additional revenue from new taxes that the government is proposing on coal and wheat imports.

High GDP forecasts are based on (i) continued strong flows of foreign direct investment, which has more than doubled between 2010 and 2011; (ii) continued rapid expansion of the mining sector, including coal; (iii) public investment being raised by a factor three (according to plans), with second-round effects on economic growth due to multiplier effects; and (iv) strong consumer demand due to the final disbursements of cash to the citizenry ahead of the 2012 elections, in order to fulfill the political promises made during the 2008 elections.

### **...which may not be realized**

But these highly optimistic scenarios could fail to materialize. For instance, while OT could conceivably start producing in 2012, output may not be as high as projected if there are delays in obtaining power from China. Moreover, initial production will still need to ramp up until 2016 to reach full production. Alternatively the proposed taxes on coal are controversial among the business community and may not be passed, while transportation bottlenecks could prevent coal exports from expanding. Similarly, there could be large revenue shortfalls at a time the global economic environment is deteriorating and commodity prices falling and external financing harder and costlier to obtain. And ambitious public investment plans, including into housing, may not materialize due to lack of capacity and financing.

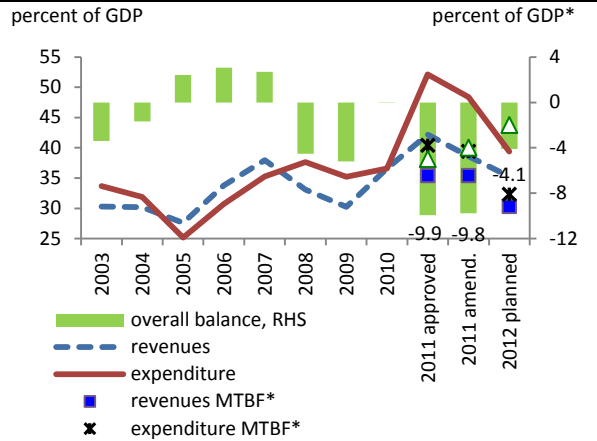
### **Mongolia's universal cash transfers will be replaced by a system of proxy means tested benefits targeted to the poorest households**

The government also submitted an amended HDF Law for consideration alongside the 2012 budget<sup>6</sup>. The amendment to the HDF increases the cash transfer payment to MNT 721,450 mn from MNT 702,500 mn, but decreases the student tuition to 70,766 mn from MNT 82,500 mn. It also adds another expenditure item: MNT 20 bn for mortgage payments.

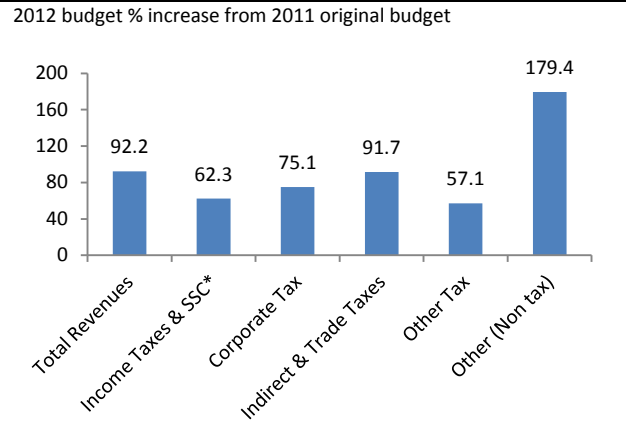
---

<sup>6</sup> Recall that the financing of the Human Development Fund is complex. In particular, the financing structure of the HDF forces state owned mining companies charged with depositing funds into the HDF for wealth distribution purposes to seek funds on commercial markets at high interest rates. The HDF is financed by mineral sector revenues (royalties, dividends and prepayments from Oyu Tolgoi and Tavan Tolgoi) and funds all wealth distribution programs including monthly cash handouts for citizens and tuition fees for students. The 2011 Budget identified prepayments from the Tavan Tolgoi mining project as a principal source for financing the HDF. So while the current cash handouts could have been funded straight from the budget, the HDF law prohibits this. Instead, state mining companies have had to find the money, including by borrowing on commercial terms from the local market and pre-paying taxes to the government. For instance, with prepayments from Tavan Tolgoi failing to materialize, Erdenes TT (one such company) has already had to borrow US\$50mn, of which MNT25bn was transferred (via Erdenes MGL) to fund the HDF. In addition, hard-pressed to provide funding for the HDF's cash-handouts for the coming months, the company recently signed a forward coal sale contract with Chinese Chalco for US\$250mn. On this contract, US\$100mn was received in August with the remainder by the end of the year.

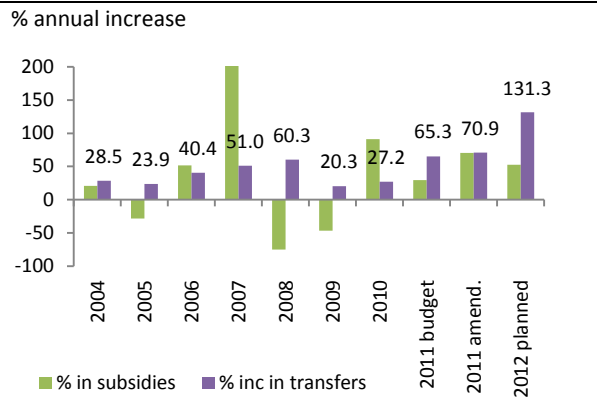
**Fig 19 The 2011 budget amendment and 2012 proposal aim to raise spending sharply**



**Fig 20 supported by mining sector revenues as production from Oyu Tolgoi is brought forward**



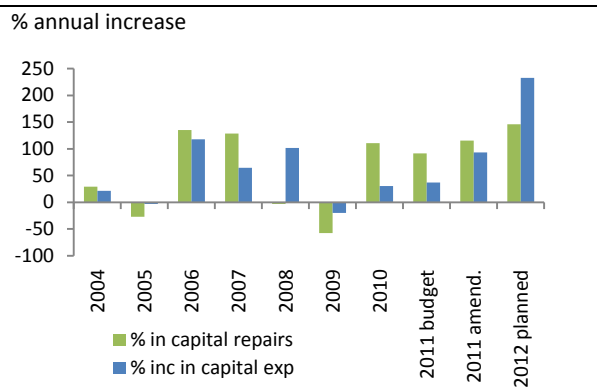
**Fig 21 with large increases planned in transfers and subsidies relative to the original 2011 budget..**



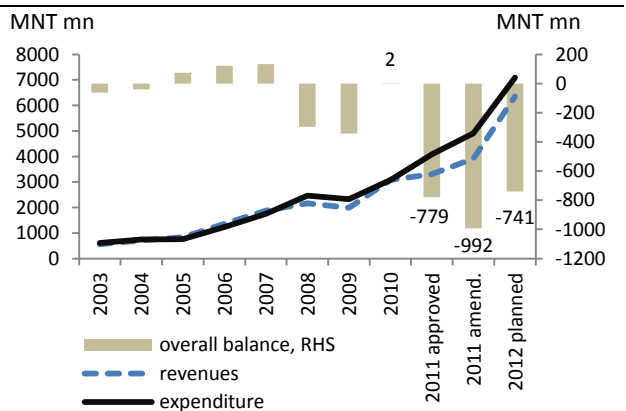
**Fig 22 .. and on wages and salaries**



**Fig 23 ...as well as on capital expenditures**



**Fig 24 The overall balance will deteriorate sharply**



Source: NSO, WB, MOF.\* NDIC GDP estimates used

Under the proposed 2012 budget, the Human Development Fund is projected to increase to MNT 892.1 bn from MNT 316 bn in 2010. Resources from the HDF are projected to be used for: (i) payments for health insurance premiums and educational services (MNT 88.6 bn); (ii) housing purchases (MNT 100 bn); (iii) cash benefits (MNT 692.6 bn).

The government intends to distribute the majority of the increase as the remainder of the cash transfer program, amounting to MNT 128,000 per citizen in the first half of 2012. The Oyu Tolgoi and Tavan Tolgoi mining projects remain as the principal sources for financing of the HDF in 2012. The HDF is expected to receive a total of MNT 414.2 bn as prepayment, MNT 367.9 bn as royalty fees from mining licenses, and MNT 110 bn as dividends and capital gains from the selling shares of strategic deposits.

The draft 2012 budget also allocates 12 percent of total expenditures towards a benefit targeted towards low-income households to start in the second half of 2012. Social protection, notably the consolidation of the myriad of transfer programs combined with better targeting towards the poorest households, was one of the key areas identified for reform by the development partners in their support programs during the crisis period. These reforms were necessary in order to ensure that the neediest would be shielded from the boom-and-bust cycles so common for mineral-dependent economies. The targeted program is expected to reach about 130,000 households, over one-fifth of total households in Mongolia. Household should receive a monthly payment equal to MNT 7,000 per each adult in the household and a further MNT 10,000 per child (Box 3).

### Box 3 What Next? Proposed Social Welfare Changes as per the 2012 draft budget

The current regime of universal and unconditional cash transfers funded by the Human Development Fund is set to come to an end in July 2012. How will Mongolia's social welfare system change once the promise of distributing MNT 1,500,000 to all citizens is fulfilled by mid-2012?

**The draft 2012 budget recently submitted to Parliament includes MNT 31.2 bn for a benefit targeted to low-income households to start in the second half of 2012.** This program is expected to reach about 130,000 households, over one-fifth of total households in Mongolia. Household should receive a monthly payment equal to MNT 7,000 per each adult in the household and a further MNT 10,000 per child. The average household covered by the program is expected to receive about MNT 40,000 per month.

**Households would be selected according to a Proxy-Means-Testing (PMT) approach.** With the support of the ADB and the World Bank, the household-level data necessary to target poverty according to a PMT methodology is currently being collected. As of October, the first phase of the data collection (covering over 80,000 households) had been completed, and the Second Phase (scheduled to reach a further 200,000 households) is underway. The Third (and most likely last) Phase of the data collection will run from early 2012 and collect information on the remaining approximately 40 percent of households covered by the survey. As information is collected and checked for quality, it gets fed into an Inter Sectoral Database, a platform that is being developed in parallel and that will enable different government agencies to share the data collected. By accessing the information included in the ISDB, government agencies will be able to target welfare programs based on potential beneficiaries' poverty ranking. At present, the data collection and the ISDB are expected to be complete by mid-2012.

**The estimated cost of financing social welfare programs included in the proposed SWL Amendments is set at about MNT 47.2 bn for the second half of 2012,** and the draft 2012 budget under discussion does indeed include such resources. The breakdown of the total (that can be modified at Parliament's discretion) is as follows:

- MNT 31.2 bn for the above mentioned poverty benefit (reaching 130,000 households receiving an average of MNT 40,000 per month);
- MNT 6.9 bn for social welfare pensions (reaching 21,400 individuals receiving an average of MNT 53,000

per month);

- MNT 5.3 bn for orphans below the age of 18 (about 16,400 people receiving MNT 53,800 per month);
- MNT 3.7 bn for reintegration payments to ex-convicts and homeless people (about 7,400 people receiving a one-off payment of MNT 500,000);
- MNT 93 mn to provide payments to 117 “heroes” (4 quarterly payments of MNT 200,000).

Source: World Bank staff.

## External sector

### The trade deficit has widened to record levels as mining related equipment imports have surged

The trade deficit has climbed to record levels in recent months as imports have surged (Fig 25). The latest data show a deficit of \$1.4bn in September (on a 12 month rolling sum basis), slightly less than the peak of \$1.5bn recorded the previous month. Imports—mostly mining transport equipment, fuel and machinery imports (Fig 26)—climbed to US\$5.9bn in September (12 month rolling sums), double the level in September 2010.

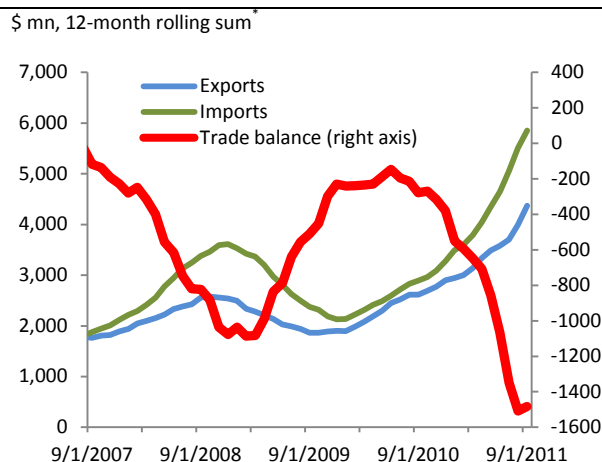
Exports are growing strongly too, up 176 percent yoy (from 30 percent in June) supported almost entirely by large coal shipments to China from coal mines in Southern Mongolia (Fig 27). Constituting 44 percent of the value of total exports (Fig 28), coal exports increased by 178 percent yoy and contributed 146 percentage points to overall export growth. The sector has become the fastest growing sector, surpassing copper exports in becoming the top export earner for the country. Coal exports in the year up till September (US\$ 1.5bn) were 1.7 times higher their total export value in all of 2010 (US\$ 0.9 bn) and China, the largest thermal coal consumer in the world, remains the only destination for coal from Mongolia. It is expected to grow even faster in the near future when large coal mining projects start production.

However, despite gold prices benefiting from flight to safety flows into the metal, gold exports were sharply down in volume terms (33 percent), so that overall gold exports fell in dollar terms. Exports of greasy cashmere and combed goat down performed badly as well, declining 12 percent and 28 percent yoy in volume terms (YTD terms) in September (Fig 28).

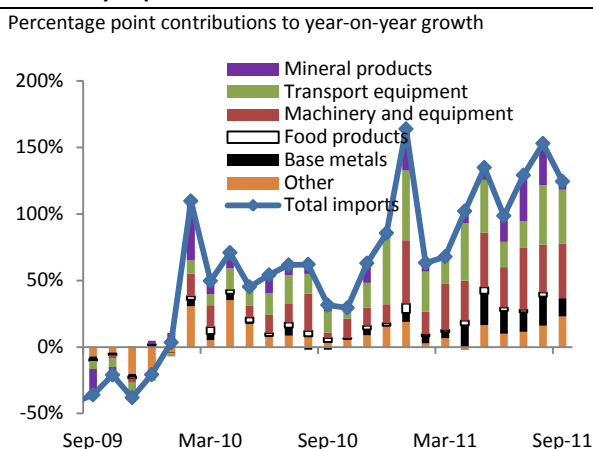
Although the dollar value of copper exports is up by 32 percent yoy (YTD basis), in volume terms, exports are barely changed. In addition, the large swings in commodity prices in recent months are a source of concern. Climbing steadily and supported by strong demand in emerging market economies, notably China, copper prices by January had surpassed their previous peak in 2008. However, since July alone they have fallen by 14 percent (Fig 29) and, with the global economic environment deteriorating, could fall further.

Going forward, note that Mongolia is the most exposed among East Asia’s commodity exporters vulnerable to a terms-of-trade shock from volatility in commodity prices (Fig 30). Commodity exports accounted for nearly 90 percent of Mongolia’s exports and 40 percent of its fiscal revenues in 2010.

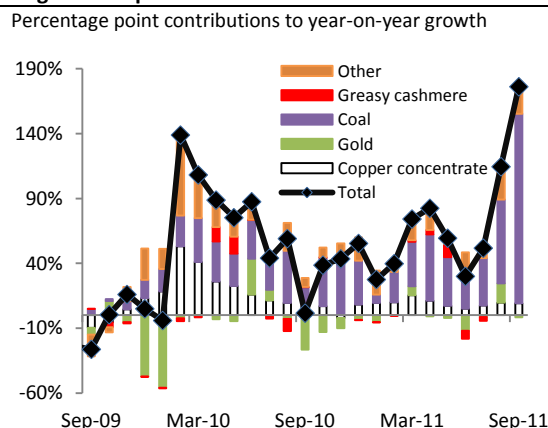
**Fig 25 The trade deficit is close to record levels**



**Fig 26 driven mostly by transport equipment and machinery imports**



**Fig 27 Exports are growing strongly as well driven by large coal exports to China**

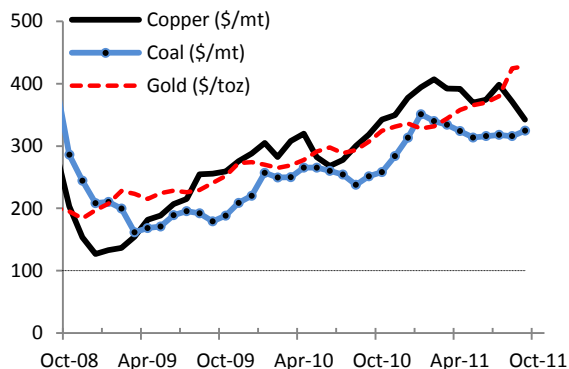


**Fig 28 But copper exports are not doing so well and unprocessed cashmere and gold even worse.**

Export decompositions, % yoy year to date basis, Sep 2011

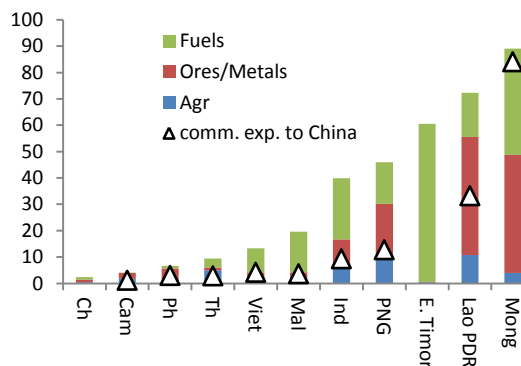
	% change in \$ val.	% change in vol.	% change in unit price	% of total
Copper concentrate	32	-1	34	21
Gold	-7	-33	39	4
Coal	178	25	122	44
Combed goat down	14	-28	59	1
Greasy cashmere	20	-12	36	4
Zinc concentrate	19	6	13	3
Crude petroleum oils	56	14	37	5

**Fig 29 Commodity prices have experienced large fluctuation in recent months and...**



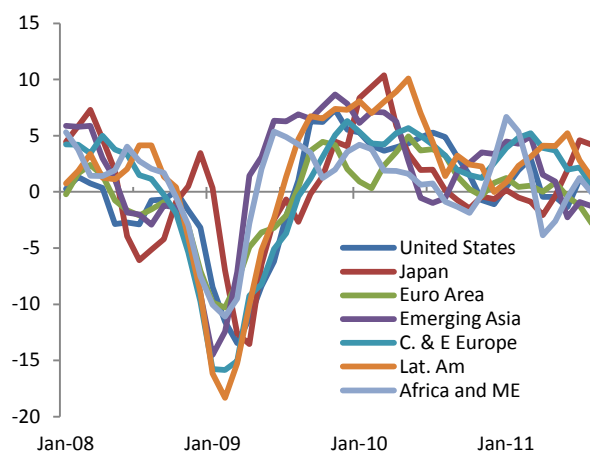
**Fig 30 ...Mongolia is the most exposed in East Asia to volatility in commodity prices**

Commodity exports as % of total



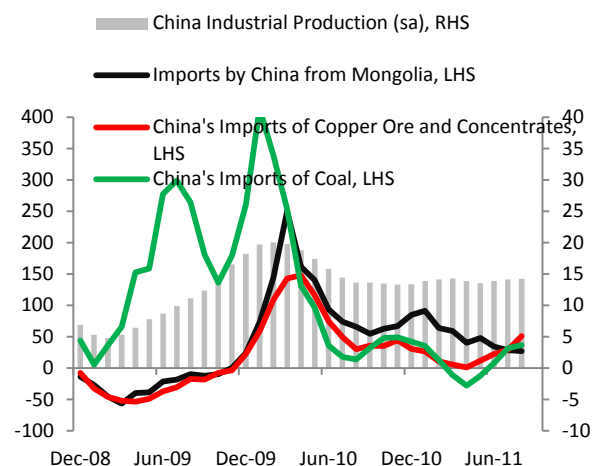
**Fig 31 Global trade is losing momentum rapidly, reflecting fragile demand in advanced economies**

Import volumes, % mom 3mma

**Fig 32 ...and it is unclear to what extent China will act as a “growth pole” for its neighbors**

% yoy 3mma

% yoy 3mma



Sources: BoM, MoF, NSO, Haver, WITS, Dutch CPB and WB staff estimates. \* Monthly trade data tends to be highly volatile and also is affected by seasonal factors. For this reason, 12-month rolling sums are illustrated.

## The Exchange Rate and Balance of Payments

The Togrog has depreciated somewhat against the US\$ since mid-August. This was in line with other currencies in the region due to a rising global risk aversion. The depreciation has been relatively small (about 4.8 percent, Fig 33), as FDI inflows into the economy to develop the Oyu Tolgoi mine remain strong.

International reserves of the Bank of Mongolia declined by about 2 percent from an all time high of US\$ 2,460 mn in August, to US\$ 2,407 mn. The central bank has been sterilizing the monetary impact of capital inflows over the past year into Mongolia with the issuance of central bank paper, although this has declined in recent months (Fig 35 Issuance of central bank bills has fallen in recent months Fig 35).

Monthly balance of payments statistics show that the current account deficit has continued to climb, driven by a growing trade deficit. The combined data from July, August and September show an overall current account deficit at US\$ 2.1 bn in terms of 4-quarter rolling sums. Compared to third quarter of 2010, this level is almost tripled.

Rising goods and service imports are pushing both the goods and service trade deficits higher. For instance, fuel imports mostly by the mining sector, amounted to US\$ 791 mn alone in the year up until September, compared with US\$ 672 mn worth of imports during the whole of 2010. Meanwhile, with freight transportation payments increasing, the service deficit rose to US\$ 845 mn in the year to September, roughly two and half times the total service deficit for 2010.

The bulk of the current account deficit continues to be financed by net foreign direct investment (Fig 37). FDI has surged over the past year into Mongolia, amounting to US\$ 1.2 bn in Q2 alone with another (total) US\$ 0.8 bn worth flowing in Q3. Such large FDI flows are related to the development of the OT mine and will continue until the mine becomes operational (expected end of 2012). Net remittances also remain high: the inflow in the first three quarters of 2011 amounted to US\$ 189 mn, an increase of 4 percent from total flows in the first three quarters of 2010.

Portfolio inflows have however dried up completely this year, reflecting growing uncertainty in international financial markets and flight to safety flows out of developing and emerging market economies (Fig 38).

## Banking sector

---

### MNT and US dollar deposits reached new peaks and credit grew at a record pace

Reflecting current extremely high economic growth, the volume of MNT deposits hit a new peak of above MNT 2.8 trillion in September, up 64 percent from a year ago (Fig 39). Deposits in foreign currency also hit a new peak of MNT 896 bn despite the expectation of further currency appreciation. Nominal interest rates on US dollar deposits are very high by international standards with time deposits offering rates reaching above 14 percent, reflecting the continued perception of risk by the market. In addition, as inflation has picked up, real interest rates declined in September (Fig 40).

Banks are in a stronger position compared to 2008-09 with regard to capital buffers. The overall capital adequacy ratio of the banking system (excluding Zoos and Anod, the two failed banks) currently stands at 14.3 percent (although ratios are much better for some banks than others), compared to the regulatory threshold of 12 percent and compared to just 5.5 percent in 2009 (including Zoos and Anod).

That said the central bank needs to remain vigilant with regard to financial sector stability on a number of counts. First, credit growth is much higher than the underlying growth in the real economy. The stock of loans outstanding has by now exceeded MNT 5 trillion, rising by 52 percent yoy in real terms (Fig 41). Moreover, most of the credit is still directed towards a small group of borrowers: the loan stock of the 50 largest borrowers increased by 42 percent yoy, and they accounted for 26 percent of total loans in September.

Meanwhile the loan-to-deposit ratio (excluding government deposits) has been steadily increasing since the start of the year, and at close to a 100 percent, indicates one source of potentially growing liquidity risks (Fig 43). A loan to deposit ratio indicates the share of a bank's loans that are funded through deposits, with an upswing indicating that banks have less of a cushion to protect themselves against a sudden recall of their funding in case of a confidence shock. Note that potentially higher liquidity risks come from large maturity mismatches on the banks' balance sheets.

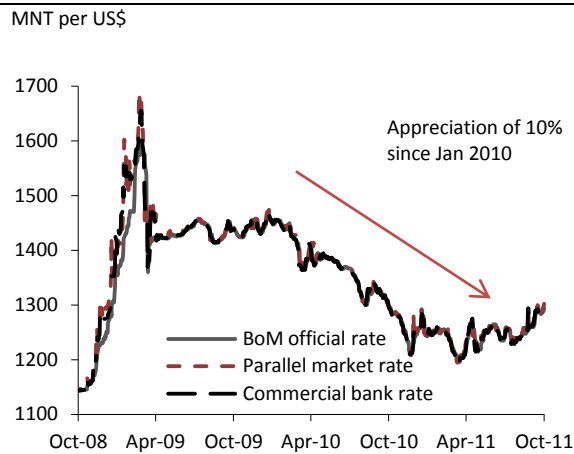
With credit growing as fast as we have seen prior to the last crisis, it is critical that the BOM enforces full compliance of Mongolian banks with current prudential norms, particularly with respect to having adequate capital buffers to absorb the losses from current and possible future NPLs (non-performing loans)<sup>7</sup>.

In addition, the stock of NPLs is slowly decreasing but still remains high at MNT 357 bn from MNT 361 bn in January including the NPLs of the two failed banks (Fig 44). Together with loans in arrears, the ratio to total outstanding loans was about 8.4 percent in September. This is an improvement from a peak of 24.6 percent in November 2009, but to a large extent it is due to the rapid growth of loan portfolio. The government has paid MNT 100 bn for one of the failed banks and has so far recovered about MNT 30 bn. The MoF expects that another MNT 50 - 60 bn could be recovered by 2013.

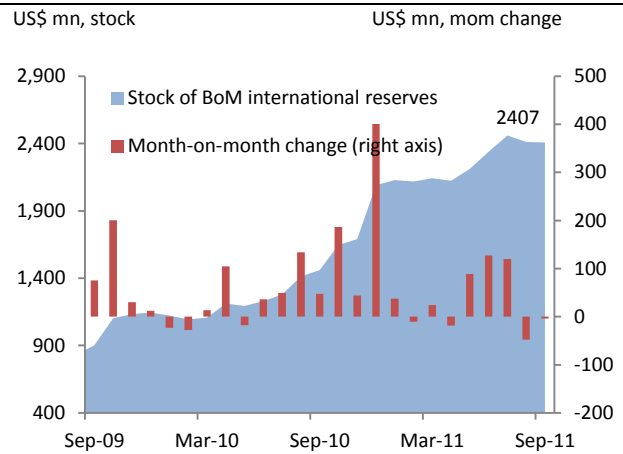
---

<sup>7</sup> According to the bank loan classification regulation, loans with principal in arrears automatically become NPLs after 90 days.

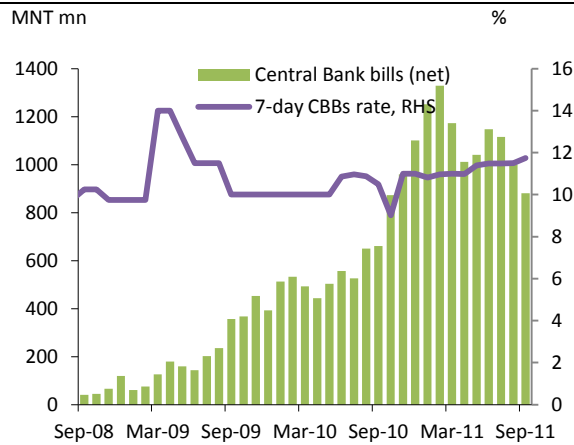
**Fig 33 The exchange rate\* has appreciated sharply since the start of 2010**



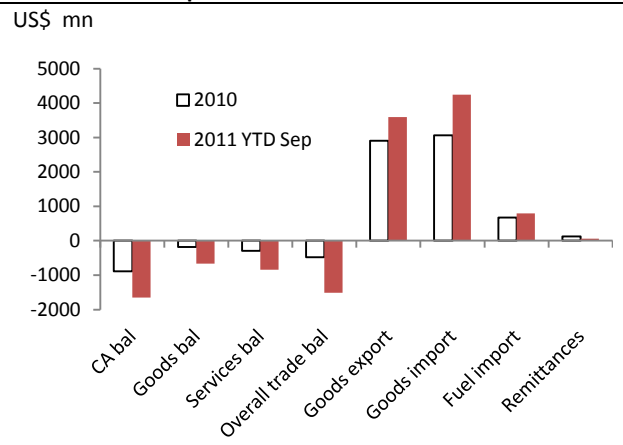
**Fig 34 while FX reserves have stabilized at close to record levels**



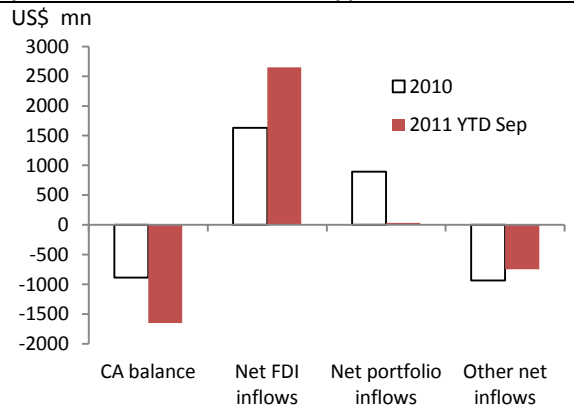
**Fig 35 Issuance of central bank bills has fallen in recent months**



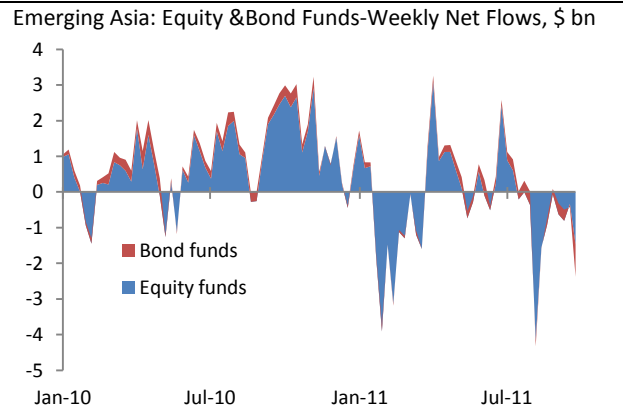
**Fig 36 The CA deficit continues to grow, pushed up by rising mineral sector imports**



**Fig 37 Net FDI inflows remain strong in contrast to portfolio inflows which have dropped to zero**

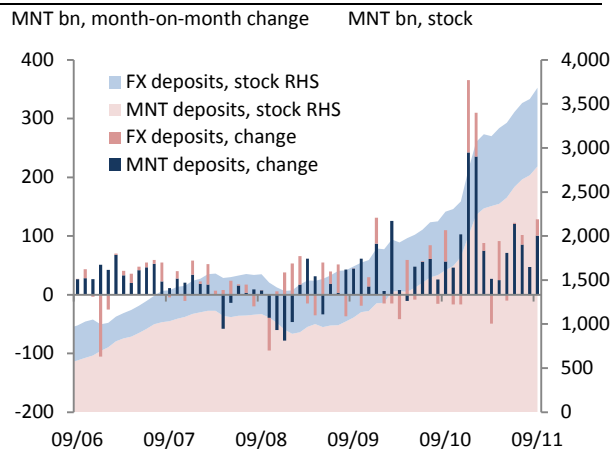


**Fig 38 .. reflecting global flight to safety flows as the global economic environment has deteriorated**

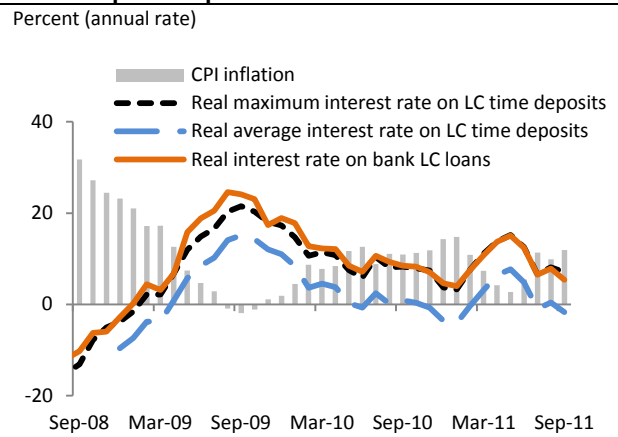


Sources: MoF, NSO, Haver, WB staff estimates. \* Note: Parallel market rate is mid-point of bid and ask rates. Positive spread over official rate indicates relative depreciation. Ask-bid spread measured as% of mid-point of the two. Last

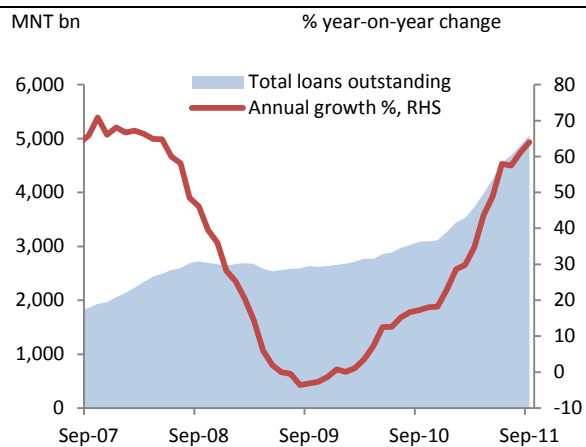
**Fig 39 Both local and foreign currency deposits continued to reach new highs in September**



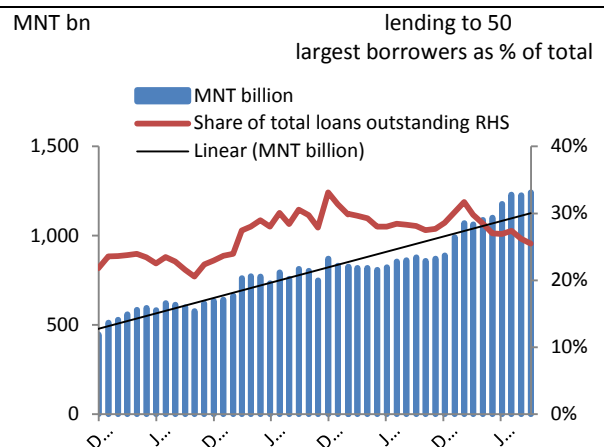
**Fig 40 Real economy-wide interest rates fell as inflation picked up**



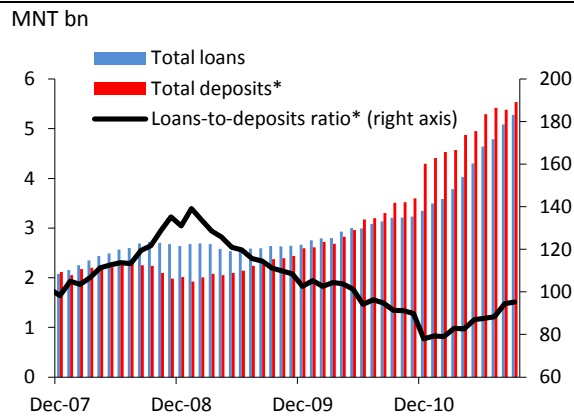
**Fig 41 Credit continues to surge**



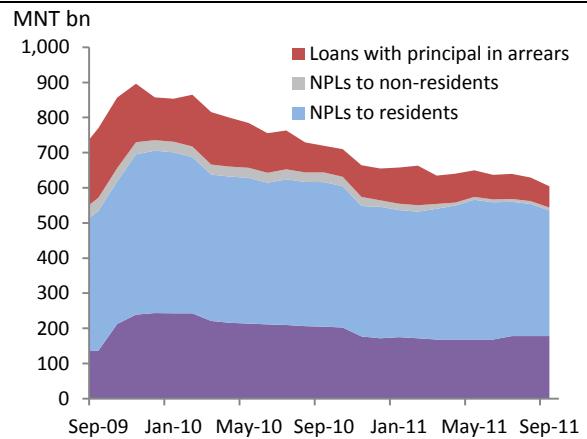
**Fig 42 ... directed mostly to a small number of borrowers**



**Fig 43 Loan to deposit ratios are close to 100 percent**



**Fig 44 .. while the volume of NPLs remains high**



Sources: BoM, MoF, NSO, WB staff estimates. \* Deposits exclude govt deposits

## Economic outlook

---

The economic rebound in recent quarters has been stronger than expected and the economy is showing signs of overheating. The economy is already running at capacity, driven by the booming mining sector. Although medium term prospects are bright, in the near term the country remains at risk of repeating the boom-bust cycle of the past decade. Public sector spending remains strongly pro-cyclical, supported by rising mineral and non-mineral revenues and the government is choosing to mostly spend rather than save windfall receipts.

With budget expenditures being hiked up sharply in 2011 and 2012, overheating pressure will increase, feeding inflation which is already running in low double-digits. The 2012 budget envisages a 57 percent increase in wages and 40 percent increase in transfers on the 2011 approved budget. There is therefore a substantial risk of a wage-price spiral, if higher inflation expectations become entrenched. While higher levels of inflation may not be particularly worrying from an economic growth perspective (a widely held view in Mongolia), it hurts the poor disproportionately. Rising inflation, if not matched by pre-emptive tightening of interest rates, will push real interest rates close to zero or into negative territory, as happened in the run-up to the previous bust.

High domestic inflation also causes the currency to appreciate in real terms, hurting the export sectors. For instance, this would hurt both agricultural exports, on which the rural population depends and an already small manufacturing sector.

Although the Bank of Mongolia has been quick to raise policy rates and reserve requirements, its efforts to control inflation will be more than offset if the extraordinarily large fiscal injections planned by the government for the remainder of this year and next year materialize as planned. Other domestic risk factors include the banking sector which remains under-regulated, and which is expanding lending at a furious pace in order to utilize the strong influx of deposits. It is therefore crucial that the Bank of Mongolia ensures full compliance of all commercial banks with minimum prudential norms. In addition, the BOM is exploring various macro-prudential policy options<sup>8</sup> in order to limit the emerging risks in the banking sector and make the system more resilient to possible future shocks.

On the external front, until the Oyu Tolgoi mine becomes operation and a structural increase in mineral output and revenues takes place, Mongolia remains exposed to volatility in commodity prices. Indeed, among East Asian commodity producers, it has the highest ratio of commodity exports to total exports. With global economic uncertainties remaining high, and with any potential stimulus package from China unlikely to be focused on infrastructure as during the last global financial crisis in 2008-09, the support from China in the event of the global environment deteriorating is also unclear.

The severity of an external shock will depend in part on the institutional arrangements in place to cope with it. For instance, during the previous boom in commodity prices in 2005-08, Mongolia did not save enough of the windfall revenues, unlike, say, East Timor which saves its oil revenues in a sovereign wealth fund invested overseas. And, unlike other commodity producers in the region such as Indonesia and Malaysia, Mongolia had a de-facto peg to the dollar. This transmitted the subsequent fall in prices at

---

<sup>8</sup> Macroprudential policy seeks to limit system-wide financial risk, rather than the risks to individual banks which is typically addressed through traditional supervision. Over the past decade a number of countries (especially in East Asia region) have successfully applied a range of credit-related, liquidity-related, and capital related macroprudential instruments to contain the risks stemming from rapid growth and to reduce the volatility in the system.

the end of 2008 directly to export and fiscal revenues, hitting the economy extremely hard: GDP growth fell from 8.9 percent to minus 1.3 percent in 2009.

Although Mongolia has since adopted a flexible exchange rate and introduced a structural budget deficit rule which mandates the saving of excess mineral revenues in a stabilization fund *a la* Chile, the budget rule only becomes binding in 2013. Meanwhile the 2011 budget was the largest on record and the 2012 budget plans to continue the spending expansion. Funds in the stabilization fund are expected to reach only MNT 218bn by the end of the year (or about 2 percent of GDP). This suggests limited space to provide a stimulus in case of a sharp terms of trade shock that undermines mineral revenues.

Furthermore, China's ability to act as a "growth pole" in the region is likely to be limited in case the global economic environment deteriorates even further. Instead of another large, infrastructure and investment heavy fiscal and monetary stimulus, the next package is expected to focus on social spending, possibly housing. In the absence of a second investment boom in China that keeps commodity prices and demand buoyant, commodity producers are likely to suffer, unless these are commodities related to housing such as copper. But even so, such a stimulus (including one focused on social housing) will take time to kick in, and until such time Mongolia's public finances and export revenues remain vulnerable to sharp swings in commodity prices in the near term or at least until the OT mine becomes fully operational and there is a structural increase in copper exports.

Indeed incoming trade show that global trade is rapidly losing steam on rising global uncertainties and increasing fragility of advanced economies. Export growth in Latin America, for example, was hesitant through 2011, with gains of 6 percent month-on-month in May turning negative by July, as demand fell in one of their biggest markets: China. Meanwhile, China's brake in import demand corresponds with its own dwindling export orders, a trend reflected in the EAP region more broadly.

The global economic climate remains extremely uncertain as the sovereign and banking sector debt crisis in the euro-zone drags on. Financial contagion to the rest of the world is evident in the sharp falls in global equity markets, rising spreads for sovereign borrowers regarded as more risky, and also a sharp pull back in debt and equity markets. And global trade is also losing momentum, with growth in Europe doing poorly. The global economy looks risky on many fronts.

These increased global risks make Mongolia enter a phase reminiscent of 2008. However, the current budget proposals set Mongolia up for a replay of the 2006-8 boom years, leaving it vulnerable to a bust similar to the one that occurred in 2008-9. Accordingly, pro-active, prudent and risk-averse economic management is now needed more than ever, as the economy shows signs of overheating while global risks are rising, and mineral prices are falling.

Table 5 Mongolia: Key Indicators

	2008	2009	2010	2011f	2012f
<b>Output, Employment and Prices</b>					
Real GDP (% yoy change)	8.9	-1.3	6.4	14.9	15.1
Industrial production (2006=100)	113	109.6	120.5	130.14	140.6
% yoy change	2.7	-3.3	10	8	8
CPI (% yoy change, eop)	23.2	1.9	14.3	17	17
<b>Public Sector</b>					
Government expenditures (as % of GDP)*	37.6	35.2	36.6	52.1**	39.4**
Government revenues (as % of GDP)*	33.1	30.2	36.6	42.2**	35.3**
Government balance (% of GDP)*	-4.5	-5	0	-9.9**	-4.1**
Non-mineral govt balance	-14.1	-12.2	-9.9	-13.3	-28.7
Public Sector Debt (% of GDP) (1)*	31	49.4	42.2	38.6	37.1
<b>Foreign Trade, BOP and External</b>					
Trade balance (\$ mn)	-613	-195	-278	-1049.0	-1107.0
Exports of goods (\$ mn)	2534.5	1875.9	2899	3825.0	4083.0
(% yoy change)	30	-26.0	54.5	31.9	6.7
Imports of goods (\$ mn)	3147	2070	3177	4874.0	5190.0
(% yoy change)	57.1	-34.2	53.5	53.4	6.5
Current account balance (\$ mn)	-722	-410	-931	-1301.0	-1438.0
(% of GDP)*	-12.9	-9	-5.8	-15.1	-13.6
Foreign direct investment (\$ mn)	835.5	495.8	1574	3400	1500
External debt (% of GDP) (2)*	31	43.3	30.3	22.8	19.8
Foreign exchange reserves, gross (\$ mn)	637	1145	2091	2407 (Sep)	
In month of next years imports of g&s	3.7	4.3	5.1	5.6	
<b>Financial Markets</b>					
Domestic credit (% yoy change)	52.5	-7.6	42.2	42.9	...
Base policy rate (eop)	9.75	10.0	11.0	11.5 (Sep)	...
Exchange rate (MNT/USD, avg)	1169	1441	1348	1294****	...
REER (real effective exch rate) (% yoy eop, +app)	13.7	-15.5	26.9	-0.4***	...
Stock Market Top 20 index (2000=100, eop)(5)	1182	1229	2931	3984 (Jun)	...
<b>Memo:</b>					
Nominal GDP (MNT bn)*	6556	6591	8414	11096	14657
Nominal GDP (\$ mn)*	5607	4574	6243	8575	...
GDP per capita (\$) *	2109	1688	2270	3071	...

1) Total public sector debt. (2) On public and publicly guaranteed debt. \* Estimates based on NSO reweighted nominal GDP data till 2010. WB forecasts thereafter. \*\* 2011 Budget and 2012 Budget projections. \*\*\*YTD till June. \*\*\*\* rate on October 21<sup>st</sup>.  
Source: Bank of Mongolia, National Statistical Office, Ministry of Finance, IMF and World Bank staff estimates