Mongolia Economic Update

December 2014

This Economic Update assesses recent economic developments and discusses policies in Mongolia. The Update was prepared by Taehyun Lee (Task Team Leader, Senior Country Economist), Altantsetseg Shiilegmaa (Economist) and Davaadalai Batsuuri (Economist), under the overall guidance of Chorching Goh (Lead Economist for Mongolia, China and Korea) and Mathew Verghis (Practice Manager, GMFDR). This Economic Update also greatly benefited from advice and contributions from Mark Charles Dorfman (Senior Economist), Erdene Ochir Badarch (Operations Officer), Tungalag Chuluun (Operations Officer) and the guidance from James Anderson (Country Manager for Mongolia), Bert Hofman (Country Director for China, Mongolia and Korea) and Sudhir Shetty (Chief Economist for East Asia and Pacific Region). Copies can be downloaded from www.worldbank.org/mongolia.

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Mongolian Economy - Prospects and Challenges Ahead

The Mongolian economy is facing challenges from persistent economic imbalances

In 2014, economic growth slowed as it began to adjust to unsustainable economic imbalances. Real GDP growth softened to 7 percent in the first 9 months, from 12.8 percent in the previous year. Despite strong mining production growth of 26 percent, the growth of the non-mining sector of the economy dropped to 2 percent in the third quarter from 17.4 percent a year ago. Investment sharply fell amidst declining FDI and weakening business prospects. Consumption remains relatively strong but is also gradually softening. The growth effect from stimulus measures of the last year is also wearing off in 2014 as large liquidity support from the central bank cannot be sustained in the wake of high inflation and external vulnerabilities. The current account deficit is narrowing significantly to around 11 percent of GDP from almost 30 percent in the previous three years, due to import contraction over 16 percent and stronger copper exports. However, a significant external financing gap continues amidst declining foreign investment, reducing internal reserves to less than three months' import cover. Inflation remains in double digits after a strong credit boom in 2014 and continuous currency depreciation.

Economic growth is likely to continue to soften in 2015 as the economy remains under pressure from the external imbalance and high inflation. Weak FDI and the contractionary effect of currency depreciation will continue to weigh on economic growth, particularly in the non-mining sector. Mining sector growth will gradually moderate in 2015 as the Oyu Togloi mine enters into the second year of full-year production. The current account deficit is expected to slightly narrow to around 10 percent of GDP. However the external financing gap will still remain high in 2015, likely further exhausting international reserves under the current trend of weak foreign investment and large current account deficit. Inflation will also likely remain in double digits in 2015 above the 7 percent target of the central bank.

External and financial vulnerabilities are growing

The external situation may become more vulnerable over time in the wake of large external debt repayments scheduled for 2017-18. US$580 million of the DBM Euro bond will mature in March 2017 and US$500 million of the Chinggis bond will mature in January 2018. Drawings of the bilateral currency swap facility with the PBoC will also have to be either renewed or repaid in 2017. In light of the declining international reserves and the prospect of a large current account deficit of around 10 percent of GDP in the coming years, the large external public debt repayment schedule may become a challenge to external liquidity situations over time. The debt repayment schedule may also put large fiscal burden in the future as the size of the debt repayment is equivalent to 9 percent of 2014 GDP.

Deteriorating bank asset quality calls for heightened vigilance. Credit expansions in 2013 equivalent to over 20 percent of GDP and loosened prudential regulation significantly increased the vulnerability of the banking system and have translated into worsening asset quality of banks in the wake of the economic downturn. Non-performing loans and past-due loans increased rapidly, by 48 percent and 166 percent, respectively, in the last twelve months. While the non-performing ratio is still relatively low, past experiences suggest that rapid increases of past-due-loans tend to precede accelerating growth of non-performing loans. Continuous degradation of asset quality would continue to undermine the liquidity situation and confidence in the banking system.

Priority now is to address the growing external risks

Economic policy needs to focus on addressing growing external vulnerabilities with tighter macro-economic policies and reviving foreign investment into the economy. The recent cooling of the economy helped narrow the current account deficit and ease the balance of payments pressure in 2014. However, the balance of payments pressure still poses a downside risk to the economy as foreign investment continues to decline and the current account deficit will still remain substantial. The external vulnerabilities may be mitigated if: (i) the current account deficit narrows further through tighter economic policies; (ii) FDI substantially recovers in the coming years providing buffers to the external liquidity situation.

Some welcome steps were taken but further actions are needed

Monetary and fiscal policy became tighter. The BoM began to gradually adjust the monetary policy stance by tapering the monetary easing programs and raised the policy rate by 150 basis points to 12 percent. As a result, private sector credit growth slowed to 22 percent in October, down from over 53 percent a year ago. The BoM also strengthened prudential regulations on foreign currency loans and imposed a higher general provisioning ratio in the wake of worsening bank asset quality. The budget is also tightening its expenditures facing revenue shortages and the off-budget expenditures are planned to be reduced to MNT 1-1.2 trillion in 2014, from MNT 1.5 trillion in 2013.

Further policy adjustment is necessary. Despite the recent gradual tapering, the outstanding domestic credit of the economy is more than twice its size at the end of 2012. The housing mortgage program continues to expand, currently accounting for more than 60 percent of outstanding policy credit. The fiscal deficit will still remain high at more than 7 percent of GDP in 2014 due to off-budget expenditures through the Development Bank of Mongolia. International reserves – already lower than three month's import cover – will remain under pressure from the persistent external financing gap.

Strong resolve of the new Government to address economic challenges is encouraging

The Government led the by the new Prime Minister with a grand collation of parties has been showing its resolve to address economic difficulties. We particularly note the speech of the new Prime Minister which acknowledged the underlying causes of the current economic difficulties and set out economic policy priorities of the new "Solution-oriented Government" to address structural problems including:

- Build stronger economic and fiscal management system in order to prepare for unpredictable but possible economic downturn;
- Create a strong debt management system including a comprehensive plan on sovereign debt service;
- Build a rational fiscal policy mechanism and debt management system that will consider external and internal macroeconomic factors;
- Move large mining projects forward and improve the management of the minerals exploration sector;
- Further tightening of the budget for 2015 under more realistic revenue projections;
- Prepare for the repayment of government bonds, social insurance and pensions in the future.

Economic Policy Framework

To help achieve the goal of the new Solutions-oriented Government to overcome economic challenges and build a sound economic management system, the following policy actions are recommended to be considered in the economic policy framework:

1. ***Macroeconomic policy needs to be tightened.*** Continued tightening of monetary policy and fiscal spending will help ease the balance of payments pressure and contain inflation. It will also help rebuild policy buffers to cope with possible external shock in the future.

   - **Consolidate the off-budget spending made through the DBM into the budget.** The DBM needs to be brought under the control of the Fiscal Stability Law and the government budget.
   - **Prepare a credible and realistic fiscal consolidation plan to reduce the deficit.** A medium-term fiscal consolidation plan is needed to reduce the fiscal deficit toward the 2 percent FSL target within 2-3 years. A temporary exception to the FSL may be considered to allow the mid-term fiscal consolidation plan.
   - **Monetary policy should be tightened.** The Price Stabilization Program should be phased out. Further direct liquidity injections should be avoided. If affordable housing remains an important policy priority, the housing mortgage program may be better targeted toward its objective of affordable housing.
   - **Further quasi-fiscal activities need to be avoided.** The Price Stabilization Program and the housing mortgage program are budgetary operations in nature. Central bank financing to the quasi-fiscal activities weakens the effectiveness of the macro-fiscal policy and the FSL. They also create additional economic burdens adding to inflationary pressure and therefore creating an inflation tax.
   - **Exchange rate should be left flexible.** The current floating exchange rate system is a key mechanism to adjust to the large balance of payments pressure. Excessive interventions of the central bank will likely exhaust international reserves further.

2. **Strengthen prudential supervision and monitoring of the banking system.** The rapid expansion of bank assets in 2013-14 indicates high likelihood of excessive risk taking and moral hazard in the banking system. Banks need to be encouraged to set aside sufficient loan-loss provisions, particularly given that the current provisioning system does not adopt forward looking criteria. The authorities may consider applying the new general provisioning ratio to all existing loans. The regulatory forbearance on policy loans should be lifted including zero risk weights allowed to policy loans in calculating capital adequacy ratio.

3. **Reviving foreign investment is critical to mitigate the external vulnerabilities.** While external debt financing may also help ease the balance of payment situation in the short term, it is only a temporary solution as the new debt liabilities will eventually return as a fiscal and external debt burden for future generations. Substantial recovery of FDI will provide relief to the balance of payments situation without creating such future burdens to the economy and also contribute to reviving declining domestic investment. Early start of major projects with significant economic implications will provide a positive momentum.

Recent Economic Developments

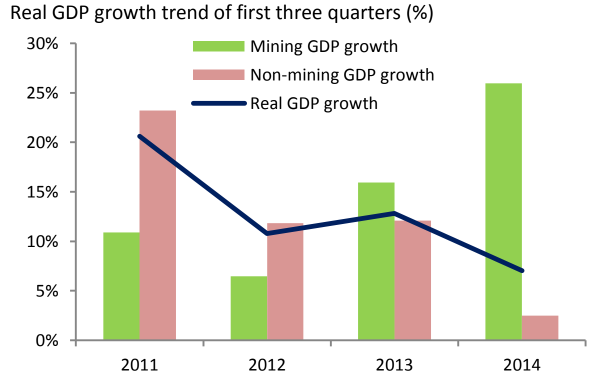
Economic growth is slowing despite strong mining production

Mongolia's real GDP growth in the first nine months of 2014 slowed to 7.0 percent, down from 12.8 percent in the same period of 2013. Mining GDP growth remained robust, expanding 26 percent in the same period, a significant jump from 15.9 percent a year ago. The strong mining production was led by revamped copper production largely from the new Oyu Tolgoi (OT) mine while the declining coal price further dampened coal production. Despite the strong mining sector, growth in the non-mining sector dropped to 2.5 percent in the first nine months from 12.1 percent in the same period of 2013, due to contraction in construction and wholesale/retail industry and an overall slowdown in other non-mining sectors. (Figure 1)

Quarterly GDP growth (y/y) of the non-mining sector continued to drop for four consecutive quarters, from 17.4% to 2.0% in the third quarter of 2014. The growth gap between the mining output (accounting for about 20% of GDP) and the non-mining sector has been rapidly widening in 2014. (Figure 2) The continuously softening non-mining sector output growth likely reflects adverse impacts from rising production cost due to high inflation and currency depreciation, but it also largely stems from waning policy stimulus effects. In 2013, strong economic stimulus measures managed to maintain non-mining sector growth close to 10 percent despite declining FDI and a weakening minerals market, through substantial liquidity injection (equivalent to over 20 percent of GDP) by the central bank's policy lending programs and large off-budget expenditures on construction of public infrastructure (equivalent to eight percent of GDP). The policy-induced high growth in the non-mining sector was fundamentally unsustainable as policy stimulus measures of such a large scale could not continue without creating substantial economic imbalances which would pose significant downside risks to the economy's strength. In 2014, the non-mining sector of the economy has been slowing as inflation accelerated to double digits and the exchange rate depreciated over 20 percent amidst substantial balance of payments pressure. Meanwhile, the authorities are facing challenges in further supporting economic growth as continuous expansion of economic stimulus measures became impossible amidst growing macro-economic instability and limited financing source for off-budget spending.

Figure 1. Economic growth softened to 7% in the first 9 months of 2014 from 12% a year ago.

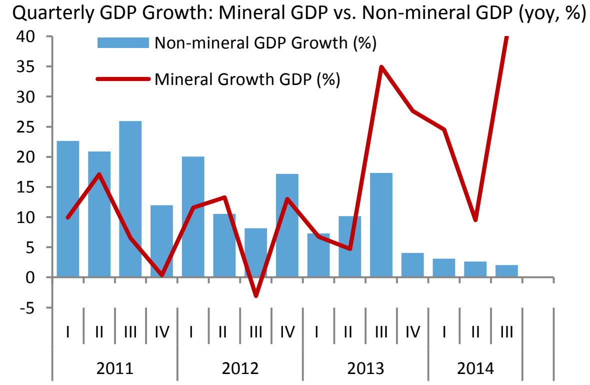
Real GDP growth trend of first three quarters (%)



Source: NSO Bulletin, WB staff estimates

Figure 2. Non-mining growth dropped for 4 consecutive quarters despite the strong mining production.

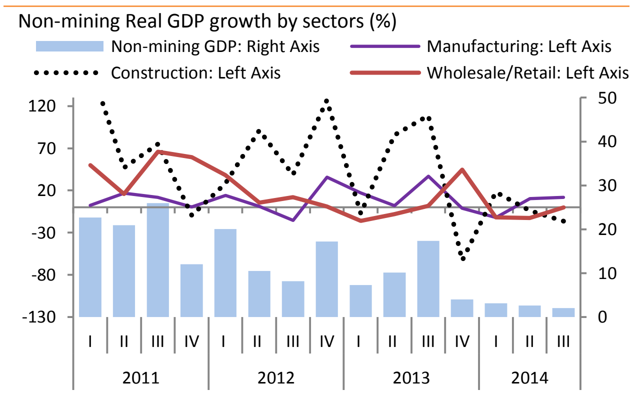
Quarterly GDP Growth: Mineral GDP vs. Non-mineral GDP (yoy, %)



The economic slowdown is sharper in the construction industry and wholesale and retail business. Agriculture maintained robust growth of 15.4 percent in the first nine months due to favorable weather conditions this year and the transportation sector displayed strong growth of 11.8 percent thanks to strong road transportation demand from increased copper exports from Oyu Tolgoi (OT) mine. However, the construction industry contracted 11 percent in the first nine months from striking 91 percent growth in the same period last year. The wholesale and retail sector continued to contract 6.8 percent over the same period after 6.5 percent negative growth last year. (Figure 3)

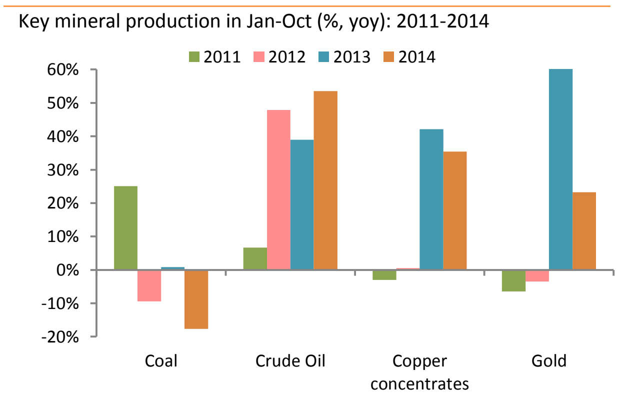
Mineral production remained strong due to robust copper production boosted by the start of production of OT mine but the coal industry is facing increasing difficulty. The mining sector accounted for 71 percent of total GDP growth rate in the first nine months. Copper concentrate production increased by 38 percent over the first nine months of this year reflecting the new production of the large OT mine that began its commercial operations in mid-2013. The OT mine produced 377 thousand of copper concentrates in the first three quarters, 134 percent increase from its production in the same period last year. Crude oil production also displayed robust growth of 54.3 percent from a year ago over the same period. However, coal production – which accounted for 20 percent of total mining production in 2013 – declined 14.6 percent in nine months to 15.5 million tons from 18.2 million tons last year due to continuously deteriorating of global coal market. (Figure 4)

Figure 3. Weakening construction and wholesale/business industry is dragging non-mining economic growth.



Source: NSO Bulletin, WB staff estimates

Figure 4. Strong copper and petroleum production is leading robust mining out.



Composition of aggregate expenditures shows that a sharp drop in investment is dragging economic growth and final consumption is also gradually softening. Over the first nine months, fixed investment dropped 31.2 percent from a year ago. Between 2010 and 2012, investment became a main driver of economic growth, increasing 38 percent on average annually. (Figure 5) The GDP share of investment jumped to 60.8 percent in 2012, from 32.7 percent in 2009. Large foreign direct investment has been a main financing source of investment during this period. As foreign investment substantially increased from 10.8 percent of GDP in 2009 to 45 percent of GDP in 2011, foreign investment (FDI) accounted for more than two-thirds of total investment in Mongolia between 2010 and 2012. In 2013-14, sharp drops in foreign investment have been heavily weighing on investment as the FDI continued to more than halve on the back of the completion of the underground Oyu Tolgoi mine as well as deteriorating foreign investment sentiment. FDI dropped 52 percent in 2013 and further declined by 58 percent in the first nine months of 2014. In the absence of significant foreign investment, the growth of investment dropped to 0.7 percent in 2013 and further declined to negative 31.2 percent in the first nine months of 2014. (Figure 5) GDP ratio of FDI inflow is likely to drop back to the 2009 level, around 35 percent. (Figure 6)

Final consumption growth also softened in 2014 but still remains robust. Final consumption growth slowed to 12.1 percent in the first nine months of the year, slightly down from 14.3 percent in 2013. (Figure 5) The strong final consumption data amidst weak recurrent budget expenditures suggests that the private consumption still remains relatively strong. As a result of a sharp drop in investment and relatively resilient consumption growth, the final consumption accounted for 74 percent of total GDP in the first nine months of 2014, rising from 69.6 percent in 2013. Significantly narrowing negative net exports is also largely contributing to the economic growth in 2014, due to improving trade balance in 2014. (Figure 6)

Figure 5. A sharp drop in investment is dragging economic growth and final consumption growth is gradually slowing.

Annual real GDP growth contributions by expenditures (%p)

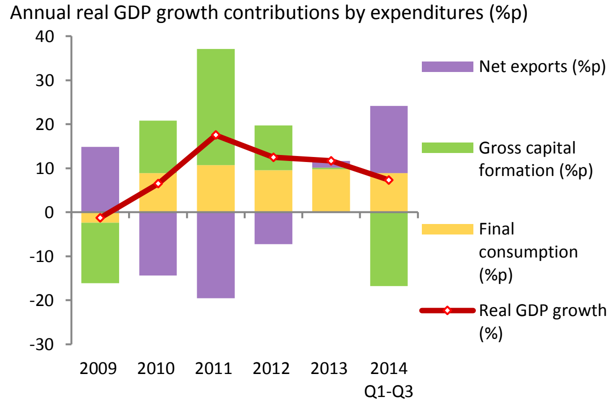
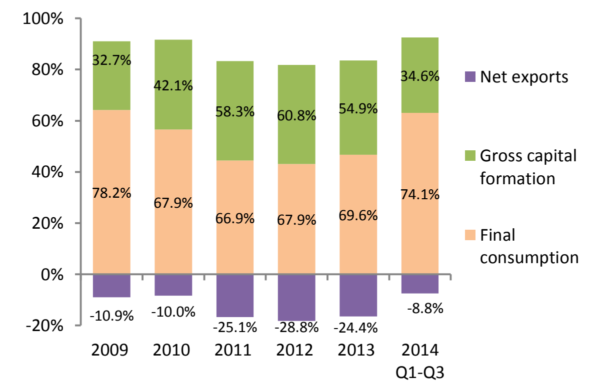


Figure 6. Investment now accounts for only 35% of total economic output, back to the 2009 level.

Composition of GDP by expenditures (%): 2009-2014



Source: NSO, WB staff estimates

Inflation remains in double digits but gradually moderated in recent months

Headline inflation remains in double-digit territory but has been on a moderating path since August. The national headline inflation – which has accelerated to 14.9 percent (y/y) in July – has gradually moderated down to 12.1% in October 2014. The headline inflation in Ulaanbaatar also had accelerated to 15.4% in July and softened to 12.7% in October. (Figure 7) The recent moderating inflation trend came with slowing money supply growth and moderating rate of currency depreciation in recent months. The central bank raised its policy rate by 150 basis points to 12 percent in July, the first policy-rate increase since April 2014. Broad money growth slowed to 14.4 percent in October from its peak of 42.2 percent in April amidst the gradual tightening of monetary policy of the central bank. The slowing pace of currency value depreciation also contributed to moderating inflation trend. The rate of currency depreciation slowed to 8.5 percent (yoy) in October from its annual peak of 26.2 percent (y/y) in June due to the base effect from over 20 percent currency depreciation of the last quarter in 2013. (Figure 8)

Core inflation rate contributed to moderating headline inflation but it still remains at the highest level since 2010. Core inflation has been a main driver of high inflation since mid-2013, constantly exceeding headline inflation, reflecting the substantial demand-side pressure from loose economic policies and currency depreciation. After reaching its peak of 17.9 percent in July, the core inflation rate gradually moderated to 15.5 percent in September and further down to 14.1 percent in October 2014. Despite the recent slowing trend, the core inflation still remains higher than 10-11 percent during the high inflation period in 2012 when the headline inflation reached over 15 percent. Food price inflation remained in double digits as well, reaching 10.3 percent in October largely due to rising bread and flour prices despite the stabilizing meat price level. Energy and fuel price level rose 24.4 percent in October from a year ago reflecting the higher prices of electricity, petrol and solid fuel.

Inflation will likely remain in double digits in the coming months but continuous tightening of monetary condition would contribute to easing inflationary pressure. Headline inflation is expected to gradually moderate toward 11-12 percent at the end of 2014 under the current trend due to the slowing domestic demand and the base effect from the high inflation rate of the last quarter in 2013. In 2015, tight monetary policy stance would likely help gradually ease inflationary pressure over time, especially in containing high core inflation that has been stimulated by loose monetary conditions and rapid exchange rate depreciation. However, in light of the persistent balance-of-payments deficit and the substantial fiscal deficit expected in 2015, it will likely be a significant challenge for the monetary authorities to curb inflation to the single-digit level despite its announcement to tame the inflation toward its 7 percent target. Further action may be needed to contain inflationary pressure toward the central bank's inflation target.

Figure 7. Inflation still remains in double digits but is slowing recently…

Consumer Price Inflation (year-on-year, %): Ulaanbaatar

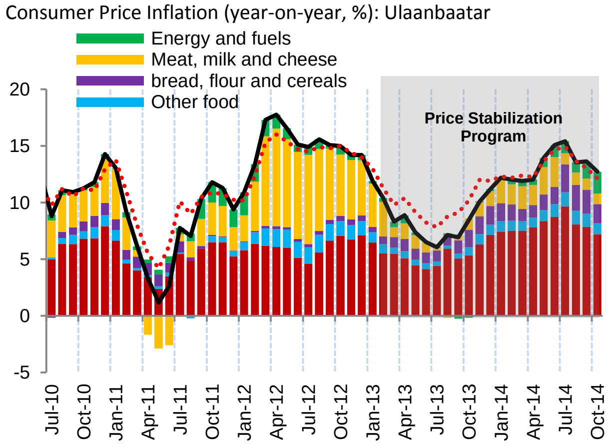
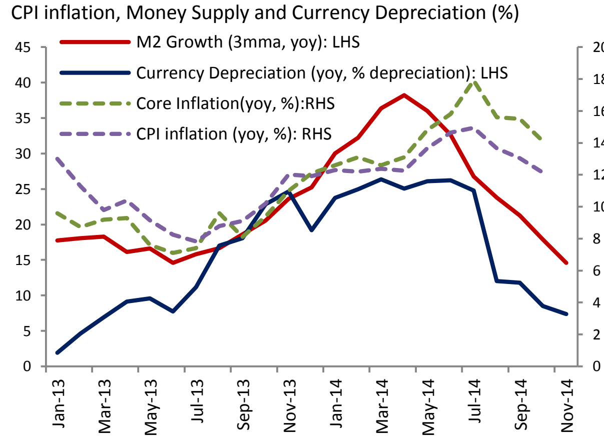


Figure 8. … as monetary conditions are tightened and the rate of currency depreciation slowed.

CPI inflation, Money Supply and Currency Depreciation (%)



Source: NSO Bulletin, WB staff estimates

The unemployment rate declined to 6.4 percent in the third quarter

Recent labor market data seems yet to reflect the slowing economy. The unemployment rate stood at 6.4 percent in the third quarter of 2014, slightly lower than its level in the same period of the last year. (Figure 9) There were 78.1 thousands of unemployed people in September, down by 23.3 thousand people from a year ago. Total labor force was estimated at 1.2 million persons and the labor force participation rate stood at 63.7 percent. The labor market data may reflect that employers choose to respond to increasing business difficulties by reduced work hours or unpaid leaves of employees, the effects of which are not likely to be properly captured by the official labor statistics.

Labor participation of the female population is increasing. Economically active population increased by 26 thousand males and 25 thousand females in September from the same period in 2013. The number of employed people rose by 37 thousand females and by 25 thousand males from a year ago. The unemployment rate by gender confirms increased labor market participation and job opportunities of females. The female unemployment rate declined to 5.9 percent in the third quarter of 2014 from 8.4 percent a year ago while the male unemployment rate has remained almost unchanged at 6.9 percent. (Figure 10) Improving female labor participation is likely to reflect increasing job opportunities in expanding service industries including accommodations and food service business.

Figure 9. Unemployment rate declined to 6.4 % in the third quarter of 2014.

Quarterly Unemployment Rate (%)

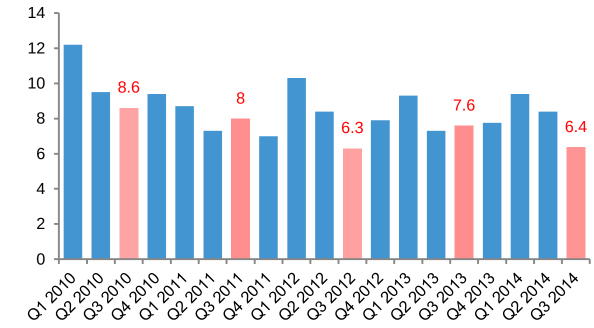
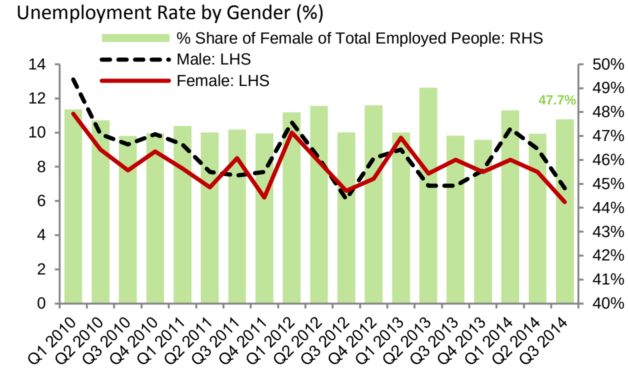


Figure 10. Unemployment rates declined for all genders.

Unemployment Rate by Gender (%)



Source: Labor Force Survey

Employment composition by job types indicates signs of deteriorating employment quality. The share of informal sector employment rose from 21.1 percent to 23 percent of total employment over the past twelve months. Self-employed workers, who often are unable to find higher paying jobs in the formal sector, rose 13 percent from a year ago, from 203 thousand to 229 thousand persons. Increasing number of self-employment – usually small scale and family businesses including kiosks and small vendors – may indicate weakening employment in the formal sector and it also suggests that increasing labor force is likely being absorbed more by small scale or informal/self-owned businesses due to weakening economic activities. The number of unpaid family workers also rose to 32.7 thousand persons in September from 25.5 thousand persons a year ago. (Figure 11)

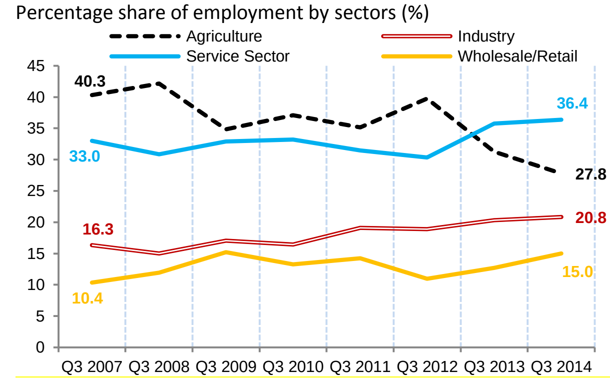
The labor force continues to shift from the traditional agricultural sector into other sectors. The employment share of agriculture has been declining in recent years from 40.3 percent in 2007 down to 27.8 percent in the third quarter of 2014. The employment share of industrial sector including mining, manufacturing and construction business steadily increased over the same period, reaching nearly 21 percent in the third quarter of 2014 from 16.3 percent in 2007. Service sectors including wholesale and retail business also absorbed a large number of workers that migrated from agriculture with its job share rising to 36.4 percent from 33 percent. The employment share of mining sector has remained around 4 percent since 2010 reflecting the capital intensive nature of the industry. However, the size of employment in the mining sector declined by 17.1 percent (8.6 thousand) from the same quarter last year, reflecting growing difficulty of the mining industry particularly in the coal mining sector. (Figure 12)

Figure 11. Self-employed workers have been on a rising trend since late 2013.

Changes in the number of paid-employees and self-employed workers (thousand people)

Figure 12. Labor market is shifting away from agriculture.

Percentage share of employment by sectors (%)



Source: Labor Force Survey, WB staff estimates

Fiscal policy became tighter but the fiscal deficit will remain high due to continuous off-budget expenditures

Fiscal policy has been highly pro-cyclical over the previous three years amidst double-digit economic growth. The GDP ratio of the budget deficit widened to 4 percent in 2011 and further to 10 percent in 2012 as budget expenditures doubled in two years while the economy was strongly boosted by surging foreign investment. In 2013, fiscal policy maintained a highly expansionary stance to keep high economic growth, actively using the proceeds of US$1.5 billion from the Chinngis bond issued in December 2012. As the Fiscal Stability Law (FSL) became effective in 2013 requiring the structural budget deficit be kept within the two percent of GDP, the authorities decided to spend the proceeds of the Chinggis bond through the Development Bank of Mongolia (DBM) and to keep the spending channeled through the DBM outside the official budget. As a result, the official budget deficit was contained with the FSL limit in 2013 but the off-budget spending through the DBM amounted to over 8 percent of GDP, pushing the annual consolidated budget deficit to 8.9 percent in 2013.

In 2014, fiscal spending became tighter due to budget revenue shortfall and the growing concern on high inflation and large balance-of-payments pressure. On-budget expenditure is being tightened amidst weak revenue outturn. Budget revenue shortage is expected to be around MNT 800 billion, over 10 percent of the original revenue projection. 70 percent of budgeted expenditures were executed between January and October. Capital expenditures were hit hard by the revenue shortage: budget execution of capital expenditures was only 50 percent in the first ten months of the year while the execution rate of recurrent expenditures was 77 percent in the same period. Repeated mid-year downward adjustments of budget have been undermining the budget credibility as unrealistically optimistic budget revenue projections tended to lead to large mid-year spending cuts since 2012. As a result of mid-year spending adjustments, the on-budget structural deficit will likely meet the 2 percent of GDP target in 2014.

Off-budget spending is also scaled back compared with the last year, but substantial spending remains outside the budget, pushing the consolidated fiscal deficit to 7 percent of GDP in 2014. The DBM's financing source included the proceeds of a sovereign bond (US$1.5 billion from Chinngis bond) and government guaranteed borrowing of the DBM (JPY 30 billion from Samurai bond and US$580 from the DBM Euro bond). More than half of the DBM programs provided financing to budgetary projects implemented directly by government agencies, mostly through direct contracting procurement, which are required to be repaid by the budget in the future. The rest of the DBM financing was used to provide cheap financing to the private sector including housing construction, agriculture and light industry. Detailed information is yet to be publicly available on the expenditures made through the DBM, however we estimate that the DBM spent about MNT 1 trillion until November from the remaining proceeds from the Chinggis bond, DBM Euro bond and the Samurai bond. The Government plans to contain the DBM spending within MNT 1-1.2 trillion in 2014, lower than MNT 1.5 trillion in 2013. Overall, we expect that the off-budget spending through the DBM will be reduced from 8 percent of GDP in 2013 to around 5 percent in 2014. (Figure 13) Consolidated fiscal deficit including both on-budget and off-budget expenditures will likely reach 7 percent of GDP in 2014. (Figure 14)

In 2015, the fiscal deficit will likely be further reduced to around 5-6 percent assuming further tightening of off-budget expenditures. We expect that MNT 1-1.5 trillion will remain available for the operation of the DBM in 2015 including the remainder of the Chinggis bond proceeds and the additional funding from new external borrowings in 2014. The DBM received additional financing of more than US$ 340 million in 2014 under the government guarantee for its lending operations, including the long-term loan from the China Development Bank (US$160 million) and a syndicated loan (US$180 million as of September 2014). We expect that the DBM will spend around MNT 1-1.2 trillion in 2015 as the authorities plan to curb the size of off-budget spending in the wake of growing economic vulnerabilities and the falling international reserves. On-budget spending will likely continue to be tightened due to weak revenue prospect. The 2015 budget plans to keep the on-budget structural deficit within the two percent of GDP ceiling of the FSL. Tightening of on-budget spending is planned to be done by containing the budget expenditure growth at 4 percent from the 2014 budget.

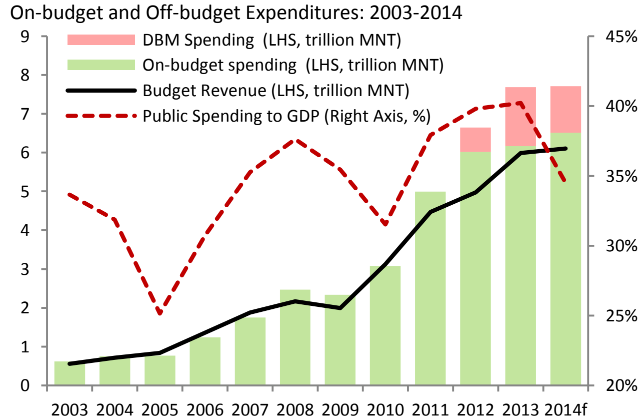
While the fiscal policy will likely become tighter in 2015 compared with previous years, the budget plan still runs the risk of revenue shortages and does not include off-budget expenditures. The budget revenue projection became more realistic compared with previous years but it still seems to rely on optimistic assumptions. The current revenue projection is based on the 2014 budget revenue projection which overestimated the budget revenue by over 10 percent. Even though the 2015 budget revenue is projected to increase by only 3.8 percent compared with the projection of the 2014 budget, the budget revenue growth compared with the actual budget outrun is estimated to be more than 15 percent. This revenue growth assumption seems optimistic especially considering that the budget revenue outturn growth in 2014 is estimated at only 3 percent. Considering the previous revenue trend and the economic prospects, the 2015 budget may overestimate the revenue projection for 2015 by 8-10 percent. On a more conservative revenue projection, the budget expenditure would need to be downward adjusted by more than MNT 500 billion in order to meet the two percent of GDP ceiling of the FSL in 2015. (For more details of the 2015 budget, see Box 1.)

A welcome step was taken to improve the transparency and accountability of the public expenditure management system by adopting the Glass Account Law. The new law aims to enforce public disclosure of budget and financial information of state and local government entities as well as other public entities. Disclosed information of public entities will include budget and its execution report, financial report and audit report on an annual, semi-annul, quarterly and monthly basis. Proper implementation of the Glass Account Law will likely significantly contribute to promoting transparency and accountability in the public expenditure management of the country by enhancing the public access and awareness on the public spending and its process. The law will become effective in 2015. (For more details of the Glass Account Law, see Box 2.)

Increasing fiscal burden for pension liabilities may constrain fiscal capacity in the future. Challenges of the current pension system and reform options are discussed in a special section: A Selective Topic – Mongolia's Pension System.

Figure 13. Fiscal policy is moderately tightened due tighter on-budget and off-budget expenditures.

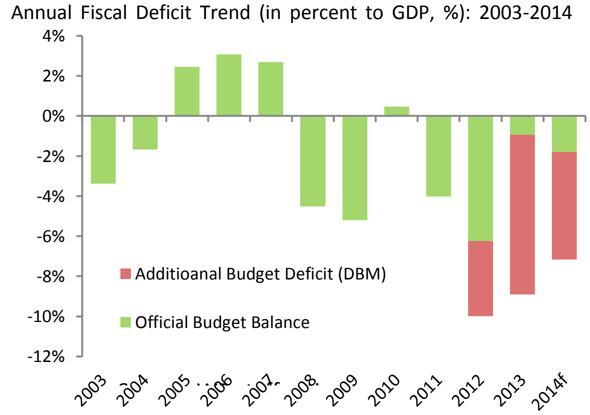
On-budget and Off-budget Expenditures: 2003-2014



Source: MoF, WB staff estimates

Figure 14. Consolidated budget deficit will likely be lower in 2014 but will remain high at 7% of GDP

Annual Fiscal Deficit Trend (in percent to GDP, %): 2003-2014



Box 1. Summary of the 2015 Budget

The 2015 budget was approved by the Parliament of Mongolia on November 15, 2014 amidst of the weaker revenue outturn and growing macro-economic instability. While the current 2015 budget will likely be amended in early 2015, the current budget for 2015 is based on following assumptions.

The 2015 budget was prepared under the assumption including: (i) real economic growth of 6.9 percent in 2014 and 7.1 percent in 2015; (ii) strong production of copper concentrate and continuously weak coal market; and (iii) the start of second phase development of OT mine from the next year. It also assumes that the inflation will be be contained at 7.0 percent in 2015 as part of the monetary policy guidelines. Under the macro-economic assumptions, the 2015 budget provides the following revenue projections and corresponding expenditure plans, as summarized in Table 1.

- Total revenue is projected to increase by 3.8 percent against the amended 2014 budget, reaching MNT 7194.4 billion which equals to 30 percent of estimated GDP in 2015. Total mineral revenue including CIT, royalties and dividends is expected to account for about 15.7 percent (MNT 1.1 trillion) of total revenue.

- Total expenditure and net lending is planned to rise by 3.9 percent compared to the amended 2014 budget, reaching MNT 7,599.2 billion or 31.7 percent of GDP in 2015, largely due to the increase in current expenditure by 12.9 percent. Wage bill is estimated to be up by 22 percent in 2015 than in amended 2014 budget. Capital budget is planned to be reduced by 21.7 percent compared with the 2014 budget.

- The structural balance is projected to reach 1.8 percent of GDP, meeting the ceiling (two percent of GDP) set by the Fiscal Stability Law. However, it remains highly uncertain whether the projected fiscal deficit can be actually met, given the deteriorating revenue outlook and ambitious expenditure plans. MNT 34.4 billion (equivalent to 0.1 percent of GDP) is planned to be deposited in the Stabilization Fund.

Table 1. Summary of the 2015 Budget

	2014 amended budget		2015 approved Budget		
	Billion MNT	% of GDP	Billion MNT	% of GDP	2015 / 2014 budget (% increase)
A. TOTAL REVENUE & GRANTS	6,933.6	32.0	7,194.4	30.0	3.8
B. TOTAL STRUCTURAL REVENUE & GRANTS	6,903.8	31.9	7,160.0	29.8	3.7
Tax revenue	6,227.2	28.7	5,900.5	24.6	-5.2
Non tax revenue	676.2	3.1	1,195.6	5.0	76.8
C. TOTAL EXPENDITURE & NET LENDING	7,312.4	33.8	7,599.2	31.7	3.9
CURRENT EXPENDITURE	5,344.8	24.7	6,033.2	25.2	12.9
Wages and salaries	1,608.5	7.4	1,962.9	8.2	22.0
Subsidies and transfers	2,197.4	10.1	2,292.7	9.6	4.3
Capital expenditure	1,999.0	9.2	1,565.1	6.5	-21.7
Domestic investment	1,771.4	8.2	813.9	3.4	-54.1
D. STRUCTURAL BALANCE: B-C	-408.5	-1.9	-439.2	-1.8	
E. OVERALL BALANCE: A-C	-378.8	-1.7	-404.8	-1.7	
F. STABILITY FUND: E-D	29.8	0.2	34.4	0.1	

Source: MOF 2015 Budget, WB staff calculation

Box 2. Key Features of the Glass Account Law

The Constitution of Mongolia guarantees that citizens have the right to inquire information from the government and its related agencies. There are number of reasons why information must be available and accessible to the public, including strengthening accountability of the state organizations. One of the ways to be accountable to its citizens by the state is improving public access to information on the budgetary and financial performance of all government and public entities.

Although the Mongolian government has taken a series of initiatives toward budget transparency and citizen participation, information about the budget and their roles in the budget process (planning, approval, implementation and reporting) has not been well defined and understood. In order to ensure that budgets are managed efficiently and in line with the need of the country, comprehensive budget information needs to be widely and meaningfully available to its citizens. Having such mechanism will enable civil societies and citizens to actively participate in budget decision making process in a comprehensive way.

Against this backdrop, the Mongolian parliament approved the “Glass Account Act” in July 1014. The law will become effective in January, 2015. The overall objective of the act is to establish an information system for transparent, open and comprehensive process of decision-making and activities for budget governance and public oversight in order to effectively manage the state and local budget as well as state and local properties/or assets.

The Act consists from 14 articles with 3 chapters including: scope of the law, terms and set principles; form of information in glass account, timelines and ways to deliver information; and implementation oversight including public oversight and liabilities. The Act applies not only to all budgetary entities, but also state owned entities including the SOEs and subcontractors providing works and services associated with government function based on contracts.

The Glass Account Act stipulates that state and local budgets including human development and the social Insurance funds; local development and government special funds; public procurement plan; debt notes at central and local administrations; PPP and concessions; and any state and local guarantee and any other decision that create budget debt and receivables must be available to the public. All budget entities should publish budget information through websites or on the public board. The Ministry of Finance is responsible for consolidating webpages which will be operational prior to June 30, 2016.

The Act sets certain dates when information must be available to the public. For example, budget governors must publish information on its annual budget, procurement plan and use of local development funds within the first ten days of each year. Budget entities should publish their budget performance on a monthly, quarterly, semi-annual and annual basis. State debt and its spending must be published on a quarterly basis by the Ministry of Finance. Oversight on the implement of the law will belong to the Parliament (Citizens Representative Khural) and state audit institutions. If citizens feel that the budget entities fail to deliver information, they can deliver complaints to state audit institutions.

The Act is expected to largely contribute to improving the mechanisms to promote public participation and awareness on the budget process by providing more established and comprehensive public information on all levels of government institutions and state-owned entities.

Source: World Bank staff

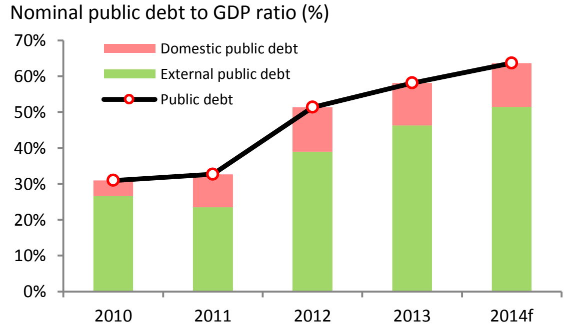
Public debt is rising and fiscal space is constrained by growing debt service.

Mongolia's public debt has been increasing in recent years since 2012. GDP ratio of nominal public debt rose to 51.3 percent in 2012 due to the issuance of sovereign Chinggis bonds (US$1.5 billion) and the DBM Euro bonds (US$580 million), from 32.7 percent in the previous year. In 2014, the public debt to GDP ratio will likely reach over 60 percent due to the currency depreciation effect, and the increase of the central bank foreign liabilities and the new external borrowing by the DBM guaranteed by the government. (Figure 15) The public debt to GDP ratio excluding the central bank foreign liabilities will likely reach around 51 percent in 2014, up from 29.8 percent in 2011. External commercial public debt is estimated to be over 20 percent of GDP, accounting for one-third of total public debt in 2014. The share of loans from multilateral and bilateral creditors among total public debt continued to drop since 2012, from 63 percent in 2011 to 34 percent in 2013. (Figure 16)

Fiscal space is increasingly constrained by increasing interest payments amidst rising government debt in recent years. The interest payment of the budget rose more than tenfold over the last three years from MNT 37 billion in 2011 to over MNT 470 billion in 2014 due to rising government or government guaranteed debt. Interest payment now accounts for around 7 percent of total on-budget expenditures, a sharp increase from 0.7 percent in 2011. GDP ratio of interest payment also jumped from 0.3 percent in 2011 to around 2 percent in 2014. (Figure 17) As a result of increasing interest payment, the gap between the primary budget deficit and the overall budget deficit has been widening. In 2014, the primary budget deficit including the off-budget spending will likely reach 5 percent of GDP, down from 7.5 percent in 2013. (Figure 18)

Figure 15. Public debt will likely reach over 60% in 2014…

Nominal public debt to GDP ratio (%)



Source: MoF, BoM, WB staff estimates

Figure 16. …led by large increase in commercial external debt and the BoM's foreign liabilities.

Composition of public external debt (in percent to GDP, %)

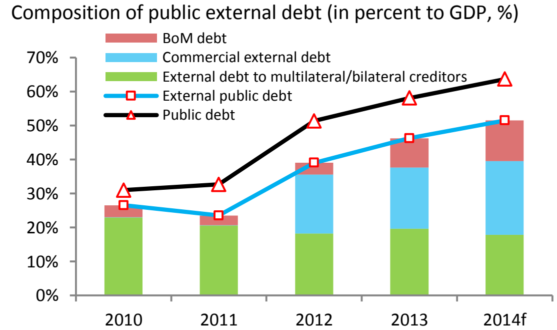
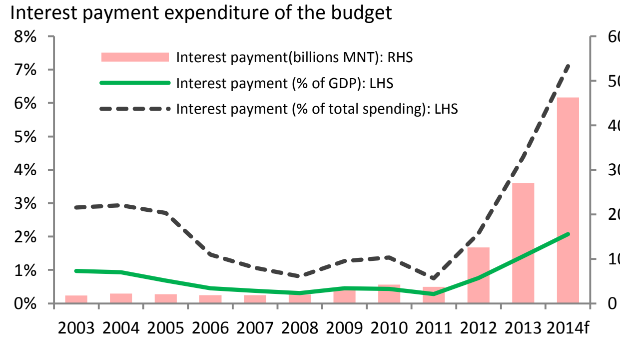


Figure 17. Rising interest payment is increasingly constraining the fiscal space.

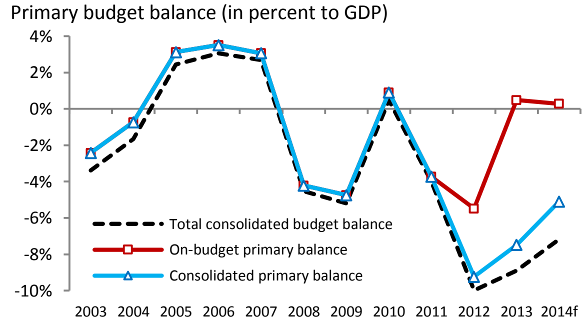
Interest payment expenditure of the budget



Source: MoF, WB staff estimates

Figure 18. The gap between the primary balance and the overall balance is widening.

Primary budget balance (in percent to GDP)



Monetary conditions are being gradually tightened

The central bank supported economic growth through strong monetary easing programs amidst declining foreign investment and dampening minerals market since November 2013. The monetary easing programs included (i) MNT 900 billion of deposit support to commercial banks made in early 2013 in the form of BoM's time deposit bank accounts; (ii) MNT 1.9 trillion injected to the discounted housing mortgage lending program including securitized mortgage loans; (iii) over MNT 1 trillion provided to construction companies and suppliers of construction materials, meat, flour, imported consumption goods and petroleum products under the Price Stabilization Program (PSP). In addition to the large liquidity injection to the economy, the BoM lowered its policy rate three times in January, April and June by 275 basis points to 10.5 percent from 13.25 percent in 2013.

As a result, outstanding central bank credit (excluding short-term credit support through RP transactions) injected to the economy reached its peak of MNT 3.2 trillion in September 2013 – equivalent to 17 percent of GDP. The monetary easing programs supported double-digit economic growth in 2013, particularly through boosting the construction sector and housing market which accounted for more than 70 percent of total central bank credit support. However, strong credit boom driven by liquidity injection inevitably led to adverse macro-economic consequences: stimulating demand-pulled inflationary pressure and adding to the persisting balance-of-payments pressure.

In 2014, the central bank has taken welcome steps to address high inflation and the large balance-of-payments pressure by tapering some of policy loan programs. As the credit growth reached over 50 percent and inflation accelerated to over 13 percent, the BOM began to adjust its monetary policy stance to gradually tighten monetary conditions: (i) the central bank withdrew MNT 900 billion that were deposited in banks; (ii) the policy rate was raised by 150 basis points to 12 percent in July, the first policy rate increase since April 2012; (iii) about MNT 200 billion of cheap credit extended under the Price Stabilization Program has been withdrawn as they mature in 2014. As a result of these steps, the outstanding central bank credit provided to the economy moderately declined to MNT 2.8 trillion in September 2014 from MNT 3.2 trillion a year ago. (Figure 19)

Recent monetary data reflect the effect of gradual tightening of monetary conditions and softening economic growth. Broad money growth decelerated to 14.4 percent (y/y) in October, from its peak of 42 percent in April 2014. Domestic loan growth also steadily declined to 22 percent in October, down from over 53 percent in November 2013, along with the slowing money supply. (Figure 20) Overnight inter-bank rate also has been on a climbing path since the policy rate hike, from 10.6 percent in July to 12.6 percent in October.

Figure 19. Central bank began to taper quantitative easing programs.

Outstanding BoM credit to banks (trillion MNT): 2012-2014

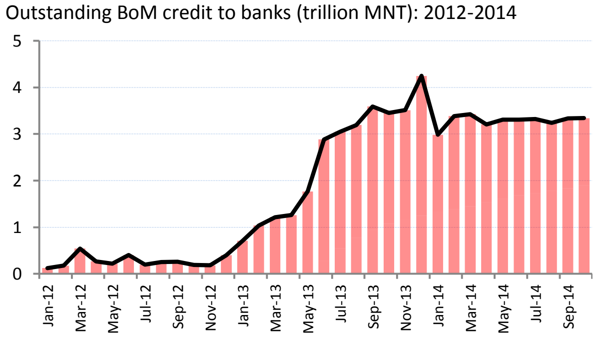
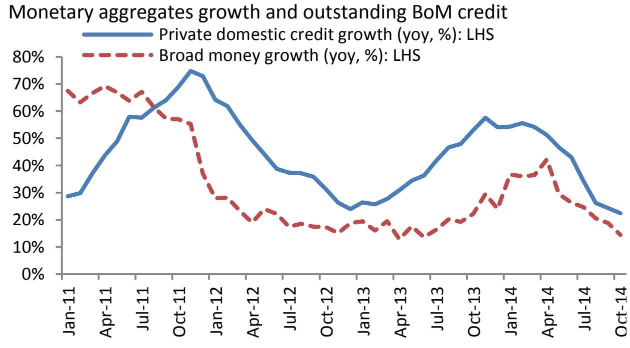


Figure 20. Growth of monetary supply and bank loans has been declining since mid-2014.

Monetary aggregates growth and outstanding BoM credit



Source: Balance sheet of the BoM

Maintaining a tight monetary policy stance seems necessary for the coming months. The outstanding domestic credit in October 2014 (MNT 14.9 trillion) is still about twice its size of MNT 7.7 trillion at the end of 2012 when the monetary easing just began. (Figure 23) The high loan-to-deposit ratio also indicates that liquidity buffers of the banking system have been increasingly undermined by excessively high loan issuance. The loan-to-deposit ratio has been climbing rapidly since early 2011 and accelerated to 135 percent in October 2014, sharply up from 99 percent at the end of 2012. (Figure 21) The rising loan to deposit ratio also indicates that commercial banks now excessively rely on the central bank credit as a result of monetary easing programs. In October 2014, the central bank credit accounted for almost 15 percent of total commercial bank liabilities, from a mere 2.1 percent two years ago. (Figure 22) Inflation will also likely remain high in double digit territory in 2015, above the seven percent target of the central bank. Mongolia's inflation has been the highest level compared to other developing countries in the region in the past three years. (Figure 24) Continuous tapering of the policy loans will help contain further inflationary pressure and help gradually achieve the single-digit inflation objective of the central bank.

Figure 21. Loan to deposit ratio reached 132%.

Loan-to-Deposit ratio, Bank loan and deposit growth (yoy, %)

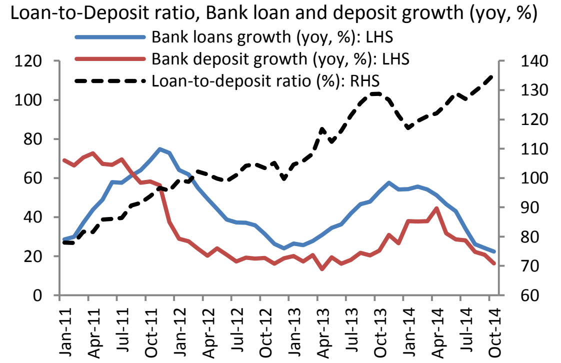
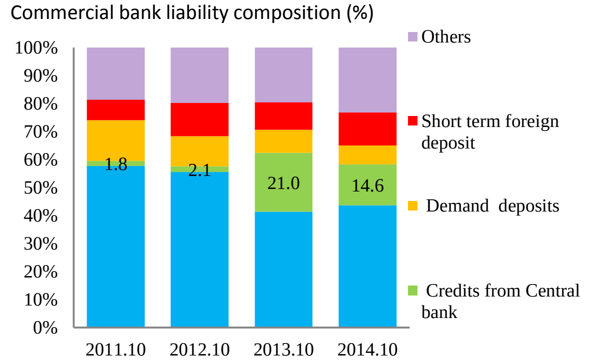


Figure 22. Banks are now relying excessively on central bank credit.

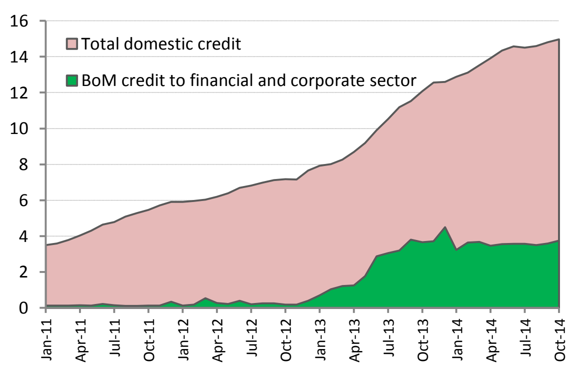
Commercial bank liability composition (%)



Source: BoM, WB staff estimates

Figure 23. Total domestic credit is still high, twice its size at the end-2012.

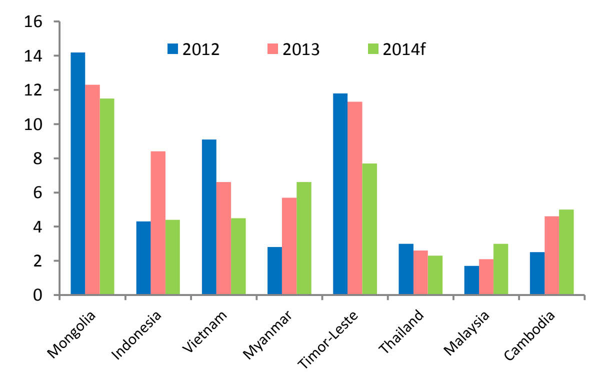
Total domestic credit (trillion MNT)



Source: BoM, WB staff estimates

Figure 24. Mongolia's inflation remains at the highest level in the region.

CPI inflation (%) in select countries in the EAP region



Source: WB EAP Regional Updates, IMF

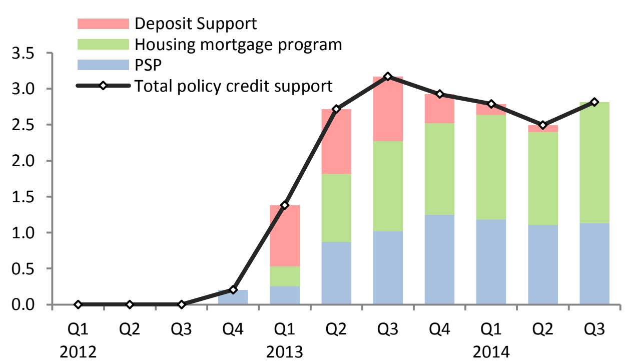
The tapering effect is still limited as the housing mortgage lending program is gradually expanding and most of the policy loans under the Price Stabilization Program will mature in 2015. While central bank policy credit was moderately unwound early this year by withdrawing the deposit support (MNT 900 billion) and some of policy loans under the Price Stabilization Program, tapering effect has been limited in recent months. The politically popular housing mortgage program – which provided

MNT 1.9 trillion of subsidized credit to apartment buyers since June 2013 – will likely further expand, albeit at a more moderate pace. In addition, more than MNT 1 trillion of policy credit that was injected to construction sector and other select sectors under the Price Stabilization Program will likely remain in the system for a while as much of these policy loans likely have long term maturity. (Figure 25)

Uncertainty still remains about the prospect of monetary policy stance. Given the weak budget revenues and the expected economic slowdown, the BoM may find itself under growing pressure to undertake further quasi-fiscal activities to support economic growth. The BoM may also have to face growing demands from business and political circles to provide emergency liquidity into the private sector. According to monetary survey data, the central bank recently increased liquidity injection to the non-banking financial sector (largely to refinance mortgage loans by purchasing securitized mortgage loans from the Mongolia Ipotek Corporation). The central bank also newly provided MNT 150 billion directly to the corporate sector in October, in addition to the central bank credit to commercial banks. (Figure 26)

Figure 25. Tapering effect remains limited as the housing mortgage program loans continue to expand.

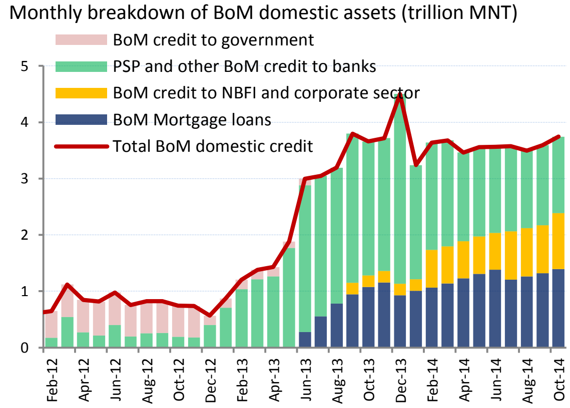
Quarterly estimates on outstanding BoM policy credit support excluding ST RP transactions (trillion MNT)



Source: WB staff estimates

Figure 26. BoM credit support to non-banking sector is also increasing in recent months.

Monthly breakdown of BoM domestic assets (trillion MNT)



Source: WB staff estimates based on BoM B/S data

Banking sector vulnerability is growing as the asset quality deteriorates

As large monetary easing was implemented through the banking system, vulnerability of banks has been also increasing. The program did not allow banks to fully price credit risks of the borrowers by imposing caps on the lending rates – around half the commercial lending rates. The policy loan programs may have created significant distortion of financial resource allocation across different industries as the programs provided cheap credit to only a few sectors selected by policy considerations. The banking system also became more exposed to higher concentration risks. As over 60 percent of policy loans were supplied to construction and housing sector through the Price Stabilization Program and the housing mortgage program, banks became more vulnerable to construction and property market cycle. The program also increased possibility of moral hazard in the banking system and weakened incentives to set aside sufficient capital buffers by allowing prudential regulatory forbearance including allowing zero risk weights to Price Stabilization Program loans.

Credit conditions have become tighter particularly in construction sector. Credit growth has been declining in most of all private sectors since the first quarter of 2014 but the tighter credit situation seems most severe in construction sector which had largely benefitted from liquidity support in 2013. Credit growth on year-on-year basis substantially dropped to 19.8 percent in the construction sector and to 29.1

percent in the real estate sector in the third quarter, from 117.5 percent and 72.7 percent in the first quarter respectively. Credit growth to mining sector and wholesale and retail sector also dropped to 8.8 percent and 18.9 percent respectively from over 50 percent credit growth in the first quarter. (Figure 27) Outstanding loans to construction, mining and wholesale/retail sectors shrank in the third quarter from the previous quarter as commercial banks tighten new loan issuance to these sectors amidst sharper deterioration of loan qualities of these sectors. (Figure 28) Mortgage loans, however, maintained high credit growth of 54 percent on year-on-year despite the moderating pace of mortgage loan growth. Manufacturing and Agriculture sectors also kept relatively stable credit growth.

Figure 27. Credit growth has been declining in most sectors, but more sharply in construction sector.

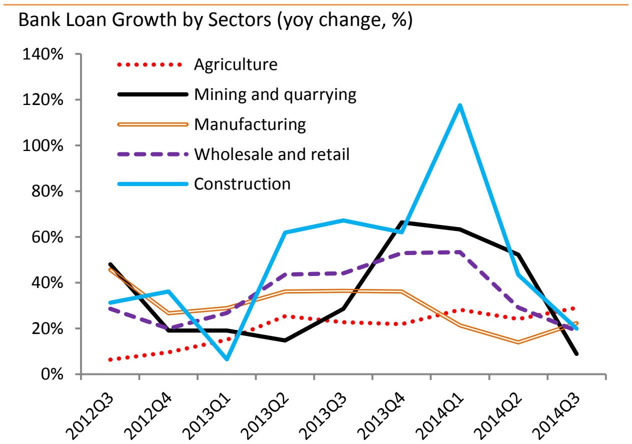
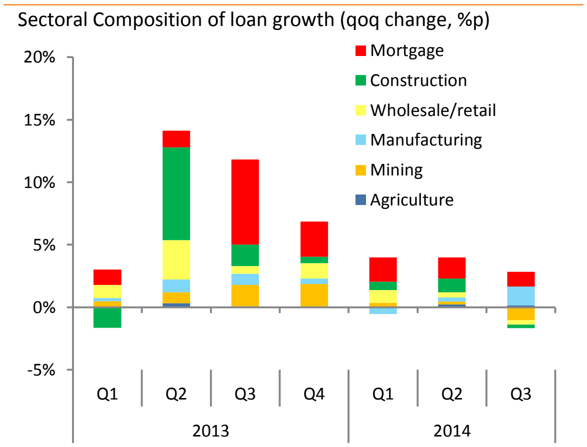


Figure 28. Outstanding loans declined in construction, retails and mining sector in Q3 from Q2 in 2014.



Source: BoM, WB staff estimates

Asset quality of the banking system is deteriorating fast. The non-performing loans (NPLs) of commercial banks have reached MNT367 billion in October, 47.7 percent increase from the NPL level a year ago. The NPL ratio (non-performing loans in percent to total outstanding loans) remains stable at 2.9 percent in October despite the increasing size of NPLs due to high growth of loans (denominator) over the last year. Past-due-loans have been increasing faster. The amount of past-due loans has more than doubled to MNT450 billion from MNT170 billion over the same period (Figure 29). Ratio of past-due loans to total loans jumped to 3.5 percent in October from 1.1 percent at the end of 2013. (Figure 30) Despite the relatively stable NPL ratio, rising trend of NPLs and faster increases in past-due-loans call for particularly heightened vigilance and strengthened monitoring from the supervisory authorities. Past experiences suggest that fast increases of past-due-loans tend to precede accelerating growth of non-performing loans. The soundness and liquidity buffers of the banking sector would be increasingly undermined should the rapidly rising past-due loans begin to turn into more NPLs going forward amidst slowing economy.

Figure 29. Size of NPLs and past-due loans has been on the rise since late 2013.

NPL and Past-due Loans (billions of MNT): 2008-2014

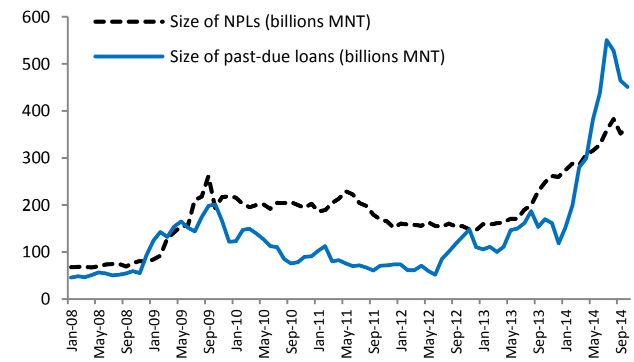
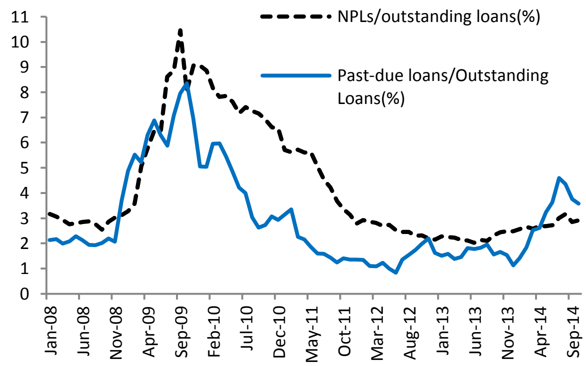


Figure 30. While NPL ratio still remains stable, past-due-loan to total loan ratio is rising fast.

NPLs and past-due loans in percent to outstanding loans (%)



Source: BoM Bulletin, WB staff estimates

Deteriorating credit quality is strongest in construction sector and wholesale/retail business. Mining and manufacturing sector has been traditionally accounting for major share of problematic loans – non-performing loans and past-due loans – in the bank sector. However, worsening loan quality has been more concentrated in construction sector and wholesale and retail business since mid-2013 reflecting the weakening business performance as well as the negative sectoral GDP growth. Problematic loans in the mining sector and manufacturing industry rose 2.5 percent and 9.9 percent respectively from a year ago, accounting for 25.7 percent and 15.4 percent of total problematic loans in October. Problematic loans of wholesale and retail business – accounting for 21.6 percent total problematic loans – have almost tripled to MNT227 billion from a year ago. Construction sector also recently displays fast deterioration of loan quality. Problematic loans to construction sector increased 141 percent since September 2013 from MNT 58 billion to MNT 139 billion. We also note that significant portion of outstanding problematic loans in wholesale and retail business and construction sector were incurred over the last twelve months. 73 percent of outstanding problematic loans in the wholesale and retail business and 59 percent of problematic loans in the construction sector were added over the last twelve months. (Figure 31)

The ratio of problematic loans to total outstanding loans has been on the rise in key sectors of the economy. The problematic loans ratio reached 12.9 percent in the manufacturing industry, 12 percent in the wholesale and retail business and 8.4 percent in construction industry in October. One-quarter of mining sector loans are either non-performing loan or past-due loans currently. (Figure 32)

Figure 31. Loan quality is worsening fast in construction and wholesale/retail sector.

Increase of problematic loans by sectors (in billions of MNT)

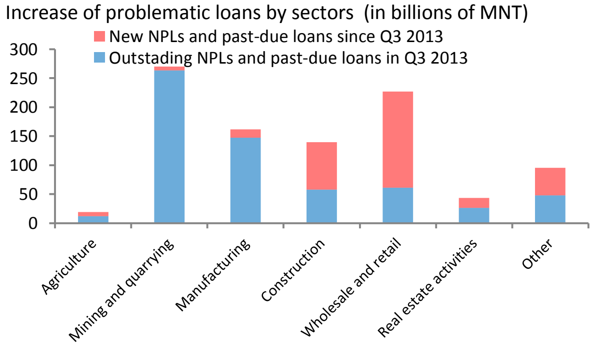
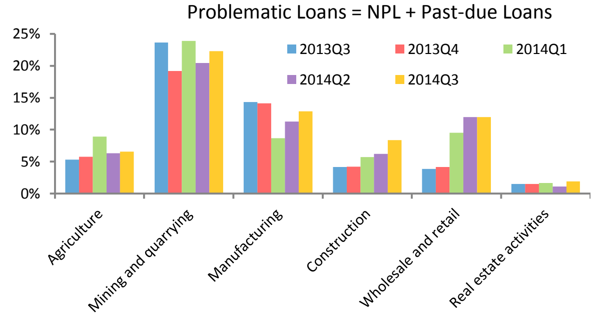


Figure 32. NPL ratio has been continuously rising in construction, wholesale/retail and manufacturing sector.

Trend of Problematic Loans/Total Loans by Sectors (%):

Problematic Loans = NPL + Past-due Loans



Source: BoM, WB staff estimates

Steps were taken to mitigate growing vulnerabilities of the banking system but further actions are needed

Available financial soundness indicators suggest that the banking system as a whole remains liquid. The system-wide capital adequacy ratio is currently above the minimum threshold of 14 percent for systemically important banks required by the central bank. Bank reserves stood at 20 percent of total deposit in October above the 12 percent reserve requirement ratio and the ratio of liquid assets – which includes bank reserves, central bank bills and government bonds – to total bank liabilities was 27 percent in October, above the minimum threshold of 25 percent imposed by the central bank.

However, banks' liquidity situations become increasingly tighter. Bank's reserve ratio to deposit has decline to 20 percent in October from 38 percent a year ago and the liquidity asset ratio to total liabilities also fell to 27 percent from 31.5 percent due to overall declines in excess reserves and holdings of central bank bill, reflecting tightened liquidity in the banking system. (Figure 33) Excess reserves of banks declined by 30 percent in the first ten months in 2014 and domestic currency excess reserves became highly tight. Outstanding central bank bill held by banks also declined by 46 percent during the same period. While bank's holdings of government bonds continued to increase, bank's demand for the safe assets has weakened due to tightened liquidity situation, reflected in the fast rise of government bond yields in recent months. (Figure 34)

Figure 33. Banking system seems to remain liquid but the liquidity situation becomes increasingly tighter.

Liquidity indicators of banking system (%)

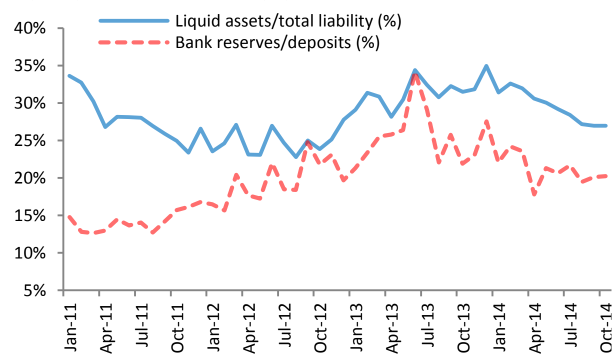
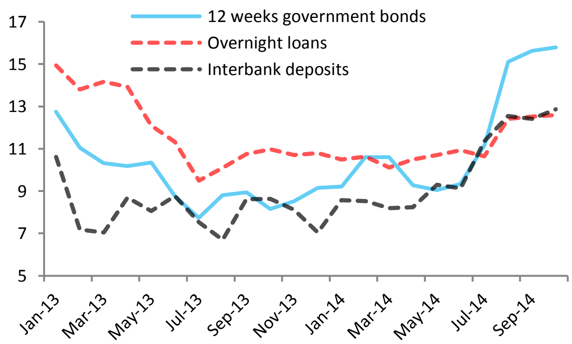


Figure 34. Rising yields of government bonds and inter-banking lending rates reflect tighter liquidity situations.

Yields of the government bonds and inter-bank market (%)



Source: BoM, WB staff estimates

The banking system is also exposed to high currency mismatch risks and exchange rate-related credit risks. The size of foreign liabilities of the banking system stands at twice the size of foreign assets, which exposed banks to high currency mismatch risks particularly in times of exchange rate depreciation. Credit risks associated with exchange rate fluctuation still remains high as foreign currency loans account for a quarter of total loans and significant portion of foreign currency loans were likely provided to unhedged borrowers. Further worsening of quality of foreign currency loans would likely weigh on foreign exchange liquidity buffers of the banking system, particularly in light of the high deposit share (30 percent) of foreign currency deposits. The share of foreign currency loans to total loans fell to 23 percent from over 30 percent in early 2013 as banks have significantly tightened new foreign currency loans.

The supervisory authorities have recently taken some steps to strengthen prudential regulations. In July 2014, the central bank announced measures to strengthen prudential regulations including: (i) imposing higher risk weights (120 percent) on foreign currency loans to unhedged borrowers; and (ii) raising provisioning ratio for normal loans to 1 percent from zero. These measures will likely contribute to building up more buffers in the banking system once the law becomes effective in January 2015.

However, its impact on the capital adequacy ratio will likely be gradual and limited as the strengthened prudential regulations will be applied only to loans that are newly issued loans.

Further actions are needed in the wake of worsening asset quality and weak economic prospects. The banking system needs to be encouraged to set aside sufficient loan-loss provisions in preparation for further deterioration of asset quality. The current provisioning system based on asset quality classification relying only on current debt-service status of loans may be vulnerable to the prospect of worsening asset quality during economic downswings. Prudential regulatory forbearance on policy lending programs should be also lifted. The regulatory forbearance allows zero risk weight to policy loans issued under the Price Stabilization Program, which will likely overstate capital adequacy ratio compared with international standards. Loans to certain sectors (construction, transport and industrial sector) are also allowed to have lower risk weights (70 percent) than loans to other sectors. Continuous monitoring and supervision is needed also on banks' concentration risk including their lending exposure to related parties and to large borrowers, in light of the past experience with the Savings Bank's failure in late 2013.

Box 3. The Housing Mortgage Lending Program

Overview of policy support to construction and housing sector. The central bank has been implementing the comprehensive stimulus measures to the construction and housing sector since early 2013 both in the supply and demand side. Supply-side stimulus measures included: (i) the Price Stabilization Program (PSP) to the construction sector that provided subsidized loans to supplies of construction materials and (ii) an additional construction support program that provided cheap credit to construction companies and real estate developers. Along with the supply-side stimulus program, the BoM launched a housing mortgage lending program to stimulate housing demand that provided cheap mortgage loans to households at a discounted interest rate of 8 percent (less than half the on-going commercial mortgage lending rates). As of August 2014, The BoM has provided about MNT 700 billion to the construction PSP and additional support program. During the same period, MNT 1.8 trillion was provided to households under the housing mortgage program. Overall outstanding policy loans that were provided to construction and housing market are estimated to be around MNT 2.4 trillion in October, over 80 percent of outstanding BoM policy loans and 18 percent of total outstanding private loans.

The housing mortgage program provided central bank credit to commercial banks at 4 percent interest rate which will be on-lent to households at 8 percent interest rate with up to 20 year maturity. Since late 2013, some of the subsidized mortgages have been securitized into residential mortgage backed securities by the Mongolian Ipotek Corporation (MIK) which was purchased by the BOM to refinance banks' funding sources for further housing mortgage loans. Loan eligibility criteria set a limit on the apartment size at 80 m^2 and required that loan applicants have more than MNT 1 million of monthly income. There is no ceiling on the maximum eligible income. As of October 2014, MNT 1.9 trillion of housing mortgage loans were issued to around new 30,000 borrowers since June 2013. MNT 1.1 trillion (60 percent of total mortgage program) was provided to new mortgage borrowers and MNT 245 billion (13 percent) was issued to existing mortgage borrowers who want to switch existing commercial term mortgages to subsidized mortgages. MNT 0.5 trillion of housing mortgage loans was securitized so far. In November 2014, the central bank announced to loosen the eligibility criteria for the housing mortgage loan applications to purchasing non-apartment housing by citizens in the rural area. The recent announcement seems to consider the slowing construction sector and the moderating mortgage loan growth in recent months.

Commercial mortgage businesses were substituted by the subsidized mortgage program. Existing commercial mortgage borrowers switched to the subsidized loan program and new mortgage loan demand was almost fully absorbed by the subsidized program. Between March 2013 and October 2014, outstanding commercial mortgage loans were reduced to MNT 800 billion from MNT 986 billion. In October, the subsidized housing mortgage loans accounted for 70 percent of total outstanding mortgage loans.

While the large scale mortgage lending program has helped many households buy their homes, the program also contains the following potential adverse effects:

- **Adverse macro-economic impacts.** The program injected liquidity equivalent to 9 percent of GDP and accounted for 40 percent of total private sector credit growth (MNT 4.6 trillion) since May 2013. This substantial liquidity contributed to excessive credit growth. The program is also vulnerable to speculative demand in the housing market. As the housing price more than doubled since 2011, high inflation expectation on the housing market has also built up. The program does not set a limit on the number of apartments owned by borrowers or an upper boundary of income as eligibility criteria, which is vulnerable to stimulating speculative demands.

- **Impact on housing price inflation.** By stimulating the demand for housing market, the program might have also contributed to the spike in apartment prices. During the program implementation since May 2013, the number of total mortgage borrowers doubled to 63 thousand borrowers from 32 thousand borrowers. It implies that the demand for eligible apartments almost doubled in one and half year, inevitably putting significant pressure on housing price inflation. Housing price in Ulaanbaatar rose over 23 percent in twelve months since the program began in May 2013.
- **Increasing vulnerability of banks.** As the program remains as the main pipeline of policy lending, banks will likely be increasingly exposed to the housing market performance. Housing price of UB recently shows signs of cooling housing market as the UB housing price declined for three consecutive months since July. The quality of mortgage loans is also deteriorating recently. The NPL ratio of mortgage loans rose to 0.5 percent in October from 0.2 percent at the end of 2013 with the size of mortgage NPLs tripling in ten months. The ratio of past-due loans also rose to over 2.2 percent from 0.3 percent over the same period and the size of past-due loans increased tenfold in 2014.

The authorities may want to consider ways to achieve its goal of providing affordable housing to those in need in a macro-economically more cost effective way. Better targeted mechanism may be an option. Having the program more targeted toward the low and middle income families (e.g., based on monthly incomes or existing number of apartment ownership of applicants), the program would need less liquidity injection while still providing affordable housing support to those in need. Strengthened supervision to enforce proper level of the debt-to-income ratio and the loan-to-value ratio will contribute to mitigating potential risks to the banking system by curving excessive household borrowing, particularly in the wake of cooling housing market.

Figure 35. 8% housing mortgage lending program has been implemented actively since July 2013.

Monthly housing mortgage loan trend (in trillions of MNT)

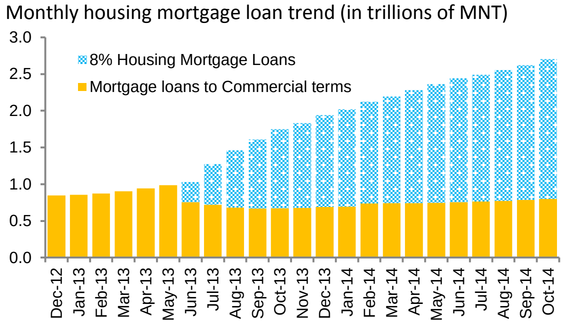
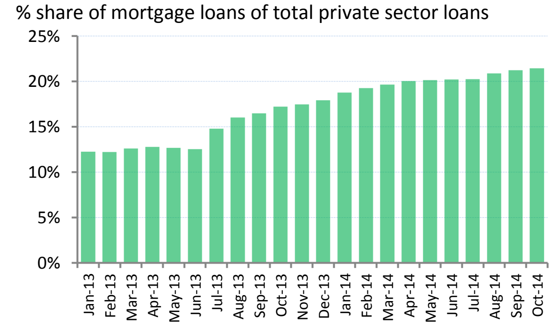


Figure 36. Mortgage loans now account for more than 20% of total private sector loans.

% share of mortgage loans of total private sector loans



Source: BoM, WB staff estimates

Figure 37. Housing price inflation has been high since May 2013 and recently shows signs of cooling.

Housing price inflation in UB

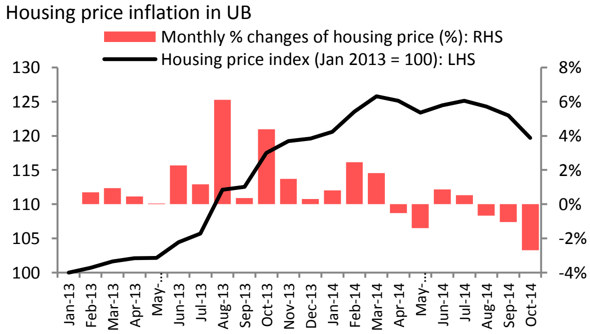
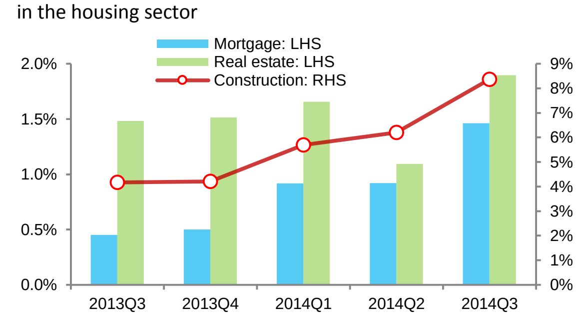


Figure 38. NPLs and past-due mortgage loans are increasing.

Problematic Loans (NPL+Past-due Loans)/total loans in the housing sector



Source: BoM, WB staff estimates

Source: World Bank staff

Current account deficit continues to narrow due to stronger copper exports and import compression

Significant current account deficit persisted over the previous three years, hovering over 25 percent of GDP. Substantial current account deficit emerged in 2011-2012 when the economy grew at double-digits on the back of doubling foreign direct investment largely for developing the OT's surface mine. While the current account significantly deteriorated due to surging imports, economic policies further fueled the aggregate demand by increasing budget deficits, instead of adopting counter-cyclical measures to curb overheating of the economy. As a result, the economy displayed amazing growth of 17.3 percent and 12.4 percent in 2011 and 2012 respectively but the current account deficit also widened to close to 30 percent of GDP. However, the economy was able to finance large current account deficit due to surging FDI and external commercial debt-financing of the public sector in 2011-12. In 2013, the economy faced deteriorating external environment due to substantial declines in FDI inflow and dampening global minerals market. In the absence of capital inflow that had fueled economic growth in previous years, economic policies scaled up stimulus measures to maintain high growth through supporting construction of properties and public infrastructure with high off-budget expenditures and large monetary easing. It brought another double-digit economic growth in 2013 but also kept current account deficit at unsustainable level, over 25 percent of GDP in 2013. (Figure 39)

While large current account deficit became unsustainable without sufficient foreign capital inflow, sharp declines in FDI in 2013 created large balance-of-payments pressure. The FDI dropped to US$ 2.3 billion in 2013 from US$ 4.4 billion in 2012 as the first phase investment of OT mine was completed and the foreign investment sentiment weakened amidst deteriorating investment environment. Weak global minerals market added to the balance of payments pressure, causing coal exports to drop by over 40 percent. Persistent large current account deficit and substantial declines in foreign capital inflow inevitably created a large external financing gap of US$ 1.7 billion in 2013 – equivalent to 14 percent of GDP, putting heavy pressure on currency value and foreign exchange reserves. (Figuer 40)

In 2014, a correction of large external imblance is underway as the foreign capital inflow further declines and currency depreciation continues reflecting the balance of payments pressure. The current account deficit narrowed to US$1.1 billion in the first nine months of 2014, from US$2.4 billion a year ago thanks to improving trade balance. (Figure 41) Trade balance turned into a surplus of US$317 million during the same peiord from a deficit of US$1.1 billion a year ago, led by significant import contraction by 16 percent and strong export growth by over 30 percent led by revamped copper exports from the new Oyu Tolgoi mine. (Figure 42) Service and income account deficit is moderately higher than last year's deficit level due to expanding external trade and outflow of investment income to foreign investors.

The annual current account deficit will likely narrow to around 11-12 percent of GDP in 2014, down from over 25 percent in 2013. Trade balance is expected to turn into a moderate surplus from a large deficit last year due to continuous import compression and strong copper exports, which will significantly contribute to the narrowing currenct account deficit. The service and income account deficit will likely moredately increase due to continued deficit in transportation, travel and other services and increasing investment income payment to foreign investors.

Figure 39. Current account deficit is narrowing significantly in 2014 after substantial deficits in the previous three years.

Current account deficits in percent to GDP (%): 2008-2014

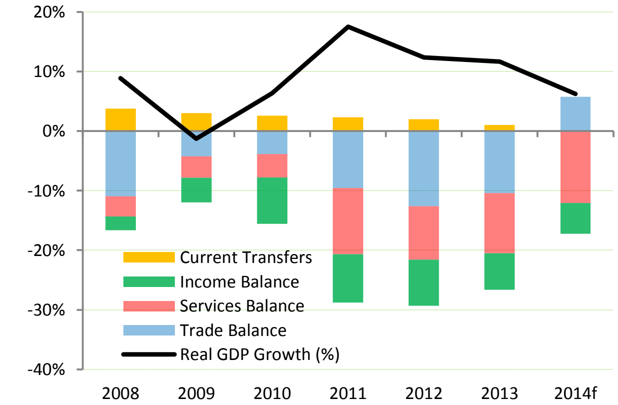
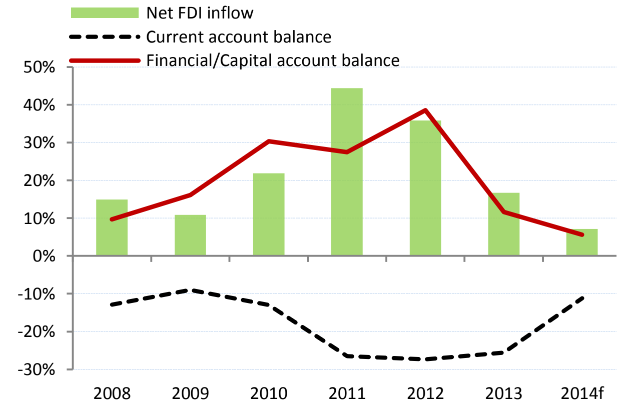


Figure 40. Continued declines in FDI made substantial current account deficit unsustainable.

Balance of payments (in percent to GDP): 2008-2014



Source: BoM, WB staff estimates

Figure 41. Improving trade balance is contributing to narrower current account deficit…

Monthly CA balance and trade balance (3 month moving average)

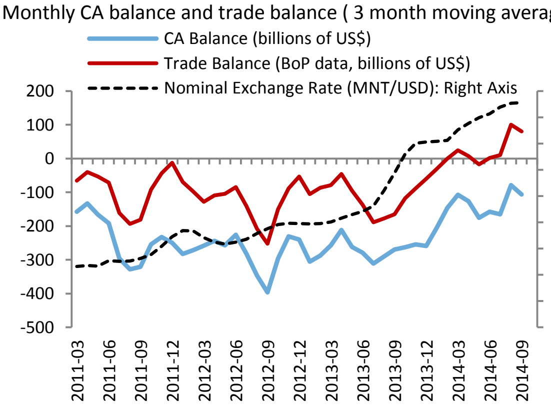
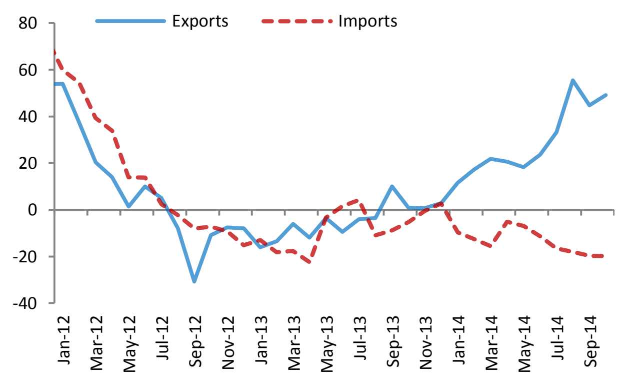


Figure 42. … driven by stronger copper exports and import compression.

Y/Y growth of exports and imports (%, 3 month moving average)



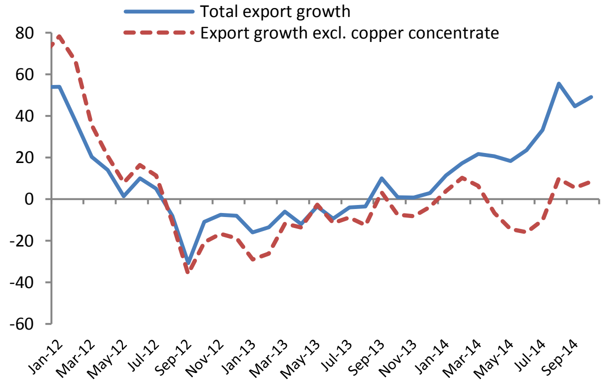
Source: BoM, WB staff estimates

Total exports increased 32.3 percent for the first ten months, driven by the large copper concentrates exports of the Oyu Tologi (OT) mine. In 2013, OT exported only 26.4 thousand tons of copper concentrates since it began commercial production from June 2013. As it entered into the first year of full-year production, the OT mine exported 471 thousand tons of copper concentrates in the first nine months of 2014, which drove 157 percent increase in total copper concentrates exports of the country. OT's copper exports alone accounted for over half of total copper exports and a quarter of total exports so far. However, exports excluding copper concentrates declined by two percent in the first ten months due to declining coal exports. (Figure 43) Coal exports – another key export commodity in Mongolia – continued to decline throughout the year, dropping 22.4 percent in the first ten months due to continuous dampening of coal price. (Figure 44)

Imports dropped 16 percent (y/y) in the first ten months of this year. The import compression is driven by widening contraction of imports of investment-related goods, including machinery and transportation equipment which dropped 28 percent and 42 percent from a year ago respectively. Growth of Imports of mineral products also turned negative during the same period, dropping 11.4 percent in the same period. (Figure 45) Construction and other consumptions goods also displayed negative import growth since mid-2014. (Figure 46)

Figure 43. Copper exports led strong export growth while non-copper exports remained moderate.

Export growth with and without copper concentrates (yoy, %)



Source: NSO, WB staff estimates

Figure 44. Coal exports declined 22 percent due to falling coal prices.

Coal Export volume and realized sales price per ton (yoy, %)

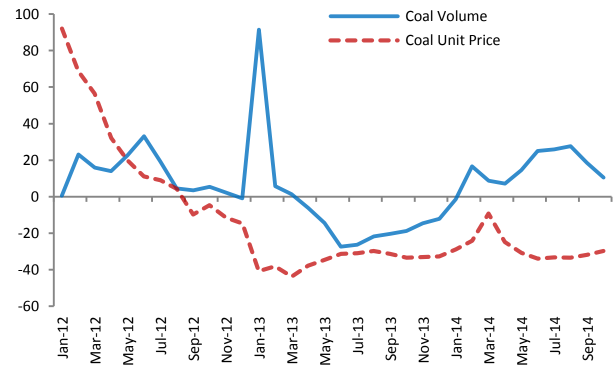


Figure 45. Weakening imports are led by declines in imports of investment-related goods…

Imports of investment-related goods (y/y % change, 3 month moving average)

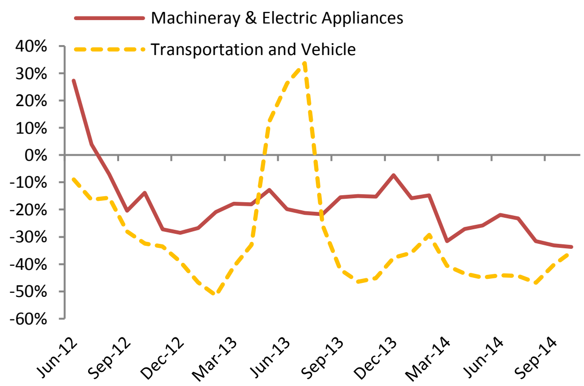
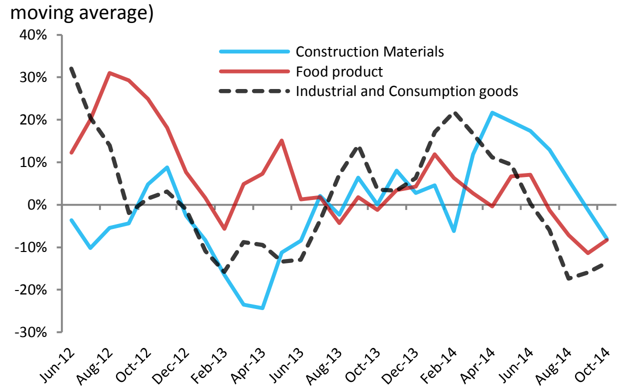


Figure 46. … and imports of consumption goods also began to decline recently.

Imports of food and consumption products (y/y % change, 3 month moving average)



Source: NSO, WB staff estimates

Balance of payments pressure still remains substantial due to a sharp decline in capital inflow

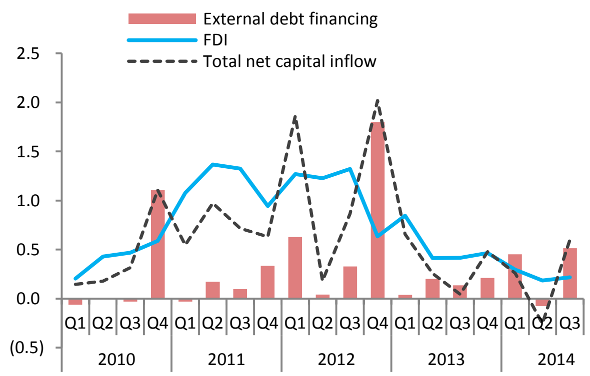
Despite the narrowing current deficit, balance of payments pressure still remains high as foreign investment continues to drop. Capital and financial account registered a surplus of US$0.6 billion in the first nine months of 2014, a sharp drop from a surplus of US$1.4 billion during the same period in 2013. (Figure 47) After a sharp decline of 52 percent in 2013, the FDI inflow continued to drop in 2014, declining by 58 percent in the first nine months, straining the foreign currency liquidity condition. The FDI inflow between January and September in 2014 reached US$696 million, only 18 percent of the FDI inflow in the same period in 2012. Declining capital inflow kept the balance of payments under severe pressure despite the large improvement in the current account deficit.

The authorities borrowed about than US570 million so far in 2014 to supplement the capital inflow deficit from declining FDI and help ease the persistent balance of payments pressure. The government provided guarantees to new external financing of US$578 million for the Development Bank of Mongolia in 2014 including: (i) the proceeds from Samurai bond issuance in January (around US$230 million), long-term loan from the China Development Bank (US$162 million) and a syndicated loan from Credit Suisse (US$180 million as of Sep) in the third quarter. The central bank also has been withdrawing from the bilateral currency swap facility with the People's Bank of China to smooth volatile exchange rate fluctuation and meet foreign currency demand.

The overall financing gap will likely reach around 9-10 percent of 2014 annual GDP, exhausting half of gross international reserve level at the beginning of this year. Overall external financing gap in the first nine months eased to US$803 million in the first ten months, down from US$ 1,867 million a year ago. The new external debt financing of around US$ 0.6 billion by the DBM and the drawings of the PBoC swap-line provided a relief to the balance of payments pressure, narrowing the external financing gap. However, increasing reliance on external debt-financing backed by the direct government guarantees is concerning as these new foreign liabilities will pose another repayment risks in the future, putting additional burden on the financial strength of the economy and the fiscal soundness.

Figure 47. Capital and financial account surplus shrank amidst weakening FDI...

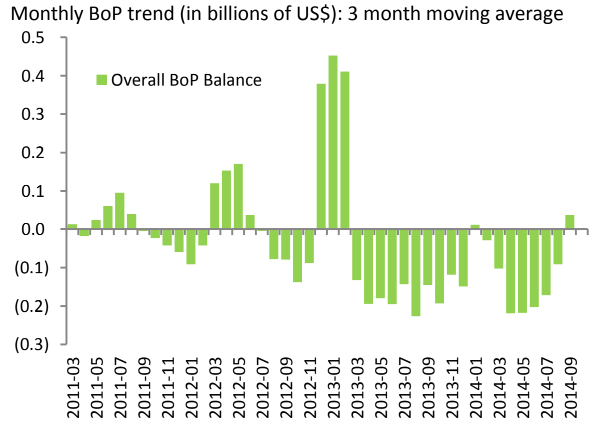
Monthly trend of net FDI Inflow (in millions of US$)



Note: External debt financing = portfolio investment + loans

Figure 48. ... and the BoP pressure remains high despite the narrowing current account deficit.

Monthly BoP trend (in billions of US$): 3 month moving average



Source: BoM, WB staff estimates

Persistent large balance of payment pressure has been translating into declining international reserves and weakening currency value. Local currency value against the U.S. dollar weakened 20 percent in 2013 and further depreciated by 13 percent over the first ten months of 2014. The international reserve level continued to decline reflecting the large external financing gap. The gross reserve level peaked at US$4,125 million at the end of 2012 due to the receipts of the Chinggis bond proceeds (US$1.5 billion). The reserve level steadily declined since the end of 2012 except for brief rebounds in January, September and October in 2014 (due to new external debt financing). The international reserves dropped to US$1.4 billion in October, exhausting US$849 million in ten months. (Figure 49) The current international reserve level is 34 percent of its peak level at the end of 2012 and is equivalent to slightly above two month's import cover. The international reserve level is likely to remain under continuous pressure in light of the weak FDI inflow and still high current account deficit.

Drawings of the bilateral currency swap line with China have been contributing to moderating the pace of declining international reserves. The BoM made a bilateral currency swap agreement with the People's Bank of China (PBoC) in 2011 which was renewed for another three years and expanded to RMB15 billion (around US$2.4 billion under the current rate) in 2014. While the PBoC currency swap line can provide significant buffers to external liquidity situations, withdrawals from the currency swap facility also incur foreign liabilities of the BoM and will need to be repaid or renewed again in the future.

Figure 49. International reserves declined to less than three month's import cover.

Gross international reserves (in millions of US$)

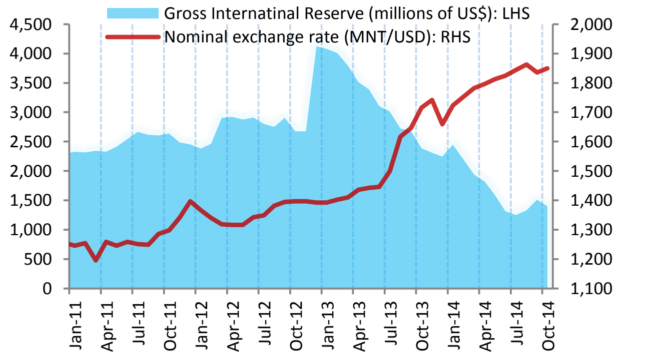
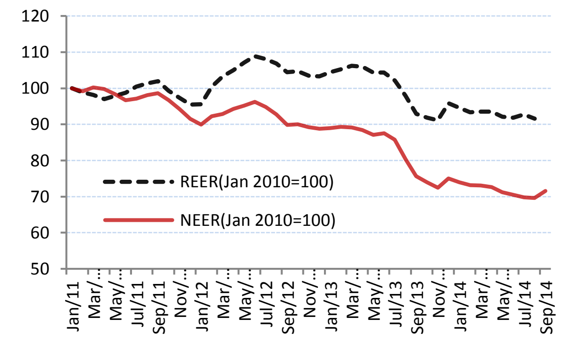


Figure 50. Exchange rate remains under pressure from the large BoP pressure.

Currency value trend: Real and Nominal Effective Exchange rate (Jan 2011 = 100)



Source: BoM, World Bank staff estimates

The external situation may become more vulnerable over time

External liquidity risk is low in the near term. No large external debt obligations were due in 2014 both in the private and public sector. As of June 2014, total short-term external debt stood at US$ 1,636 million, accounting only for 8.3 percent of total external debt. Foreign liabilities of the BoM including the drawings of the PBoC bilateral currency swap facility accounted for 59 percent (US$965 million) of total short-term debt which however will not be repaid until 2017. Private sector short-term debt reached US$ 671 million which will be due within a year, including commercial banks (US$214 million), corporate sector (US$240) and trade credits (US$216). Except the BoM foreign liabilities, the short-term external debt stood at 45.3 percent of gross international reserves in June.

External situation may become more vulnerable over time. US$580 million of the DBM Euro bond will mature in March 2017 and US$500 million, the first tranche of the Chinggis bond, will mature in January 2018. Outstanding credit withdrawn from the PBoC currency swap facility will also have to be either renewed or repaid in 2017. (Figure 52) In light of the declining international reserves and the prospect of current account deficit over 10 percent of GDP, the external public debt repayment schedule will likely become a challenge unless the current account deficit narrows further through tighter economic policies and the FDI substantially recovers in the coming years.

Figure 51. Ratio of ST external debt to reserves is rising.

ST external liquidity indicators (%)

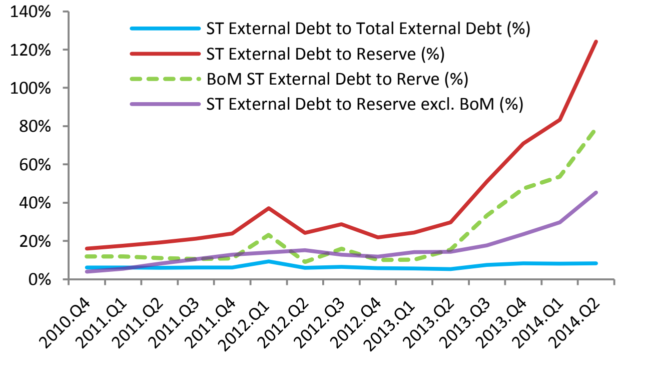
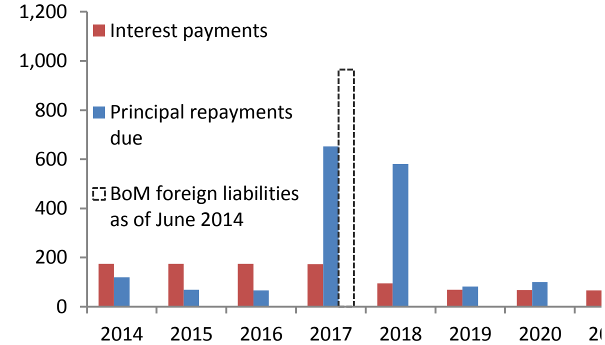


Figure 52. Large external public debt repayment is scheduled in 2017 and 2018.

External public debt service schedule (millions of US$)



Source: WB staff estimates based on IIP, External Debt Statistics

Box 4. External Position of Mongolia (as of June 2014)

Mongolia's external debt has been on the rise since 2010 for both public and private sectors. Total external debt of Mongolia – which includes both public and private sectors – rose to US$ 19.8 billion, reaching 161.5 percent of projected annual GDP in the second quarter of 2014, from 82.5 percent (US$5.9 billion) at the end of 2010 and 151.6 percent (US$19 billion) at the end of 2013. Public sector – which includes the general government and the central bank – accounted for 27.9 percent of total external debt and the commercial banks' external debt took up 7.4 percent of total external debt. 53.8 percent of Mongolia's external debt came from intercompany borrowing of foreign-invested companies which picked up significantly in 2011 and 2012 amidst surging FDI. The external debt to GDP ratio excluding inter-company borrowing reached 74.5 percent at the end of 2013, also up from 37.2 percent at the end of 2011 and from 60.2 percent a year ago.

Public and publicly guaranteed (PPG) external debt rose to US$5.5 billion (45 percent of GDP) in June 2014, from US$2.2 billion (21.3 percent of GDP) in 2011. The large increase in PPG external debt stemmed from the issuance of commercial bonds by the general government and the increase of external debt of the central bank. Issuance of commercial bonds include the sovereign Euro bond (Chinggis bond) of US$1.5 billion issued in December 2012 and the DBM Euro bond of US$580 million issued in March 2012, and the DBM Samurai bond of JPY30 billion issued in January 2014. In June 2014, the external debt of the general government including guarantees granted to the DBM bond and the Samurai bond reached US$4.5 billion – equivalent to 36.6 percent of GDP. The external debt of the central bank also grew to US$1,040 million at the end of June 2014, from US$267 million at the end of 2011, mainly due to the increasing drawdown of bilateral currency swap facility with the People's Bank of China (PBoC). As a result of the large commercial bond issuances since 2012, the share of external liabilities to bilateral and multilateral creditors (US$2.2 billion) among the total PPG external debt fell to 58.2 percent in June 2014, down from almost 100 percent in 2011 while commercial external liabilities accounted for 41.8 percent of total PPG external debt in June 2014.

FDI still accounts for a majority of foreign capital invested in Mongolia. Outstanding amount of FDI reached US$16.7 billion in June 2014, up from US$ 15.5 billion at the end of 2013. The FDI accounted for 64.3 percent of total foreign investment position in Mongolia. Outstanding portfolio investment remained low, with US$2,316 million invested in debt securities of the public sector (including the Chinggis bond, DBM Euro bond and the Samurai bond) and US$462 million in commercial bank debt securities at the end of June 2014. Foreign investment position in equity market was US$ 86.8 million. Portfolio investment accounts for only 11 percent (US$ 2.9 billion) of total foreign investment position in Mongolia in June. Outstanding loans reached US$4.5 billion including around US$ 2.1 billion of multi-lateral and bi-lateral loans extended to the government.

Figure 53. Mongolia's external debt has been on the rise.

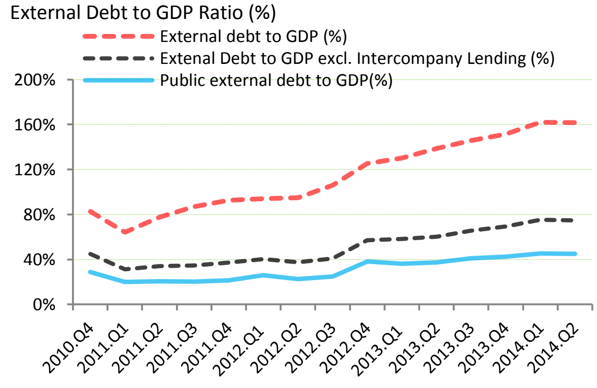
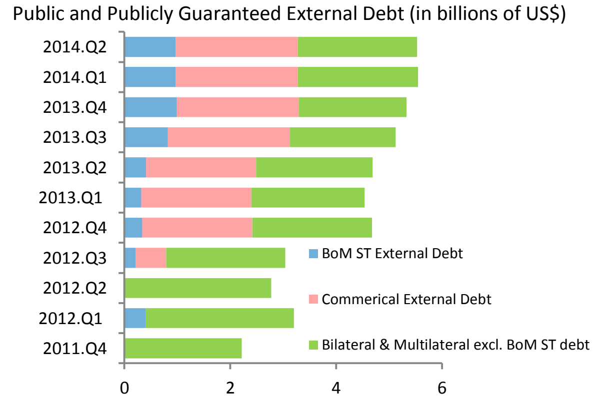


Figure 54. The recent increase in public external debt was driven by external commercial financing.



Source: BoM External debt statistics, World Bank staff estimates

Economic Prospects and Challenges

The Mongolian economy is facing challenges from persistent large economic imbalances while long term economic prospects remain strong

Pro-cyclical economic policies helped maintain double-digit growth in the previous three years but also came with growing vulnerabilities of the economy. Growth-oriented economic policies have bolstered aggregate demand between 2011 and 2013 to an extent that they created a current account deficit close to 30 percent of GDP. Such a large current account deficit was unsustainable in the event of minerals market downswing or declines in the foreign investment. Between 2011 and 2012, the large current account deficit was largely covered by surging foreign capital inflow on the back of massive development of the new Oyu Tolgoi mine. However, the persistent current account deficit began to translate into significant balance of payments pressure in 2013 as the FDI inflow halved and the minerals market weakened. Strong growth stimulus measures implemented by the fiscal and monetary authorities to counter the deteriorating external environment in 2013 added to the balance of payments pressure and fuelled high inflation. International reserves began to decline fast and the currency value fell rapidly amidst the large balance of payments deficit. Inflation accelerated to double digits as the currency value slid and the domestic credit growth reached over 50 percent driven by the monetary easing measures equivalent to 20 percent of GDP. Substantial off-budget expenditures – equivalent to over 8 percent of GDP in 2013 – also added to the widening economic imbalances by stimulating construction boom. Meanwhile, increasing reliance on external debt to finance the off-budget expenditures has increasingly undermined fiscal sustainability as the public debt almost doubled in three years.

The current economic situation reflects an adjustment to correct unsustainable external imbalances. The current account deficit is narrowing significantly to around 11 percent of GDP in 2014 from over 25 percent of the previous three years as the economy cools. Investment sharply fell due to the lack of funding sources amidst declining FDI and weakening business prospects. Consumption remains relatively strong but is also gradually softening in the wake of persistent high inflation. Also, strong policy stimulus measures that were implemented in 2013 are also weighing on the economy in 2014 as the stimulus effects wear off. In particular, the policy-induced construction boom of the last year is waning fast due to rising production costs and tighter financing while the monetary and fiscal policy cannot further sustain strong financial support and off-budget spending in the wake of high inflation and limited revenue resources.

Despite the recent improvement, economic imbalances remain high and further corrections are needed

Large balance of payments pressure will likely persist due to declining foreign capital inflow. Despite the narrowing current account deficit, the overall balance of payments deficit will likely reach 9-10 percent of GDP in 2014. In 2015, the current account deficit will likely continue to narrow further as the economic growth continues to soften while copper exports remain robust. However, the external financing gap will still remain high in 2015, likely further exhausting international reserves under the current trend of weak foreign investment and still high current account deficit. Inflation will also likely remain in double digits in 2015 under the current trend above the seven percent target of the central bank and inflation levels in most of other countries in the region.

Economic growth is likely to continue to soften in 2015 as the economy remains under pressure from the large external imbalance and high inflation. Weak FDI and the contractionary effect of currency depreciation and policy tightening will weigh on economic growth, particularly in the non-mining sector of the economy. Fixed investment will remain weak as the business sentiment remains fragile and high uncertainty continues amidst the prolonged conclusion of negotiations on the second phase investment of OT mine. Mining sector will maintained strong growth in 2014 but the growth effect from the new OT mine will gradually moderate in 2015 as the mine enters into the second year of full-year production. Extremely strong mining production growth of 26% in 9 months largely benefited from OT's new copper production as 2014 was the first year of full-year production of the mine. Growth rate effect from OT mine will likely be moderated in coming years due to the waning base effect despite the continuation of large production of the mine. Meanwhile, many other mining companies (especially in the coal industry) will likely continue to face significant challenges from deteriorating market conditions.

External and financial vulnerabilities are increasing

The external situation may become more vulnerable over time in the wake of the large external debt repayment schedule in 2017-18. US$580 million of the DBM Euro bond will mature in March 2017 and US$500 million of the Chinggis bond will mature in January 2018. Drawings of the bilateral currency swap facility with the PBoC will also have to be either renewed or repaid in 2017. In light of the declining international reserves and the prospect of current account deficit of around 10 percent of GDP in coming years, the external public debt repayment schedule may become a challenge to external situations over time. The repayment schedule may also become a burden to the budget if the debt obligation is to be repaid without refinancing. Over half of the proceeds of the Chinggis bond have been spent on budgetary programs that cannot generate sufficient revenue stream for future repayment.

Deteriorating quality of bank assets is undermining the strength of the banking system in the aftermath of the strong credit boom. Credit expansions in 2013 equivalent to over 20 percent of GDP and loosened prudential regulation increased the vulnerability of the banking system and have been translated into worsening asset quality of banks in 2014. The non-performing loans increased by 48 percent in the last twelve months and the past-due loans rose faster by 166 percent over the same period. While the non-performing ratio is still stable, past experiences suggest that rapid increases of past-due-loans tend to precede accelerating growth of non-performing loans. Continuous degradation of asset quality would make banks increasingly vulnerable to external and domestic shocks and undermine the confidence in the banking system. It would also increasingly constrain bank's liquidity situations and undermine their profitability and capital buffers, particularly in light of the high loan-to-deposit ratio exceeding 130 percent.

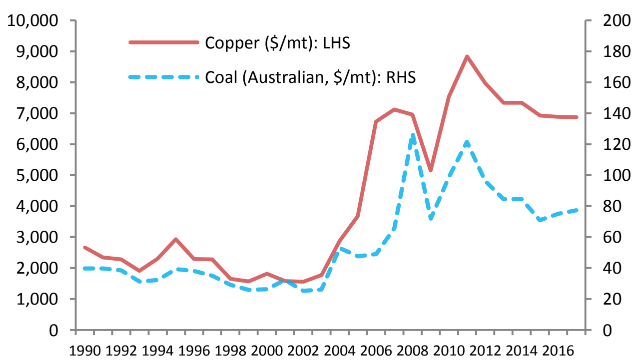
The unfavorable external environment poses further downside risks

While the recovery of the Mongolian economy largely relies on the commodity markets, the global commodity markets are expected to remain weak in the coming years. Concerns about the weak global economic prospects and the supply factors will likely continue to put downward pressure on global commodity markets. Slowing economic growth in China – a major importer of industrial commodities including copper and coal – is also slowing demand for commodity market. The recent announcement by Chinese authorities to ban imports of coals containing high levels of ash and sulfur from 2015 may also have adverse impacts on the Mongolia's coal exports. According to the commodity market forecast of the World Bank, prices of coal and copper – key export commodities of Mongolia – are projected to decline further in 2015 by 16 percent (Australian coal) and 5 percent (copper). The weak commodity market outlook suggests that Mongolia's mineral exports are likely to face more difficulties in 2015, due to weakening global demand and declines in commodity prices.

Possible disorderly adjustment of the Chinese economy may further dampen the economic prospects. Chinese economic growth is gradually slowing as the structural reforms of the economy continue. The World Bank revised China's economic growth projection downward from 7.6 percent to 7.4 percent for 2014 and from 7.5 percent to 7.2 percent for 2015 in the East Asia Pacific Update released in October, 2014. China's economic growth is expected to gradually decelerate next year, assuming a robust but moderating growth path. However, risks to orderly and gradual adjustment remain. The structural adjustments will likely be orderly and gradual but an abrupt unwinding of accumulated imbalances cannot be ruled out. The main risk is a possible disorderly deleveraging of local governments, which could trigger a sharp slowdown in investment growth. In the case of further dampening of Chinese economic growth, Mongolia's main export commodities would likely be hit hard and further weaken the growth momentum and the external liquidity situation.

Figure 55. The commodity markets will likely remain weak in coming years.

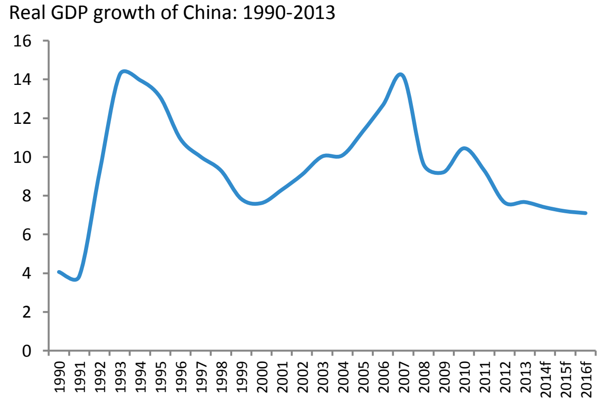
Copper and coal price forecast (US$/mt)



Source: World Bank Commodities Price Forecast (Nov, 2014)

Figure 56. China's economy is slowing in recent years.

Real GDP growth of China: 1990-2013



Source: World Bank EAP Regional Update (Oct. 2014)

Policy Discussions

Economic policies need to focus more on maintaining economic stability than stimulating growth

The current economic situation and key risk factors can be summarized as follows:

- **Economic growth is softening.** The economy is slowing as aggregate demand adjusts to significant balance of payments pressure through exchange rate depreciation and import compression. As a result, the current account deficit is narrowing.

- **Balance of payments pressures will remain high nevertheless.** Despite the narrowing current account deficit, the economy still faces a large external financing gap due to declining FDI. International reserves fell below three months' import cover.

- **External vulnerability is increasing.** Under the current trend, the external vulnerability of the economy may become more vulnerable over time due to the large external public debt repayments scheduled in 2017-18.

- **Banks become more vulnerable.** The strength of the banking system is increasingly undermined as the bad loans increase rapidly in the aftermath of strong policy-induced credit boom and loosened prudential regulations.

- **The external environment poses further downside risks.** Further dampening of global commodity markets and slowing in China's economy may weigh on the economy in the future.

- **Insufficient policy buffers.** The fiscal deficit remains high at over 7 percent of GDP. Inflation remains in double digits. Public debt level and outstanding domestic credit have more than doubled over the last two years as policies have been stimulating economic growth using off-budget expenditures and monetary easing programs.

Under the current situation, further economic stimulus measures are not likely to be very effective and may worsen the underlying risks of the economy. Expanding public expenditure and liquidity injection further may exacerbate the balance of payments pressure and high inflation, escalating external vulnerabilities. Substantial policy stimulus measures have been already implemented in the previous years and led to the overheating of the economy. The current economic situation reflects the adverse consequences of the overheated economy.

The priority now is to address growing external vulnerabilities

Economic policy needs to focus on addressing the persistent balance of payments pressure with tighter macro-economic policies. The recent cooling of the economy helped narrow the current account deficit and ease the balance of payments pressure in 2014. However, the balance of payments pressure still poses a downside risk to the economy as the foreign investment continues to decline and the current account deficit will still remain substantial. The pressure of the balance of payments may be mitigated if:

(i) the current account deficit narrows further through tighter economic policies; (ii) FDI substantially recovers in the coming years providing buffers to the external liquidity situation. Tighter economic policy will also help strengthen the capacity of fiscal and monetary policy to cope with headwinds in the future.

Strong resolve of the new Government to address economic challenges is encouraging

The Government led the by the new Prime Minister with a grand collation of parties has been showing its resolve to address economic difficulties. We particularly note the speech of the new Prime Minister which acknowledged the underlying causes of the current economic difficulties and set out economic policy priorities of the new "Solution-oriented Government" to address structural problems including:

- Build stronger economic and fiscal management system in order to prepare for unpredictable but possible economic downturn;
- Create a strong debt management system including a comprehensive plan on sovereign debt service.
- Build a rational fiscal policy mechanism and debt management system that will consider external and internal macroeconomic factors;
- Move large mining projects forward and improve the management of minerals exploration sector;
- Further tightening of the budget for 2015 under more realistic revenue projections;
- Prepare for the repayment of government bonds, social insurance and pensions in the future.

Economic Policy Framework

To help achieve the goal set by the new Government to overcome economic challenges and build a sound economic management system, the following policy actions are recommended to be considered in the economic policy framework:

1. ***Macroeconomic policy needs to be tightened.*** Continued tightening of monetary policy and fiscal spending will help ease the balance of payments pressure and contain inflation. Tightening of policies will likely be needed until: (i) the balance of payments situation becomes sustainable; (ii) inflation stabilizes towards the single-digit inflation target of the central bank; and (iii) fiscal indicators are restored to the target of the Fiscal Stability Law.

    - **Consolidate the off-budget spending made through the DBM into the budget.** The DBM expenditures have been the main channel of excessive public spending since 2012. The DBM needs to be brought under the control of the Fiscal Stability Law and the government budget.

    - **Prepare a credible and realistic fiscal consolidation plan to reduce the deficit.** Given the high fiscal deficit of over 7 percent of GDP, a medium-term fiscal consolidation plan to reduce the fiscal deficit toward the two percent FSL target by a specified year (e.g., 2016 or 2017) seems more realistic. A temporary exception to the FSL may be considered to allow budget deficit to go above the current FSL target only for a limited period (e.g., two or three years) specified in the fiscal consolidation plan.

- **Further tapering of monetary policy is needed.** The Price Stabilization Program should be phased out and further direct liquidity injection from the central bank should be avoided. Policy loans that were extended under the program need to be withdrawn as they mature. The housing mortgage lending program may be better targeted toward its objective of affordable housing. If affordable housing remains one of top policy priorities, strengthening the eligibility criteria and prudential regulation on the program would help the program serve the objective while reducing its adverse macro-economic impacts.

- **Monetary policy needs to avoid further quasi-fiscal activities.** The Price Stabilization Program and the housing mortgage program are budgetary operations in nature. The BoM has been actively financing the policy programs by directly injecting liquidity to targeted industries as the budget revenue remained weak. The central bank financing to quasi-fiscal activities weakens the effectiveness of the macro-fiscal policy and the FSL. Large scale quasi-fiscal activities will likely also create additional economic burdens by creating inflation tax.

- **The exchange rate should remain flexible.** The current floating exchange rate system is a key mechanism to adjust to the large balance of payments pressure. Excessive interventions of the central bank will likely exhaust international reserves further.

2. **Further actions are needed for heightened supervision and monitoring of the banking system.** The rapid expansion of bank assets in 2013-14 indicates a high likelihood of excessive risk taking and increasing moral hazard in the banking system. Stronger supervision and monitoring of asset quality and liquidity buffers are critical in the wake of increasing in problematic loans. Proper supervision is also needed on concentration risks and lending exposures to related parties, particularly in light of the failure of the Savings Bank in late 2013.

   - **The banking system should be encouraged to set aside sufficient loan-loss provisions.** Building sufficient liquidity buffers is important to maintaining the resilience of the banking system, particularly given that the current provisioning system does not adopt forward looking criteria. The authorities may also want to consider applying the new general provisioning ratio (1 percent) to all existing loans.

   - **The regulatory forbearance on policy loans should be lifted.** The central bank has allowed zero risk weights to policy loans (especially the loans under the Price Stabilization Program) in calculating capital adequacy ratio. Policy loans were also excluded from the lending exposure limits to related parties. Such measures likely have created significant moral hazard and may have led banks to take excessive risks.

3. **Reviving foreign investment is critical to mitigate the external vulnerabilities.** While external debt financing may also help ease the balance of payment situation in the short term, it is only a temporary solution as the new debt liabilities will eventually return as a fiscal and external debt burden for the future generation. Substantial recovery of FDI will provide a relief to the balance of payments situation without creating such future burdens to the economy and also contribute to reviving declining domestic investment. Early start of major projects with significant economic implication will provide positive momentum. The underground investment of OT mine is planned to brining over US$4 billion into the economy, which will provide some relief to the balance of payments situation over time. It may also trigger new FDI inflows from other investors and build more favorable conditions to possible rollover of external debt due in 2017-18.

Key Economic Indicators Tables

	2011	2012	2013	2014f	2015f	2016f	2017f
Real Sector							
Real GDP (% change y-y) 1/	17.5	12.4	11.7	6.3	6.0	6.1	6.3
Mineral GDP (%, yoy)	7.7	8.3	19.4	17.1	11.3	4.8	2.9
Consumer price index (% change y-y)	9.4	14.2	12.3	11.5	10.3	8.7	9.5
Public Sector							
Government revenues (% GDP)	33.9	29.8	31.3	27.3	25.9	25.3	24.7
Government expenditures (% GDP) 2/	37.9	39.8	40.2	34.5	31.4	28.9	27.5
Government balance (% GDP) 2/	-4.0	-10.0	-8.9	-7.2	-5.5	-3.6	-2.7
Nominal public sector debt (% GDP)	32.7	51.3	58.1	63.7			
Balance of Payments							
Trade balance (millions US$)	-993	-1,553	-1,310	871	1,271	1,183	634
Exports of goods (millions US$)	4,818	4,385	4,273	5,561	6,196	6,491	6,690
(% change y-y)	66.2	-9.0	-2.6	30.2	11.4	4.8	3.1
Imports of goods (millions US$)	5,810	5,938	5,583	4,690	4,924	5,308	6,057
(% change y-y)	82.9	2.2	-6.0	-16.0	5.0	7.8	14.1
Current account balance (millions US$)	-2,759	-3,362	-3,156	-1,386	-1,189	-1,497	-2,239
(% GDP)	-26.5	-27.4	-25.1	-11.3	-9.0	-10.1	-13.5
Foreign direct investment (millions US$)	4,620	4,408	2,098	882			
Gross exchange reserves (millions US$)	2,630	4,126	2,242	1,250			
(month of imports of g&s)	3.9	6.4	3.5	2.1			
Financial Markets							
Private Credit Growth (% change y-y)	72.3	24.1	54.3	22.8			
Short-term interest rate (% p.a.) 3/	12.3	13.3	10.5	12.0			
Exchange rate (Tugrik/US$, eop)	1,395	1,392	1,674				
Real effective exchange rate (2000=100)	133.3	140.0	136.5				
(% change y-y)	8.4	5.1	-2.5				
Stock market index 4/	21,687	17,714	16,736				
Memo: Nominal GDP (billions US$) 5/	10.4	12.3	12.5	12.3	13.2	14.8	16.6

Sources: Bank of Mongolia; National Statistical Office; Ministry of Finance; World Bank staff estimates.
e = estimate.
f = forecast.

1/ Real GDP estimates are based on 2010 price.
2/Government expenditures and balance include the off-budget spending by the DBM.
3/ Base policy rate
4/ Top-20 index.
5/ Nominal GDP estimates are based on the new historical data released by the NSO in August 2014.

Appendix 1: A snapshot of the 2015 Budget

This appendix summarizes the key features of the 2015 budget was approved by the Parliament of Mongolia on November 15, 2014.

1. Macro-economic Assumptions of 2015 Budget

The 2015 budget projects the economy to expand by 7.1 percent in real terms with the nominal GDP reaching MNT 23.9 trillion. It is based on the expectation that the construction and development projects implemented by the government will continue in sustainable manner and financing. It has also been estimated that the resolution of OT deal will push for foreign investment and enhance the foreign currency inflows.

Table 2. Key macro assumptions used for 2015 budget

Macro indicators	2012	2013	2014	2015
	Act	Act	Amend	plan
GDP, at current prices /bln MNT/	16,688.40	19,118.00	21,661.20	23,988.50
GDP growth, %	12.3	11.6	6.9	7.1
Total import /bln US$/	6.7	6.3	6.0	6.8
Total export /bln US$/	4.4	4.3	5.4	5.8
o.w:				
Coal /mln tn/	21	18.4	17.4	19.8
Copper concentrate /thous.tn/	574.6	649.8	1,238.3	1,409.2
CPI, %	14	12.5	11.5	7.0

Source: MOF 2015 budget document

2. Overview of 2015 Budget

Under the above mentioned macro-economic assumptions, the 2015 budget provides the following revenue projections and corresponding expenditure plans, as summarized in the below table.

- Total revenue is projected to increase by 3.8 percent against the amended 2014 budget, reaching MNT 7194.4 billion which equals to 30 percent of estimated GDP in 2015. Total mineral revenue including CIT, royalties and dividends is expected to account for about 15.7 percent (MNT 1.1 trillion) of total revenue.
- Total expenditure and net lending is planned to rise by 3.9 percent compared to the amended 2014 budget, reaching MNT 7,599.2 billion or 31.7 percent of GDP in 2015, largely due to the increase in current expenditure by 12.9 percent. Wage bill is estimated to be up by 22 percent in 2015 than in amended 2014 budget.
- The structural balance is projected to reach 1.8 percent of GDP, meeting the ceiling (two percent of GDP) set by the Fiscal Stability Law. However, it remains highly uncertain whether the projected fiscal deficit can be actually met, given the deteriorating revenue outlook and ambitious expenditure plans. MNT 34.4 billion (equivalent to 0.1 percent of GDP) is planned to be deposited in the Stabilization Fund.

Table 3. Summary of the 2015 Budget

	2014 amended		2015 approved		
	Billion MNT	% of GDP	Billion MNT	% of GDP	2014/2015, % change
A. TOTAL REVENUE & GRANTS	6,933.6	32.0	7,194.4	30.0	3.8
B. TOTAL STRUCTURAL REVENUE & GRANTS	6,903.8	31.9	7,160.0	29.8	3.7
Tax revenue	6,227.2	28.7	5,900.5	24.6	-5.2
Non tax revenue	676.2	3.1	1,195.6	5.0	76.8
C. TOTAL EXPENDITURE & NET LENDING	7,312.4	33.8	7,599.2	31.7	3.9
CURRENT EXPENDITURE	5,344.8	24.7	6,033.2	25.2	12.9
Wages and salaries	1,608.5	7.4	1,962.9	8.2	22.0
Subsidies and transfers	2,197.4	10.1	2,292.7	9.6	4.3
Capital expenditure	1,999.0	9.2	1,565.1	6.5	-21.7
Domestic investment	1,771.4	8.2	813.9	3.4	-54.1
D. STRUCTURAL BALANCE: B-C	-408.5	-1.9	-439.2	-1.8	
E. OVERALL BALANCE: A-C	-378.8	-1.7	-404.8	-1.7	
F. STABILITY FUND: E-D	29.8	0.2	34.4	0.1	

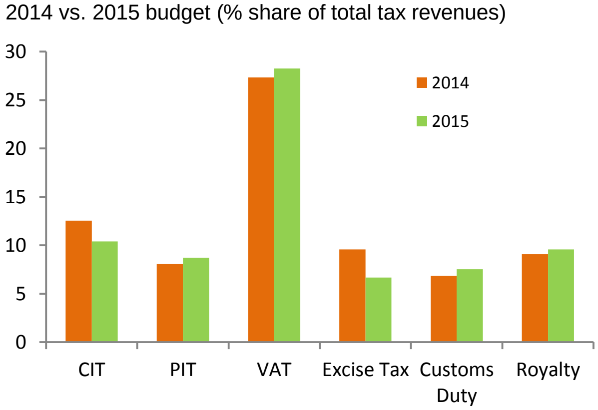
Source: MOF 2014 Budget, WB staff calculation

3. Key Features of the Revenue Projections

Total revenue is projected to reach MNT 7194.4 billion (30 percent of nominal GDP), up by about 47 percent from the 2014 revenue outturn and by 3.8 percent from the amended 2014 budget. Tax revenue constitutes 82.4 percent of total structural revenue in 2015 with VAT, CIT, royalty and other taxes and fees as major revenue sources for the government. Mineral revenue (MNT 1.1 trillion) is projected to decrease by 21 percent compared to 2014 original plan of MNT 1.4 trillion due to the freezing coal export and uncertainty around the OT mine investment financing issues, but is up by 32 percent compared to the expected outturn of mineral revenue in 2014. Non-mineral revenues - accounting for 84.3 percent of total revenue - are projected to remain stable in line with the pace of expected economic expansion.

Figure 57. Major components of tax revenue

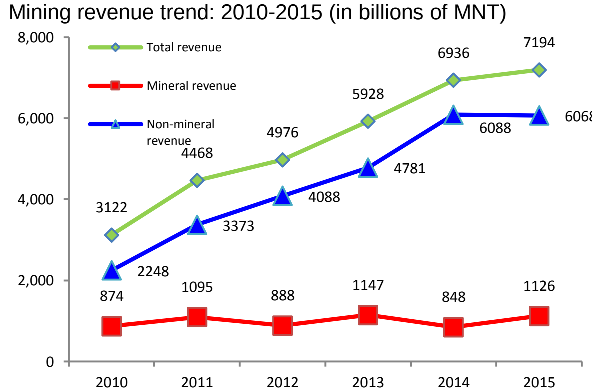
2014 vs. 2015 budget (% share of total tax revenues)



Source: MOF 2015 budget document

Figure 58. Mining revenue projection of the budget

Mining revenue trend: 2010-2015 (in billions of MNT)



Copper exporting companies OT and Erdenet and coal produces Erdenes TT are considered as the major mineral revenue generators. It has been estimated that the OT company to export 819.1 thousand tones of copper concentrate and pay 324.3 billion tugrug of taxes, while Erdenet plant to export 590.1 thousand tones of copper concentrates and pay 447.5 billion tugrug of taxes and Erdenes TT to export 6 million tones of coal and pay 60.8 billion tugrug of taxes respectively in 2015.

Table 4. Composition of Mineral Tax Revenues: 2015 Budget

#	Commodities	Volume	2015 plan by types of taxes /billion tugrug/					
			CIT	Royalty	Dividend	Other taxes[1]	Customs duty	Total
1	Gold /tn/ */domestic gold sell without OT=10.0 tn/*	31.3	21.4	87.8	-	12.5	-	121.7
2	Coal /mln tn/	25.8	34.0	103.5	7.0	43.0	29.7	217.2
3	Copper concentrate /thous.tn/	1409.2[2]	56.8	385.7	70.0	105.4	2.1	620.0
4	Zinc /thous.tn/	90.0	14.0	8.8	-	2.3	0.1	25.3
5	Iron ore /mln.tn/	5.0	7.2	*76.2*	-	5.6	6.5	97.3
6	Fluor spar /thous.tn/	356.8	0.4	16.6	-	2.1	0.5	20.1
7	Others		2.2	7.7	-	14.0	0.5	24.4
	TOTAL MINERAL REVENUE		136.1	686.2	77.0	186.2	40.5	1126.0

Note: Source: Ministry of Finance

Mineral revenue projections largely depend on the underlying assumption concerning major commodity prices and volumes. The FSL requires the Government to define major commodities that generate three or more percent of fiscal revenues and formulate their structural prices according to the special rule under the FSL[3]. The below table illustrates the assumption on structural prices of major commodities of the 2015 budget according to this rule. The structural price of coal which was based on forecasts of IMF and other financial institutions that announce commodity price statistics, has been higher than coal market price in 2015, therefore, it is unlikely to have coal generated revenues into the Stabilization Fund in 2015.

Table 5. Major Commodity Price and Volume Projections of the 2015 Budget

	Volume	Structural Price	Market Price
Copper	1409.2 thousand tons	USD 6354.7 /ton	USD 6,970.7 /ton
Coal	25.8[4] million tons	USD 82.5 /ton	
- Washed/processed coal			USD 70 /ton
- Coking coal (above 5500 kkal)			USD 50 /ton
- Thermal (raw) coal			USD 20 /ton

Source: Ministry of Finance, 2015 Budget

The 2015 budget continued recording the privatization receipts as an above-the-line item under non-tax revenue category, which has been a new practice since 2013. Prior to 2013, the privatization receipts had

[1] The government includes the VAT under the other taxes

[2] OT will produce 819.1 thous.tn and Erdenet plant produce 590.1 thous.tn of copper.

[3] According to the FSL, the structural prices of major commodities are calculated as the average of: (i) the historical average commodity prices of the past 12 years and (ii) the average of the price projections for four years including the current year.

[4] Out of which 20 million tons of coal is estimated to be exported.

been recorded as a financing component at the below the line, following the guidelines of the 2011 Government Financial Statistics Manual (IMF) which categorizes privatization receipts as a financing item. While the absolute amount of the privatization receipts is not relatively large, it must be noted that recoding the privatization receipt as non-tax revenue instead of financing would reduce the fiscal deficit by the corresponding amount. In terms of last couple of years, privatization operations haven't taken place and therefore, there has been a little or almost no privatization income generated into the budget. In addition, there has been more appetite on the side of government to establish more state-owned enterprises in the last several years. However, the latest audit opinion concludes that around 40 percent of state and locally owned companies has been operating inefficiently from the fiscal point of view which in turn pushes fiscal subsidies to them up, requires more maintenance and investment costs from the budget and potentially leads to the risk of creating state owned properties that are unable to be utilized when time runs. Therefore, the 2015 budget estimated to earn MNT 163.5 billion out of intensive privatization program in order to enhance industrial efficiency, profitability and competitiveness through promoting the private sector role in the economy. More specifically, the government is planning to earn MNT 115 billion out of privatizing 49 percent of MIAT LLC, MNT 30 billion by privatizing the Hutul Cement Factory (100%) and MNT 8 billion by privatizing 49 percent of Mongolian Stock Exchange.

4. Key Features of Expenditure Plans

Total expenditure and net lending is projected to reach MNT 7599.2 billion (31.7 percent of nominal GDP), up by about 48 percent from the 2014 expenditure outturn and up by 3.9 percent from the amended 2014 budget.

Figure 59. Percentage share of major expenditure components in 2015 budget

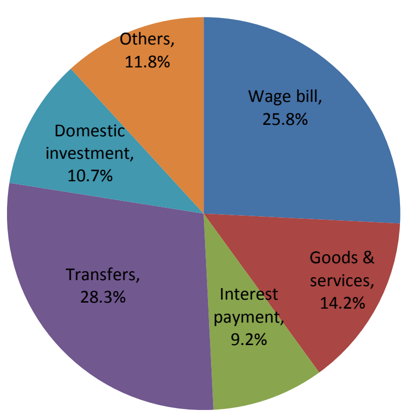
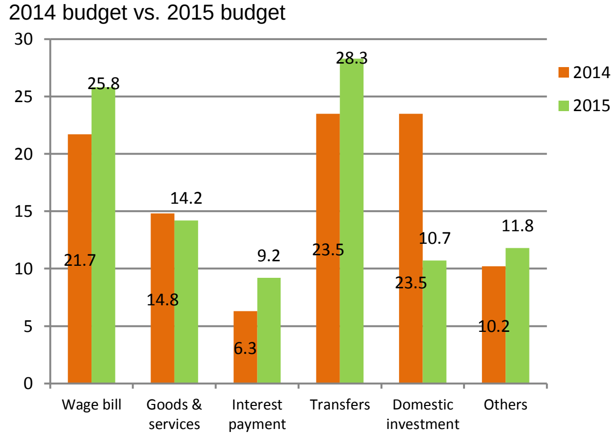


Figure 60. Capital expenditure is planned to be reduced compared with 2014 budget.

Changes in major spending components (% of total spending): 2014 budget vs. 2015 budget



Source: MOF 2015 budget document

Current expenditure is projected to expand by 12.9 percent in 2015 compared to amended 2014 budget mainly due to wage bill which is up by 22 percent (around MNT 500 billion) in order to accommodate government's decision to rise up the civil service wage, pension and benefits in phased way consistently with inflation, performance productivity and sector specifics. As a result, the wage bill has been estimated to be the second largest expenditure item under the 2015 budget plan. Maintenance and personnel cost for newly built and completed investment projects (kindergarten, dormitory, school and hospitals etc.) in the social sectors have been reflected under the 2015 budget, thus pushed up the current expenditures by another MNT 30 billion.

Capital expenditure has been down by 21.7% in 2015 compared to 2014 amended budget. With respect to the scheduled, large scale of bond repayments in the fiscal year of 2017, the government has been trying to pursue a policy to complete previously started unfinished investment projects rather than weighing on the new investments. Due to this factor, domestic investment has been estimated to drop by 54 percent in 2015 than the amended 2014 budget. Consequently, domestic investment share to GDP has been falling down from 8.2 percent in 2014 to 3.4 percent as in the 2015 plan while it is taking 10.7 percent of total expenditure in 2015.

Debt service payment has been speeding up in the last two years. For instance, MNT 37 billion had been spent for interest payment in 2011 and it has been picking up to MNT 126 billion in 2012, MNT 270 billion in 2013 and estimated MNT 697 billion for the year of 2015. The share of interest payment has been going up from 0.3 percent of GDP in 2011 jumping up to 2.9 percent of GDP in 2015 while taking 9.2 percent of total expenditure. In 2015, the government is planning to issue MNT 1.8 trillion of government treasury bills.

The government had issued US$1.5 billion of Chinggis bond in 2012 on international market for the purpose of infrastructure development and financing economically important, priority construction projects and has estimated to pay MNT 113.6 billion as an interest payment in 2015. In addition, the DBM has financed around MNT 909 billion of public/social projects using the US$580 million and equity of the DBM itself which is added to the government bill as well. Moreover, the government had issued guarantees to the following foreign loans and TBs. The following two tables show government debt guarantees provided to the DBM and other SOEs and the public debt projection of the MoF.

Table 6. Government debt guarantee

№	Guarantee receiver	Year	Size	Disbursement /Oct 30, 2014/
1	DBM /euro bond/	2012	US$580.0 million	US$580.0 million
2	MIAT SOE /EXZIM Bank's loan/	2013	US$121.4 million	US$121.4 million
3	DBM /Samurai bond/	2014	30.0 billion yen	30.0 billion yen
4	DBM /Credit Suisse's loan/	2014	US$300.0 million	US$180.0 million
5	DBM /Republic of China/	2014	US$162.0 million	US$112.0 million

Source: Ministry of Finance, 2015 Budget

Table 7. Public Debt, /in billion tugrug/

	INDICATORS	2014-09-30 Execution	2015	2016	2017
1	**Balance of external debt of the Government**	**3,911.5**	**4,089.2**	**4,299.1**	**4,169.3**
	1.1 Disbursement of foreign debt	120.2	324.4	349.7	23.1
	1.2 Debt service of foreign debt	182.7	192.6	178.7	193.1
	1.2.1 Principal amount of foreign debt	153.7	146.7	139.7	152.8
	1.2.2 Interest payment of foreign debt	28.9	45.9	39.0	40.2
2	**Balance of domestic debt of government securities**	**2,110.8**	**1,307.7**	**424.5**	**258.0**
	2.1 New securities to be issued	1,334.1	-	-	-
	2.2 Payment for domestic debt security's service	1,152.8	1,490.8	1,012.0	211.4
	2.2.1 Principal amount of domestic security	1,043.7	1,224.2	883.3	166.5
	2.2.2 Interest payment of domestic security	109.1	266.6	128.8	44.9
3	**Balance of foreign debt of government securities**	**2,760.8**	**2,625.0**	**2,550.0**	**2,490.0**
	3.1 New securities to be issued in the international market	0.0	0.0	0.0	0.0
	3.2 Payment for foreign debt security service	85.1	125.8	122.2	110.7
	3.2.1 Principal amount of foreign security	0.0	0.0	0.0	0.0
	3.2.2 Interest payment of foreign securities	85.1	125.8	122.2	110.7
4	**Government guarantee**	**2,305.5**	**2,515.8**	**2,439.2**	**1,312.5**
	4.1 New guarantee of the government to be issued	1,041.1	0.0	0.0	0.0
	4.2 Debt service of government guarantee	100.1	125.3	131.4	1,037.5
	4.2.1 Principal amount of debt with government guarantee	21.3	20.3	19.7	962.8
	4.2.2 Interest payment of debt with government guarantee	78.8	105.1	111.8	74.7
5	**Remaining debt of state owned and partly state owned companies**	**1,589.1**	**1,021.1**	**955.3**	**955.3**
6	**Remaining debt of local government owned and partly owned companies**	**174.9**	**174.9**	**174.9**	**174.9**
7	**Tax advance payments**	**385.6**	**56.1**	**0.0**	**0.0**
	Public debt (1+2+3+4+5+6+7)	**13,238.1**	**11,789.9**	**10,843.0**	**9,360.1**
	NPV of public debt	**10,682.9**	**9,534.7**	**8,891.7**	**7,743.5**
Economic indicators					
	Gross domestic products-GDP (in current price)	**21,661.2**	**23,988.5**	**27,495.3**	**31,534.4**
	Exchange rate (equivalent of 1 USD to Tugrug)used in the estimation	1840.54	1750.0	1700.0	1660.0
Fiscal stability limits		40.0%	40.0%	40.0%	40.0%
Public debt (present value) / GDP		**49.3%**	**39.7%**	**32.3%**	**24.6%**

Source: MOF 2015 Budget document

A Selective Topic: Mongolia's Pension System[5]

I. Background and introduction

Mongolia has considered a number of pension and social security reform measures over the past decade and enacted some small parametric changes. Pension and social security reform has taken on an increased urgency in recent months as amendments enacted in 1999 to the contributory scheme will reduce benefits for retirees born beginning in 1960. Over the past two years, the Mongolian authorities have therefore undertaken a process of evaluating the costs and benefits of several reform measures and are expected to debate an overall framework document in Parliament in the coming months.

The World Bank has supported this process through technical assistance and policy advice over the past six years. This has included using the Pension Reform Options Simulation Toolkit (PROST) to simulate the long-term financial effects of the current schemes and reforms to parameters and qualifying conditions. The World Bank earlier provided technical assistance by training Mongolian officials to use the model and by undertaking its own evaluation in 2012[6].

The Ministry of Population Development and Social Protection (MPDSP), along with other ministries and stakeholders represented in an inter-ministerial working group have embarked upon a process of reviewing and potentially reforming pensions and social security. An overview of anticipated legal reforms has been drafted by the MPDSP and is expected to be discussed by the Cabinet and by the Parliament in the coming months. The objectives of the proposed reforms are to strengthen the long-term sustainability of pension and social security provisions, improve the adequacy of benefits, and extend coverage to workers not contributing to existing schemes. The scope of the Government's review extends to multiple pension and social security instruments including the contributory pension insurance scheme which provides benefits in old-age and in cases of disability and survivorship; the non-contributory Social Welfare Pension which provides benefits to those who do not qualify for contributory pensions; some occupational schemes which have been established by private companies for their employees to supplement the benefits provided by other schemes; and potential instruments to extend labor force coverage to herders, informal sector workers, self-employed and unemployed who may not be covered under existing arrangements.

Mongolia shares a number of pension reform challenges with other former Socialist countries with similar historical circumstances. Mongolia had a universal non-contributory pension scheme for all workers prior to the early 1990s. A contributory defined-benefit pension scheme was established by 1994 Law on pensions and benefits paid from social insurance funds which directly linked years of covered service and wages to benefits. With liberalization of the economy in the 1990s, pension and social insurance labor force coverage rates fell considerably. Elderly coverage remained at close to 100% as the legacy of retirees with fully vested pension rights continued. Faced with growing expenditures due to population aging and a declining covered population, in 1999, the authorities sought to revise pension policies to reduce ballooning fiscal costs. This reform proved insufficient and had a

[5] This selective topic was prepared by Mark Dorfman, Senior Economist, the World Bank.

[6] See World Bank, *Mongolia: Policy Options for Pension Reform*, January 20, 2012.

number of technical weaknesses. During the 2008 international financial crisis, the authorities reduced the pension contribution rate which materially increased the state subsidy requirement.

II. Current schemes

The Social Welfare Pension is a non-contributory pension paid from the Social Welfare Fund that provides benefits to those men aged 60 and above and women aged 55 and above who do not qualify for contributory pension benefits. The benefit size is periodically revised by Cabinet and is generally established in reference to the Minimum Living Standard (MLS).

The Pension Insurance Scheme (PIF) is a contributory scheme which is mandatory for workers with employment contracts. The contribution rates are 7% of wages for employers and 7% for employees. Those workers who complete 20 years of participation under the scheme are entitled to a benefit which is calculated as follows: 45% for the first 20 years of eligible service and 1.5%/year for each year of eligible service after that. The wage base for determining the benefit is the best 5 years' consecutive wages out of the 20 years wages reported. Men are eligible to receive benefits at age 60 and women at age 55 while workers in hazardous professions, high heat and women with at least 4 children can retire earlier.

> As an example, suppose a man aged 60 retires after 25 years of service and a reference wage for determining benefits of MNT 300,000 per a month. Twenty-five years of service would result in a "replacement rate" of 52.5%.
>
> 45% + (5 [years] * 1.5%)=52.5%
>
> His pension would be calculated as 52.5% of the reference wage of MNT 300,000 that equals to MNT 157,500.

A worker is entitled to a minimum pension which 75% of the minimum wage after 20 years or a lower (proportional) level of such pension after 10 years of service. Indexation increases are determined by Cabinet on an ad-hoc basis, although the law states that pensions should be increased in "relation to changes in the cost of living".

Table 8: Social insurance contribution rates (in percent of covered wages)

Types of insurance	Contribution (%) to be paid by Employer	Contribution (%) to be paid by Employee
Pension insurance	7.0	7.0
Benefits insurance	0.8	0.8
Health Insurance	2.0	2.0
Unemployment Insurance	0.2	0.2
Total contribution	10.0	10.0

Source: Social Insurance Law, provision 15.1

The PIF also provides benefits for permanent disability and survivorship as detailed in the Appendix below[7]. Survivorship benefits, for example are provided as the same benefit a worker would have received as in old age retirement, albeit survivors receive a certain percentages depending upon the

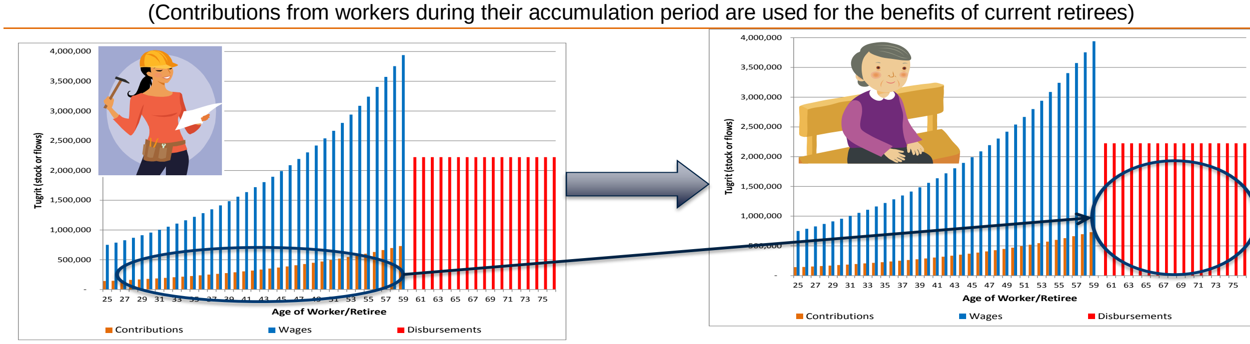
[7] Survivorship benefits in the law are defined as "benefits for loss of a bread winner".

number of survivors: for three or more -100%, two - 75% and one - 50%. In addition, retired spouses can elect to receive the better of the benefit which they are entitled based on their own work history and the survivors' benefit of their spouse.

The PIF is financed on a pay-as-you-go basis. What this means essentially is that employers and employees make contributions which are then used to pay current retirees. Put in individual terms, the contributions of a young worker today are used to pay the pension benefits of a retiree (see Figure 61). The scheme has had insufficient contributions to cover benefit payments in every year since the governing legislation was put in place in 1994. These annual deficits had to be compensated by State subsidies, a matter made worse in 2008 with the reduction in total contribution rates enacted from 19% of wages to 14%. As a result, the State has provided a subsidy amounting to about a third of the amount of annual disbursements.

Figure 61. An Illustration of Pay-as-you-go financing

(Contributions from workers during their accumulation period are used for the benefits of current retirees)



Amendments to the pension's policy enacted in 1999 changed the benefits for workers born in or after 1960 although these provisions have so far not been applied[8]. The Notional Defined Contribution (NDC) scheme enacted establishes a system of accounting entries or "notional" individual accounts for those born beginning in 1960. Contributions are recorded each month which pertain to each individual's account and a "notional interest rate" is applied to the average notional account balance each year[9]. Work histories and contributions made prior to 1999 have been used as a basis to determine an initial notional balance for all affected workers. The benefit at retirement is determined by taking the notional account balance and calculating an annuity for retiree based on the life expectancy at retirement age at the date that benefits are calculated.

Error! Reference source not found. below provides an example which illustrates how an NDC scheme ould operate. In this example, a worker earns MNT 300,000 at the beginning of the series. He works and contributes for a 25 year period from age 25 through age 59 and contributes 14% of wages. He retires at age 60 and lives for 15 years. The assumed wage growth is 5% per year and the notional interest rate is also 5% per year.

[8] See "Law on individual accounts for social insurance contributions", 1999.

[9] The notional interest rate is defined as the average rate of growth of total covered wages over the previous three years.

Figure 62. An Illustration of Notional Account Contributions, Accumulations and Benefits

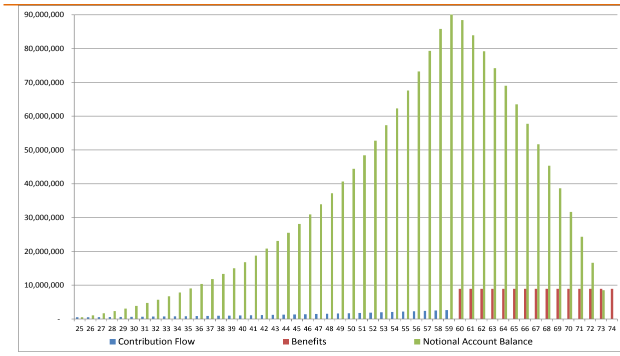
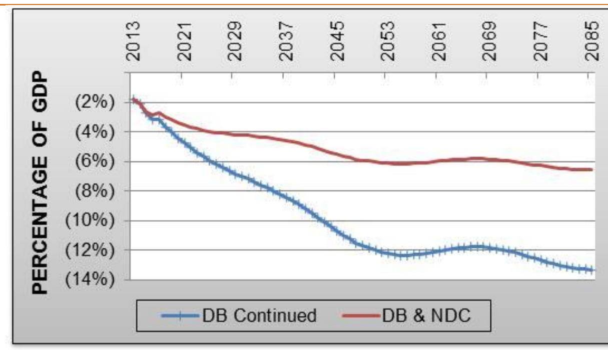


Figure 63. Projected Pension Insurance Scheme Net Financing Gap



Source: PROST Projections, 2013.

The NDC scheme (for post 1960 cohorts) is financed on a pay-as-you-go basis just as the defined-benefit scheme (for pre 1960 cohorts) is funded[10]. The interest rate applied to the notional accounts (the "notional interest rate") as prescribed in the law is not affected by reserve accumulations. In this way, any returns on reserves have no effect on individual notional account balances and on benefit calculations. As illustrated above, with pay-as-you-go the contributions of current and future workers are used to finance the NDC benefits.

Several <u>occupational pension savings schemes</u> are provided by employers in Mongolia. Such schemes aim to supplement pensions provided by the Pension Insurance Fund, provide benefits based on separate qualifying conditions, and provide a supplementary severance benefit. A key aim is therefore to provide an incentive to retain employees. These schemes are entirely unregulated and therefore present substantial risks both to sponsors and employees. Moreover, in the absence of a framework for regulation and supervision, understandably contributions to the scheme have not been subject to tax deductibility. With such unregulated risks, occupational pension savings schemes have not been able to perform the valuable function they could fill in a multi-pillar pension system.

III. Challenges motivating pension system reform

A number of key challenges are motivating reform:

- ***Substantial reduction in benefits for those born on and after 1 Jan 1960.*** If the 1999 law were to be applied as specified by law, a substantial number of women will start retiring under this scheme beginning in 2015 and men in 2020. The differences between the benefit formulas applied to pre- and post-1960 cohorts would result in a substantial reduction in the replacement rate creating inequity in benefits between cohorts. In addition, the benefit formula in the 1999 law has a number of technical weaknesses, including those concerning disability and survivorship benefits.
- ***Unsustainable fiscal costs***. Fiscal transfers from the State Budget for the Pension Insurance Fund have been running about 2% of GDP yet are projected to substantially increase to almost 13% of

[10] An appendix to the 1999 law created some confusion. Although the text of the law was explicit that the scheme would be financed on a pay-as-you-go basis, the amendment specified a target funding schedule during which time it was hoped that contribution inflows would exceed outflows resulting in some level of pre-funding.

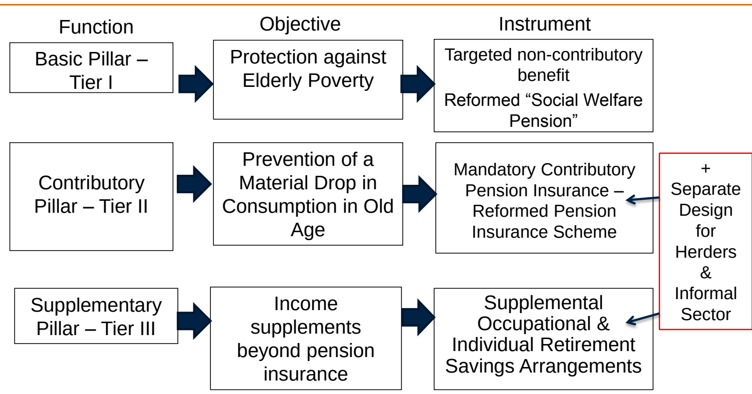
GDP over about 70 years unless substantial reforms are adopted (**Error! Reference source not ound.**)[11]. Even if the NDC scheme were to be implemented starting from 2015 as planned, the projected deficit would still rise to over 6% of GDP in the long-run[12]. The causes of these unsustainable costs include an aging of the population, relatively low retirement ages, particularly for women, and a very low contribution rate when compared to the benefit size guaranteed by law.

- ***Poor coverage***. Only about half of the economically active population contributes to the PIF. Moreover many workers have intermittent coverage histories so end up just barely meeting the 20 year vesting requirement. Of the uncovered or intermittently covered population, most are herders, informal sector workers or the self-employed.
- ***A very limited framework for prudent investment management of any reserves set aside for future benefits.*** Prudent investment management is important not only to maximize the returns on reserves invested to prepare for future obligations; it can also have significant macroeconomic implications as well. Separating the returns on pension reserves from the formula for public pension benefits, might shield workers and retirees from the investment risks to protect pension promises.

IV. Reform options

The authorities have indicated their desire to move to a multi-pillar social insurance system in The Government's Action Plan (2012-2016) (Figure 64). The draft White Paper prepared by the MPDSP shares the same approach. The multi-pillar approach provides instruments which have different characteristics so that together the instruments provide a web to ensure both the smoothing of consumption and protection against poverty in old age.

Figure 64. Illustration of a Multi-pillar design



<u>Social Welfare Pension (SWP).</u> Over the coming years, the SWP will play an increasingly important role in protecting the elderly against poverty and vulnerability yet will also pose an increasing fiscal challenge and could impact work incentives as a result of a reduction in eligible retirees under the PIF. This is anticipated as the reduction in labor force coverage by the PIF in the 1990s gradually results in a similar reduction in the covered elderly population years later. In addition, the proportion of the population that is elderly is projected to substantially increase in the decades ahead. As

[11] This assumes that all cohorts born in 1960 or afterwards receive the benefits of the pre-1999 (DB) scheme. If these cohorts were to receive benefits (NDC) as prescribed in the 1999 Law, the total long-term financing gap would still increase to over 6% of GDP (**Error! Reference source not found.**).

[12] These projections already reflect substantial projected growth rates in GDP and wages in the economy from minerals.

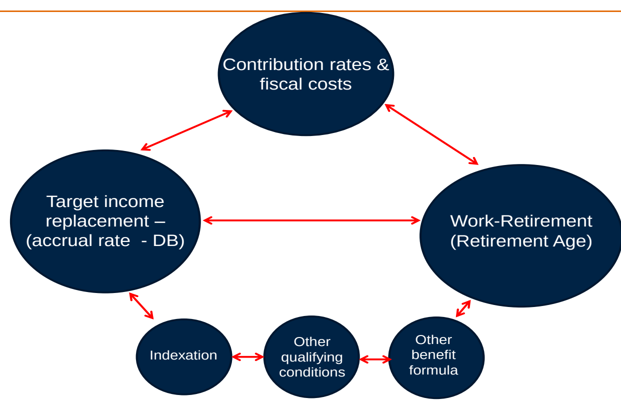
a result of these factors, the design and implementation of the SWP will come to play an increasingly important role in protecting the elderly.

Key parameters of the SWP which the authorities may review are the qualifying conditions (such as the age and/or means testing), the benefit level (and its relationship to per capita income) and the indexation provided (such as price indexation). Another consideration is whether to replace the minimum benefit of the PIF with the SWP. As currently designed, the SWP faces some key weaknesses: (i) the benefit level is adjusted in accordance with the Minimum Living Standard (MLS) yet evidence suggests that the framework used for determining the consumption basket for the MLS needs to be reviewed and revised; (ii) the indexation process for the SWP is unnecessarily subjected to a political process that could be mitigated or eliminated by linking the indexation to a readily acceptable index such as the Consumer Price Index; (iii) although beneficiaries of the old-age benefit under the PIF cannot receive a benefit under the SWF, there are better ways of linking the level of the SWF benefit to the amount received under the PIF. For example, if the PIF were to remove its minimum benefit provision, the SWF could "top-up" the PIF benefit. An more nuanced way of providing strong incentives for workers to contribute to the PIF would be to partially reduce the SWF benefit based on the PIF benefit but not eliminate eligibility for the SWF for those PIF beneficiaries with low benefits; and (iv) the fiscal cost can substantially increase in the years ahead as the elderly population increases and the proportion of elderly receiving a PIF pension gradually decreases.

One option which may be considered is to gradually reduce the SWF benefit level by a portion of PIF benefits. The effect of this approach is to retain a substantial incentive for workers to continue to contribute to the PIF scheme while also limiting the overall expenditure through such benefit adjustment. This approach provides a lower effective tax on PIF benefits and therefore stronger incentive for low income workers and workers with short work histories to contribute to a reformed PIF. It also is a means by which the SWP can be fiscally affordable over the coming decades as the proportion of elderly in Mongolia increases and as the proportion of retirees with little or no benefits from the PIF also increases.

Reforms to the Contributory PIF. Faced with unaffordable costs and an aging population, reform options for the PIF aim to minimize the state subsidy to, minimize benefit reductions and support a smooth transition process between cohorts. Key reform options are primarily to: (i) increase the contribution rate; (ii) reduce the benefit provided for each year worked and therefore the replacement rate at retirement; and/or (iii) increasing the age at which individuals can receive benefits. (Figure 65) It is also possible to change the indexation used, the vesting period or other benefits or qualifying conditions though these generally have a somewhat less significant long-term effect. The tradeoffs between these parameters need to be considered regardless of the benefit design or funding option chosen.

Figure 65. Key Pension Design Parameters



Reforms in the design parameters can aim to minimize the state subsidy to the PIF over the long-term, minimize benefit reductions and support a smooth transition process between cohorts. MPDSP has used the Pension Reform Options Simulation Toolkit (PROST) model to evaluate projected long-term financial flows of the PIF according to existing and reformed parameters. The model has also been used to evaluate different design and funding options. The World Bank provided earlier technical assistance by training Mongolian officials to use the model and by undertaking its own evaluation in 2012[13]. Projections of the model indicate the financial flows including the required fiscal subsidy as well as the anticipated wage replacement rates provided by pension benefits.

Design parameters which the MPDSP have considered have included:

- Increasing the total contribution rate ;
- Reducing the accrual rate for work after the reform is initiated;
- Increases in the age for eligibility for old-age benefits, including unifying the age between men and women;
- Adjustments to the minimum pension provision, including replacing it with the SWP;
- Changes to the indexation rules; and
- Changes in the benefit formula for disability and survivorship, respectively.

The MPDSP has also evaluated options for delaying the implementation of the NDC scheme by applying it to cohorts considerably later than those born in 1960. The NDC scheme has some compelling technical features that either should be the basis for retaining the scheme in some form or, alternatively, ensuring that the continuation of the current PAYG defined-benefit scheme incorporates such features. Specifically: (i) the benefit under the NDC scheme materially changes according to the age at which the individual chooses to begin to receive benefits because the annuity is calculated based on the life expectancy at such age. This can be emulated by the PAYG DB scheme through penalties or supplements for retirees that begin to receive benefits before or after the prescribed retirement age; (ii) the NDC scheme achieves sustainability by calculating benefits based on accumulated contributions and setting an interest rate linked to wage growth. In a PAYG DB scheme, penalties and supplements to benefits at the retirement age can help to achieve balance although other periodic parametric reforms may be needed; and (iii) the NDC scheme needs to set aside contributions for minimum pension, disability and survivorship benefits. Similar set-asides can be established in the PAYG DB scheme.

MDPSP has evaluated the possibility of setting aside reserves in some form to finance a portion of future pension obligations. We would agree with the principle of setting aside reserves (such as from mineral revenues) as a means of financing growing pension costs as Mongolia's elderly population grows. This may contribute to confidence in the ability of the system to deliver promised benefits. Options which aim to accumulate reserves for the purposes of financing mortgages or other development activities should be avoided however, as they will likely increase the fiscal costs of providing pensions. Moreover, we do not believe that workers or retirees should bear the risk of the investment returns on reserves as such risks could impair their future benefits.

***Coverage incentives for herders, the self-employed & informal sector workers*. Herders and the informal sector have low, intermittent and volatile incomes and therefore likely need special incentives to encourage them to contribute to social insurance.** The authorities are considering several options aimed at strengthening incentives for savings and social insurance contributions for over half of the labor force who are herders or informal sector workers. This is a substantial challenge with no easy or readily available templates. Extending coverage to herders and the informal sector will inevitably

[13] See World Bank, *Mongolia: Policy Options for Pension Reform*, January 20, 2012.

need to involve several instruments and require not just well-designed policies but also extensive efforts at implementation. The process of developing alternative pension instruments is expected to proceed more slowly than the other areas discussed above. Under consideration are programs which would be part of the PIF, programs operating as stand-alone funds, and measures to improve implementation and compliance under the existing scheme. The MPDSP is evaluating the possibility of targeted matching contributions for low income workers. They are also exploring administrative means of enhancing compliance, particularly amongst informal sector workers. Finally, a parallel process is being undertaken to strengthen the data management and administrative systems at the Social Insurance General Office (SIGO), including measures to accommodate a broader scope of contributors.

<u>Supplementary Voluntary Private Pensions</u>. Supplementary pensions can play an important role in aligning pensions to the needs of specific sectors and companies yet Mongolia lacks the legal and institutional infrastructure for such arrangements. The authorities are considering establishing a regulatory and supervisory framework for supplementary voluntary private pension schemes. These instruments can serve a number of important functions in the overall portfolio of pension instruments. They can be provided as a supplemental incentive for workers to stay with firms over a long period. In principle, they can be received at an age earlier than in the case of Pension Insurance and, in this way, provide special support for workers in hazardous or arduous professions. Voluntary instruments can also be structured as pension savings instruments for the self-employed, herders and the informal sector.

Mongolia at present lacks the legal and institutional infrastructure that would be required to support the organization, operation and supervision of voluntary private pension arrangements. The recent Securities Market and Investment Funds laws include a number of key elements regarding the division of legal and beneficial ownership, prudential requirements for fund managers and portfolio composition standards. These will, however, need to be further refined to address the higher standards of security required for pension funds. Further, an authority will be needed with the capacity and expertise to provide effective oversight of private pension funds. The depth of capital markets and products currently available will also significantly constrain the ability to introduce private pension. Financial incentives or other advantages under the tax law would distinguish private pension funds from other forms of savings. Finally, a complete and readily accessible system for consumer protection and redress would be needed.

V. Conclusions

Policy decisions taken in respect to pensions and social insurance will have a profound impact on Mongolia's fiscal position, social protection for its elderly population, labor and financial market development. It is therefore essential that the authorities weigh the short- and long-term tradeoffs in designing a pension and social insurance system which is fiscally sustainable, provides adequate and equitable old age income protection, and establishes the infrastructure and incentives to substantially increase coverage of the working age population. In addition, decisions should be guided by solid evidence, including the use of long-term actuarial projections of the anticipated financial flows for each of the instruments in the multi-pillar pension system envisioned.

A multi-pillar social insurance system can strengthen pensions and social security to reduce the fiscal burden and ensure the adequacy of benefits. The design of the SWP will play an increasingly important role in protecting the elderly against poverty and vulnerability as elderly coverage by the PIF declines. Parametric reforms to the PIF will prove pivotal, as well as facilitating a smooth transition to the NDC scheme for younger cohorts. Coverage incentives will likely be needed for herders, the self-employed & informal sector workers who often have low, intermittent and volatile incomes. Finally, supplementary pensions can play an important role in aligning pensions to the needs of specific sectors and companies yet will take both legal and institutional reforms to put in place such arrangements.

Appendix 2: Mandatory pension parameters

	Defined-Benefit Scheme (pre-1960 Cohorts)	NDC Scheme (post 1960 cohorts)
Old Age Insurance	**Law on Social Insurance (1994) and Law on Pensions and Benefits Provided by the Social Insurance Fund, 1994** (as amended)	**Law on Individual Pension Insurance Contribution Accounts, 1999**
Applicability	Pre -1960 cohorts	All contract employees born after January 1, 1960.
Contribution Rate	14% of wages (7.0% employer and 7.0% employee)	14% of wages
Minimum Wage subject to Contributions	National Minimum Wage (revised periodically)	National Minimum Wage (revised periodically)
Maximum Covered Wage	None	None
Benefits - Accrual rate	45% for the first 20 years of eligible service and 1.5% for each year of eligible service after that.	Based on Notional Account balance for 15% contribution rate for years of contributions, accrued notional returns for each year (average growth in the last three years' average wages), and average life expectancy factor.
Wage base for benefit determination	Best 5 years' consecutive wages out of the 20 years wages reported.	Not applicable.
Minimum Pension	75% of the minimum wage.	20 percent of the national average wage, plus an additional 0.5 percent of the average wage for each additional service year beyond the minimum of 15 years
Indexation	In practice, pension increases are determined by Cabinet resolution on an ad-hoc basis, although the law states that pensions should be increased in "relation to changes in the cost of living".	As per law, indexation shall be "in direct relation to the inflation rate". The pension adjustment index and the procedure for its application shall be determined by the National Statistical Office based on the suggestion of the Social Insurance National Council.
Taxation of benefits	Tax exempt	Tax exempt
Qualifying Conditions		
Vesting Requirements	• 20 years	• 15 years of contributions
Retirement Age	• 60. • optional 55 for women with 20+ years of service • optional 50 for women with 20+ years of service and who brought up 4+ children • . • 50 for men and 45 for women with 20 years of service, and some specific years of service in hazardous conditions, high heat and underground, •	same
Invalidity/Disability		
Enabling Legislation	Law On Pensions & Benefits Provided By The Social Insurance Fund, enforced on 1/1/1995.	Law On Individual Pension Insurance Contribution Account. Effective 7/1/1999
Contributions	Contained within the combined contribution rate.	Contained within the combined contribution rate.

	Defined-Benefit Scheme (pre-1960 Cohorts)	NDC Scheme (post 1960 cohorts)
Benefit Formula	DP = W* Percentage of capacity loss(I) DP = W* Percentage of capacity loss(II) DP = Disability pension W = Insured person's monthly average wage PCL(I) = 10% (up to 10 per cent) PCL(II) = Percentages over 10 per cent	Note: This law is not applicable to injury related benefits.
Formula	Total invalidity = same formula as retirement Partial Invalidity = (retirement formula)* percentage of loss of capacity for work	Total invalidity = W*60% Partial invalidity = (W*.6) * (percentage of loss of capacity for work) W = monthly average wage in the last three years,
Length of pension	From the date of commencing invalidity and ending with the day of rehabilitation, or with the following month in which the beneficiary dies	Same
Minimum pension	Same as the minimum retirement pension	Same as the minimum retirement pension
Qualification	Not less than 50 per cent loss of capacity for work permanently, or for a long duration due non-occupational disease or injury	Same
Classification of invalidity	Total invalidity (70% and more loss of working capacity) and partial invalidity (from 50 to70%)	Same
Minimum length of service for qualification	Not less than 20 years insured service, or three years out of five, immediately preceding the date of commencement of invalidity	Same
Incomplete service (minimum 3 years)	Disability benefit is reduced proportionally to the period of pension insurance, but its minimum is equal to minimum reduced retirement pension	Not allowed
Minimum pension	Not less than 75 per cent of the wage in case of working capacity loss over 30% and more	
Length of pension	From the date of commencing disability and ending with the day of rehabilitation, or with the following month in which the beneficiary dies	
Qualifying service	While discharging employment duties at work place or other places; before the commencement of the general working hours or after the general finishing time in the course of arranging the work place & equipment; travel to or from an insured person's place of work	
Certification	Determined by Medical Labor Accredited Commission, whether cases are relevant to employment injury determined by Employer's Investigating & Registering Commissions.	Same
Dependent's/Survivorship Pension		
Applicable Legislation	Law on Benefits Provided By The Social Insurance Fund Against Employment Injury & Occupational Diseases. Enforced on 1/1/1995	Law On Individual Pension Insurance Contribution Account Effective 7/1/1999
Benefit formula	Same benefit formula as old age retirement; Survivors receive pension in proportion to certain percentages depending upon the number of survivors: for three or more -100%, two - 75% and one - 50%.	40% monthly average wage in the last three years for one dependent increased by 10% per each member over two and more. But pension should not exceed 60% monthly average wage
Eligibility	Family dependents determined as survivors under the Law On Pensions & Benefits Provided By The Social Insurance Fund	Family dependents determined as survivors under the Law On Pensions & Benefits Provided By The Social Insurance Fund
Length of pension	Same as survivor's pension under the Law On Pensions & Benefits Provided By The Social Insurance Fund	
Credit for period of invalidity pension	Pension increased by 1 per cent pension amount for each year of total invalidity, if the deceased was on the receipt of invalidity pension	No credit
Minimum pension	50% minimum wage for one dependent, 75% for two dependents and 100% for three dependents; reduced pension should not be less than 50% same wage.	Same as the minimum retirement pension provided from Individual Account

	Defined-Benefit Scheme (pre-1960 Cohorts)	NDC Scheme (post 1960 cohorts)
Length of service	Not less than 20 years insured service, or three years out of five, immediately preceding the date of breadwinner's death due to non-occupational disease or accident.	Same
Incomplete service (minimum 5 years; continuous in last year)	Pension is reduced proportionally to the period of pension insurance.	Not allowed
Eligible survivors	Born or adopted children under 16, if student children to age 19; grandchildren, brothers and sisters under 16 without caregivers; grandchildren, brothers and sisters disabled or got disabled prior attaining age 16; parents over retirement age or disabled parents, spouse or grandparents, brothers and sisters without caregivers; any of parents or spouse not working and caring for children under 8, or grandchildren and younger brothers and sisters, also family dependents of the deceased who was on receipt of retirement or invalidity pension and who totally lost capacity for work in months preceding the death; step-parents; step-children not receiving alimony from their own parents; family dependents of the disappeared;	Same
Length of pension	From the date of death up to the day on which surviving children attain age 16, if student children to age 19, incapacitated persons for period of loss of working capacities, survivors who have attained the pension age up to the end of the following month in which the insured breadwinner's dies	Same
Social Welfare Pension		
Enabling Legislation	Social Welfare Law, enforced on 1/1/1999.	Social Welfare Law, enforced on 1/1/1999
Pension Rate	Set by government resolution in consideration of minimum living standard.	Same
Eligibility	▪ Men aged 60 and women aged 55 who are not in receipt of an annuitized Pension Insurance Fund benefit.	Same
Indexation of benefits	In relation to the movements in the minimum living standard.	Same