Mongolia

Recent Economic Development and Challenges

July 2014

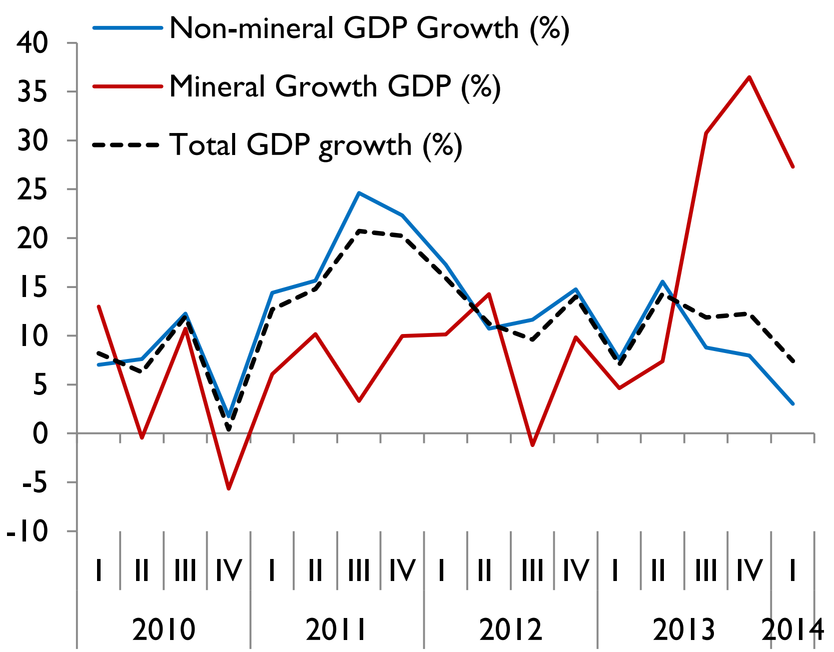
The World Bank in Mongolia

Recent Economic Developments

Economic growth is slowing due to weakening non-mineral economic activities.

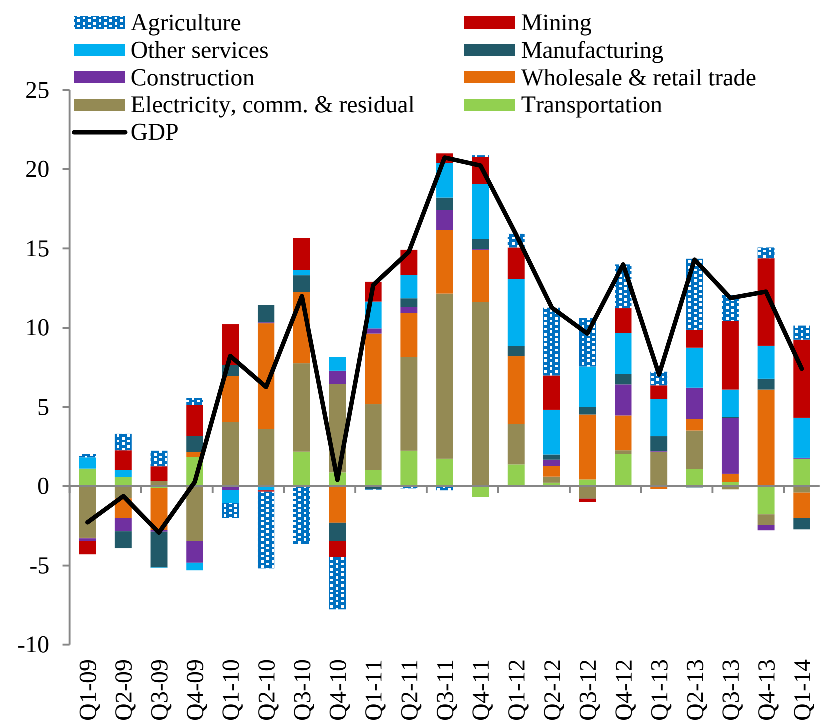
Growth further softened to 7.4 percent in the first quarter of 2014.

Quarterly Mineral and Non-mineral Real GDP Growth (yoy, %)



Mineral sector remains robust but domestic industry is weakening.

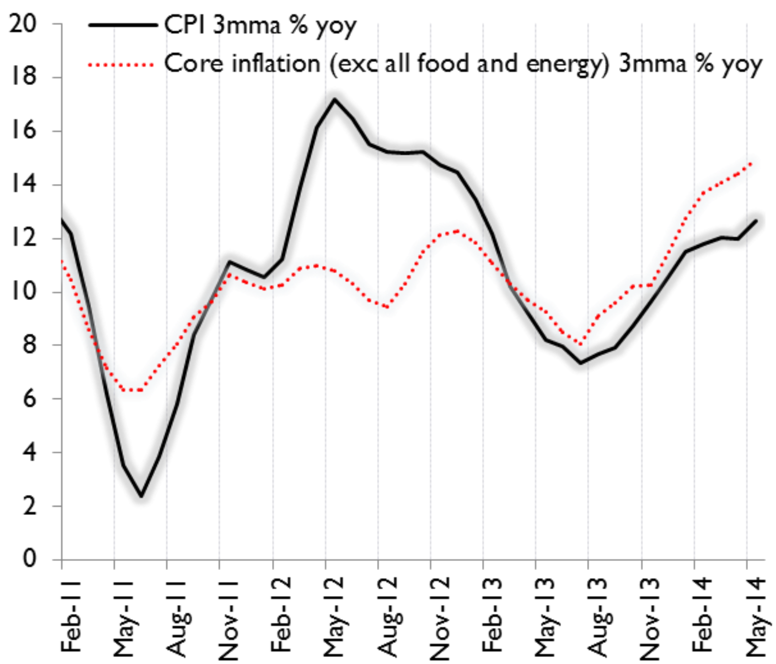
Real GDP growth contribution by sectors (%p)



Inflation remains at double-digit level.

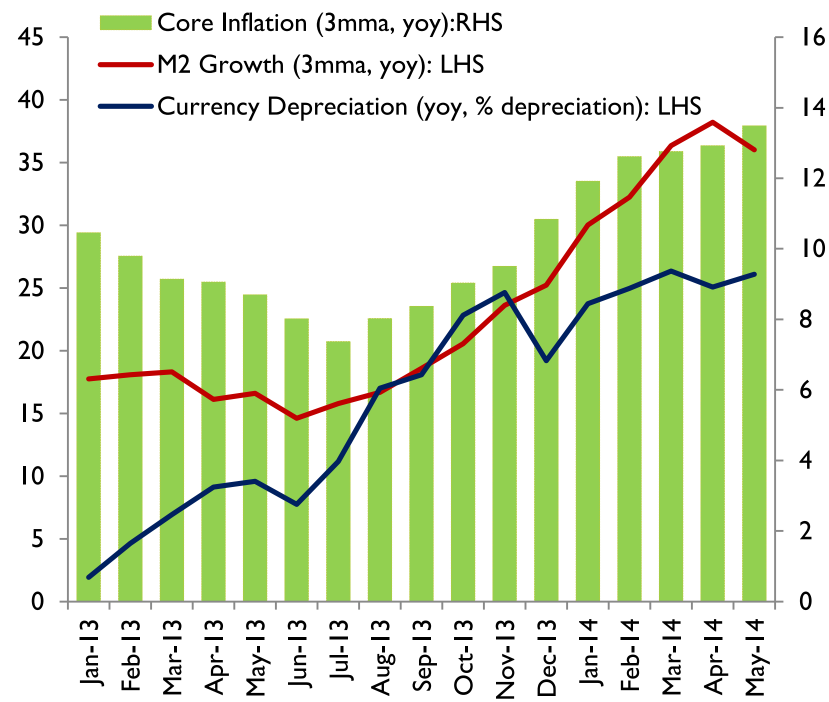
Inflation has accelerated to over 13 percent in May.

Headline inflation and core inflation (%)



Recent double digit inflation is driven by growing demand-side pressure.

Headline inflation and Monetary Indicators

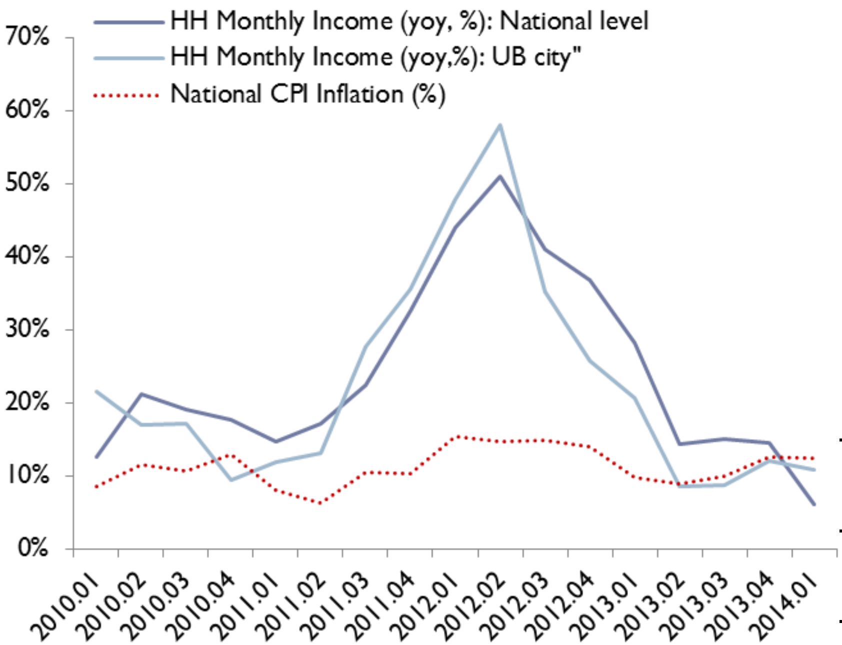


High inflation weighs on purchasing power of households and domestic demand.

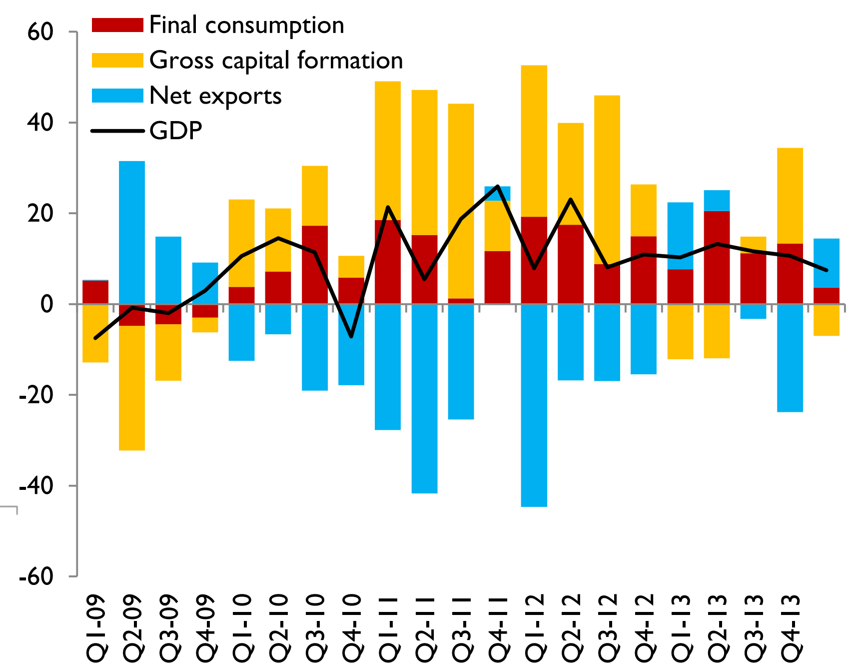
Inflation rate is exceeding the growth of nominal household income.

Growth contribution of consumption and investment dropped.

Household income growth and CPI inflation (%)

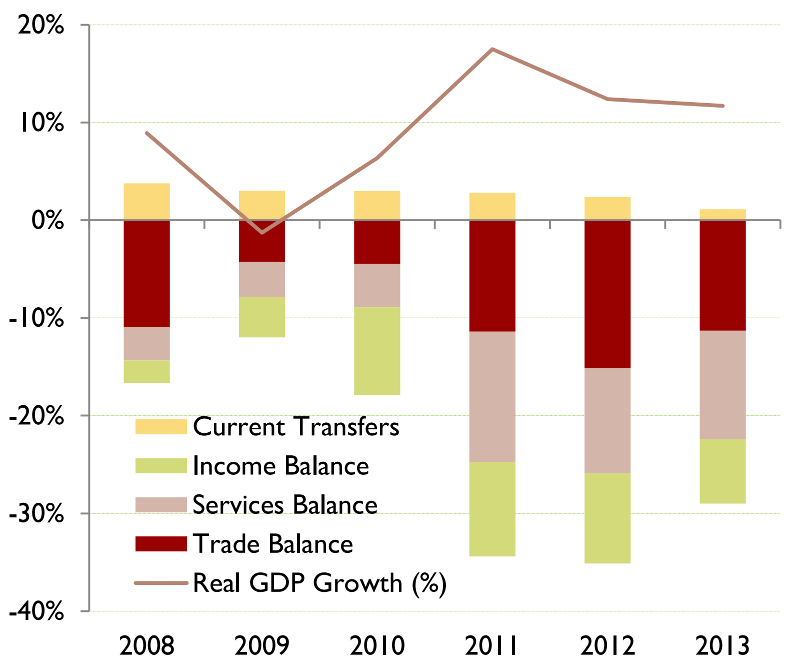


Quarterly real GDP Growth by Expenditures (%p)

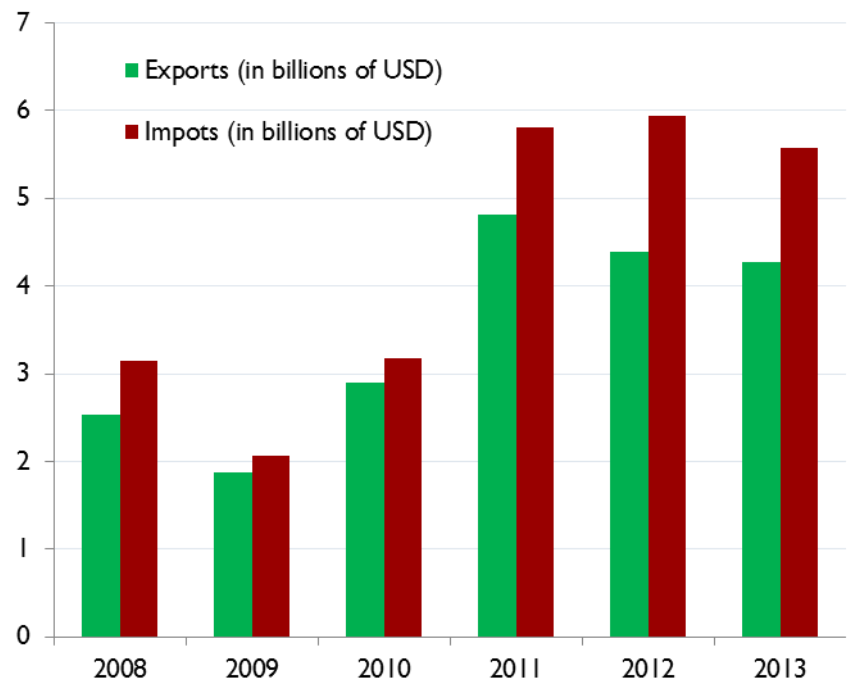


Three year's high economic growth came with excessive current account deficit that cannot be sustained without strong FDI.

Current account deficit jumped to over 30% of GDP during the double digit growth period between 2011-2013.



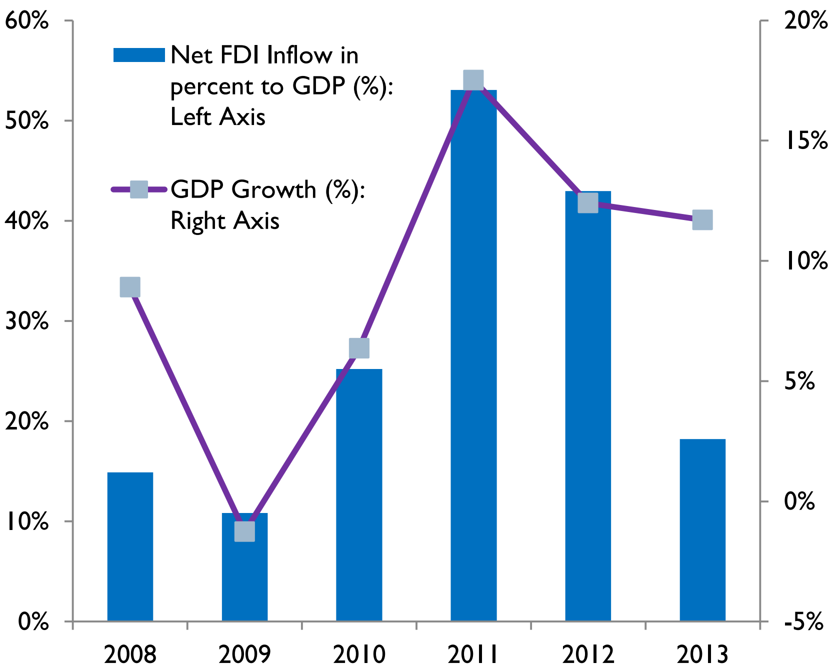
Mounting current account deficit was driven by large increase in imports from 2011.



FDI was a main driver of growth and financed the CA deficit for the last three years but continues to drop in 2013 and 2014.

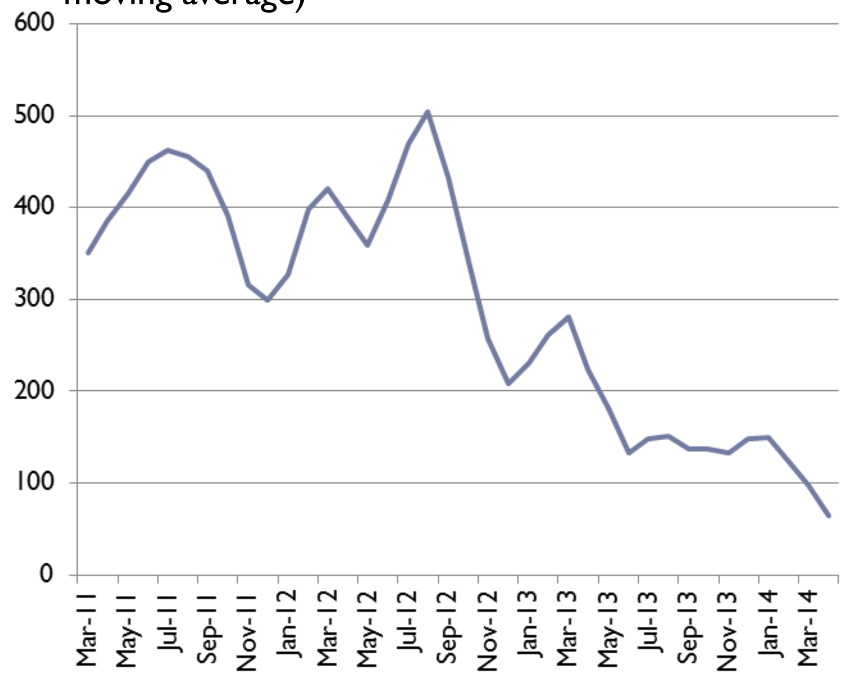
FDI dropped to an half in 2013…

Annual FDI inflow (in percent to GDP, %)



… and continues to decline in 2014.

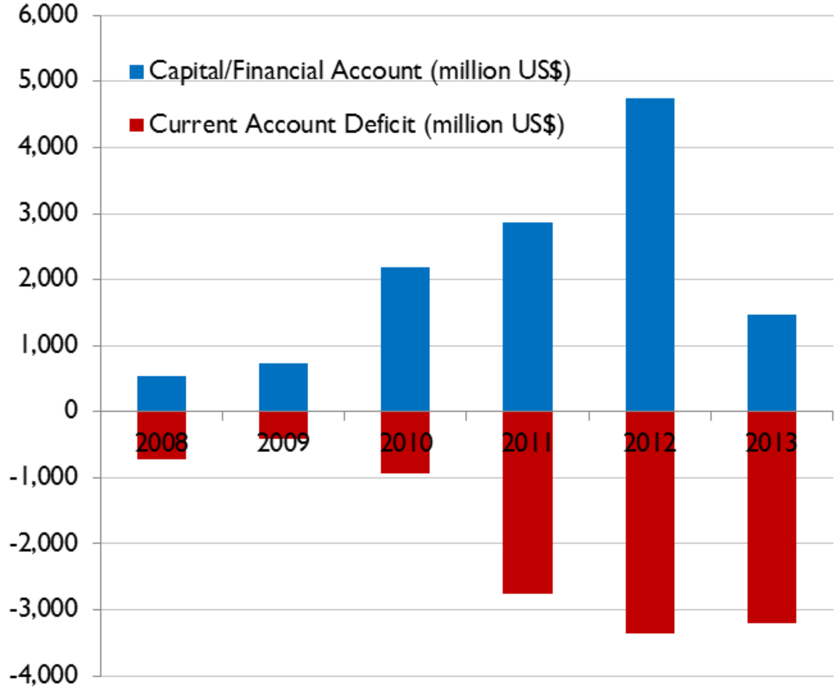
Monthly FDI trend (in millions of US$, 3 month moving average)



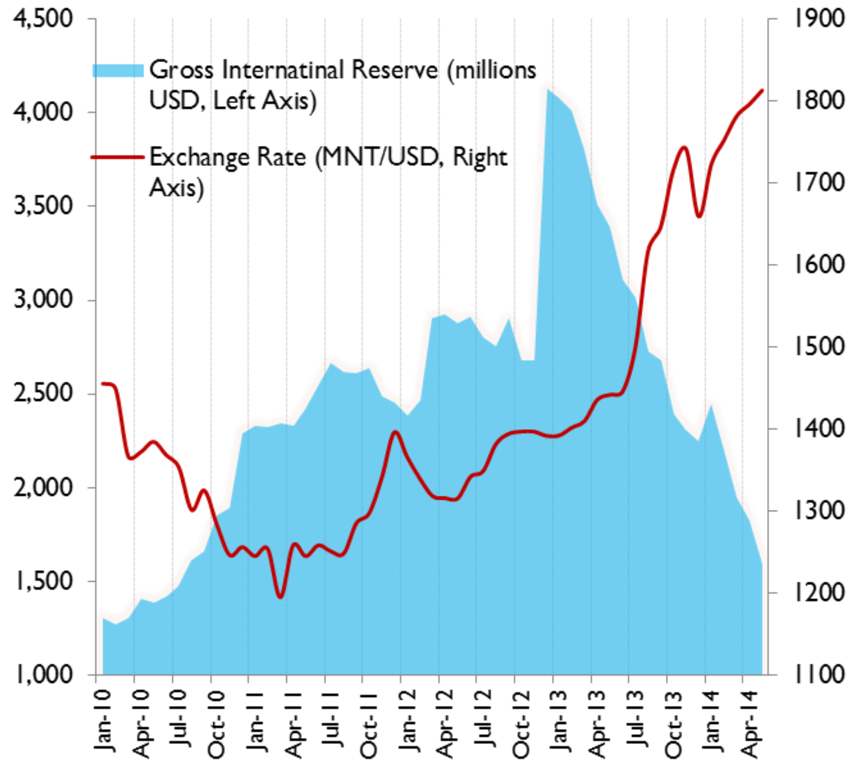
Large balance of payments imbalance put pressure on currency value and international reserve.

External financing gap became significant due to large CA deficit and dropping foreign capital inflow.

Annual Balance of Payments (in millions of US$)



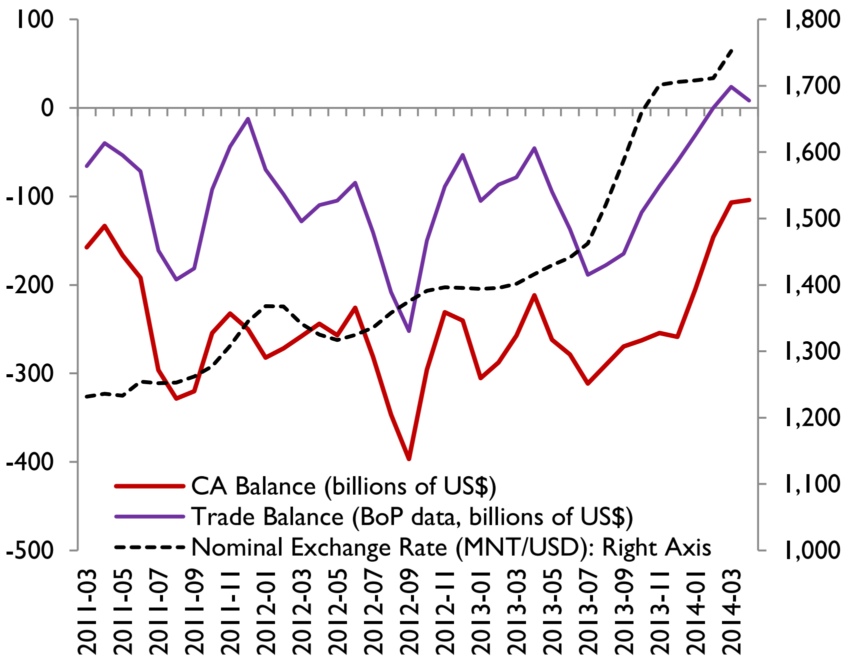
As a result, currency value weakened and international reserves dropped.



And the current account deficit is narrowing.

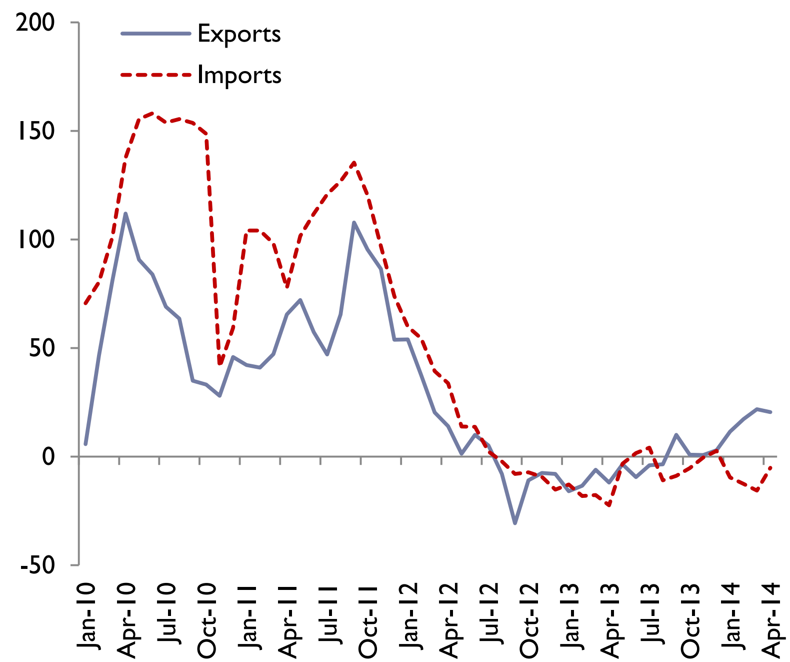
Current account is narrowing…

Monthly CA and Trade Balance (in billions of US$)



… and the adjustment is occurring through import compression and robust copper and oil exports.

Y/Y Growth of Exports and Imports (%, 3 months moving average)



Economic Prospects and Challenges

In 2014, the economic growth will likely soften as a result of the large economic imbalances.

- **The real GDP growth will likely moderate to a single digit level but still remain high relative to most of other countries in the region.**

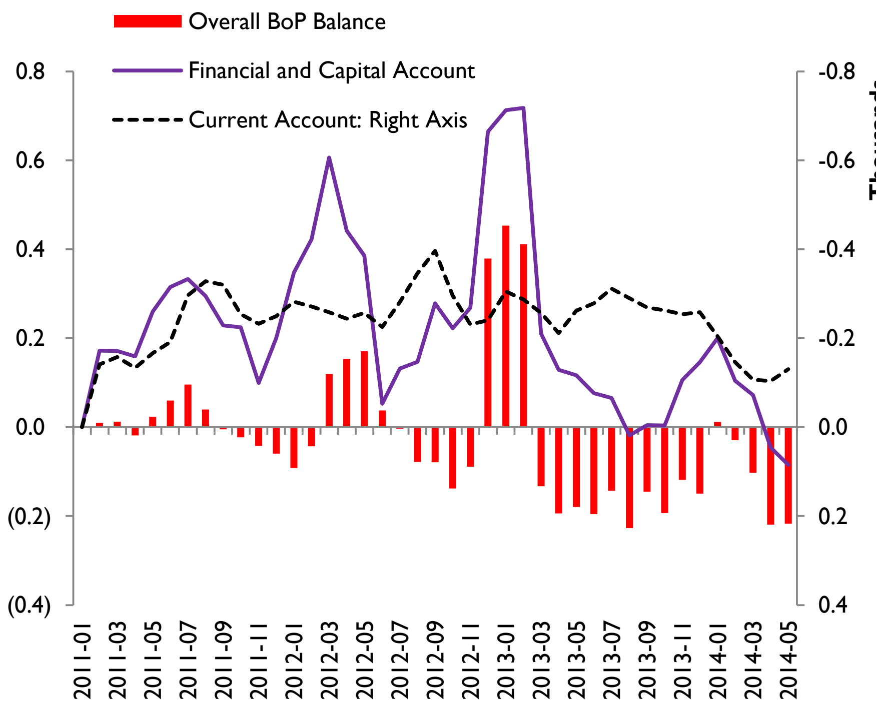
  - Strong mineral GDP growth will continue due to revamped copper production of OT mine.
  - Non-mineral output will likely remain under pressure from high inflation and heavy balance of payments pressure.

- **Slowing economic growth reflects an adjustment of the economy expected in response to high inflation and the large external financing gap.**

The economy faces downside risks from the heavy BoP pressure and weakening financial soundness.

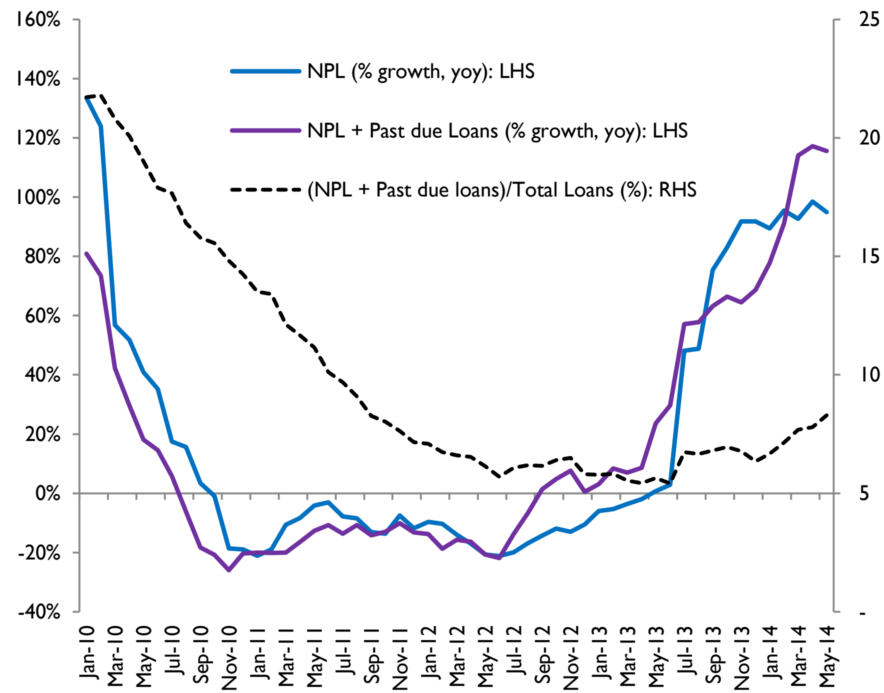
Despite the narrowing CA deficit, the BoP deficit still remains high due to falling FDI.

Key Monthly BoP Trend (3 month moving average, billions of US$)



Amidst policy-induced rapid credit growth, non-performing loans and past-due loans are increasing fast.

Non-performing loans and Past-due loans (yoy growth, %)

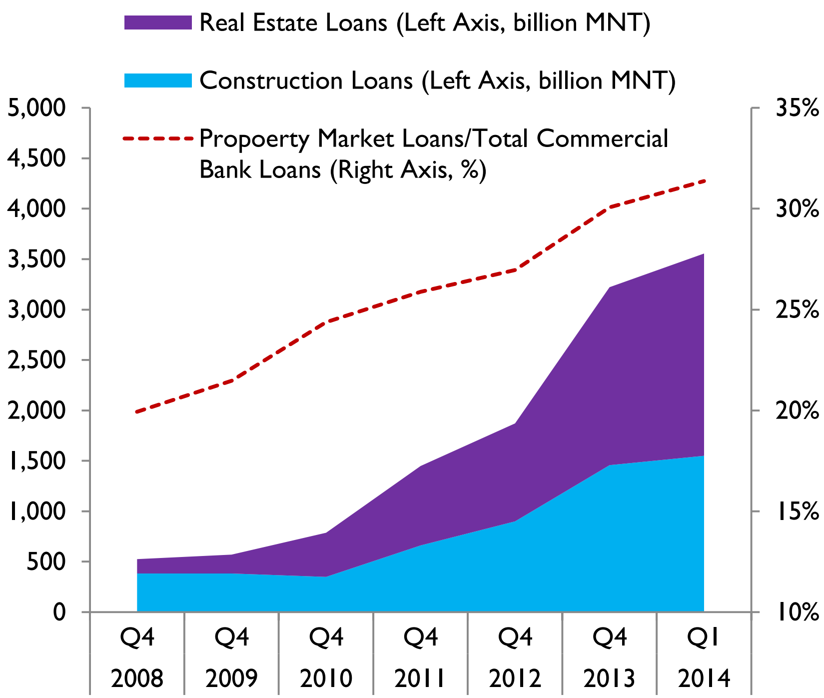


Rapid growth in housing market may lead to overheating situation.

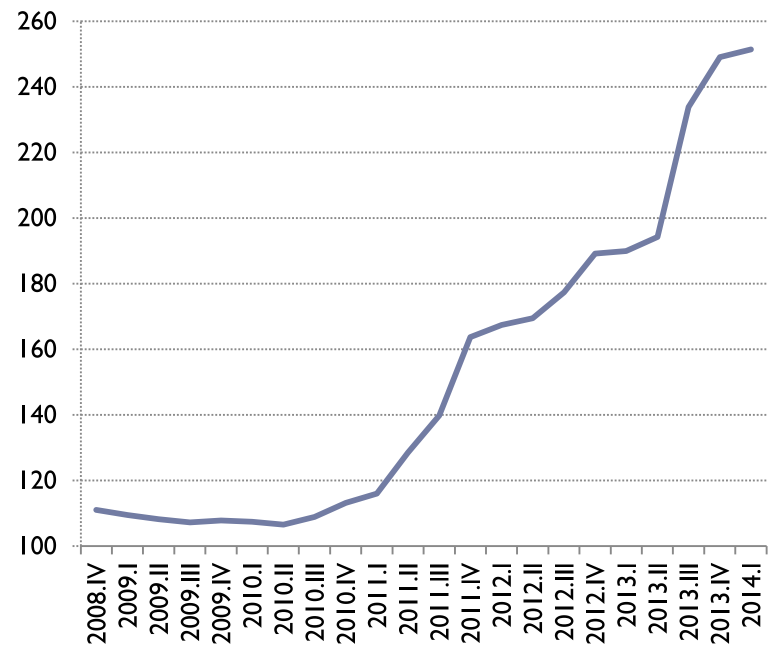
MNT 2 trillion of cheap credit has been provided to construction and housing market in 2013.

Housing price has been picking up fast over the past three years.

Commercial Bank Loans to Construction and Housing Market



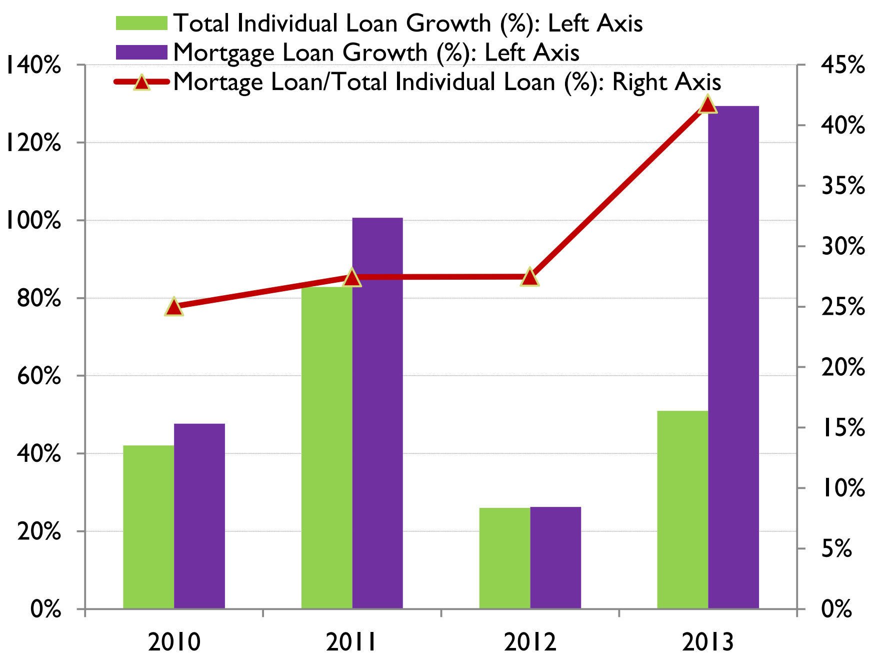
Housing Price Index (2007=100)



Rising household debt also needs close monitoring.

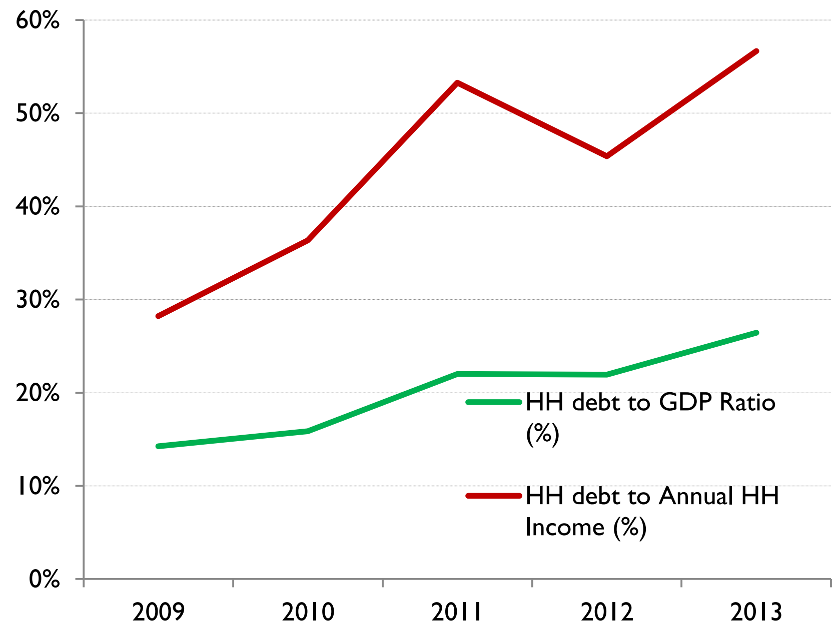
Household loans increased over 50 percent led by rapid growth of housing mortgage loans.

Commercial Bank Loans to Households and Mortgages



Average household debt to annual household income rose close to 60 percent in 2013.

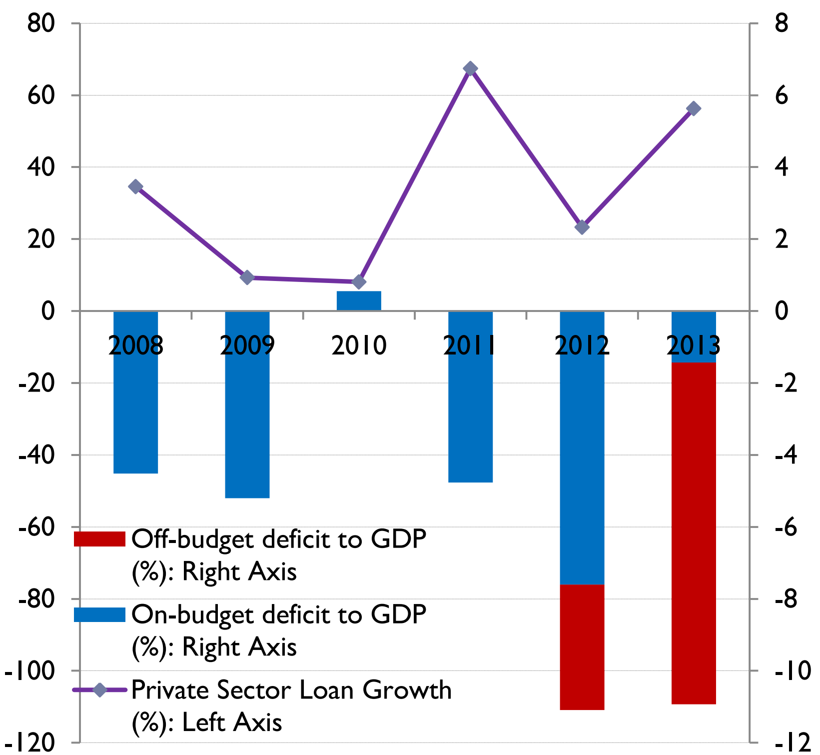
Household Debt Ratios to Annual Income and GDP



So, what is needed?

Pro-cyclical economic policies increased economic vulnerability.

Key macro-economic policy indicators show economic policies have been pro-cyclical over the past three years.



Between 2011-2012, the economy displayed strong economic growth led by surging FDI…

and economic policies further fueled the FDI-induced high economic growth by (i) expanding budget deficits and (ii) allowing strong credit boom created by surging FDI inflow.

In 2013, economic policies faced a challenge between slowing growth momentum from weakening FDI/minerals market and the large BoP imbalance…

and chose to stimulate economic growth through off-budget spending and quantitative easing.

→ Large CA deficit close to 30% of GDP remained and double-digit inflation re-emerged in 2013.

Restoring economic and financial stability is urgent.

- Does economic stability mean "maintaining double-digit growth at the expense of internal and external economic balances"?

  - Current economic vulnerability came amidst overheating of the economy.
  - Economic stability means stabilizing prices and reducing balance of payments pressure through prudent economic policies.
  - Ensuring economic stability enables the economy to grow on a sustainable and stable path toward future prosperity in the long term.

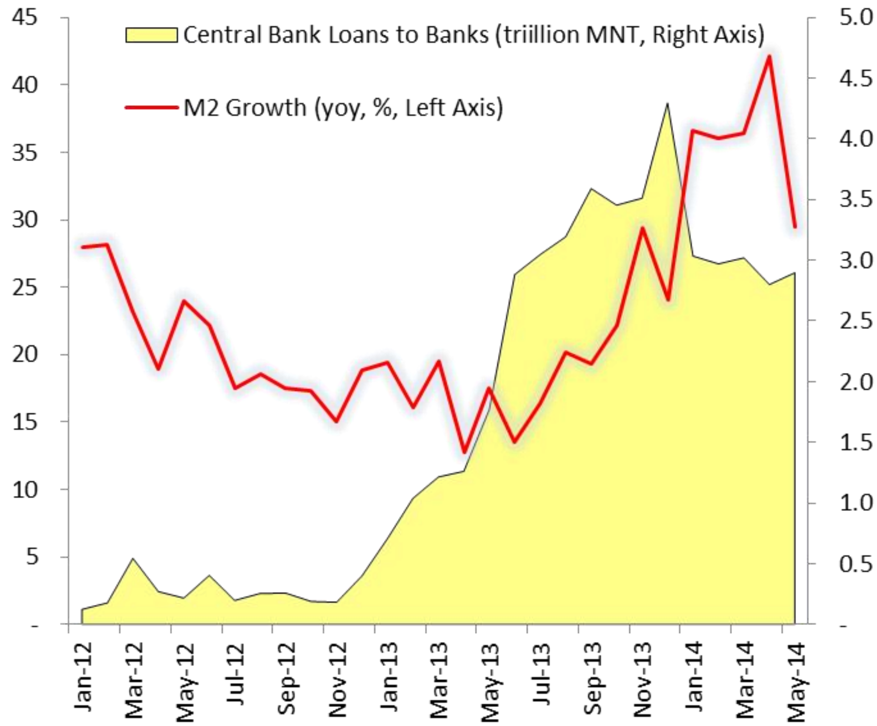
- Need for structural shift of economic policies from growth-stimulus to economic and financial stability.

  - Tightening of monetary and fiscal policy
  - Strengthened supervision of banking sector soundness.

Monetary policy needs to be tightened and focus on maintaining soundness of the banking system.

Recent monetary indicators show loose monetary policy has been gradually tightened.

Central Bank Loans to Commercial Banks

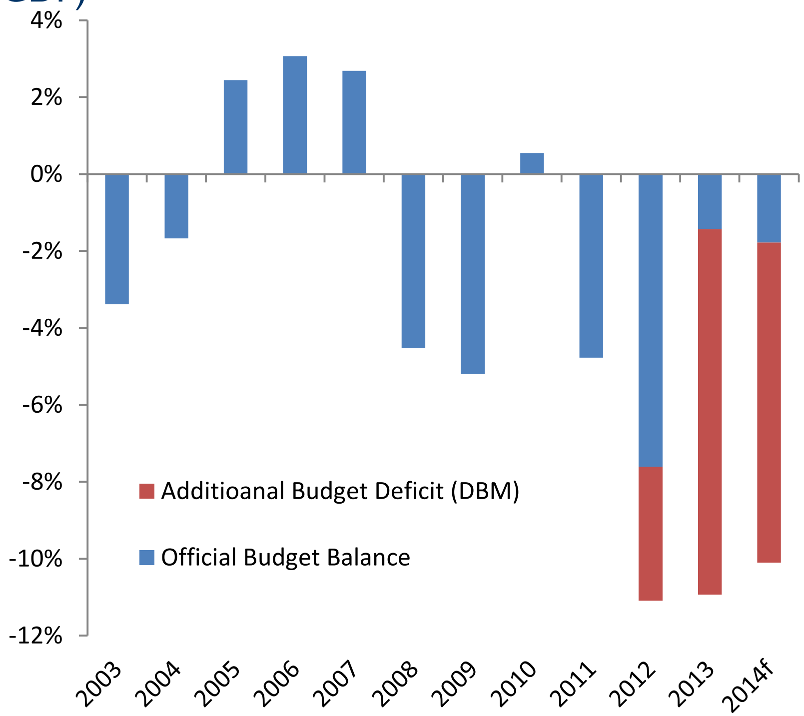


- ✓ **Gradual tapering of expanded policy-induced credit will help moderate inflation over time.**
- ✓ **Tightening monetary policy will also help ease the pressure on the currency value.**
- ✓ **Banking supervision needs to be strengthened given the deteriorating bank assets.**
- ✓ **Loose enforcement of prudential regulations on policy-induced credit needs to be normalized.**
- ✓ **Flexible exchange regime needs to be maintained.**
- ✓ **Exchange rate movement is one of key adjustment mechanism of the economy to large economic imbalances.**

Fiscal policy needs to restore prudent path according to the FSL.

Under the current trend, fiscal deficit will reach 10% of GDP in 2014.

On-budget and Off-budget Deficits (in percent to GDP)



- ✓ **Continued large fiscal deficit through off-budget spending will boost imports and exacerbate economic imbalances.**
- ✓ **Weakening fiscal strength amidst continued large fiscal deficit will likely adversely affect credit-worthiness of the country in the international financial market.**
- ✓ **Political consensus would likely be essential to curb excessive spending and adhere to the FSL.**
- ✓ **It is time to think about managing mineral revenues more effectively.**
- ✓ **A good sovereign wealth fund system may provide a tool to start saving for rainy days and for the future generation.**