THE WORLD BANK GROUP IN MONGOLIA

Mongolia Economic Update

June 2014

This Economic Update assesses recent economic developments and policies in Mongolia. The Update was prepared by Taehyun Lee (Senior Country Economist) and Altantsetseg Shiilegmaa (Economist) under the overall guidance of Chorching Goh (Lead Economist for Mongolia, China and Korea). This Economic Update also greatly benefited from advice and contributions from Deepak K Mishra (Lead Economist for Economic Policy). Copies can be downloaded from http://www.worldbank.org.mn. For further information, comments and questions, please contact Tina Puntsag (tpuntsag@worldbank.org).

Table of Contents

Table of Figures

Executive Summary

Likely economic adjustment in 2014 as a result of growing external and internal economic imbalances

Three years of growth-oriented economic policies have led to large economic imbalances. The Government of Mongolia and monetary authorities in 2013 implemented strong economic stimulus measures to maintain double-digit growth as the country gradually was losing growth momentum amidst falling Foreign Direct Investment (FDI) and the weakening global minerals market. The central bank injected fresh liquidity equivalent to 20 percent of GDP to boost credit and the fiscal deficit ballooned to over 10 percent of GDP, driven by substantial off-budget spending through the Development Bank of Mongolia (DBM). These expansionary policies relying on quantitative easing and debt-financing contributed to the country maintaining double-digit economic growth last year despite the weakening external environment. The policy-induced high growth, however, also came with significant balance of payments pressure and high inflation. Heavy balance of payments pressure appeared in 2013 as the current account deficit remained close to 30 percent of GDP for the third consecutive year, while FDI in 2013 dropped to half of its level from the year before. Inflation has been accelerating back to a double-digit level since mid-2013 and picked up to over 13 percent in May.

In 2014, the economy is undergoing an adjustment in response to the large external and internal imbalances. Economic growth slowed to 7.4 percent in the first quarter of this year, from 12.3 percent in the last quarter of 2013. Despite robust mineral GDP growth at over 27 percent, non-mineral GDP growth dropped to 3 percent in the first quarter of this year, down from 15.6 percent in the previous quarter. Domestic demand is now under growing pressure from high inflation and continued currency depreciation. Annual economic growth is expected to soften to 9.5 percent in 2014 reflecting waning domestic demand, despite robust growth of mineral production led by revamped copper production at the new Oyu Togoi (OT) mine. Considering the expanded domestic credit and currency depreciation trend, inflation will likely remain at a double-digit level for the remainder of the year.

Increasing short-term economic risks amidst the large balance of payments pressure and deteriorating financial soundness.

Large balance of payments pressure will likely persist in 2014. The balance of payments pressure is expected to ease in 2014 due to the narrowing current account deficit, but a significant external financing gap will continue as a result of the declining inflow of foreign capital. The current account deficit has been on a downward path over the past seven months as the economy began to adjust to the large external imbalance and the OT mine began its copper production. However, surplus of capital and financial account also dropped substantially amidst the continuous decline of FDI. The overall external financing gap of the balance of payments slightly eased over the first five months of this year (compared with the same period last year) but remains high. The external financing gap of the first five months reached over five percent of expected annual GDP of 2014. The large external financing gap will likely continue to weigh on the international reserves and the currency value throughout the year. Reflecting the external imbalance, the international reserves have been on a downward trend over the past seventeen months. The gross international reserve level dropped to US$ 1.6 billion in May—around the three-month's import cover, down by 61 percent from its peak at the end of 2012. However, possible extension and increase of the bilateral currency swap line with the neighboring China would be able to provide a significant buffer against the large balance of payments pressure in the near term.

Asset quality of banking sector is deteriorating. Recent fast increases in non-performing loans (NPL) and past-due loans indicate signs of weakening financial soundness following the policy-led credit boom. While domestic credit increased by more than 50 percent over the last twelve months, the size of problematic loans (NPL and past-due loans combined) more than doubled to MNT 1 trillion in May, up from MNT 464 billion in the same month the year before. The share of problematic loans among total outstanding loans remained at a relatively moderate level of 8.3 percent in May, as the rising amount of problematic loans was overshadowed by surging domestic credit; the ratio, however, has also been rising over recent months, increasing from a level of 6.3 percent at the end of 2013. The NPL ratio will likely remain under growing pressure over the coming months amidst the slowing economic activities, which may strain the liquidity and soundness of the banking system going forward.

Need for structural shift in the economic policy framework to restore economic and financial stability.

The economic policies of the past three years have been focused on stimulating economic growth. The growth-oriented policy framework indeed maintained economic growth at a double-digit level despite weakening growth momentum from the falling FDI and weakening mineral exports in 2013. The double digit growth also helped reduced poverty rate from 38.7 percent in 2010 to 27.4 percent in 2012. However, pro-cyclical economic policies also led to an unsustainable level of balance of payments pressure, high inflation, and weakening strength of the financial system. Continuation of growth-oriented economic policies may not be sustainable under the growing economic vulnerability. Further economic stimulus relying on credit expansion and large fiscal deficit will likely have only limited effects and add to the high inflation and currency depreciation, which will further weigh on consumption and investment. Moreover, continuous expansionary policies would also likely accelerate depletion of international reserves through a slower adjustment of the balance of payments imbalance.

Monetary policy needs to be tightened to address high inflation. The monetary authorities need to reorient their policy focus on inflation by tightening the monetary policy stance. Recent monetary indicators show some signs of a gradual tightening of the expanded balance sheet of the central bank in the face of rising inflation and the persistent large external financing gap. We believe that the recent tapering of expanded credit is necessary and will help address the high inflation problem going forward. Tapering of the expanded balance sheet of the central bank would likely be gradual to avoid possible abrupt credit tightening given the extended credit to commercial banks from the central bank over the last year. Commercial banks' borrowing from the central bank jumped to 20 percent of bank assets in May 2014 (up from 5 percent at the end of 2012) under the quantitative easing of the central bank. Assuming that monetary tightening continues in the coming months, inflationary pressure will likely gradually ease over time. Yet, it remains unclear at this stage whether the recent gradual tapering of extended credit signals an official turnaround of the monetary policy stance.

Financial sector policy should focus on ensuring financial stability. Continuous degradation of bank asset qualities would likely pose an increasing risk to the banking system. Weak enforcement of prudential regulations for major policy lending programs adds concerns, as it may have led to weakening underwriting practices and a deteriorating quality of bank assets. The recent episode of the Savings Bank—a systemically important bank that failed last year—shows what can result from the combination of poor governance structure and weak adherence to prudential regulations. Regulatory forbearance given to the policy lending programs needs to be lifted and the existing lending limits on a single borrower and a bank-related party need to be strictly reinforced.

Fiscal policy should adhere to the fiscal discipline imposed by the Fiscal Stability Law (FSL). Legal institution for fiscal discipline is already in place, but implementation remains questionable. While the FSL became effective in 2013, the law has been largely bypassed as a substantial amount of fiscal spending has been implemented outside the scope of the budget through the DBM. Under the current trend, fiscal policy will likely remain on an expansionary path in 2014 again, with an expected overall fiscal deficit reaching 10 percent of GDP due to continuous off-budget spending. It may be politically challenging to include off-budget spending into the budget as it would surely breach the deficit ceiling of the FSL. A more realistic approach—given the political environment—may be to propose a mid-term fiscal consolidation plan that would comprise both official budget spending and off-budget spending within a specific timeframe, led by strong political consensus and leadership on the needs for fiscal consolidation.

Time to think about managing resource revenues more effectively

Mongolia has not accumulated savings from its resource revenues during the past high-growth period. The development of a good sovereign wealth fund (SWF) framework could provide the momentum to build a more prudent resource revenue management system. As a result of the large fiscal deficits and rising public debt level over the last two years, the capacity of fiscal policy to counter possible external shocks has become increasingly limited. The current minimal fiscal savings in the Fiscal Stabilization Fund cannot provide enough policy buffers when needed. In this light, the Government of Mongolia is developing legislation for a new SWF framework, which we welcome as a positive step toward a more prudent and efficient resource revenue management framework. Yet, it must also be noted that a SWF itself cannot ensure effective resource revenue management if it is not accompanied by a strong and prudent fiscal policy framework. To ensure that the government generates net fiscal savings, the establishment of the fund needs to be aligned with the design of an implementable fiscal adjustment plan. Strong consensus should be reached to curb spending and allow room for net accumulation of wealth before a SWF is established and becomes operational.

Recent Economic Developments

Economic growth is softening as a result of economic imbalances

The economy is undergoing an adjustment in response to persistent high inflation and large balance of payment pressure. Mongolia's economic growth continued to soften over the last two years from its peak of 17.5 percent in 2011 to 11.7 percent in 2013 despite the start of production of the new Oyu Tolgoi (OT) mine last year and economic stimulus measures (Figure 1). Economic growth further slowed to 7.4 percent in the first quarter of 2014 from 12.3 percent in the previous quarter. Mineral GDP registered 20.7 percent growth in 2013 and 27.3 percent in the first quarter of 2014 as the OT mine began production in the second half of the last year. Contrary to the strong growth of mineral production, non-mineral sector output has been slowing since the third quarter of 2013 amidst the rising inflation and continued currency depreciation. Non-mineral GDP growth fell from 15.6 percent in the second quarter of 2013 down to 3 percent in the first quarter of 2014 (Figure 2).

Figure 1. The economy maintained double-digit growth in 2013 but has been on a downward trend since 2011.

Annual Real GDP Growth Trend (%): 2000-2013

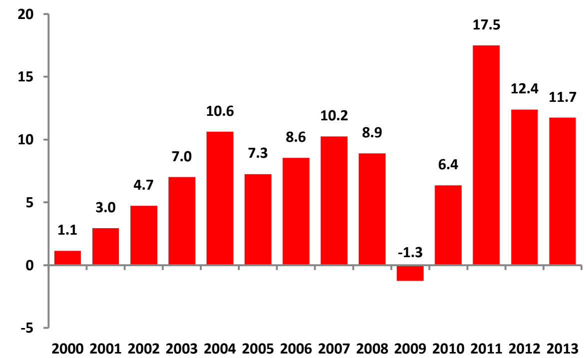
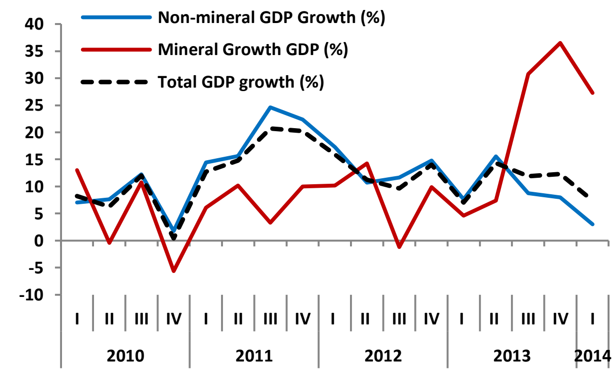


Figure 2. Growth further softened in the first quarter of 2014 due to weakening non-mineral production.

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



Source: NSO Bulletin, WB staff estimates

Mineral production remains strong driven by robust copper production boosted by the start of production of OT mine. Mining sector accounted for two thirds of total GDP growth rate in the first quarter (Figure 3). Copper concentrate production increased by 85 percent over the first five months of this year reflecting the new production of the large OT mine that began its commercial operation in mid-2013. The OT mine produced 103 thousands of copper concentrates in the first quarter which is estimated to be almost half of total copper production during the same period. Crude oil production also displayed a robust growth of 53 percent from a year ago over the first five months. Coal production remained weak during the same period, rising slightly by 1.6 percent from a year ago amidst the weak global coal market condition (Figure 4). GDP share of mining sector rose to 21.4 percent in the first quarter of 2014 thanks to revamped copper production, up from 18.1 percent a year ago.

Growth momentum in non-mineral sector is weakening, especially in manufacturing industry and retail and wholesale business. Manufacturing industry registered negative 12.9 percent growth in the first quarter and the retail and wholesale sector output also contracted by 12.2 percent during the same period. Weak performance of these sectors was accompanied by a large drop of imports, which indicates weakening domestic demand in the face of high inflation and currency depreciation. Transportation sector showed robust growth of 15.5 percent reflecting increased freight transportation from the OT mine. Agriculture also displayed a robust growth of 18.4 percent thanks to favorable weather during the winter.

Figure 3. Mining sector became the largest growth driver while growth momentum of non-mineral sector weakened.

Real GDP growth contribution by sectors (%p)

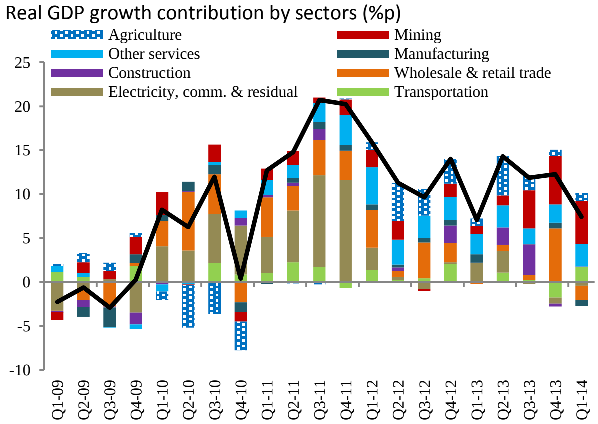
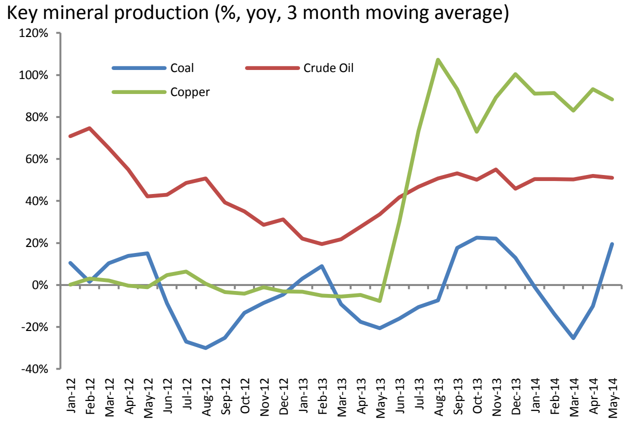


Figure 4. Strong copper and petroleum production is leading strong mining out.

Key mineral production (%, yoy, 3 month moving average)



Source: NSO Bulletin, WB staff estimates

Expenditure composition of economic growth confirms weakening domestic demand. Economic growth in 2013 was largely led by robust final consumption with its growth contribution reaching 13.7 percentage points. However, the growth momentum from consumption expenditures seems to be waning in 2014 under growing pressure from high inflation. Growth contribution of final consumption fell to 3.7 percent points in the first quarter of 2014, a significant down from 13.3 percentage points in the previous quarter. Growth contribution of gross fixed capital formation turned negative in 2013 and remained in negative territory in the first quarter of 2014 amidst declining private sector investment despite large construction work supported by the government. Changes in inventory data suggests increased accumulation of unsold products over the last year. Growth contribution of changes in inventories was estimated to be 5.6 percentage points in 2013, a significant turnaround from negative 0.5 percentage points in 2012 (Figure 5). The large increase in inventories amidst weakening economic prospects and external environment is likely to signal possible delays in production schedules in 2014, which may also adversely affect economic growth. Meanwhile, significant improvement in net exports largely contributed to the economic growth in the first quarter amidst rising exports of copper and a significant drop in imports (Figure 6).

Figure 5. Final consumption and increased inventory were main drivers of economic growth in 2013…

Annual real GDP growth contributions by expenditures (%p)

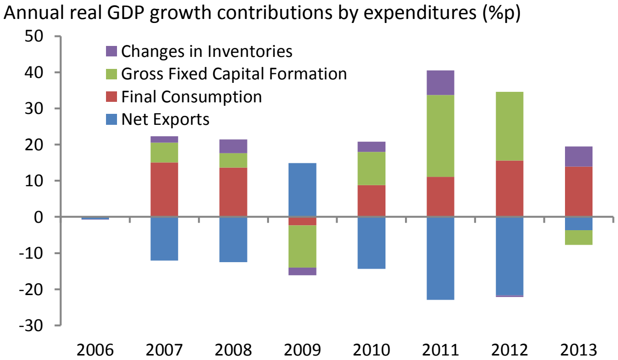
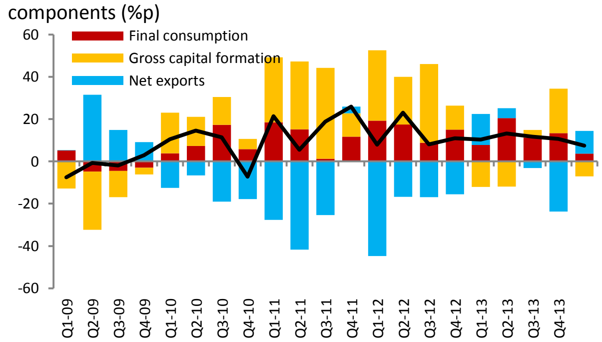


Figure 6. … but the growth contribution from final consumption expenditure is waning in 2014.

Quarterly real GDP growth contributions by expenditure components (%p)



Source: NSO, WB staff estimates

Construction boom buoyed by policy support contributed to double-digit growth of the economy in 2013 but also raises concern on overheating housing market. The government and the central bank together provided MNT 3-4 trillion – equivalent to around 20 percent of GDP – to construction of infrastructure (mostly roads) and apartments over the last year, which led to 66.5 percent growth of construction sector in 2013. Construction of apartments jumped by over 50 percent during the same period which was intended to be largely absorbed by the expanded demand created by the lower-rate housing mortgage program of the central bank. While the construction stimulus measures and the housing mortgage program were politically popular and contributed to economic growth, the real estate market boom created by subsidized credit from the central bank raises concerns on possible overheating of the housing market. Housing price has been rapidly rising over the past three years amidst continued double-digit economic growth and strong policy support measures. Housing price level in Ulaanbaatar rose 33 percent over the past year and has more than doubled since 2011. The current housing market boom boosted by cheap credit is likely to be vulnerable to further economic slowdown. Strong construction boom of apartments over the last year also indicates possible excess supply of residential buildings, which may lead to an adjustment in the housing market. An adjustment of the overheating housing market would likely have a large spill-over effect to the banking system that has scaled up its lending to construction and real estate sectors. See Box 1 for further discussion on construction and housing sector.

Box 1. Is construction and housing market overheating?

Construction sector output grew 66.5 percent in real terms in 2013, up from 38.9 percent in the previous year buoyed by strong economic stimulus measures. (Figure 7) Construction of apartments and roads surged in 2013. Construction of new apartments rose by 58 percent, to 18,012 apartments in 2013 from 11,413 apartments in 2012. Roads construction projects boosted by public investment using the Chinggis bond proceeds added 1,213 kilometers of new roads in 2013, a significant increase from 120 kilometers of new roads in 2013 (Figure 8).

Figure 7. Construction sector grew rapidly in 2013…

Real GDP Growth of Construction Sector (%)

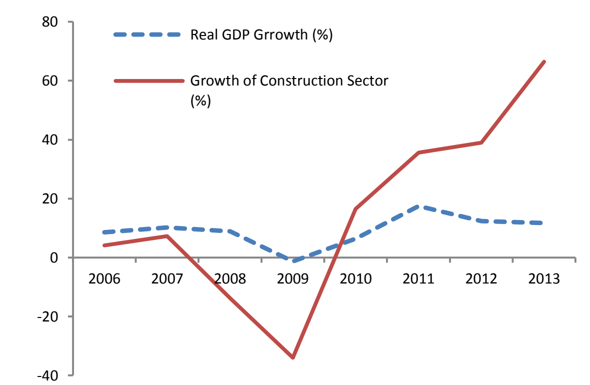
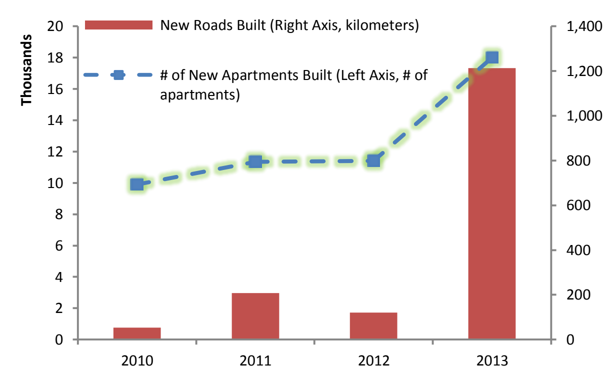


Figure 8. … largely driven by construction of housing and roads supported by economic policies.

Construction of Roads and Apartments



Source: NSO, WB staff estimates

Strong growth in construction was fueled by active support from off-budget spending of the government and cheap credit from the central bank. Around MNT 3-4 trillion (equivalent to around 20 percent of GDP) was provided by the government and the central bank to stimulate construction over the last year. While exact data is yet to be available, the government is estimated to have provided around

MNT 1.3 trillion to construction-related projects through the Development Bank of Mongolia, focused on road and street renovation projects (Figure 9). Subsidized lending from the central bank has been largely focused on both supply and demand sides of housing market. The Bank of Mongolia provided cheap credit of around MNT 0.8 trillion to construction companies and suppliers of construction materials. These supply-side measures were combined by the low rate housing mortgage program that was also carried out by the central bank in an effort to create demand for boosted supply of housing. In 2013, MNT 1.2 trillion was provided to 1,226 borrowers under the housing mortgage program through commercial banks. Overall, around MNT 2 trillion was provided to the construction sector and housing market in the form of cheap credit from the central bank.

Lending exposure of commercial banks to construction and housing market is on the rise. As a result of the subsidized policy lending programs, commercial bank loans to construction sector jumped by 61.9 percent and outstanding mortgage loans surged by 129 percent over the last year. Commercial bank loans to construction and real estate sectors almost doubled over the last year and the percentage share of bank loans to these sectors rose to over 31 percent (MNT 3.6 trillion) in the first quarter of 2014 from 27 percent (MNT 1.9 trillion) from a year ago (Figure 10).

Figure 9. Significant off-budget financing was provided to public investment projects.

Total Public Capital Expenditure (MNT, trillion)

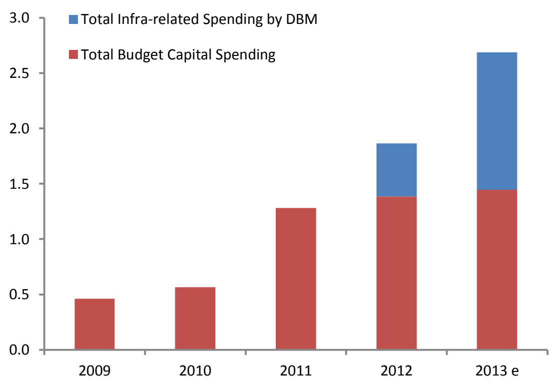
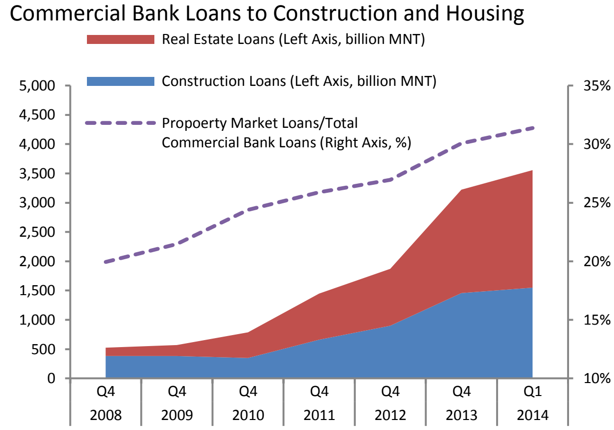


Figure 10. The central bank also provided MNT 2 trillion of cheap credit to construction and housing sector.

Commercial Bank Loans to Construction and Housing



Source: NSO, BoM, WB staff estimates

Amidst the revamped demand and supply of housing market, housing price inflation has been accelerating. Housing price inflation has been constantly exceeding the headline inflation since early 2011. (Figure 11) Since mid-2013 when stimulus measures to housing and construction sector began to be implemented, housing price level has been rapidly rising, registering 32 percent increase over the last four quarters, reflecting stronger demand boosted by the mortgage lending programs. (Figure 12)

The recent developments in construction and housing sector needs close monitoring. While financial support to construction and housing sector contributed to economic growth in 2013 and growing housing opportunities to middle-income families, high housing price inflation indicates growing signs of overheating housing market which is accompanied by growing household debt. (For more discussion on household debt, see Box 4.) The housing price level in Ulaanbaatar more than doubled (122 percent increase) between 2011 and 2013. Anecdotal evidences suggest that a large number of mortgage borrowings may have been made to borrowers with speculative motives seeking for cheaper-cost financing opportunity and that the current housing market boom may be driven by prevailing expectation of persisting housing price inflation in the future. This expectation will likely grow if the authorities expand the eligibility of mortgage borrowing to larger size apartments and non-apartment housing. Possible oversupply of residential buildings is also concerning. Construction boom of residential buildings last year may have led to excess supply in the housing market. Meanwhile, slowing economic growth indicates that policy-induced housing market demand may soften in the coming months. A combination of continued housing price inflation and possible excess supply situation suggests a possibility of an adjustment in the overheating housing market.

Figure 11. Housing price inflation has been exceeding headline inflation constantly since 2011…

Housing Price Inflation Of Ulaanbaatar (%, year on year)

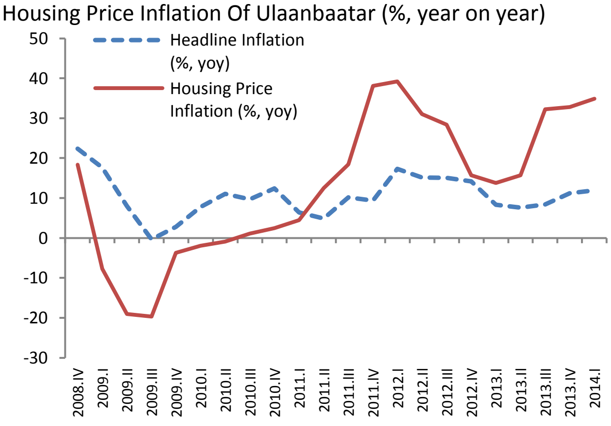
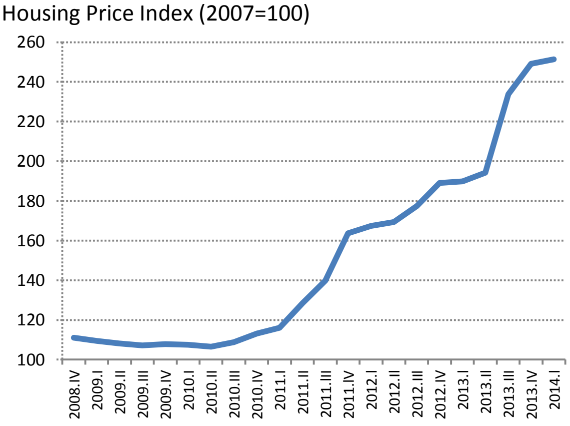


Figure 12. … and the housing price inflation is picking up further.

Housing Price Index (2007=100)



Source: NSO, WB staff estimates

Source: WB staff analysis

Double-digit inflation continues led by rising core inflation.

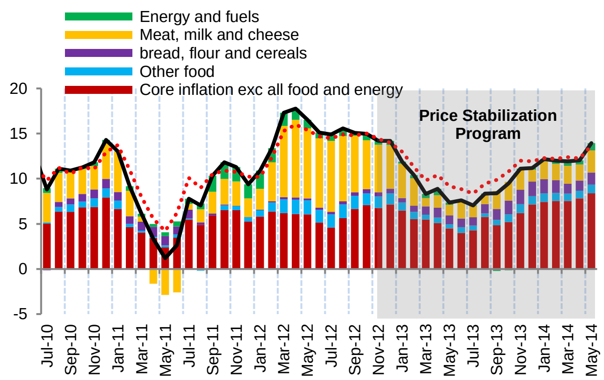
Persistent high inflation is weighing on the economy as the headline inflation remains double digits amidst policy-led credit boom and sliding exchange rate. The national headline inflation reached 12.3 percent on year-on-year basis in April and further accelerated to 13.7 percent in May, the highest level over the past fifteen months. (Figure 13) The headline inflation had been subsided for the first six months last year from over 14 percent at the end of 2012 to 8.3 percent in June 2013, reflecting stabilizing meat price and some effect of the Price Stabilization Program. However, headline inflation began to pick up again from July 2013 led by accelerating core inflation amidst growing money supply and escalating currency depreciation. (Figure 14)

Core inflation rate reached its highest level since 2009. Core inflation – which excludes food and energy items – climbed to 16 percent in May, up from 13 percent at the end of last year and 7.7 percent of last June. Comparing main drivers of inflation between the high inflation period in 2012 and the current high inflation period since mid-2013 suggests that current double-digit inflation trend is driven more by rising core inflation while the previous high inflation period of 2012 came largely from disrupted supply of meat in the aftermath of the harsh winter in 2010. In 2012, average headline inflation reached 15 percent led by surging meat price inflation of 55 percent on average. During the same period, average core inflation was 10.8 percent. Over the past eight months of double digit inflation since October 2013, however, the meat price inflation has been relatively moderate around 10 percent. Meanwhile core inflation has been constantly exceeding headline inflation since early 2013 and accelerated to over 16 percent in May 2014. (Figure 15)

Underlying pressure on inflation will likely remain high in the coming months in light of extended money supply and continuous pressure on exchange rate. As large balance of payments imbalance is likely to remain, external financing gap and weak confidence in local currency will continue to weigh on the local currency value. Further monetary easing would further add to the inflation pressure. However, inflationary pressure may begin to ease gradually over time in the latter half of the year if the monetary authorities start tightening monetary policy stance by curbing credit growth and avoid further injection of fresh liquidity to finance economic stimulus programs of the government.

Figure 13. Inflation has accelerated back to double digit level since mid-2013…

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



Source: NSO Bulletin, World Bank staff estimates

Figure 14. … and rising inflation has been fed by growing credit supply and continued currency depreciation.

CPI inflation, Money Supply and Currency Depreciation (%)

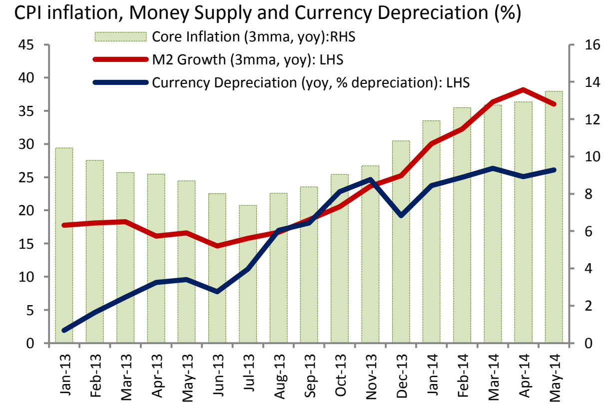
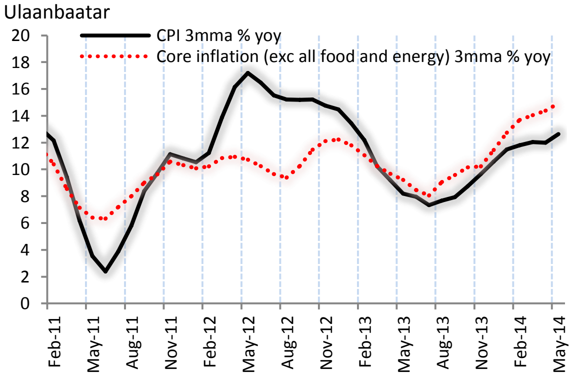


Figure 15. Recent double-digit Inflation is driven by rising core inflation.

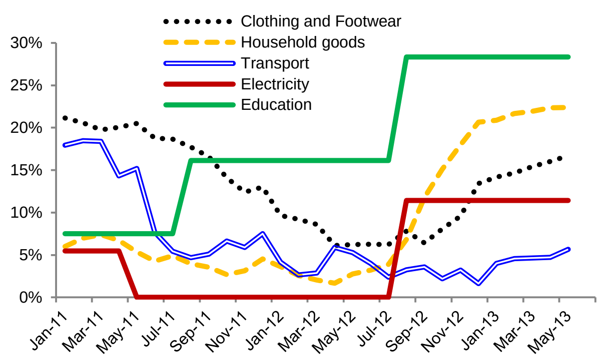
Headline inflation and Core Inflation (year-on-year, %): Ulaanbaatar



Source: NSO Bulletin, World Bank staff estimates

Figure 16. Price increases are also observed in most of non-food consumption goods and services.

Inflation trend of key core price items (yoy, %)



Unemployment reached 9.4 percent in the first quarter.

Key labor market indicators of the Labor Force Survey did not suggest clear indications of deteriorating labor market condition despite the slowing economic growth. Unemployment rate stood at 9.4 percent in the first quarter of 2014, similar to the level in the same period of the last year. (Figure 17) The first quarter's unemployment rate was higher than 7.7 percent in the previous period. However, unemployment rate has displayed highly seasonal pattern in Mongolia due to difficult work conditions in the harsh winter, reaching the highest level in the first quarter especially in the areas that are heavily dependent on seasonal businesses such as construction, agriculture and mining. The first quarter unemployment rate remained largely unchanged from the level of the same period a year ago. There were 108.7 thousands of unemployed people in the country at the end of March, up by 2.6 thousand people from a year ago. Total labor force was estimated at 1.1 million persons and the labor force participation rate reached 61.7 percent. (Figure 18)

Figure 17. Unemployment rate rose to 9.4 % in the first quarter of 2014.

Quarterly Unemployment Rate (%)

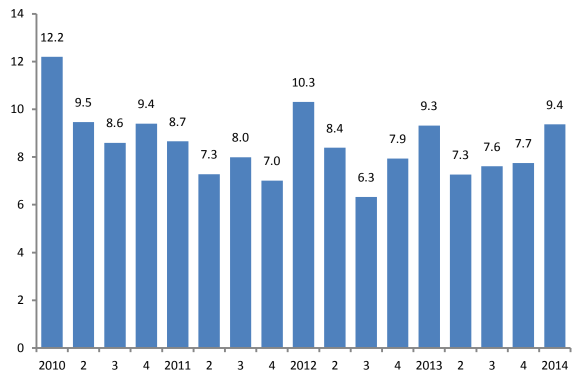
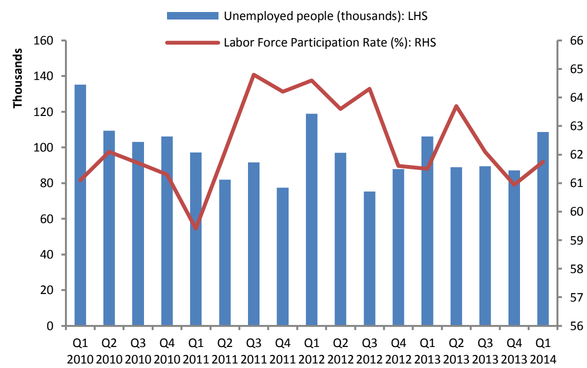


Figure 18. The number of unemployed people reached 108 thousand.

Number of the Unemployed and Labor Force Participation Rate (%)



Source: Labor Force Survey

Breakdown of employment data by gender indicates increasing labor force participation and higher growth of employment for females in the first quart of 2014. Economically active population increased by 13 thousand females and 8.5 thousand males from the same period in 2013. The number of employed females rose by 18.9 thousand persons from a year ago, exceeding the number of new female labor force. Meanwhile the total number of employed males remained almost unchanged during the same period, indicating most of the new male labor force remained unemployed. Unemployment rate by gender confirms increased labor market participation of females. Female unemployment rate declined to 8.4 percent in the first quarter of 2014 from 9.7 percent a year ago while male unemployment rate went up to 10.2 percent from 9.0 percent. (Figure 19) However, it remains to be seen if the rising labor force participation and improving employment statistics for females are temporary, given that the labor market situation had been more favorable to male labor force throughout the last year.

Employment composition by types of jobs indicates signs of deteriorating employment quality. Over the past twelve months through the first quarter of 2014, number of paid-employees dropped by 25 thousand while number of self-employed workers – usually small scale and family businesses including kiosks and small vendors – jumped by 58.9 thousand. (Figure 21) The share of self-employed workers rose to 21.8 percent of the total employed in the first quarter from 16.5 percent in the same period of previous year. The share of paid employees declined to 49.2 percent from 52.6 percent over the same period. The shift of composition of job types 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.

Sectoral composition of employment shows continuous sectoral shift of labor force from traditional agricultural sector into non-agricultural sectors and the rising difficulty in the mining industry. Agriculture sector employed 27.7 percent of total number of jobs in the first quarter of 2014 but it has been on a steady downward path from 42 percent in 2007. The share of industrial sector including mining, manufacturing and construction business steadily rose over the same period, reaching 20 percent in the first quarter of 2014 from 11.9 percent in 2007. Service sectors including wholesale and retail business also absorbed a large number of labor force that migrated from agriculture with its job share rising to 52 percent from 44 percent. The share of mining sector has been around 4 percent of total employment since 2010 reflecting capital intensive nature of the industry, but the size of employment in the mining sector declined by 27 percent (15.6 thousand) from the same quarter last year, reflecting growing difficulty of the mining industry especially in coal mining sector. (Figure 22)

Figure 19. Male unemployment rate rose to over 10.2% while female unemployment rate remained stable.

Unemployment Rate by Gender (%)

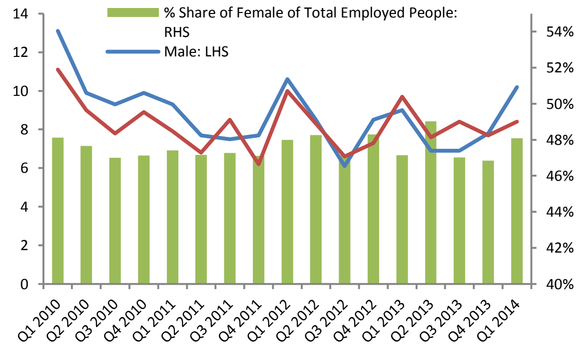


Figure 20. Labor force participation of females rose from a year ago while male labor force participation rate declined.

Labor Force Participation Rate by Gender (%)

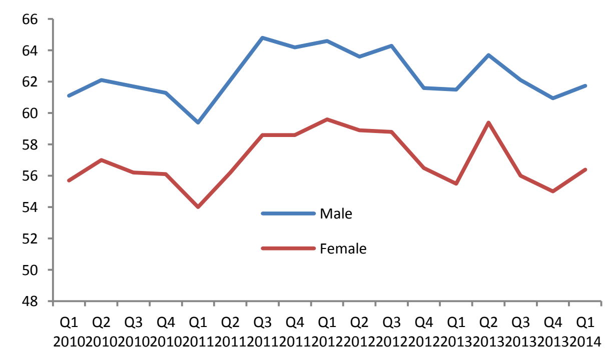


Figure 21. Self-employed workers are increasing while paid-workers are declining.

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

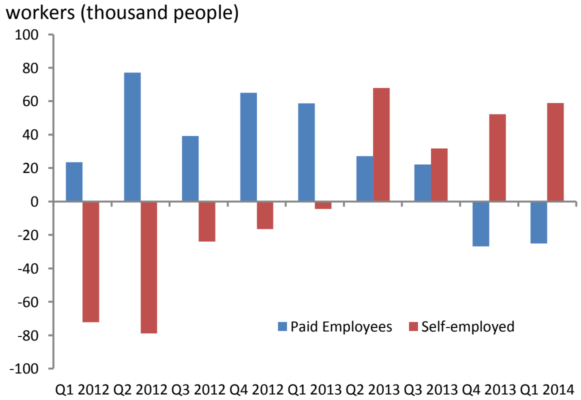
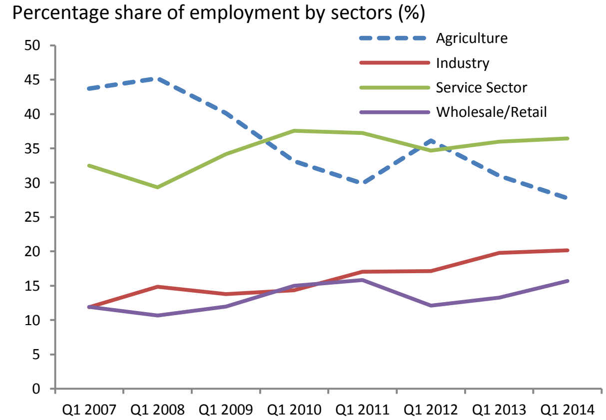


Figure 22. Labor market is shifting away from agriculture.

Percentage share of employment by sectors (%)



Source: Labor Force Survey, WB staff estimates

Fiscal deficit reached 10.9% of GDP in 2013 and will remain over 10% in 2014.

Fiscal policy remained highly expansionary in 2013 with the overall fiscal deficit reaching 10.9 percent of GDP. Official budget – which excludes the spending of the Development Bank of Mongolia (DBM) – was able to keep the budget deficit within the annual ceiling imposed by the Fiscal Stability Law. However, additional spending by the DBM has been implemented without being recorded in the official budget, bypassing the control of the FSL since 2012. The official budget recorded overall deficit of 1.4 percent of GDP and its structural deficit to GDP ratio was 1.7 percent within the two percent structural deficit ceiling of the Fiscal Stability Law. Total budget revenue and grants reached 33.8 percent of GDP. The 2013 budget experienced a large revenue shortfall equivalent to 13 percent of original revenue projection due to optimistic revenue forecast. Budget expenditure was adjusted downward by 17 percent in November 2013 in the face of revenue shortfall, which allowed the official budget to meet the budget deficit ceiling required by the FSL. Despite the tightened official budget, the DBM financed around MNT 1.7 trillion for public projects and other government policy measures using the proceeds of the sovereign bond (Chinggis bond) and the DBM bond (under the direct sovereign guarantee) that were issued in 2012. The off-budget spending channeled through the DBM in 2013 is estimated to be around 9.5 percent of GDP and total government expenditure including the DBM spending reached 44.7 percent of GDP,

Fiscal deficit will likely remain over 10 percent to GDP in 2014 driven by continued off-budget spending scheme. We expect the structural deficit of the official budget to be kept within the two percent ceiling of the FSL considering the strong commitment of the budgetary authorities to the law. However, substantial off-budget spending will likely continue outside the control of the budgetary authorities. Available funds for off-budget spending through the DBM in 2014 is estimated to be around US$ 1 billion including the unused Chinggis bond proceeds and the new proceeds of Samurai bond. Most of the available funds are expected to be used this year to finance public projects and economic stimulus programs announced by the government in 2014. Under these assumptions, the overall fiscal deficit including the DBM spending is expected to reach over 10 percent of GDP.

Figure 23. Fiscal spending will remain over 40 percent of GDP due to continuous off-budget spending.

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

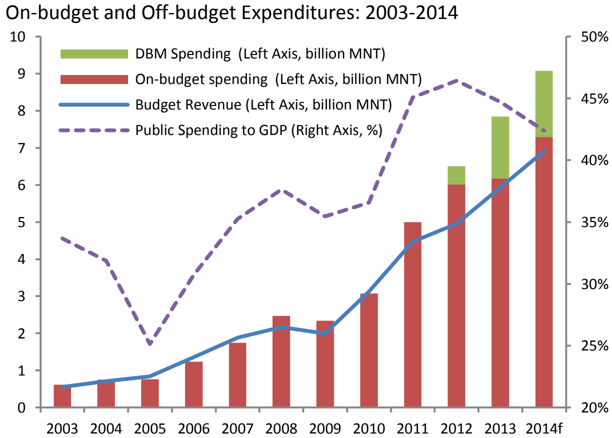
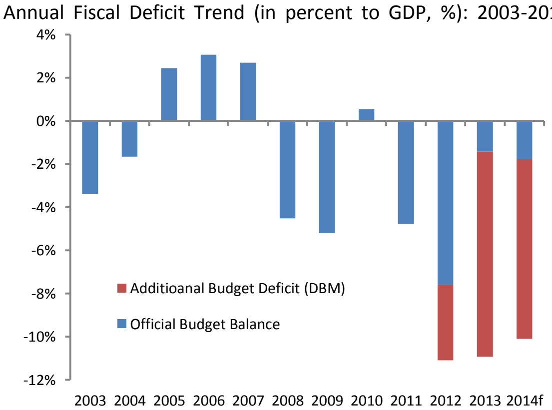


Figure 24. Total budget deficit including the DBM spending will likely remain 10 percent of GDP in 2014.

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



Source: MoF, WB staff estimates

The 2014 budget will likely face another revenue shortfall in light of the weak revenue outturn so far and weak economic prospects. The 2014 budget revenue projection was prepared in November

2013 based on the revised revenue projection of the 2013 amended budget. The 2013 amended budget downward-adjusted original revenue forecast by 11.4 percent in November 2013 in the face of weak revenue stream. The 2014 budget projected the revenue to increase by 7.5 percent in 2014, compared with the revenue projection of the 2013 amended budget. However, the actual annual revenue outturn in 2013 fell short of the revised revenue projection of the amended budget by 7.9 percent due to weaker-than-expected revenue performance in the last quarter of the year. The current revenue projection for 2014 is now 17 percent higher than the actual budget revenue outturn in 2013. Total mineral revenues including corporate income tax, royalties and dividends were projected to account for about 20.6 percent (MNT 1.4 trillion) of total revenue. The current revenue projection is likely to be over-estimated as it is based on the over-estimated revenue projection for 2013 and optimistic macro-economic assumptions envisioning 14.8 percent economic growth for 2014. Over the first five months in 2014, budget revenue increased only by 7.7 percent from the same period last year, due to sluggish growth of consumption-related tax revenues and a drop in corporate income tax amidst slowing economic growth. In light of the weaker revenue performance so far and optimistic revenue assumptions of the budget, budget revenue will likely experience around 10 percent of revenue shortage from the current budget revenue projection.

Box 2. Mineral Revenue Projections of the 2014 Budget

The 2014 budget projects total revenue to reach MNT 6,914 billion (33.7 percent of nominal GDP), up by about 16.6 percent from the 2013 revenue outturn and by 7.5 percent from the amended 2013 budget. Tax income constitutes 90.5 percent of total structural revenue in 2014. Total mineral revenues including CIT, royalties and dividends are expected to account for approximately 20.6 percent (MNT 1.4 trillion) of total revenue. Mineral revenues for 2014 are projected to grow by 30.2 percent, reflecting its asusmption of stronger exports of coal, copper and gold. Table 1 provides projections for mineral revenues estimated by the Ministry of Finance.

Table 1. Composition of Mineral Tax Revenues: 2014 Budget

№	Commodities	2014 plan by types of taxes (in billions of MNT)						
		CIT	Royalty	Progressive royalty	Dividend	Other Taxes	Customs fee	Total
1	Gold	71.0	89.3	15.0		4.6	0.3	**180.2**
2	Coal	222.2	188.9	86.5	7.3	60.9	47.0	**612.7**
3	Copper concentrate	30.0	130.0	117.1	15.0	98.0	1.2	**391.3**
4	Others	61.2	81.5	59.7		26.9	14.1	**239.8**
	TOTAL MINERAL REVENUE	**384.4**	**485.6**	**278.4**	**22.3**	**190.4**	**62.9**	**1,424.0**

Note: The Government excludes the VAT from mining sector from the mineral revenue calculation.
Source: Ministry of Finance

The FSL defines major commodities as those that generate three or more percent of fiscal revenues. The law requires that structural prices be set according to the special rule under the FSL[1]. Table 2 below illustrates the assumption on structural prices of major commodities of the 2014 budget according to the rule. Government projections on structural prices of major commodities seem conservative compared to

[1] 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.

the structural prices of the 2013 budget as they followed the fiscal rule set in the FSL.

Table 2. Projections of the 2014 Budget on Prices and Volumes of Major Commodities

	Volume	Structural Price	Market Price
Copper	1,225 thousand tons	USD 6,242.0 /ton	USD 6,836.7 /ton
Processed coal	5.6 million tons	USD 115.9 /ton	USD 119.8 /ton
Coking coal (above 5,500 kkal)	22.3 million tons	USD 81.6 /ton	USD 83.4 /ton

Source: Ministry of Finance, 2014 Budget

Source: 2014 Budget, MoF

The structural official budget deficit – excluding the DBM spending – reached 0.5 percent of annual GDP over the first five months. Budget revenue receipts grew by 7.7 percent from 2013 revenue outturn over the first five months. Despite the weak revenue stream, official budget expenditure increased by 22 percent compared with the expenditure level during the same period last year with recurrent spending rising by 18.7 percent and capital expenditures surging by over 50 percent. Information on the DBM spending so far in 2014 is yet to be available but the DBM spending is likely to accelerate in the coming months as many of government policy measures began to be implemented in recent months.

In light of the weak revenue performance, downward adjustment of revenue projection and tightening of budget spending plan seem likely in the coming months. The 2014 annual budget underwent minor adjustment in early June in the composition of recurrent and capital expenditures without adjusting revenue projection, which did not affect main fiscal indicators. As the budget expenditures tend to seasonally accelerate in the summer, the budget will likely display a rising deficit under the current trend of weak revenue receipts. We expect that further tightening of official budget is likely in the coming months.

The Development Bank of Mongolia has been at the center of fiscal debate throughout the last year as it played an increasingly important role as the main financier of off-budget spending. The DBM's main financing sources in 2013 were the remainder of the DBM bond and the proceeds from the Chinggis bond that were issued in late 2012. The spending by the DBM needs to be properly recorded in the budget on the following grounds: (i) the DBM bond (US$ 580 million) was issued under the direct guarantee of the government and the DBM alone lacks the capacity to borrow from international financial market; (ii) the Chinggis bond (US$ 1.5 billion) was a direct borrowing of the government and the receipt and use of its proceeds should be properly recorded in the budget according to international principles; (iii) many of DBM-funded projects are non-bankable and the repayment of the DBM bond and the Chinggis bond will highly likely be made by the state budget when the repayments are due in 2017 and 2022. However, the spending through the DBM has not been accounted and monitored by the budget or other fiscal documents that are publicly available. (See Box 3 for more discussion on the operations of the DBM)

Box 3. Unreported Government Spending through the DBM

Mongolia established Development Bank of Mongolia (DBM) in March 2011 that is regulated by the Law on Development Bank of Mongolia. The DBM has been financing projects in 2012-2013 out of three sources: own capital, midterm euro bond (US$ 580 million) and US$ 1.5 billion of Chinggis bond which was issued directly by the Government in November 2012. In addition to these funding sources, the DBM issued samurai bond with a 10 year maturity at 1.52% coupon rate in late 2013. The low coupon rate was possible due to the guarantee provided by the JBIC (Japan Bank for International Cooperation). JPY 24.3 billion – equivalent to US$230 million – has been transferred to the DBM account on January 6, 2014. Although the DBM's operation relies on the state budget and its guarantee, its operations have not been reported in the officially approved government budget or other related documents. Only interest payments to midterm euro bond and Chinggis bond have been reflected in the annual budget.

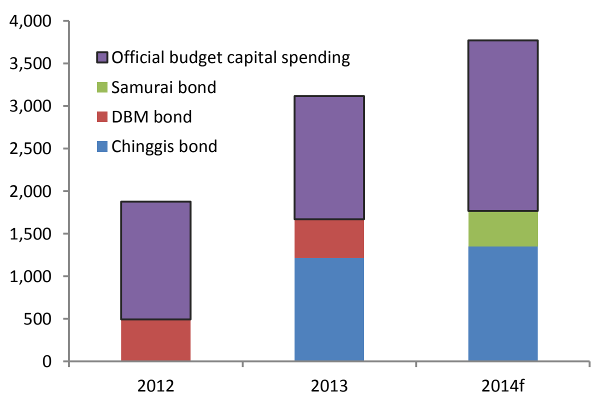
In 2013, we estimate that the Chinggis bond proceeds provided US$ 0.7-0.8 billion to DBM-financed projects and about MNT 0.5 trillion was provided from the proceeds of the DBM bond. Total amount of public projects financed by the DBM is equivalent to 9.5 percent of GDP in 2013. In 2014, the DBM will likely spend the remaining Chinggis bond proceeds and the new proceeds from the Samurai bonds in order to fund more public projects, which is estimated to be over eight percent of GDP.

The DBM loans are classified into two types of operations: (i) loans to be repaid by the state budget and (ii) loans that are supposed to be repaid by the revenue stream of projects that are financed by the DBM. Projects of the first type are regarded as "social projects" that include construction of roads, street renovation, power station and railway projects. They are government budget operations in nature and are implemented by responsible line ministries. Loans to these projects should be repaid by the state budget to the DBM. Projects of the second type include loans that were issued mostly to private sector recipients including transportation, mining and housing construction sectors. These projects are deemed bankable by the government as recipients of these loans are supposed to be able to generate sufficient financial revenue streams. At the end of 2013, over 60 percent of total outstanding loans from the DBM were issued to social projects.

The DBM and the MOF signed an agreement in 2013 that the repayments of loans to social projects will be reflected in annual budget from 2015. This will likely be problematic in terms of account principle as well as transparency and accountability of budget operations. DBM-financed budget operations that are implemented by line ministries will not be recorded in the budget when actual spending occurs by line ministries. Instead, only repayment of loans to the DBM by line ministries will be recorded in the future. As this stage, it remains unclear how the budget will record the repayment in the future while the initial borrowing of the line ministries at the current stage are not recorded as a proper financing item in the budget.

Figure 25. Fiscal spending financed by the DBM is almost equivalent to the size of on-budget capital expenditures.

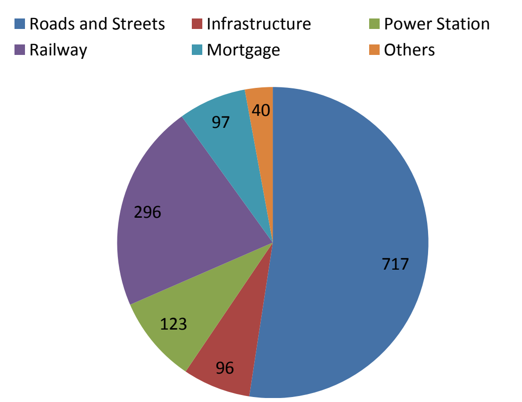
Composition of DBM Financing by Sources vs. Official budget capital spending (in billions of MNT)



Source: DBM, WB staff estimates

Figure 26. Two thirds of DBM-financed projects are budgetary operations to be repaid by the state budget.

Composition of budgetary operations financed by the DBM (in billions of MNT)



Source: World Bank staff

Policy-led credit boom came with deteriorating quality of bank assets

Monetary policy has substantially eased in 2013 by providing fresh liquidity equivalent to over 20 percent of GDP and lowering policy rate. Under the Price Stabilization Program and the low rate mortgage lending program, the monetary authorities provided MNT 4.1 trillion of fresh money in subsidized terms into the economy through commercial banks. The central bank also reduced its policy interest rate three times to 10.5 percent from 13.25 percent in 2013. As a result, outstanding central bank loans to commercial banks jumped from MNT 181 billion in November 2013 to MNT 4.3 trillion at the end of 2013. The substantial easing of monetary policy contributed to revamping credit growth in early 2013 and maintained double-digit economic growth last year. However, the quantitative easing programs of the central bank has also added high demand-side pressure to inflation, exchange rate and raised concern on the quality of bank loans that rapidly expanded over the last year.

Domestic credit growth reached its peak of 75.3 percent on year-on-year basis last November and remains high at 55 percent in May 2014. The growth of bank credits to private sector has also peaked at 77.4 percent at the end of November last year and gradually softened to 46 percent in May. Outstanding domestic credit reached 74.8 percent of GDP in the first quarter this year, up from 57.3 percent in the same period last year. (Figure 28) Money supply has been on the rise in 2014 reflecting the effect of loose monetary policy of the last year and drawdown of proceeds of Chinggis bond. M2 growth has been on a rising trend over the past nine months and reached 42 percent in April on year-on-year basis, the highest level over the last two years.

Recent monetary indicators suggest that the expanded balance of the central bank is being unwound gradually. MNT 900 billion (equivalent to around 7 percent of GDP) that had been placed at commercial banks as one-year deposit in early 2013 has been gradually withdrawn and fell to around MNT 150 billion in March. Policy lending under the Price Stabilization Program and mortgage lending program has also been gradually tapered. Outstanding amount of central bank credit extended to commercial banks reached its peak of MNT 4.3 trillion at the end of 2013 and was reduced to MNT 2.9 trillion in May 2014. (Figure 27) Annual growth of M2 also moderated to 29.4 percent in May with the reserve money growth decelerating to single-digit level in April and May. Yet, it remains unclear at this stage whether the recent gradual tapering of extended credit signals official turnaround of monetary policy stance.

Figure 27. Central bank credits to commercial banks declined recently but still remain substantial.

Central Bank Credits to Commercial Banks and M2 growth

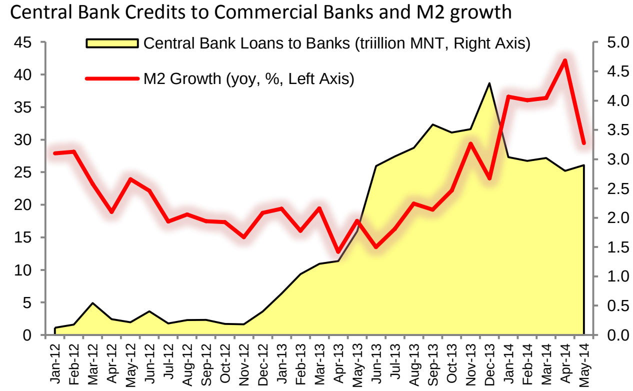
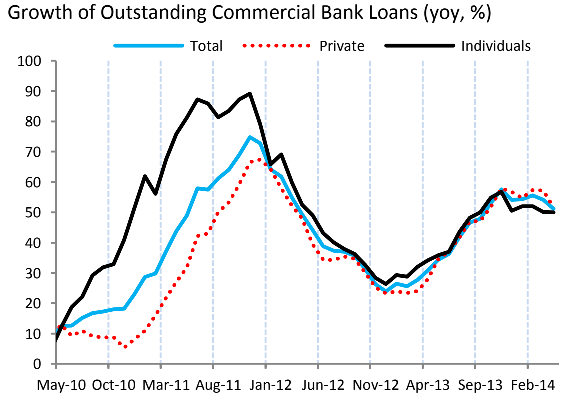


Figure 28. Domestic credit growth still remains over 50 percent despite the gradual slowdown in recent months.

Growth of Outstanding Commercial Bank Loans (yoy, %)



Source: BoM Bulletin, WB staff estimates

Loan to deposit ratio reached 125 percent in May 2014, slightly moderated from its peak of 128 percent last October. (Figure 29) The rising loan to deposit ratio reflects increasing reliance of commercial banks' operation on the credit extended by the central bank's policy lending programs. Total loan growth of banks reached over 55 percent in May, exceeding the growth of total deposits of 31.6 percent. Total outstanding loans of banks reached MNT 14.3 trillion in May while the total bank deposit (except for government deposit) was MNT 9.6 trillion. Foreign current deposits accounted for 19.8 percent of total deposit in May. (Figure 30)

Figure 29. Loan to deposit ratio reached 125% in May.

Commercial Bank Loans and Deposits (% change, month-on-month, 3 month moving average)

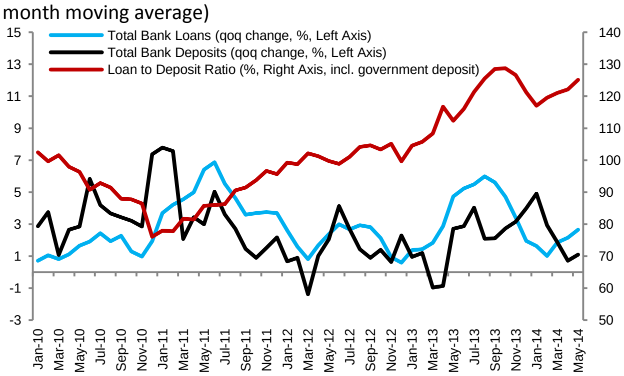
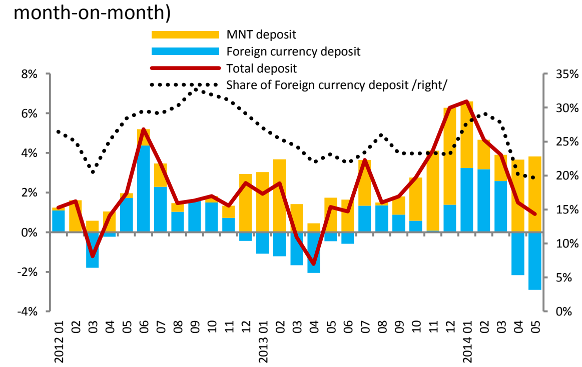


Figure 30. Foreign currency deposit takes up 20% of total deposit.

Local Currency and Foreign Currency Deposits (% change, month-on-month)



Source: BoM, WB staff estimates

While credit boom appeared across all sectors, credit provision was more concentrated on construction and real estate sectors as well as mining sector. Loans to construction sector grew 117.5 percent in the first quarter of 2014, followed by real estate loans (72.7 percent), mining sector loans (63.2 percent) and wholesale/retail industry (53 percent). (Figure 31) Percentage share of loans to construction and real estate sector rose to 31.4 percent in the first quarter of 2014 from 27 percent at the end of 2012. The wholesale industry accounted for 16.7 percent of total loans, followed by 12.1 percent of the mining sector (Figure 32). Around 60 percent of policy lending programs of the central bank was targeted at the construction and housing sectors, including the Price Stabilization Program, additional measures for construction and housing development and the low rate mortgage lending program.

Figure 31. Credit growth has been concentrated on construction, real estate and mining sectors.

Bank Loan Growth by Sectors (year on year percent change, %)

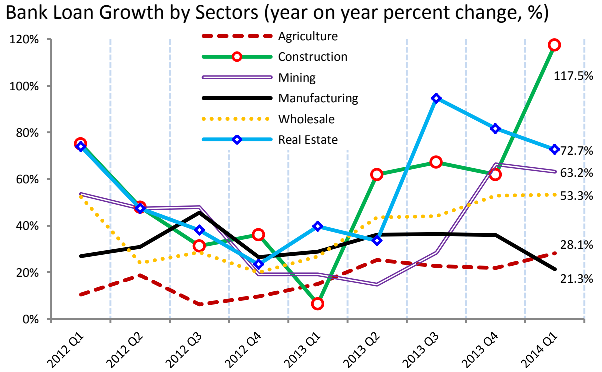
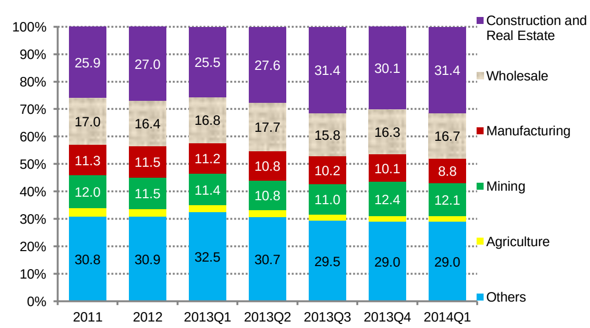


Figure 32. Construction and real estate loans account for one third of total bank loans.

Sectoral Composition of Bank Loans (%)



Source: BoM Bulletin, WB staff estimates

Recent increase in non-performing loans and past-due loans signals deteriorating quality of bank assets, amidst strong policy-induced credit boom and slowing economic activities. Problematic loans (including NPL loans and past-due loans) accounted for 8.3 percent of total loans in May 2014. However, the ratio has been on a rising trend in recent months from 6.3 percent at the end of 2013. (Figure 34) More concerning is a rapid rise in the size of problematic loans since July 2013 – the amount of problematic loans more than doubled to MNT 1 trillion in May from MNT 464 billion twelve months ago. (Figure 33) Past-due loans had been stable over the last year but began to rise steeply over the recent five months of 2014, indicating increasing financial difficulties of borrowers. Ratio of past-due loans to total loans more than doubled to 3.2 percent in May from 1.1 percent at the end of 2013.

The banking system remains liquid but rising problematic loans would likely increasingly weigh on the banking sector soundness. Banks currently have reserves amounting to 30 percent of total deposit which exceeds the minimum reserve requirement of 25 percent, including their holding of central bank bills. However, prudential regulatory forbearance that was given to loans issued under central bank's policy lending programs suggests that underwriting practice of such policy loans may have been weaker and the new credit extended under the policy lending programs is likely more vulnerable to economic downturn and downside risks. Heightened vigilance and strengthened supervision on the banking sector is highly important.

Figure 33. The amount of NPL has been on a steep rise in 2014...

Size of NPL Loans (in billions of MNT)

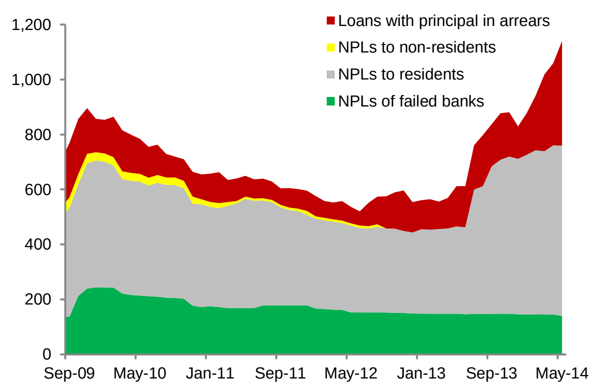
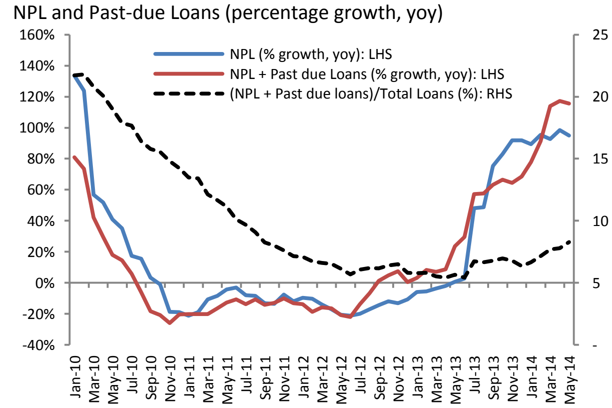


Figure 34. ... and the NPL ratio is also on the rise recently.

NPL and Past-due Loans (percentage growth, yoy)



Source: BoM Bulletin, WB staff estimates

Sectoral composition of NPL shows that deteriorating quality of bank loans are more significant in mining sector and wholesale/retail industry. Both sectors showed higher growth in problematic loans over the last two quarters: the mining sector showed 24 percent increase of problematic loans during the fourth quarter of 2013 and the first quarter of 2014 and the wholesale/retail sector's problematic loans almost doubled by 194 percent during the same period. (Figure 35) The two sectors accounted for over 90 percent of total increase in problematic loans over the six months. Among outstanding loans to individual sectors, 23.9 percent of mining sector loans were either non-performing loans or past-due loans in the first quarter of 2014, up from 19.2 percent of the previous quarter. The ratio for wholesale/retail sector more than doubled to 9.5 percent from 3.8 percent over the first three months of 2014. (Figure 36)

Construction sector's problematic loans increased by 52 percent and real estate loans displayed 25 percent growth of problematic loans. The problematic loans ratio rose to 5.7 percent from 4.2 percent for construction sector and to 1 percent from 0.5 percent for mortgage loans over the first three months. While the ratio still remains relatively moderate for both sectors, it will likely stay on a rising trend amidst softening economic activities as increasing amount of loans to these sectors will become seasoned going forward. One third of outstanding loans to construction and real estate sectors were issued in the last three quarters.

Figure 35. Rising NPL ratio was led by mining sector and wholesale/retail sector.

Sectoral Composition of NPL Ratio (%p)

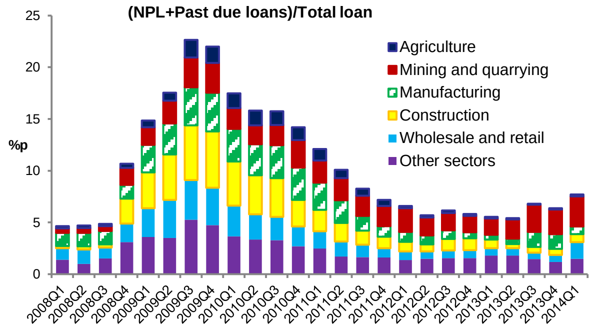
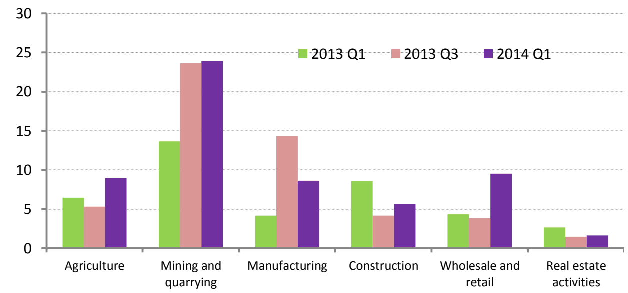


Figure 36. A quarter of mining sector loans is now problematic.

Problematic Loans/Total Loans by Sectors (%):
Problematic Loans = NPL + Past-due Loans



Source: BoM, WB staff estimates

The housing mortgage program of the central bank will likely remain as a main channel of liquidity injection despite recent gradual tapering of other policy lending programs. The housing mortgage program provided cheap mortgage loans to qualified middle income borrowers with 8 percent interest rate, a substantial discount compared with prevailing market rates of 15-16 percent. MNT 1.5 trillion of the low rate housing mortgage loans – equivalent to around 7 percent of 2014 GDP – was issued over the past nine months since the program had been launched in June 2013. Among MNT 1.5 trillion of loans issued under the housing mortgage program, MNT 0.8 trillion was extended to new mortgage borrowers and MNT 341 billion was used to switch existing commercial mortgage loans to lower rate mortgage loans. Meanwhile, the outstanding size of mortgage loans on commercial terms were reduced to MNT 742 billion in March 2014 from MNT 986 billion in May 2013 when the housing mortgage program was yet to be launched. In March, housing mortgage lending program accounted for 13 percent of total commercial bank loans and two-thirds of total outstanding mortgage loans (MNT 2.3 trillion). (Figure 37) The mortgage lending program will likely continue to expand as the growing size of mortgage loans has been securitized with Mongolian Mortgage Corporation (MIK), which will provide additional funding sources for commercial banks to carry out further subsidized policy lending. In March, MNT 0.3 trillion of the low rate housing mortgage loans were securitized through the MIK.

Figure 37. 8% housing mortgage lending program has been implemented actively since July 2013.

Monthly housing mortgage loan trend (in trillions of MNT)

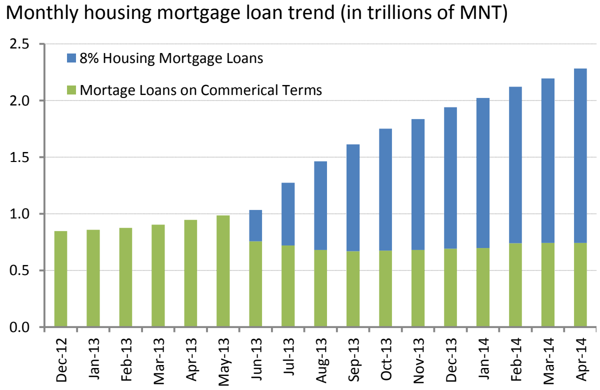
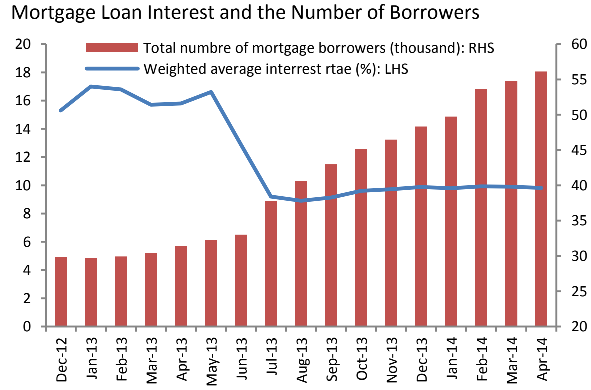


Figure 38. Number of mortgage loan borrowers almost doubled as the program offers cheaper housing loan opportunities.

Mortgage Loan Interest and the Number of Borrowers



Source: BoM, WB staff estimates

The monetary authorities is now facing a difficult policy challenge from persistent high inflation, softening economic growth and rising non-performing loans. The loose monetary stance have contributed to the double digit growth amidst the weak commodity market and maintained robust domestic credit growth through liquidity support to industries and households. However double-digit inflation and excessive credit boom with weak enforcement of prudential regulation over the last year has also led to rising problematic loans and weakening domestic demand in recent months. Monetary policy in 2013 has been largely inconsistent between contradicting goals of price stabilization and growth stimulus. While the Price Stabilization Program intended to curb inflation by addressing supply-side bottleneck that had been a major cause for the high inflation in 2012, inflationary measures were taken to finance the supply-side policy measures by providing more than 20 percent of fresh liquidity into the economy, adding to demand-side inflationary pressure. The low rate housing mortgage lending program was also implemented by the central bank instead of the budget in order to avoid possible termination of the politically popular program due to budget revenue shortages. While the overarching goal of providing affordable housing to low and middle-income families is noble, the program also added to inflationary pressure and raised household debt level, while housing prices continued to rise. (For more discussion on household debt, see Box 4.) Substituting budget with the central bank's currency issuance power has put the monetary authorities in a difficult position in the face of rising prices and deteriorating banking sector soundness amidst slowing economic growth.

Monetary policy needs to be recalibrated towards price stability and the soundness of banking system. Should the current double digit inflation persist, high inflationary expectations would likely be formed among the general population, which may exacerbate the inflation situation further. While the loose monetary policy originally intended to revamp slowing credit growth in early 2013, continued credit boom with loosened prudential regulations also provided an environment where the quality of bank assets can quickly deteriorate as the economic growth softens amidst high inflation.

We expect that the monetary authorities are aware of risks underlying the current loose monetary policy and are contemplating ways to gradually taper its expanded balance sheet. The current Price Stabilization Program is likely to be gradually unwound as the recent monetary indicators suggest. However, the politically popular mortgage lending program will likely remain providing continuous discounted loans to housing market, which will limit the tapering effect. The government needs to avoid relying on central bank as an alternative financing source to fiscal operations and should prioritize policy measures within affordable budget revenue envelope including the Price Stabilization Program and the low rate mortgage program. The Price Stabilization Program was originally announced to be transferred to the budget in 2013 but the operation remained as a central bank operation throughout the entire year as the budget failed to achieve its projected revenues.

Prudential regulations on banks needs to be properly enforced and waivers granted to policy lending programs needs to be lifted. While credit risks associated with policy lending reside on banks' balance sheets, banks cannot fully price the credit risks of individual borrowers in their lending rates due to the rate cap imposed by the authorities. Recipients of subsidized credit under policy lending program were pre-selected by the government and were sent to banks for loan approval process. Under this operational environment, commercial banks will likely have weaker incentive to apply strict and proper screening procedures during their underwriting process. Furthermore, some policy loans (e.g., Price Stabilization Program) have been exempt from some of key prudential regulations (e.g., reduced risk weights), which could lead to increasing moral hazard and adverse selection in bank's lending operations.

Box 4. Household Income and Debt

The World Bank team analyzed the trend of household income and household debt level in light of the increasing mortgage borrowing by households. This assessment on the household income and debt situation was done for an indicative purpose in order to see possible impact of rising mortgage loans on financial burden of households relative to their income level. However it must be noted that the scope of this quick assessment is limited due to data availability. The team used household income data from the Household Income and Expenditure Survey (HIES) as a proxy for household disposable income. Individual loan data from commercial banks was used as a proxy for household financial debt data which is not currently available in Mongolia.

Real household income growth entered into negative territory in 2014, indicating significantly lower purchasing power and weakened consumption capacity of households. Average nominal household income growth slowed down to 16.9 percent in 2013 after reaching 22 percent in 2011 and its peak of 46.3 percent in 2012. In the first quarter of 2014, the nominal household income growth further moderated to 6 percent, below the headline inflation rate over 12 percent. (Figure 39 and 40)

Figure 39. Nominal household income growth has been moderating over the last year…

Household Nominal Income Growth Trend and CPI Inflation (%)

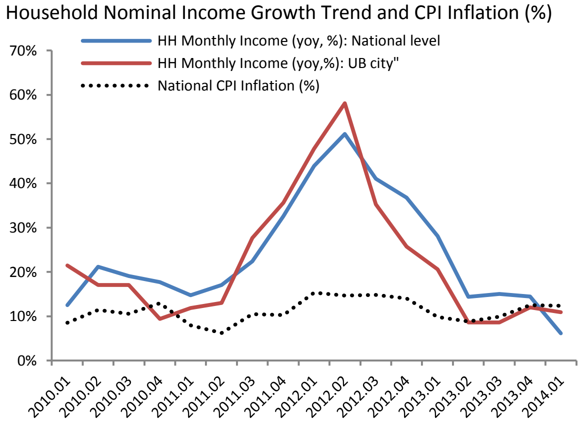
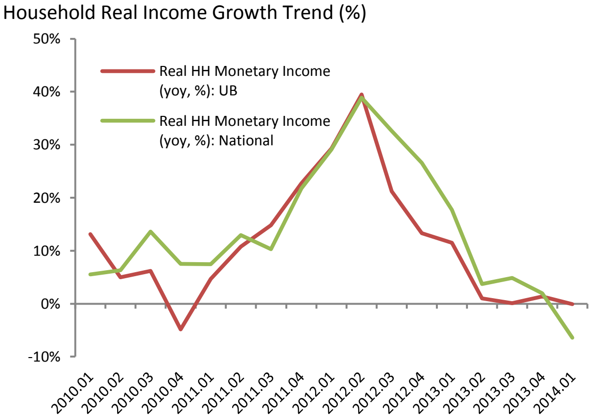


Figure 40. … and real household income growth turned negative in 2014.

Household Real Income Growth Trend (%)



Source: NSO, WB staff estimates

Average household debt is estimated to be close to MNT 6 million per household in 2013. Total loans to individuals of commercial banks rapidly grew over the last year driven by the large issuance of low-rate housing mortgage loans. Individual loans from commercial banks include pension loans, salary overdraft, consumer loans and mortgage loans. It also includes loans to small enterprises including small kiosks and vendors. We used individual loans data as an indicative measure for household financial liabilities. Individual loans grew by 51 percent over the last year, up from 26 percent in 2012. Mortgage loans surged by 129 percent last year. At the end of 2013, outstanding mortgage loans account for 42 percent of total loans to individuals, a significant rise from 27 percent in 2012. (Figure 41) Average size of bank loans per households – measured by average individual loans per households – climbed to MNT 5.8 million in 2013 from MNT 1.8 million in 2010, a three-fold increase over the past three years. (Figure 42)

Figure 41. Household financial liability rose, led by large mortgage borrowings.

Individual Loans and Mortgage Loans Growth (%): 2010-2013

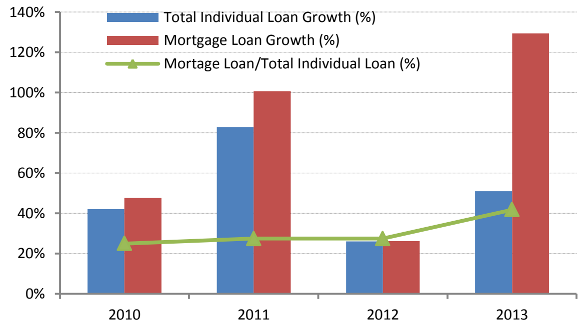
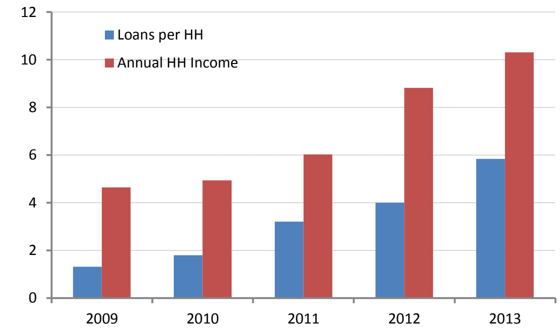


Figure 42. Average size of bank loans per household reached close to MNT 6 million.

Average Debt and Income per Household (in millions of MNT)



Source: NSO , WB staff estimates

Household debt to income ratio has been on a steep rise recently. Average nominal household income was estimated to be around MNT 10 million in 2013. Average household debt to income ratio – measured by average household financial liabilities to annual household income ratio - has reached 57 percent in 2013, up from 36 percent in 2010. Household debt to GDP ratio also rose to 26 percent in 2013 from 16 percent three years before. (Figure 43) Problematic loans – including NPL and past-due loans – accounted for 2.3 percent of total individual loans. Yet, the size of problematic loans has been rising fast since mid-2013 with its annual growth reaching over 50 percent. (Figure 44)

Figure 43. Household debt ratios to GDP and income have been on the rise.

Household debt to GDP and Income Ratio (%)

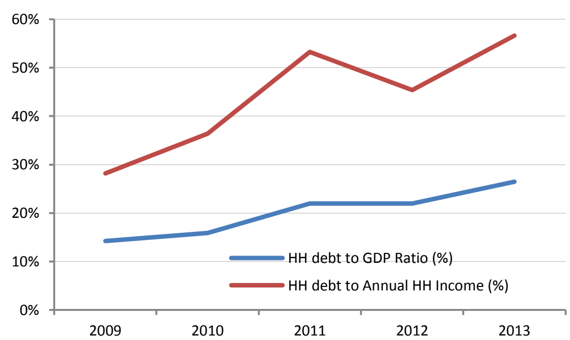
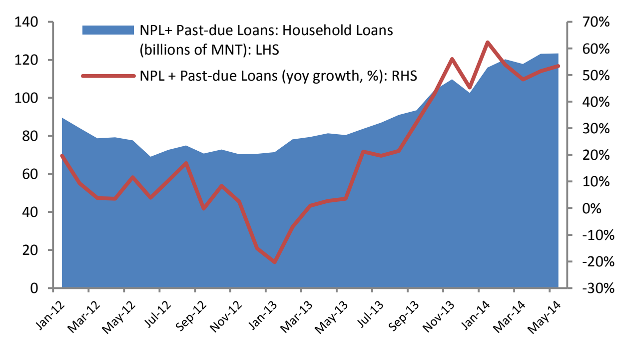


Figure 44. NPL ratio is low for household loans but the level of NPL is rising.

NPL Trend of Household Loans



Source: NSO, WB staff estimates

Slowing household income and growing household debt implies weakening consumption capacity of households. The relatively moderate level of household debt to income ratio is yet to indicate imminent risks from rising household level. However, a rapid rise in financial liabilities of households will likely add to weakening consumption capacity of households and weigh on economic activities going forward. While data on debt-service to income ratio is not available currently, debt-service to income ratio is likely to be also on a rising trend. In light of softening economic growth, higher household debt level also indicates the likelihood that the quality of household loans may continue to deteriorate in the coming months. Close monitoring on financial liabilities of households is needed.

Source: WB staff analysis

Current account deficit is narrowing but the balance of payments pressure remains high.

Significant current account deficit continued over the past three years, hovering around 30 percent of GDP. Current account deficit widened rapidly during the period of double digit economic growth which was first fueled by the doubling FDI inflow largely for OT mine investment between 2011 and 2012. Economic policies adopted expansionary stance to further stimulate the FDI-driven economic growth by increasing budget deficit, instead of counter-cyclical measures to curb overheating of the economy. As a result, the economic growth jumped to 17.3 percent and 12.4 percent in 2011 and 2012 respectively, from 6.4 percent in 2010 and current account deficit also surged to over 30 percent of GDP, from 14.9 percent in 2010. The large current account deficits were financed by the surging FDI and external commercial debt-financing of the public sector. In 2013, economic policies chose to scale up stimulus measures to maintain high economic growth as the economy gradually lost its growth momentum with the weakening FDI inflow and the global minerals market. As a result, current account deficit remained significant, reaching 27.9 percent of GDP in 2013. (Figure 45)

The large current account deficit was unsustainable without significant foreign capital inflow and the balance of payments came under heavy pressures in 2013 as the FDI almost halved. 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 debates over the OT mine investment agreement and strengthened regulations on foreign investment. Weak global minerals market added to the balance of payments pressure, causing coal exports to drop by over 40 percent. The lack of capital inflow and persistent large current account deficit inevitably led to a large external financing gap of US$ 1.7 billion in 2013 – equivalent to 10 percent of GDP, putting pressure on local currency value and foreign exchange reserves. (Figure 46)

Figure 45. CA deficit has remained around 30% of GDP over the last three years of double-digit growth period.

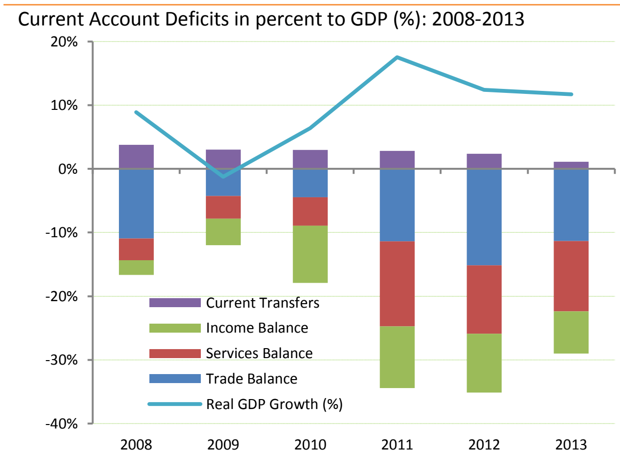
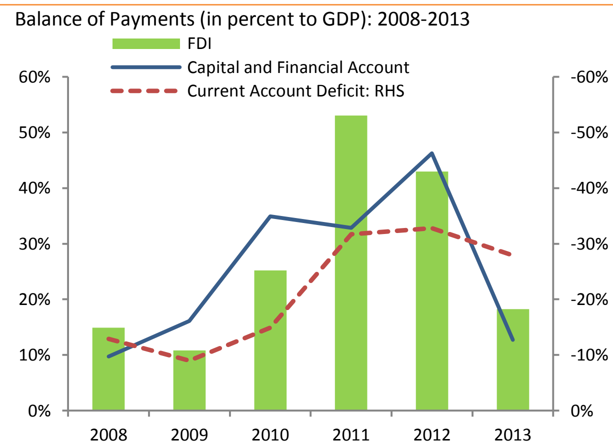


Figure 46. BoP came under heavy pressure in 2013 as foreign investment halved and could not finance CA deficit.



Source: BoM, WB staff estimates

Current account deficit began to gradually narrow in the second half of 2013 as the economy began to adjust to the balance of payments imbalance and the OT mine began its copper

production. The current account deficit has been on a downward trajectory over the past seven months. Adjustment of the current account seems to have gained its momentum in the first five months of 2014 as the size of current account deficit (US$ 580 million) fell to 44 percent of the level (US$ 1,308 million) a year ago. The adjustment of external imbalance came with softening growth of non-mineral sector and import compression over the last three quarters despite revamped economic stimulus measures. The local currency depreciated over 25 percent over the last twelve months, putting pressure on imports and adding to inflation and domestic demand. (Figure 47)

Narrowing trade deficit has been a main factor behind the improveming current account balance while services and income account deficits eased moderately. Trade balance registered a slight deficit of US$ 60.5 million in the first five months of 2014, from a deficit of US$ 593 during the same period last year. (Figure 47) Both import compression and recovery of exports contributed to the improving trade balance. Services and income account recorded a deficit of US$ 663 million in the first five months, down from US$ 871 million a year ago. Services account deficit came from continued deficits of freight and passenger transportation and other services. Income account deficit largely came from investment income paid to external liabilities including outstanding bonds issued by the government and the Development Bank of Mongolia.

Figure 47. Current account and trade balance began to adjust to the large imbalance.

Monthly CA Balance and Nominal Exchange Rate (3 month moving average)

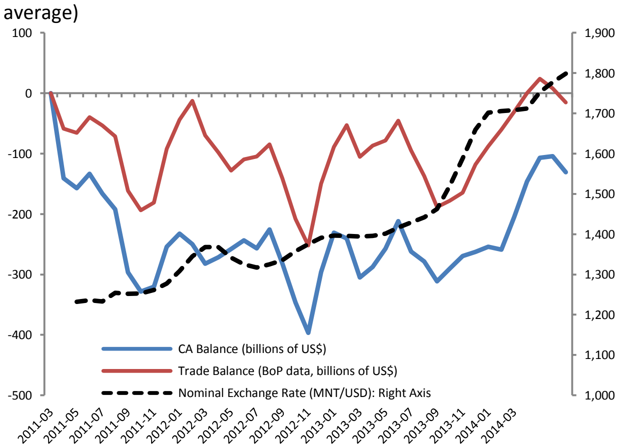
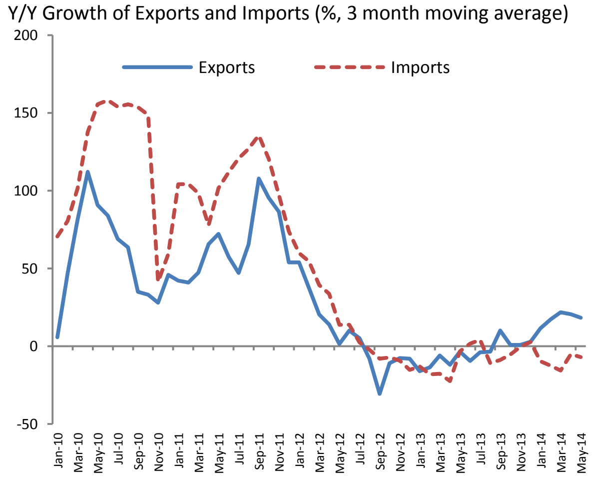


Figure 48. Adjustment of current account is occurring through both import compression and rising copper exports.

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



Source: BoM, WB staff estimates

Recovery of exports contributed to the improving current account balance by increasing 21.2 percent in the first five months from a year ago driven by robust growth of mineral exports. (Figure 48) Strong mineral export were mainly driven by a jump in copper exports by 112.6 percent from a year ago due to the production of OT mine that began its commercial operation in the second half of 2013. (Figure 49) OT mine is estimated to currently account for around a half of total copper production. Coal exports remain under heavy pressure from further dampening of coal price while coal export volume shows signs of recovery in 2014. (Figure 50)

Imports dropped 10 percent over the first five months of this year on year-on-year basis. Import compression is driven by widening contraction of imports of investment-related goods, including machinery and transportation equipment which dropped 26 percent and 42 percent from a year ago respectively. Growth of Imports of mineral product also turned negative during the same period, dropping 7.2 percent over the first five months. (Figure 51) However, construction and housing-related materials showed resilient import growth since March, increasing 19.6 percent over the first five months. Food product and industrial goods also maintained positive growth during the same period, which likely reflected limited adjustment of domestic prices of such goods to currency depreciation due to the price control of the Price Stabilization Program implemented last year. (Figure 52)

Figure 49. Export growth was driven by the strong growth of copper exports from OT mine.

Copper Export Volume and Price (year to year % change)

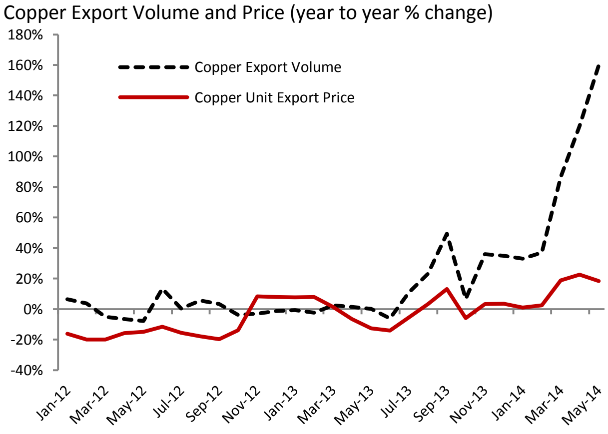
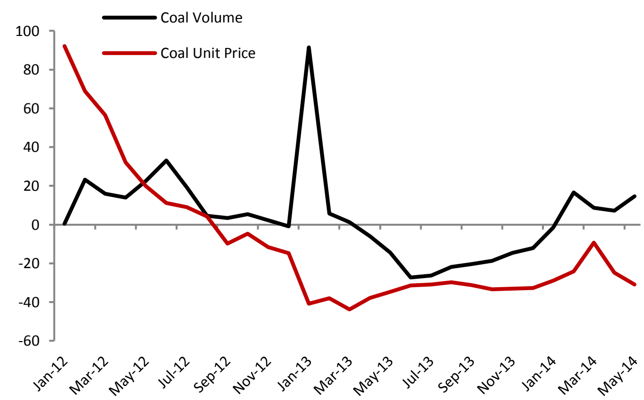


Figure 50. Coal exports remain under heavy pressure from weakening export prices…

Coal Export Volume and Price (year to year % change)



Source: NSO, WB staff estimates

Figure 51. Weakening imports are led by a decline in imports of investment-related goods…

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

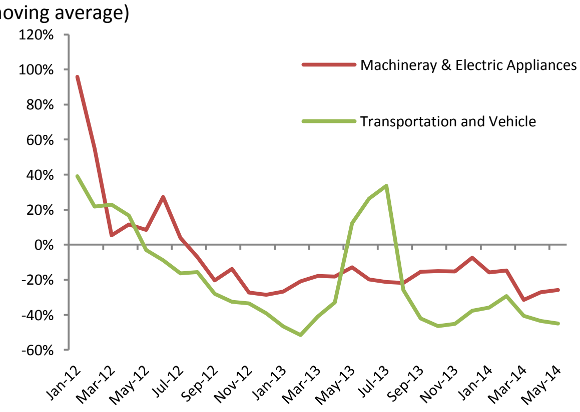
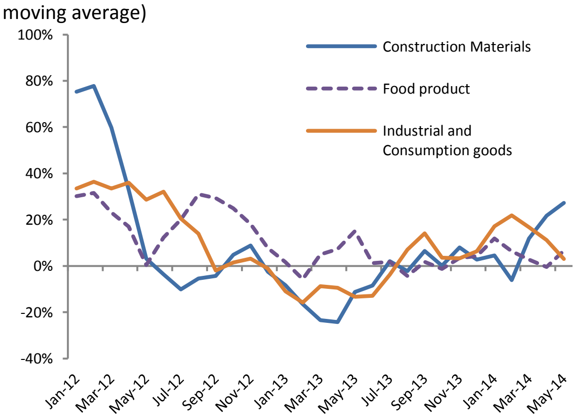


Figure 52. … while imports of consumption related materials show positive growth.

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



Source: NSO, WB staff estimates

Despite the narrowing current deficit, balance of payments pressure still remains high due to declining foreign capital inflow. Capital and financial account registed a deficit of US$ 2.6 million in the first five months of 2014, a sharp drop from a surplus of US$ 967 million during the same period in 2013. (Figure 53) The capital and financial account turned into a deficit of US$ 261 million in April and May. Due to deteriorating capital and financial account surplus, overall external financing gap only slightly eased to US$ 646 million over the same period from US$ 739 million of the first five months of 2013. The external financing gap in the first five months is estimated to be over 5 percent of expected annual GDP for 2014. (Figure 54)

Continuous decline in FDI inflow is concerning as it translates into weakening investment and may increase the country's reliance on external debt-financing to cover significant financing gap. After a 47 percent drop in 2013, net FDI inflow further dampened to US$ 393.6 million in the first five months, down by 64 percent from the same period of the last year. Net FDI inflow also continued to drop since January of this year, from US$ 153.8 million in January to US$ 46.7 million in May. (Figure 53)

Samurai bond was issued in January but its positive effect on the external situation was short-lasting. The Development Bank of Mongolia issued 10-year Samurai bonds in January of JPY 30 billion (equivalent to around US$ 290 million) under the guarantee of the government which was re-guaranteed by Japan Bank for International Cooperation (JBIC). The proceeds of the Samurai bonds contributed to easing the balance of payments situation in January, increasing the international reserve level for the first time since the end of 2012. The gross international reserve level has declined for four consecutive months since then.

Figure 53. Capital and financial account surplus shrank amidst weakening FDI…

Monthly Trend of Net FDI Inflow (in millions of US$)

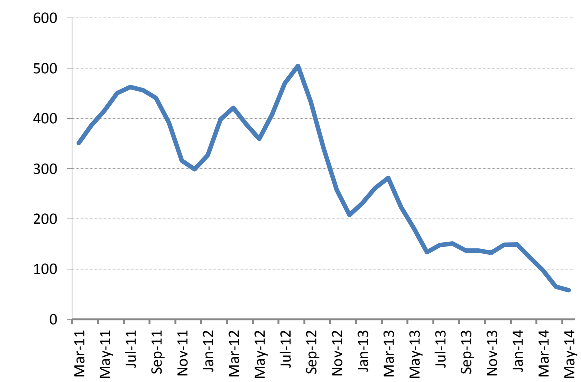
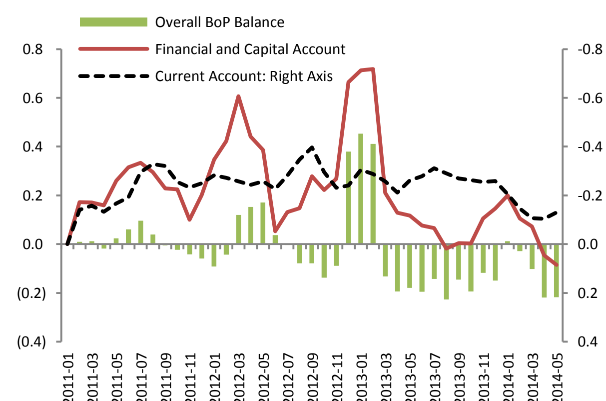


Figure 54. … and the BoP pressure remains high despite the narrowing current account deficit.

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



Source: BoM, WB staff estimates

Continued large balance of payment pressures have been translated into declining international reserves and weakening currency value. The exchange rate has resumed its depreciation trend since January after a brief rebound in December. Local currency value against the U.S. dollar weakened 20 percent in 2013 and further depreciated by 9 percent over the first five 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$1.5 billion). The reserve level steadily declined since the end of 2012 except for a brief rebound in January of 2014, dropping to US$ 1.6 billion in May. (Figure 55) The current reserve level is 38 percent of its peak level at the end of 2012 and is equivalent to around three month's import cover. The international reserve level is likely to be under continuous pressure in light of the weak FDI inflow and announced plans to draw down the remaining proceeds of the Chinggis bond and Samurai bond to finance a series of policy measures for public investment and to support export promotion and import substitution measures of the government.

Drawdown of the bilateral currency swap line with the People's Bank of China has been contributing to slowing the pace of declining international reserves. The external short term debt of the central bank reached around a half of the gross international reserve level at the end of 2013 according to the external debt statistics released by the central bank.(Figure 56) Extension of the currency swap line and likely expansion of the size of the credit line would be able to provide a significant buffer against the large balance of payments imbalance situation. For more discussion on Mongolia's external position, see Box 5.

Figure 55. International reserve level continues to decline in 2014.

Gross International Reserve (in millions of US$)

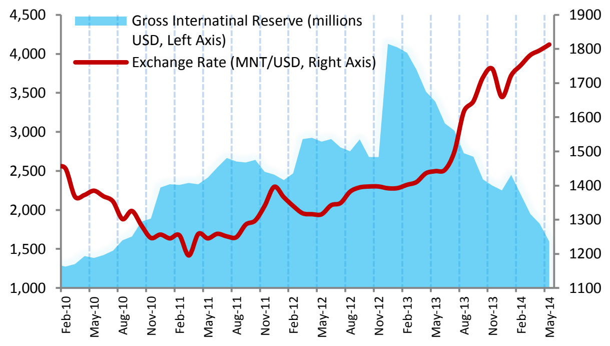
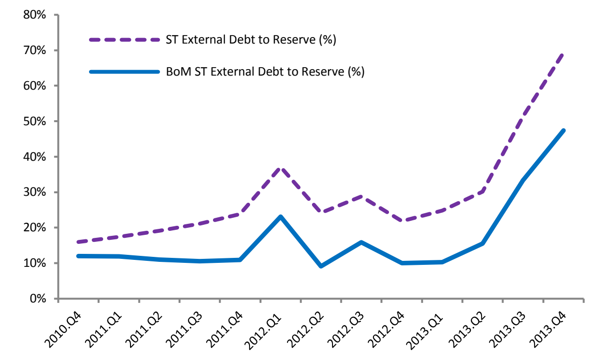


Figure 56. ST external debt to reserve ratio has been rising due to drawdown of bilateral currency swap line with PBoC.

Select Short-term Liquidity Indicators (%)



Source: BoM, World Bank staff estimates

Box 5. External Position of Mongolia

Mongolia's external debt has been rising since 2010. According to the external debt statistics released by the BoM, total external debt of Mongolia – which includes both public and private sectors – rose to 164 percent (US$ 18.9 billion) at the end of 2013, from 95.7 percent (US$ 5.9 billion) at the end of 2010. Growing external debt was largely led by the increase of inter-company borrowing of FDI-invested companies and recent large external debt financing of the public sector including the Chinggis bond, DBM bond and drawdown of the bilateral currency swap line with the PBoC. The external debt to GDP ratio excluding inter-company borrowing reached 73.6 percent at the end of 2013, also up from 51.8 percent three years ago. Total external debt excluding inter-company borrowing reached US$ 8.5 billion in 2013.

FDI accounts for a majority of foreign capital invested in Mongolia. Outstanding amount of FDI reached US$ 15.5 billion at the end of 2013 accounting for 66 percent of total foreign investment position in Mongolia. Outstanding portfolio investment was US$ 2.5 billion including US$ 2.4 billion of debt securities investment in the Chinggis bond and DBM bond that were issued in late 2012. Outstanding loans reached US$ 4.4 billion including around US$ 3 billion of multi-lateral and bi-lateral loans extended to the government on concessional terms.

Figure 57. Mongolia's external debt has been on the rise.

External Debt to GDP Ratio (%)

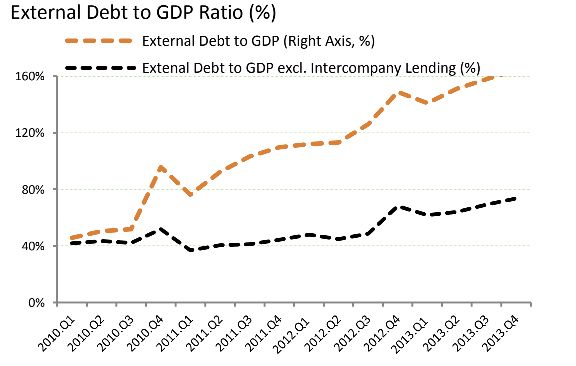
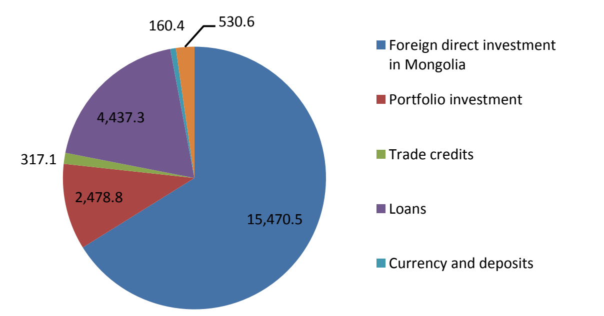


Figure 58. FDI accounts for 2/3 of total foreign investment.

Outstanding foreign Investment in Mongolia by types (billions of US$, end-2013)



Source: BoM, World Bank staff estimates

Liquidity risk from abrupt capital reversal remains low due to minimal foreign investment in the equity market and limited short-term external debt. Short-term external debt (US$ 1.6 billion) accounts for only 8 percent of total external debt and 18.4 percent of total external debt excluding inter-company lending. Short-term external debt of the monetary authorities accounted for over 60 percent of total short-term debt while commercial banks' short-term debt remained minimal.

The recent increase of short-term external debt of the central bank reflects financing from the bilateral currency swap line with the People's Bank of China. At the end of 2013, short-term external debt of the central bank reached US$ 989 million, up from US$ 315 million a year ago, according to the external debt statistics publicly released by the central bank. Drawdown of the bilateral currency swap line has been contributing to replenishing international reserves, reaching 47 percent of gross international reserve level at the end of 2013.

Figure 59. Short-term external debt remains low…

External Debt by Maturities (millions of US$, end -2013)

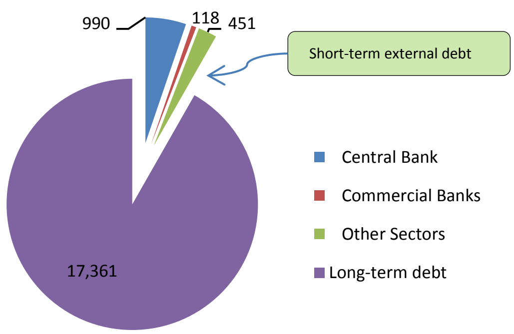
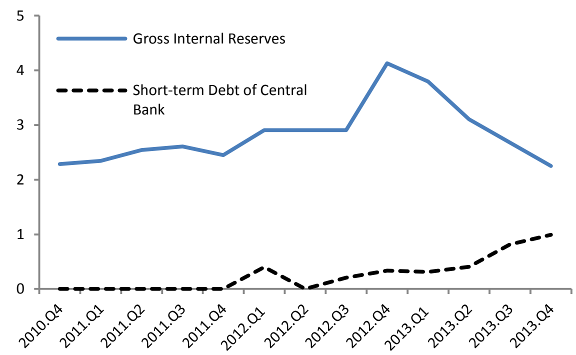


Figure 60. … and recently rose due to the drawdown of bilateral currency swap-line with the PBoC.

Short-term Debt of the Monetary Authorities (billions of US$)



Source: BoM, World Bank staff estimates

Source: International Investment Position (2013, BoM), Gross External Debt Position (Q4 2013, BoM), World Bank staff estimates

Economic Prospects and Challenges

The economy will likely undergo an adjustment in 2014 as a result of growing external and internal economic imbalances.

Economic growth is likely to soften in 2014 as the economy began to adjust to the large balance of payments pressure and high inflation. High inflation and rising cost of production amidst continued currency depreciation will likely weigh on domestic demand. Fixed investment will also likely 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. Despite the robust growth of mineral production over 20 percent boosted by the production of OT mine, its spill-over to non-mineral sector growth is likely to be limited in the coming years as the contribution of increased production and exports from OT mine to budget revenue is yet to be fully materialized.

We expect the real GDP growth to moderate to 9.5 percent in 2014 under the current trend. Mineral GDP growth will likely display strong performance at above 20 percent leading the overall economic growth. Non-mineral sector output growth is expected to slow down to a single-digit level due to weakening domestic consumption and investment. In 2015, economic growth is expected to further soften to 8.8 percent due to base effect from likely moderating growth of copper production of OT mine which is now in the second year of production.

Inflation will likely remain at a double-digit level for the remainder of the year, in light of the expanded domestic credit and the currency depreciation trend. As the household income data suggests, real household income growth turned negative in 2014 in the midst of rising price level and the slowing economic activities. High inflation will continue to raise the costs of living and production which will further dampen economic activities. Deteriorating labor market situation will also likely further erode the living standards, especially for the poor and vulnerable families. The current social welfare system – mostly categorically targeted rather than means-tested – also indicates only limited social safety net to the poor and vulnerable families during the harsh economic adjustment.

Short-term economic risks are increasing amidst the large balance of payments pressure and deteriorating financial soundness.

The balance of payments pressure will likely be eased in 2014 due to narrowing current account deficit but will still remain significant relative to the size of the economy. Strong export and declining import will largely help the current account deficit to improve from around 30 percent of GDP over the past three years. However, declining FDI will likely continue to weigh on the balance of payments imbalance as the foreign investment sentiment is yet to recover. The external financing gap over the first five months reached over five percent of annual GDP. The large external financing gap will likely continue to weigh on the international reserves and the currency value throughout the year, but the extension of the bilateral currency swap line with the PBOC would likely provide a significant buffer against the large balance of payments pressure this year.

The recent increase in non-performing loans shows increasing vulnerabilities of banking system amidst the policy-led credit boom. The relatively low NPL ratio of commercial bank loans needs to be cautiously interpreted as the recent large increase in non-performing loans and past-due loans has been dwarfed by surging domestic credit. The current level of capital adequacy ratio (CAR) appears sufficient as the minimum CAR of 14 percent was imposed on the six largest and systematically important banks by the supervisory authorities. However, actual capital buffers of banks may be more limited considering the regulatory forbearance such as reduced risk-weights given to the substantial amount of policy lending programs implemented by the monetary authority itself. Recent news also indicates increasing difficulty of industries and cost-cutting measures including temporary lay-off of workers. Quality of bank assets will likely remain under growing pressure from weakening economic activities.

Growth momentum from external environment is yet to recover and the economy may face growing head winds.

Global commodities market is yet to recover and will unlikely provide strong growth momentum to the Mongolian economy in the near future. Although the decline in key commodity prices was briefly halted during the last quarter of 2013, weak commodity market situation will likely continue in 2014. The price declines in key commodities including copper during the first quarter of 2014 reflected weaker Chinese imports amid a slowdown in investment activity as the Chinese government attempted to cool its booming property market. The World Bank expects global metal prices to decline 5 percent in 2014 as new supplies will be coupled with weaker demand, especially by China. Specifically, iron ore is expected to decline the most in 2014 (down 9.1 percent), followed by copper (-7.4 percent), aluminum (-5.2 percent), nickel (-3.1 percent), and lead (-2.5 percent). [2] Most price risks are on the downside and depend mostly on the path of the Chinese economy. The weak commodity markets outlook suggests that Mongolia's mineral exports will likely remain weak except for the increased volume of copper exports from the new OT mine.

Disorderly adjustment of the Chinese economy may further dampen the economic prospects. The World Bank expects China's economic growth will moderate to 7.6 percent in 2014 and to 7.5 percent by 2015, reflecting China's structural reform efforts to deliver a more sustainable and inclusive growth path in the medium term and long term. Our baseline projection assumes that the adjustment of the economy will take place in an orderly way that a planned decline in investment growth will be offset by a gradual increase in consumption growth. However, a disorderly adjustment may also happen in the process of addressing risks to financial stability. Quick deleveraging of large local government debt may lead to a rapid rebalancing away from investments, which has been a key driver of economic growth.[3]

Recovery of foreign direct investment may take more time despite the new the investment law. The foreign direct investment has been the main source of financing for the large current account deficit over the past three years. Due to limited development of domestic capital market, foreign direct investment has been playing a key role to boost economic activities and to support investment in the

[2] World Bank, Commodity Markets Outlook, April 2014
[3] World Bank, East Asia Pacific Economic Update, April 2014

country. However, the recent FDI trend indicates that the recovery of foreign investment may be slower than expected and that foreign investor sentiment is yet to recover. The swift resolution of the second phase investment decision of the OT mine is expected to bring at least US$ 4 billion to the economy over the coming years, which would help ease the large balance of payments pressure and also help improve fragile sentiment of foreign investors to the country.

Current economic situation shows the risks of high growth boosted by pro-cyclical economic policies in a mineral-dependent economy.

Pro-cyclical economic policies helped maintain double-digit growth over the last three years but also came with growing weakness of the economy. A trade deficit can be anticipated to some extent in a country at an early stage of developing massive mines as it requires growing imports of mining investment equipment. However, current account deficit reached an unprecedented level during the high growth period as economic policies further fueled economic growth. The pro-cyclical economic management has bolstered the aggregate demand to an extent that it could lead to substantial external imbalances that may not be sustainable in the event of minerals market downswing or a drop in the foreign investment. As a result, the Mongolian economy experienced a significant balance of payments pressure in 2013 as the FDI inflow dropped significantly and the mineral exports turned weak. Also, strong credit growth driven by loose monetary policies led to demand-pulled double-digit inflation and deteriorating quality of bank assets.

Structural shift of economic policy framework is needed toward restoring economic balances and financial stability.

The recent sign of weakening aggregate demand reflects inevitable adjustment of the economy to the large economic imbalances that have been built up over the recent years. Further economic stimulus relying on credit expansion and large fiscal deficit will likely have only limited effect in revamping domestic demand as it will likely add to the current high inflation and sliding exchange rate, which will further weigh on consumption and investment. Also, continuous expansionary policies would also likely accelerate the depletion of international reserves through slower adjustment of balance of payments imbalance. Urgent priority of macro-economic management needs to lie in minimizing the risk of the economy reaching highly vulnerable situation due to growing balance of payments pressure and rising inflation.

Monetary policy needs to be tightened and banking supervision should be strengthened.

The monetary authorities need to reorient their policy focus on rising inflation by tightening monetary policy stance. Recent monetary indicators show signs of gradually tightening of expanded balance sheet of the central bank in the face of rising inflation and continued large external financing gap. We believe that the recent gradual tapering of expanded credit is necessary and will help address the persistent high inflation problem in Mongolia going forward. Tapering of expanded balance sheet of central bank would likely be gradual in order to avoid abrupt credit tightening of commercial banks in light of banking sector's increased reliance on central bank credit over the last year. Assuming that gradual monetary tightening continues in the coming months, inflationary pressure will likely gradually ease over time.

It is concerning that there is growing tendency to rely on central bank's currency issuance power to finance policy programs of the government as the budget revenue shortfall continues. The effectiveness of the Price Stabilization Program that was introduced last year to address two objectives – stabilizing price level and boosting economic growth – remains controversial. While the program contributed to easing supply-side inflationary pressure that had been a major cause for high inflation in 2012, fresh liquidity injection provided under the program also added to demand-side pressure in 2013 which has been manifested in accelerating core inflation. Continuation of the program relying central bank's liquidity injection will inevitably create more inflationary pressure. The Price Stabilization Program needs to be phased out and supply-side measures of the program have to be implemented as part of budgetary operations. In the same context, large fresh liquidity injection from the central bank to finance new policy programs of the government needs to be avoided as it would further add to inflationary pressure going forward..

Financial sector policy also needs to shift its focus toward ensuring financial stability. As the domestic credit increased over 50 percent over a year, the size of non-performing loans and past-due loans are rising fast recently. While the current level of these problematic loans still remain relatively moderate, continuous degradation of bank asset qualities would likely pose a downside risk to the banking system. Weak enforcement of prudential regulations that has been allowed to major policy lending programs also raises concern on elevated potential downside risk of the banking sector. Past episode of Savings Bank – one of the systemically important banks that failed last year – shows what consequences can result from the combination of poor governance structure and weak adherence to prudential regulations. Regulatory forbearance given to the policy lending programs needs to be lifted in line with tapering of extended credit.

Fiscal policy should adhere to the fiscal discipline imposed by the Fiscal Stability Law.

Fiscal policy will likely remain on an expansionary path with overall fiscal deficit reaching close to 10 percent of GDP. The official budget – excluding the use of Chinggis bond and Samurais bond proceeds through the DBM – will likely be revised down again in the face of continued budget revenue shortage and is expected to meet the 2 percent target of structural deficit. The remainder of Chinggis bond proceeds and samurai bond proceeds is expected to be spent to further finance public projects through the DBM, which is estimated to reach 8 percent of GDP in 2014.

Legal institution for fiscal discipline is already in place but implementation is questionable. The FSL became effective in 2013, however the law was largely bypassed as substantial amount of fiscal spending was implemented outside the scope of the budget through the Development Bank of Mongolia.

Moreover, information on public projects financed by the DBM has not been publicly disclosed and cannot be monitored on a regular basis as they are outside the control of the budget. We acknowledge that the budgetary authorities are closely monitoring the developments of revenue situation and are willing to tighten official budget if necessary to meet the fiscal discipline of the FSL. However, under the current scheme, the fiscal discipline envisioned by the FSL would be overshadowed by substantial amount of off-budget spending and the pro-cyclical fiscal management would continue to remain.

A medium term fiscal consolidation plan would be a useful tool to provide a credible and realistic road map for fiscal consolidation. It may be politically challenging to include off-budget spending into the budget in the near future as it would breach the deficit ceiling of the FSL. A more realistic approach given the political environment may be to propose a mid-term fiscal consolidation plan that would comprise both official budget spending and off-budget spending. The medium plan could provide a concrete time frame that would reduce the fiscal deficit – including off-budget spending – to the 2 percent target of the FSL by a targeted year. A political consensus would be needed to accept the reality and to adopt a credible and enforceable fiscal consolidation plan.

When the budget resource is limited, quality of spending becomes more important. The rapid increase of public investment spending – twenty-seven fold increase over the last decade – has raised concerns about the quality of public investment projects. It is undeniably important to scale up infrastructure spending in developing countries, yet the pace should match the Government's planning and implementation capacity and the economy's absorptive capacity. All projects approved by the budget need to be equipped with proper project documentations including their feasibility, design, and accurate cost estimations. The lack of transparency in the DBM also raises a concern about the quality of public investment. Public projects financed by the DBM are not subject to the rigorous procurement and monitoring requirements imposed on on-budget investment projects as the DBM is outside the scope of the Public Procurement Law. Without transparency and regulation, there are risks that the DBM's investment projects will be more vulnerable to political influence and include uneconomic, pork-barrel projects.

It is time to think about how to manage resource revenues more effectively.

Mongolia has not accumulated savings from its resource revenues during the past high-growth period. The development of a good sovereign wealth fund (SWF) framework could provide the momentum to build a more prudent resource revenue management system. As a result of the large fiscal deficits and rising public debt level over the last two years, the capacity of fiscal policy to counter possible external shocks has become increasingly limited. The current minimal fiscal savings in the Fiscal Stabilization Fund cannot provide enough policy buffers when needed. In this light, the Government of Mongolia is developing legislation for a new SWF framework, which we welcome as a positive step toward a more prudent and efficient resource revenue management framework. Yet, it must also be noted that a SWF itself cannot ensure effective resource revenue management if it is not accompanied by a strong and prudent fiscal policy framework. To ensure that the government generates net fiscal savings, the establishment of the fund needs to be aligned with the design of an implementable fiscal adjustment plan. Strong consensus should be reached to curb spending and allow room for net accumulation of wealth before a SWF is established and becomes operational.

Key Economic Indicators Tables

	2011	2012	2013	2014f	2015f	2016f
	Year	Year	Year	Year	Year	Year
Output, Employment and Prices						
Real GDP (% change y-y)	17.5	12.4	11.7	9.5	8.8	7.4
Mineral GDP (%, yoy)	7.3	8.0	20.7	24.6	14.9	3.6
Consumer price index (% change y-y)	9.4	14.2	12.3	13.2	9.9	8.0
Public Sector						
Government revenues (% GDP)	40.3	35.5	33.8	32.3	32.2	33.0
Government expenditures (% GDP)	45.1	46.7	44.7[e]	42.4	37.7	36.3
Government balance (% GDP)	-4.8	-11.1	-10.9[e]	-10.1	-5.5	-3.3
Total public sector debt (% GDP): Nominal Value	36.7	62.7	58.7e			
Foreign Trade, BOP and External Debt						
Trade balance (millions US$)	1,640	-1,426	-1,665	-233	324	477
Exports of goods (millions US$)	4,817	4,384	4,273	5,204	6,033	6,586
(% change y-y)	65.6	-9.0	-2.6	21.8	15.9	9.2
Imports of goods (millions US$)	3,177	5,810	5,938	5,437	5,708	6,108
(% change y-y)	101.3	2.1	-5.7	-2.5	5.0	7.0
Current account balance (millions US$)	2,758	-3362	-3,155	-1,904	-1,542	-1,558
(% GDP)	-31.7	-32.8	-27.5	-16.5	-11.8	-10.4
Foreign direct investment (millions US$)	4,620	4,407	2,342			
Foreign exchange reserves, gross (millions US$)	2,630	4,126	2,242			
(month of imports of g&s)	3.9	6.4	3.5			
Financial Markets						
Domestic credit (% change y-y)	76.9	29.4	64.4			
Reserve money (% change y-y)	75.5	30.5	54.0			
Short-term interest rate (% p.a.) 2/	12.3	13.3	10.5			
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			

Source: National data sources, World Bank staff estimates
e = estimate
f = forecast