Mongolia

Economic recovery continued in 2018, buoyed by mining investment and higher output in services and industry. Growth should extend into 2019 and 2020, albeit at a declining rate, on strong domestic demand. Inflation will accelerate in 2019 before slowing again in 2020, and the current account deficit will narrow in 2019 before widening in 2020. The use of natural resource revenue can be enhanced, and sustainable development assured, through better financial management.

Economic performance

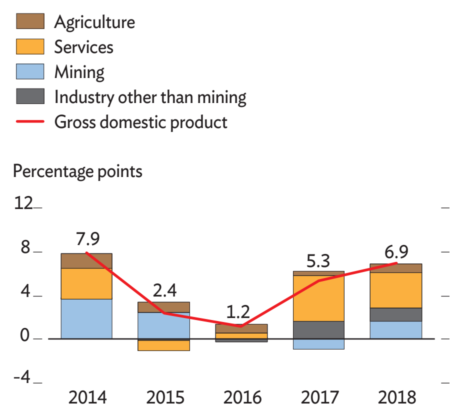
Growth quickened from 5.3% in 2017 to 6.9% in 2018 on expansion in manufacturing and services and strong investment in mining (Figure 3.10.1). Benefiting from a 55.8% rise in credit and rising demand for transport services to carry mineral exports, services contributed 3.2 percentage points to growth. Industry added 2.8 points, boosted by 15.7% growth in manufacturing and despite a slump in residential construction. Growth recovered in mining on stronger gold and coal production but remained moderate. Agriculture recovered from drought in 2017 to add 0.9 percentage points to growth as crop harvests improved sharply and livestock production rose moderately.

On the demand side, investment—buoyed by a 29.2% increase in foreign direct investment (FDI), mainly into mining—increased by 27.2%, contributing 10.0 percentage points to growth (Figure 3.10.2). Consumption contributed a more modest 2.3 points, almost entirely derived from an increase in private consumption driven by rising credit. Exports rose by 15.3% as coal shipments grew despite logistical bottlenecks at the border with the People's Republic of China (PRC). However, as imports rose by 21.4%, driven by increased FDI-financed mining inputs and a surge in car imports to beat anticipated credit tightening in 2019, net exports subtracted 5.4 points from growth.

Average consumer price inflation rose from 4.3% in 2017 to 6.8%, driven mostly by tight supply (Figure 3.10.3). Food prices increased because drought affected crop production in 2017, and meat exports increased substantially despite lower meat production. Prices for heating coal rose sharply in anticipation of a ban on the sale of raw coal in May 2019, and a higher excise tax pushed up prices for alcoholic beverages and tobacco.

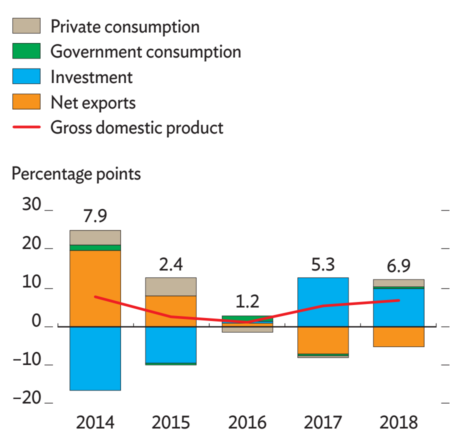
This chapter was written by Declan Magee of the Mongolia Resident Mission, ADB, Ulaanbaatar.

3.10.1 Supply-side contributions to growth



Source: National Statistics Office of Mongolia. 2019. *Monthly Statistical Bulletin*. February. http://www.nso.mn.

3.10.2 Demand-side contributions to growth



Source: National Statistics Office of Mongolia. 2019. *Monthly Statistical Bulletin*. February. http://www.nso.mn.

Budget revenue surged to equal 31.3% of GDP on increased receipts from value-added tax and social insurance, while expenditure increased modestly to 28.7%, yielding a surplus equal to 2.6% of GDP after 5 straight years of deficits (Figure 3.10.4). Interest payments on government bonds fell from 12.9% of expenditure in 2017 to 11.4% thanks to debt clearance and concessional lending from development partners. Public debt including the foreign liabilities of the Bank of Mongolia, the central bank, fell from the equivalent of 99.2% of GDP in 2017 to 86.2% as fiscal policy tightened and included a freeze on the issuance of government domestic bonds (Figure 3.10.5).

Broad money surged by 22.8% in 2018 as credit to households grew by 52.6% in anticipation of tighter credit controls in 2019 and as interest rates on loans continued to slide along with a 1.0 percentage point cut in the central bank base rate in early 2018, which followed a 2.0-point cut in 2017. In response to mounting pressure on the Mongolian togrog, the central bank hiked its base rate by 1.0 point in November 2018. Concerns about rising household indebtedness further prompted the central bank to impose restrictions on the granting of bank loans, effective in 2019. The nonperforming loan ratio jumped from 8.5% of all loans in December 2017 to 10.4% a year later, bringing the capital shortfall in the banking sector to 3.1% of GDP (Figure 3.10.6).

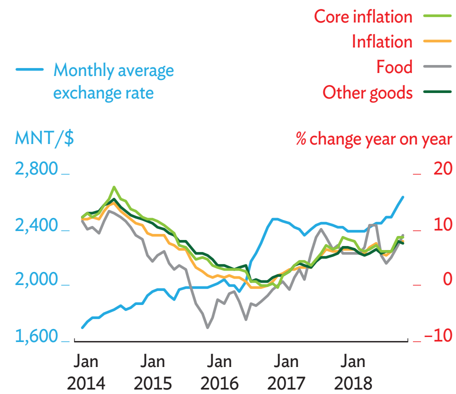
The current account deficit widened to 14.6% of GDP in 2018 as deficits in services and net income—reflecting higher transport and insurance costs for imports and dividend payments to foreign investors—outweighed the merchandise trade surplus (Figure 3.10.7). Gross reserves rose by $500 million in 2018 to equal 5 months of imports, boosted by international bond issues and FDI inflows. The togrog depreciated against the US dollar by 1.1% on average in 2018 and by 8.9% in the year to the end of 2018.

Economic prospects

Growth is forecast to slow to 6.7% in 2019 and 6.3% in 2020 (Figure 3.10.8). Domestic demand fueled by a more accommodative fiscal policy will support growth in 2019. After 2 years of fiscal consolidation, government spending will increase by 19.0% under the 2019 budget. FDI into mining will remain important, but will not increase as much as last year, making its contribution to growth statistically less pronounced. Net exports will continue to drag on growth but at a declining rate as export growth outpaces import growth. Coal exports will benefit from a gradual switch in the PRC away from more expensive processed coal from Australia, while high gold inventories in Mongolia are expected to encourage higher exports in 2019.

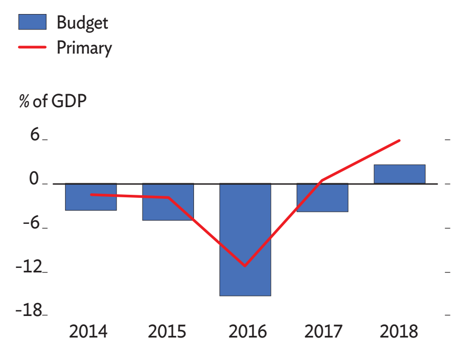
On the supply side, services will be key to growth, with transport expected to gain from growth in mining exports. Manufacturing will also benefit from mining growth and from

3.10.3 Inflation and exchange rate



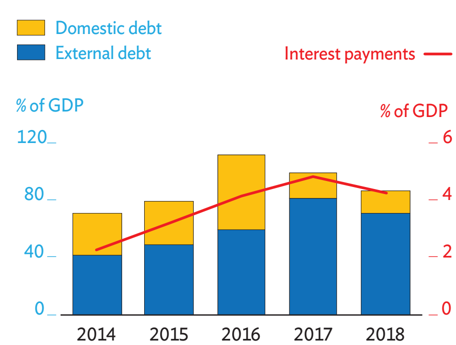
Source: Bank of Mongolia. http://www.mongolbank.mn.

3.10.4 Fiscal balance



Source: Ministry of Finance. http://www.mof.gov.mn.

3.10.5 Public debt



Note: Includes Bank of Mongolia foreign liabilities.

Sources: Ministry of Finance. http://www.mof.gov.mn; Bank of Mongolia. http://www.mongolbank.mn.

expanded processing of meat for export. Construction growth will recover, boosted by a large public investment program in 2019, but moderate in 2020 with some retrenchment expected in public investment. Agriculture will continue to recover in 2019, assuming adequate rainfall and mild winter weather, but will expand more slowly in 2020.

Average inflation will reach 8.5% in 2019 on rising domestic demand supported by higher government expenditure, as well as the effects of togrog depreciation and higher fuel prices in the second half of 2018 (Figure 3.10.9). These effects will be less pronounced in 2020 as public expenditure eases and the pass-through of depreciation wanes, allowing inflation to stabilize at 7.5%.

The 2019 budget is expected to record a primary surplus equal to 1.0% of GDP and an overall deficit at 1.4% of GDP because of a large increase in government capital and election-related spending. Revenue growth, which was high in 2017 and 2018, is expected to moderate but could benefit from any of the upside risks to the growth outlook. The budget deficit is likely to shrink in 2020 as expenditure subsides in the aftermath of the elections.

The current account deficit will narrow to equal 9.6% of GDP in 2019 as exports grow, in particular on anticipated large increases in gold shipments, and as car imports slow under tighter credit. The deficit in services will remain elevated in both years. The current account deficit will widen again to 13.0% of GDP in 2020 as export growth slows and import demand remains steady.

Mongolia is vulnerable to exogenous shocks owing to a depleted Fiscal Stability Fund and low official international reserves. Slower growth in the PRC caused by trade tensions with the US could squeeze Mongolia's mineral exports with lower prices and perhaps reduced volume. Further, continuing logistical challenges at the PRC border may slow mineral exports. Domestically, the 2020 parliamentary elections could apply political pressure to loosen fiscal and monetary policies, which would weigh on the exchange rate and put the country's scant reserves at risk, though a program agreed with the International Monetary Fund (IMF) would act as a counterbalance. Despite progress in bank recapitalization, continuing bank fragility poses a risk to economic health. As always, commodity price fluctuations present risks to the forecast in both directions, while rising FDI for new projects presents an upside risk.

Policy challenge—better use of natural resource revenue through improved financial management

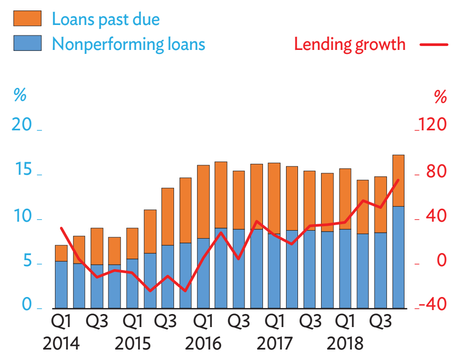
Mongolia derives almost a quarter of its fiscal revenue directly from mining, with other revenue streams closely correlated with it. To strengthen its management of the sector, Mongolia

3.10.1 Selected economic indicators (%)

	2019	2020
GDP growth	6.7	6.3
Inflation	8.5	7.5
Current account balance (share of GDP)	–9.6	–13.0

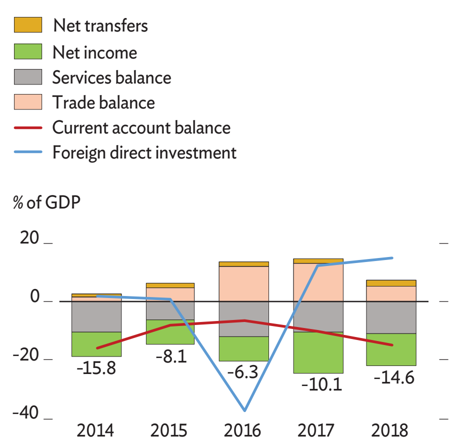
Source: ADB estimates.

3.10.6 Banking indicators



Q = quarter.
Source: Bank of Mongolia. http://www.mongolbank.mn.

3.10.7 External indicators



Source: Bank of Mongolia. http://www.mongolbank.mn.

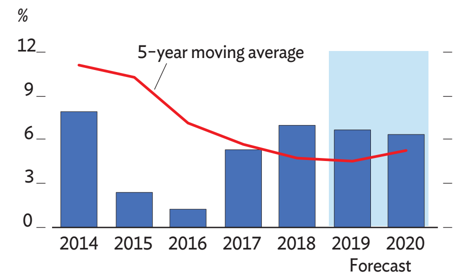
has established state-owned enterprises, enacted fiscal rules, created several extra-budgetary funds to manage mineral revenues (the Fiscal Stability Fund, the Future Heritage Fund, and, soon to close, the Human Development Fund), and established a system of distributing mineral revenue to subnational governments.

However, the original intent of these initiatives has not always been honored, and fiscal rules were abandoned when commodity prices fell after 2012. The Human Development Fund was used for universal social transfers and accumulated large debts. The Law on Government Special Funds was amended in 2016 and 2017 to allow withdrawals from the Fiscal Stability Fund to cover the budget deficit until 2023. The Fiscal Stability Law, enacted in 2010 to smooth fiscal expenditure and create precautionary savings, has been undermined by 12 amendments to allow larger deficits as off-budget and quasi-fiscal spending rose substantially. Further, fiscal expenditure has been pro-cyclical, fluctuating in line with coal and copper prices, running up public debt and proliferating public investment projects that are not always viable (Figure 3.10.10).

Under the program with the IMF, public finances have stabilized and growth has recovered. However, the recovery is fragile, debt-servicing costs are still high, and Mongolia remains vulnerable to fluctuations in commodity prices. The government should respond to these challenges and set the stage for more effective use of mineral resources, not by creating new funds, but by strengthening public financial management more broadly. This will become even more crucial as major mining investments advance toward their production stage, mineral revenues consequently rise, and debt service payments moderate with the implementation of the IMF stabilization program.

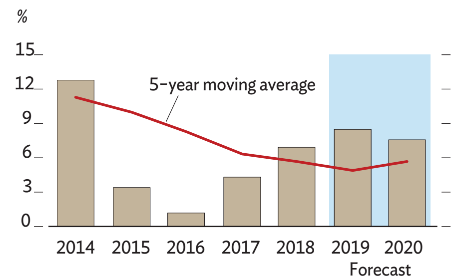
Crucial steps toward better public financial management include bringing all spending on budget and creating a stronger fiscal base that reduces dependence on commodity prices by, for example, amending excise and income taxes. The government should implement the recommendations of a 2015 World Bank report on public financial management performance, notably requiring all government entities to follow budgetary procurement procedures. It should also ensure the effective functioning and independence of the new Fiscal Stability Council, which is tasked with ensuring compliance with the Fiscal Stability Law and fiscal sustainability rules, by providing security of tenure to its members, sufficient staff and financing, and the political independence of its members. To enhance accountability, revenue projections should be strengthened and budgetary information better disseminated to the public. Investment plans should be closely aligned with national development plans, and project evaluation should be improved, to ensure that projects offer value for money and are properly implemented.

3.10.8 GDP growth



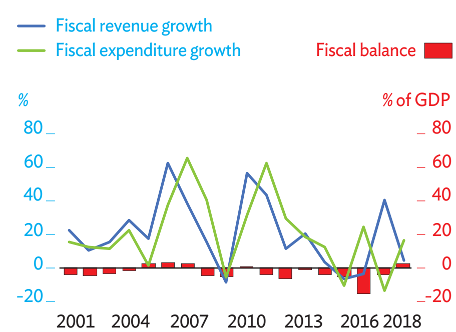
Source: *Asian Development Outlook* database.

3.10.9 Inflation



Source: *Asian Development Outlook* database.

3.10.10 Fiscal indicators



Source: National Statistics Office. *NSO Annual Yearbook. December NSO Bulletin.*