

Mongolia

The economy revived in 2017 from slowing growth in previous years. Growth will remain solid in 2018 and 2019, albeit with slight moderation, thanks to large investments in mining. Inflation will rise in 2018 before decelerating modestly in 2019, and the current account deficit will narrow considerably in 2018 before widening somewhat in 2019. Urban air pollution, especially in winter, poses an urgent and complex policy challenge.

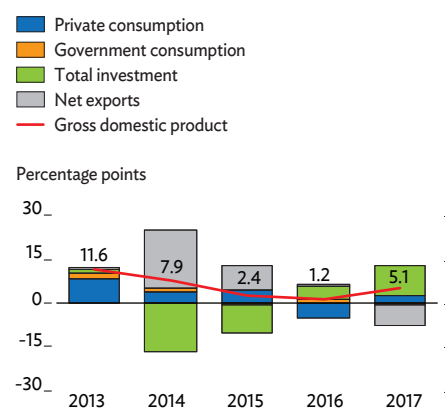
Economic performance

GDP growth accelerated to 5.1% in 2017 from 1.2% in 2016, mainly on a surge in coal exports and large investments tied to underground development at the Oyu Tolgoi copper and gold mine. Gross capital formation was a major driver of growth, increasing by 36.2% as fixed capital investments resumed, adding 10.6 percentage points to growth. Despite a fall in government consumption in line with fiscal consolidation efforts, overall consumption rose, adding 1.8 percentage points to growth, as household consumption recovered with increased income from agriculture. Exports rose by 13.4%, mainly because coal exports more than doubled. However, increased mining investments pushed up imports substantially, such that a decline in net exports subtracted 7.3 percentage points from growth (Figure 3.10.1).

A fall in copper concentrate quality at the Oyu Tolgoi mine lowered mining production by 6.9% in 2017. This was despite a 32.7% increase in coal production driven by favorable prices. Strong recovery in manufacturing—in particular coal washing, cement production, and meatpacking—helped industry contribute 0.2 percentage points to growth notwithstanding subdued mining production and a decline in construction. Large mining-related investments and imports underpinned expansion in the transport, wholesale, and retail industries, making the service sector the main driver of growth, with a contribution of 4.3 percentage points. Despite a drought affecting vegetables and staple crops, agriculture added 0.6 percentage points as livestock herds continued to grow (Figure 3.10.2).

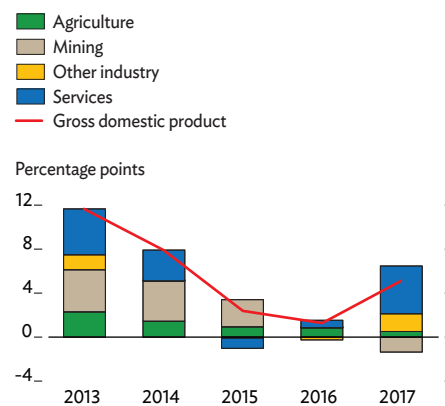
Average consumer price inflation accelerated to 4.3% in 2017 from 1.1% in 2016 as pass-through from a 24.8% depreciation of the Mongolian togrog in 2016 began to affect import prices, drought in the summer reduced supplies and boosted prices for vegetables and other foods, and higher excise taxes on vehicles pushed up transport costs. Core inflation excluding food and energy was substantially higher in the second half of 2017, and even higher in January 2018 at 8.8% year on year, indicating intensifying pressure on prices (Figure 3.10.3).

3.10.1 Demand-side contributions to growth



Source: National Statistical Office of Mongolia. 2018. *Monthly Statistical Bulletin*. January. <http://www.nso.mn>.

3.10.2 Supply-side contributions to growth



Source: National Statistical Office of Mongolia. 2018. *Monthly Statistical Bulletin*. January. <http://www.nso.mn>.

In line with the government's commitments to the International Monetary Fund under an extended fund facility agreement, the budget deficit was slashed to the equivalent of 3.9% of GDP from 15.3% in 2016 (Figure 3.10.4). Fiscal consolidation reduced budgetary expenditure by 5.4% despite continued inclusion of formerly off-budget spending in the budget, while higher receipts from taxes on external trade and connected activities lifted budget revenue by 35.8%. Even with stronger revenue performance, the authorities withdrew savings from the Fiscal Stability Fund, estimated to equal 2.1% of GDP, to finance normal budgetary operations. This negated the purpose of the fund, which is insurance against revenue shortfalls arising from natural disasters or commodity price shocks. Deficit financing, currency depreciation, and a rising share of external debt in total public debt pushed up interest payments on government debt to 12.9% of total expenditure in 2017 from 10.4% in 2016.

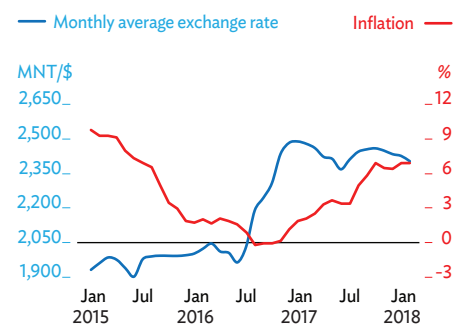
A surge in repatriated profits from mining widened the current account deficit by 62.6% to equal 10.2% of GDP in 2017 (Figure 3.10.5). Nevertheless, a sharp recovery in foreign direct investment (FDI), including the reinvestment of a record share of mining profits—as well as financial support from multilateral development partners and better terms of trade—allowed the country to refinance a major part of its external debt. Net foreign liabilities dropped by 78.1% to \$412 million, and gross reserves more than doubled to \$3.0 billion, or cover for 5.5 months of imports. These developments pushed the value of the togrog up by 2.5% against the US dollar. This will allow the Bank of Mongolia, the central bank, to pay off a portion of its short-term, high-interest foreign liabilities, which amounted to 15.4% of GDP in December 2017. Public debt including central bank foreign liabilities declined to the equivalent of 99.1% of GDP (Figure 3.10.6).

As pressure eased on the balance of payments, the central bank lowered its policy rate by 3.0 percentage points in two steps in 2017 and by a further percentage point in March this year. Net domestic credit fell by 2.8% as government borrowing dropped significantly, but broad money growth surged by 24.2% as the net foreign liabilities of the banking system declined. The nonperforming loan ratio remained elevated, officially at 8.5% of the total but likely higher if not for loan classification, forbearance, and reporting problems. A review of bank asset quality was completed in 2017, and a bank recapitalization plan is being implemented, requiring banks to meet stiffer capital adequacy requirements by the end of 2018 (Figure 3.10.7).

Economic prospects

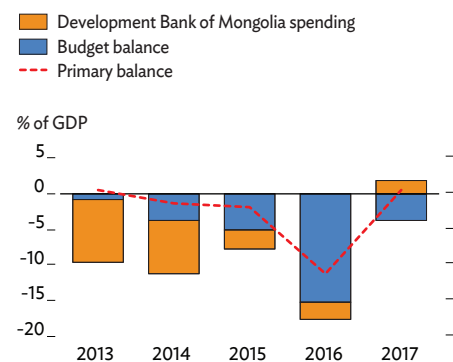
Growth is forecast to decelerate slightly to 3.8% this year before rising again to 4.3% in 2019, supported by FDI anticipated to exceed \$1 billion annually this year and next to develop the Oyu Tolgoi underground mine (Figure 3.10.8). The quality of copper concentrate from the open-pit mine is expected to improve significantly. The contribution to growth from coal mining and related activities will be smaller in 2018, as transportation bottlenecks limit expansion in coal exports, but larger again in 2019 as they are alleviated. On the whole, the contribution of

3.10.3 Inflation and exchange rate



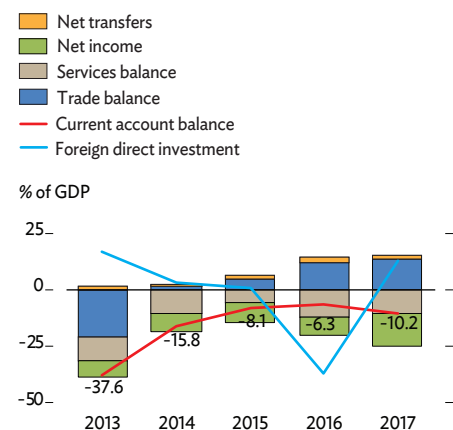
Source: Bank of Mongolia. <http://www.mongolbank.mn>.

3.10.4 Fiscal indicators



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

3.10.5 External indicators



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

mining to growth is projected to turn positive in 2018 and rise higher in 2019. The service sector will remain the driver of growth, though its contribution will be lower in 2018 as coal transport declines, recovering in 2019. Crop production is projected to return to normal in 2018 after the drought in 2017, helping agriculture recover. Manufacturing will grow at a slower rate than in 2017, with cement and food processing playing prominent roles. Construction is set to recover in line with higher mining investments.

Consumption growth will be supported in both 2018 and 2019 by rising government expenditure, higher incomes, and strengthening consumer confidence linked to mining activity. Investment will grow in both years but at a diminishing pace as FDI inflows remain stable. The decline in coal exports in 2018 will likely be compensated by increased copper concentrate exports, but with imports expected to remain robust, net exports should be negative in both years.

Average inflation will accelerate to 8.0% in 2018 and ease to 7.0% in 2019 (Figure 3.10.9). Rising domestic demand and international oil and food prices will, with the effect of looser monetary policy in 2017, drive inflation higher in 2018. These effects will be less pronounced in 2019 as oil prices and domestic demand subside.

Fiscal policy will be more expansionary in 2018 and 2019. The budget deficit is projected to equal 6.4% of GDP in 2018 and 5.1% in 2019 as expenditure on social insurance, welfare, and equipment increases—and because reform to ease reporting requirements and the tax burden for small and medium-sized enterprises is likely to reduce budget revenue.

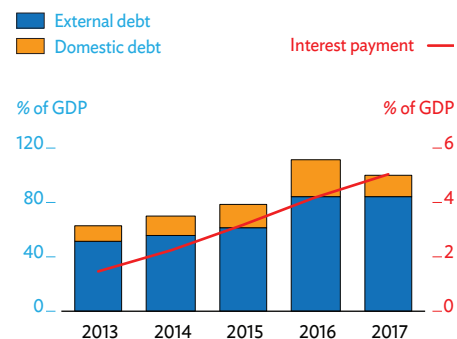
The trade surplus will narrow slightly in 2018 with rising imports related to FDI but widen again in 2019 on rising coal exports. The large service deficit will remain broadly constant in 2018 and 2019 as service payments rise with higher FDI-induced imports, and the deficit in the income account will remain high but lower than the one-off peak caused by profit repatriation in 2017. Thus, the current account deficit will narrow to 6.3% of GDP in 2018 before widening slightly to 7.0% in 2019.

Downside risks to the outlook would include lower coal and copper prices, disruptions to the successful implementation of the program supported by the International Monetary Fund, higher meat prices, interruptions to Oyu Tolgoi production or investment, and worsening financial instability arising from the bank restructuring program. Upside risks to growth would be higher commodity prices and a possible deal on large infrastructure projects tied to existing mining production.

Policy challenge—reducing the high cost of air pollution in Ulaanbaatar

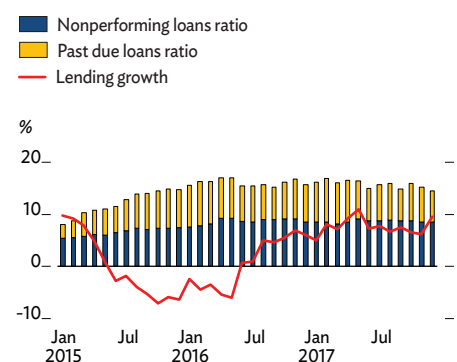
Ulaanbaatar is the coldest national capital in the world and the most polluted city in wintertime. Pollutant concentrations in the coldest months can average 20 times recommended guidelines from the World Health Organization, with daily levels up to 80 times higher (Figure 3.10.10). The annual economic cost of pollution through premature death and higher hospitalization is estimated by the Millennium

3.10.6 Public debt



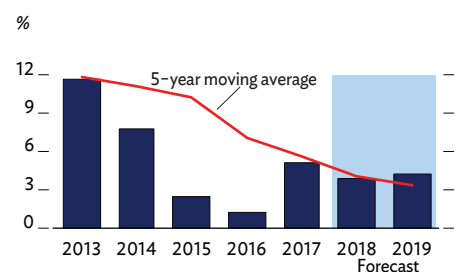
Note: Includes Bank of Mongolia's short-term liabilities.
Sources: Ministry of Finance. <http://www.mof.gov.mn>;
Bank of Mongolia. <http://www.mongolbank.mn>.

3.10.7 Banking indicators



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

3.10.8 GDP growth



Source: Asian Development Outlook database.

3.10.1 Selected economic indicators (%)

	2018	2019
GDP growth	3.8	4.3
Inflation	8.0	7.0
Current account balance (share of GDP)	-6.3	-7.0

Source: ADB estimates.

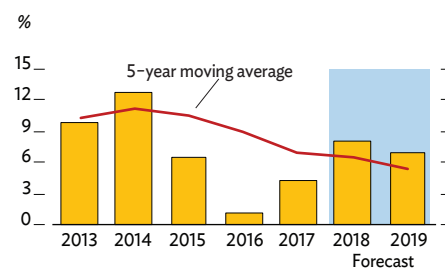
Challenge Corporation in the US to equal 8%–13% of Mongolian GDP. Poor families are especially exposed as they are more likely to live and work in the most polluted areas and often cannot afford medical care. With poverty rates estimated to have risen from 2014 to 2016 by 8.0 percentage points to 29.6% nationwide and by 8.4 percentage points to 24.8% in Ulaanbaatar mainly due to the worsening economic situation in this period, the number of people vulnerable to pollution has increased significantly. Thus, pollution both increases economic costs and deepens inequality.

High pollution has both human and natural causes. Increasingly frequent harsh winters and summer droughts worsen conditions for herders, stoking migration to cities. Ulaanbaatar has grown by more than 30% since 2007 to a population of 1.5 million, expected to hit 1.9 million by 2025. Close to 60% of city residents live in vast informal developments and rely on raw coal or refuse burned in inefficient stoves for heating and cooking, which generate 80% of pollution in Ulaanbaatar. Exacerbating the problem are the use of highly polluting coal-fired boilers for heating, combined heat and power plants, the growing number of vehicles, and mountains that trap polluted air in winter.

The National Program for Reducing Air and Environmental Pollution, 2017–2025 aims to strengthen regulations on fuel quality, ban raw coal in Ulaanbaatar by 2019, and improve access to higher-quality energy sources by subsidizing the use of electricity and cleaner fuels. It includes longer-term plans to improve energy efficiency, broaden access to clean energy sources, improve public transport, provide affordable housing, and strengthen urban planning and development. The program is estimated to cost \$4 billion, of which \$1.8 billion targets air pollution, with the remainder focused on land and water pollution. Only 4.5% has reportedly been secured. Development partners have committed to funding parts of the program, but the government will need to create the right conditions to attract additional financing. Success requires careful analysis of sustainability and cost-effectiveness to ensure resource allocation to activities with impact and the sustainability of measures such as fuel subsidies.

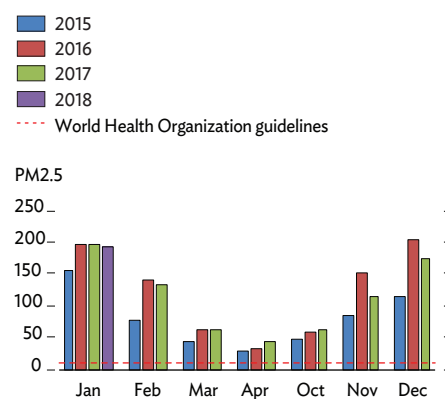
Meanwhile, improving conditions in rural areas would be better than forcing people out of the city or restricting migration, which might well exacerbate unplanned urban expansion and pollution. Finally, the national program must be immune to political changes to ensure its uninterrupted implementation.

3.10.9 Inflation



Source: Asian Development Outlook database.

3.10.10 Average concentration of pollutants in Ulaanbaatar



PM2.5 = air pollutant that is a concern for people's health when levels in air are high.

Sources: Department of Weather and Environment Analyses; World Health Organization.