Mongolia's Economic Prospects and Challenges
01-05-10[1]

Before the global downturn, Mongolia had become a market-oriented growth economy dominated by exports. Mongolia has undergone significant economic and political changes since 1990. Reforms towards a democratic and free-market system have been implemented with generally steady progress. GDP growth was high from 2002 to 2007. High copper and gold prices combined with strong demand during the period pushed up the value of exports significantly, with positive impacts on nominal GDP. Similarly, the livestock sector (sheep, goats, cattle, camels, horses) grew by an average of 12% between 2005 and 2007. In 2006 and 2007, mining and agriculture (of which livestock products made the majority) together accounted for approximately 50% of GDP, and in 2007 and 2008 they accounted for more than 90% of exports.

Growth performance has suffered in the wake of the crisis: after contracting in early 2009 output has barely risen, but it is expected to grow with more strength in 2010. Real GDP contracted in the first quarter of 2009 before slightly recovering. On average real GDP growth in 2009 is estimated to be a mere 0.5%, but it is projected to increase to 2.5% in 2010. Sharp declines in demand for copper and gold in the second half of 2008 and global decreases in mineral prices at the end of 2008 significantly affected real and nominal GDP growth due to the mining sector's prominence in Mongolia's total exports (about 80%). The fall in the price of cashmere products (by two-thirds according to some estimates), Mongolia's third largest export after copper and gold, affected the agriculture sector. Construction and manufacturing performed poorly. Although the outlook for these sectors remains dim, the prices of copper and gold have begun to recover and are expected to be high in 2010 and 2011, bringing hopes that the mining sector will be a driver of growth again.

Despite remarkable progress since the beginning of the decade, poverty remains a serious problem. Poverty has decreased since the transition but remains high, with 35.2% of the population living under the poverty line in 2008. Recent estimates reveal that 66.2% of the population lived in poverty in 2002/2003, indicating a sharp decline in poverty rates since. Around 35% of the population relies on semi-nomadic livestock herding for their livelihoods, the majority of which consists of goat herding for cashmere. Inequalities have widened along an urban-rural divide, and in rural areas the poverty headcount has actually increased. During the period of economic growth, economic opportunity was concentrated in the capital city, where 60% of the population now lives in traditional nomadic tents ("ger") surrounding the city core. Ger areas are typically disadvantaged in terms of incomes, employment, public services and human development compared to other urban areas. During the onset of the crisis, food cost

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1 Thibaut Muzart, Management Systems International, under ME/TS's Alliances, Analyses, and Program Support (AAPS) buy-in to EGAT's Business Growth Initiative. The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

hikes due to global price trends affected the urban and rural poor significantly, largely through the large proportion of food items in their consumption basket.

Although the education sector performed relatively well during the socialist years and literacy and enrollment rates are high, there were mismatches between skills and employment opportunities even before the crisis. Although official unemployment figures are low, estimates by the World Bank put the actual figure at 21% of the working age population in 2007. Since the beginning of 2009, unemployment is considered to have increased significantly, including in informal labor markets.

The current account deficit has been narrowing and the exchange rate has stabilized, but prices continue to fall. Nominal exports declined sharply in the first quarter of 2009 before slowly rising again - encouraged principally by Chinese demand and higher copper and gold prices - but have so far remained lower than in 2008. Although nominal imports (especially consumption and mining equipment) had increased during the last three quarters of 2008, they declined significantly during most of 2009 as the economy slowed. Thus, the current account deficit for 2009 is estimated at 6.9% of GDP, against 13.9% in 2008. In 2009 the current account deficit was primarily financed by capital inflows, including increasing foreign direct investment into the mining sector. This investment suggests that prospects for the sector are improving.

Net international reserves at the Bank of Mongolia (BoM, the central bank) declined by 60% between July 2008 and the first quarter of 2009. The bank had intervened in the currency markets to support the national currency (the tugrik), which nevertheless lost 37% of its value against the US dollar between the end of October 2008 and mid-March 2009. The resulting low amount of reserves (equivalent to about 1.5 months of import coverage) prompted the central bank to cease intervening and raise its policy rate to make investments denominated in tugrik more attractive. Because of this measure, as well as a better external balance situation, foreign exchange accumulation recovered and the exchange rate stabilized. Following the recovery of foreign exchange reserves and falling prices[2], the policy rate has been lowered three times since March 2009.

The boom years saw a large rise in non-performing loans that forced the government to rescue important commercial banks. Very high inflation and loose monetary policy in 2008 led to high credit growth, which masked the growing number of non-performing loans in the banking system. In December 2008, the government had to bail out Anod Bank, one of the biggest commercial banks in Mongolia. The government later put in place a blanket deposit guarantee to avoid bank runs in the event of other bank failures. In November 2009 another bank (Zoos Bank) failed, and the fact that it did not trigger a panic indicated that the measure was working. Non-performing loans, however, have continued to rise and now account for 17.3% of all loans even when the two failed banks are excluded. Non-performing loans are highest in construction, mining and quarrying, among individual borrowers, and increasing in agriculture.

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[2] Inflation has slowed since mid-2008 and prices have fallen since July, pulled down by slower economic activity as the real sector continues to perform poorly.

High real interest rates constrain lending. Nominal interest rates on both local currency deposits and loans have been constant despite the successive policy rate cuts since March 2009, and because of the recent downward price movements real borrowing costs are now close to 25%. Such high real interest rates repress private sector activity and make the potential option of tightening monetary policy undesirable for the central bank. At the same time, high risk perceptions among banks due to the large number of non-performing loans have made them more reluctant to extend credit. The issuance of new credit has declined by 13% in the third quarter of 2009 compared to the third quarter of 2008. However, high real interest rates have also pushed up the number of Tugrik-denominated deposits almost to their pre-crisis numbers.

On a positive note, the government has engaged in partnerships with various donors to undertake a number of initiatives in the banking sector. These include conducting audits of commercial banks by international firms to determine tailor-made measures that will restore confidence in the banking system, and the implementation of a supervisory enforcement plan with the help of USAID.

The impacts of the crisis on the mining sector reversed fiscal balances. The government enjoyed considerable budget surpluses between 2005 and 2007 thanks to high copper and gold prices[3] and the imposition of a profits tax in 2006. However, revenues fell by 19% during the first eight months of 2009 due to the decline in copper and gold prices at the end of 2008, compared to the same period in the previous year. The repercussions of the global downturn outlined the government's heavy dependence on mining revenues, and it has recently taken steps to establish a fiscal stabilization fund, modeled after those in other resource-rich countries, that would take into account fluctuations in the price of copper.

Nevertheless, the government increased its spending on social security payments and poverty-reduction programs, although expenditures on public sector salaries have been lower. The latest budget, approved on November 27, 2009, projected a 5% budget deficit and set aside funds [the Human Development Fund (HDF)] for pension and health insurance, housing, education and health services, as well as cash transfers to Mongolian citizens. The estimated budget deficit for 2009, however, amounts to 6.5% of GDP. On a positive note, the World Bank, the Japanese Government and the Asian Development Bank have pledged $240 million to support the fiscal sector over 2009-2010. Another key development in donor assistance has been the conclusion of an 18-month Stand-By Arrangement with the IMF in the amount of Special Drawing Rights (SDRs) 153.3 million in April 2009.

The latest Oyu Tolgoi mining project promises to reanimate the mining sector and bring substantial economic benefits. A final agreement for the development of the Oyu Tolgoi mine has been signed between the Mongolian government and Ivanhoe, a Canadian mining firm. Although full production will likely take several years to begin, the mine will exploit Mongolia's biggest copper and gold deposits. The government has had to repeal a windfall tax on mining profits under pressure from Ivanhoe, but it will own 34% of the mine and production is expected to average one billion lbs of copper and 500,000 oz of gold annually when full production begins. Other estimates state that copper produced in the mine could account for 6% of world

[3] Excluding mining revenues the budget was actually in deficit in 2007, at 13% of GDP.

copper production and that when production peaks in 2019 export revenues could equal 55% of GDP and 20% of total government revenue. It is likely that job creation will amount to 5,000 jobs during construction and 4,000 during operation.

The outlook for the mine looks bright. Demand from China, the world's largest consumer of metals, is likely to continue to increase and the mine's huge reserves are likely to keep the mine running for decades and generate tens of billions of dollars. In this respect, the management of mining sector revenues by the government is likely to make a big difference in the extent to which the mine benefits the economy. The establishment of the fiscal stabilization fund provides some measure of confidence that future developments should occur along a positive path.

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