UNDP/RCC Policy Note on the
Soaring of Food and Oil Prices in Mongolia:
Causes, Consequences and Responses at the Macro level[*]

1. Background and Objectives

The present inflationary situation in Mongolia is a major cause for concern. The continuous price rise in the domestic market has been aggravated by a corresponding sharp price rise in the global market. International prices of food have increased significantly in the recent years, with steep increases over the last one year. This has pushed up retail food prices in Mongolia. The explosion in international oil prices has also pushed up retail energy and fuel prices as well as transport cost and fertilizer prices in Mongolia. The spike in food and oil prices threatens to push large numbers of people back below the poverty line in Mongolia. This also disturbs the macroeconomic stability through rising inflation, increasing fiscal cost of food and oil subsidies, and widening trade deficits in Mongolia. In many developing countries, the sharp increase in food and oil prices has sparked protests - some of which have turned violent (riot). Governments and the international community are now scrambling to mitigate a potential socio and economic crisis.

In this context, the Government of Mongolia (GOM) has adopted a number of measures to reduce inflation and mitigate the adverse impact of price hikes. The GOM has solicited support from UNDP-Mongolia in analysing the causes and the impact of an upward price spiral, and to recommend short-term measures to provide immediate relief to the most vulnerable population, and medium and long term strategies to improve the food and oil security as well as to combat increasing poverty levels caused by the price hike. UNDP-Mongolia has agreed to initiate an assessment and provide recommendations. A two member technical team (one from RCC – T. Palanivel and another from RCB – Nandita Mongia) has been set up in this regard. Subsequently, regional experts undertook a mission to Mongolia in May 2008 for stakeholder discussions involving the GOM, UN, donors and NGOs as well as to indicate data requirements for technical analysis. During the mission, it has been agreed that RCC will focus on the macro issues and perspectives while RCB will focus on the micro issues and perspectives. Regional experts and UNDP-Mongolia have worked together to build the necessary database. This note attempts to analyse the following questions from the macro perspectives.[1]

- What are the factors causing the rise in food and oil prices in Mongolia?
- What is the likely impact of soaring food and oil prices on the Mongolian economy and society?
- What steps have Mongolia and other countries in the region taken so far to mitigate the adverse impact?
- What additional measures are needed in Mongolia to mitigate the impact?

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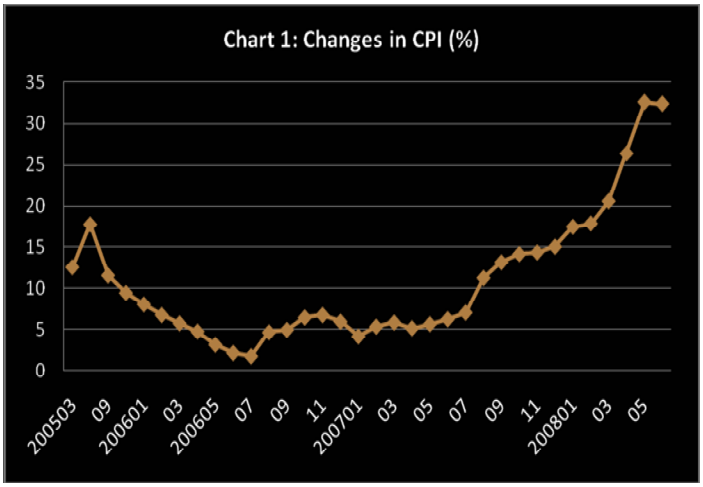
[*] This note, which is part of the UNDP Regional Centres (RCB and RCC) Policy note on high food and oil prices on Mongolia, is prepared by T. Palanivel, Senior Advisor, UNDP Regional Centre in Colombo (RCC). He would like to thank Enkhariunaa, Sanath Manage and Indunil De Silva for data collection and analysis, and to Kirsty Hayes, Taimur Khilji and Maneka Weddikkara for their feedback on the earlier draft.

[1] Similar note from micro perspectives based on primary households' survey is being prepared by Nandita Mongia of UNDP/RCB. A final integrated report will be submitted to UNDP-Mongolia soon.

2. Trends in Food and Oil Prices in Mongolia

In Mongolia, the recent inflation rate measured in terms of the Consumer Price Index (CPI) reveals:



- **Rising inflation-** After rising steadily from 5.1% in 2006 to 9.0% in 2007, Mongolian inflation reached 32.4% year-on-year (yoy) by end-June 2008 and 23.8 % since the beginning of 2008 (Chart 1)[2]. It reached as high as 33 % in May 2008 - the highest inflation rate witnessed since the beginning of this decade.
- **Volatile inflation** - Mongolian inflation has been somewhat volatile in recent years (Chart 1). The year-on-year inflation rate jumped from 10 % in December 2004 to about 17 % in June 2005, due partly to a temporary shortage in the food supply. As the supply shock was reversed, inflation steadily declined from June 2005 to June 2006. In fact, it declined to less than 2 % (year-on year) in July 2006, the lowest level in five years. Inflation subsequently picked up to 6.5 % in October 2006 and fluctuated around 5-6 % until mid 2007. It started to increase sharply from mid-2007 and the CPI growth rate on a year-on-year basis has exceeded 20 % each month from March 2008 onwards.
- **Recent price stability** - For the first time since January 2007, inflation rate showed signs of stabilization although at a very high rate of 32% in June 2008 – the last month for which data is available. This indicates some success of government efforts in price stabilization.

Table 1:
Inflation Rate in Selected East Asian Countries

	2006	2007	2008 Q1	2008 Q2
Cambodia	4.7	5.9	0.0	…
China	1.5	4.8	8.0	7.8
Indonesia	13.3	6.4	7.6	10.1
Korea, Rep.	2.2	2.5	3.8	4.8
Lao PDR	6.9	4.5	…	…
Malaysia	3.6	2.0	2.6	…
Mongolia	5.1	9.0	19.2	31.7
Philippines	6.3	2.8	5.5	9.8
Singapore	1.0	2.1	6.6	…
Thailand	4.7	2.2	5.0	7.6
Viet Nam	7.4	8.3	16.4	24.5

World Bank, "Rising Food Prices in East Asia: Challenges and Policy Options", World Bank policy note (2008)

Available data (Table 1) also indicates two other key points:

- **Rising inflation is a common phenomenon in the region** - Like Mongolia, many East Asian countries have also experienced

[2] Data source for Charts 1 to 5, 16 – Bank of Mongolia, Monthly statistical Bulletin 2008 May; for chart 6and 9 – National Statistical Office and Ministry of Finance and Economy, Mongolia; for chart 12 – ADB Development Outlook; for remaining charts – IMF – Selected issues and Statistical Appendix published from 2002 to 2008

high inflation rates in the recent months. For example, inflation has reached an 11-years high in China (8.7% in February 2008); a 9-year high in Korea (5.5% in June 2008), a 26-year high in Singapore (7.6% in April 2008); and a 12-year high in Viet Nam (25.2% in May 2008).

- **Mongolia at No 1**: Mongolia's recent inflation rate is the highest in the East Asian region (Table 1).

Mongolia's National Statistical Office (NSO) changes periodically the composition and relative weight of goods and services included in the CPI calculation in line with changes in the people's consumption of goods and services. Since April 2006, NSO has changed the base year to December 2005=100 and expanded the number of items in the CPI basket from 239 to 287. If one uses this base price and composition, the overall CPI has increased by 52 % during December 2005 to June 2008.

Table 2: Relative Importance of Household Consumption (%)

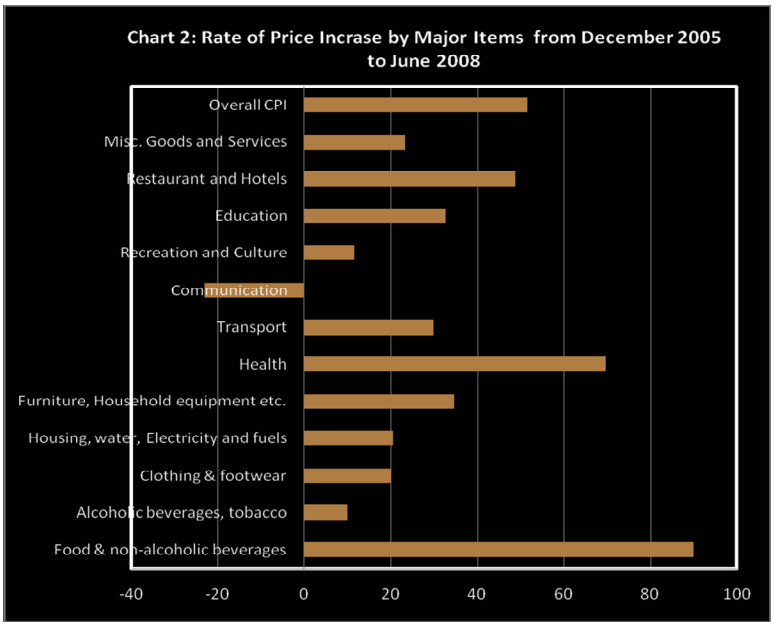
Major Categories	December 1995	December 2000	December 2005
Food and Non-alcoholic beverages	58.7	46.6	42.21
Alcoholic beverages, Tobacco			2.94
Clothing and Footwear	10.3	13.5	10.14
Housing, Water, Electricity, Gas, and Others	10.4	14.1	10.51
Furniture, Household equipment etc.	3.9	3.2	3.31
Health	2.1	1.4	1.79
Transport	7.6	10.1	9.53
Communications			3.13
Recreation and Culture	3.6	7.4	3.7
Education	3.5	3.7	5.44
Restaurant and Hotels			2.7
Miscellaneous Goods and Services			4.58
Total consumption	100	100	100

Major Food Items	Dec-95	Dec-00	Dec-05
Meat and Meat product	18.4	12.4	14.44
Bread flour and Wheat product	17.2	12.9	11.44
Milk and milk product	5.1	5.2	3.92
Sugar		4.9	2.05
Vegetables		4.1	4.28
Oil and fats		3.5	2.35
Soft drinks and cigarettes	4.5	3.7	3.73

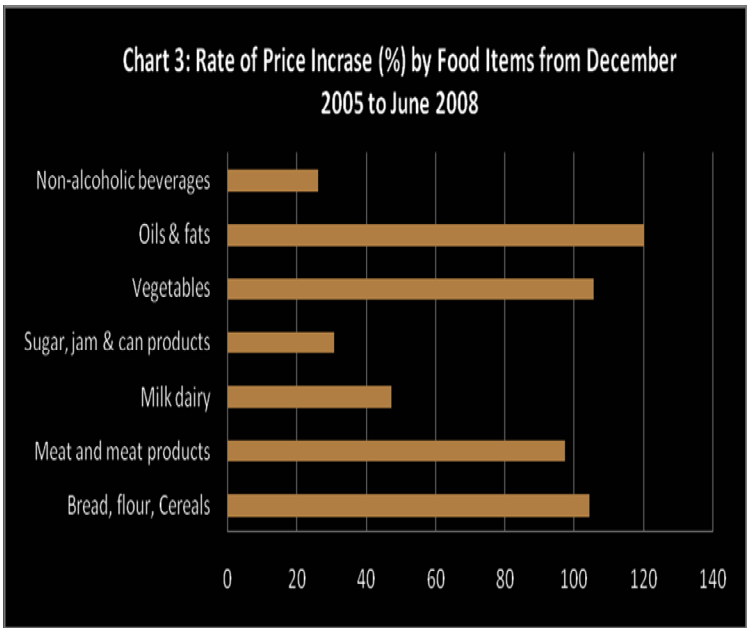
Sources: Bank of Mongolia, Monthly Bulletin, various Issues

The relative weights of consumer basket are given in Table 2. The Table reveals that consumption patterns have changed dramatically in the last decade due to rapid increase in per capita income. The share of food in household expenditures has been declining for years, while expenses on transport, medical care, education and housing are rising. A decade back an average household used to allocate about 58 % of their consumption budget to food, whereas in the recent years this share was down to less than 40 %.

An analysis of the prices of different categories of goods and services in the CPI reveals that prices in all major categories, except telecommunications, have increased in recent years (Chart 2). Prices of communication have declined by 23 % since December 2005. Food & non-alcoholic beverages experienced the largest price increase (90 %) between December 2005 and June 2008. Health services witnessed the second largest price increase (70%), followed by restaurants and hotels (49%). Alcoholic beverages, tobacco, recreation and cultural items experienced lowest price increase (10-12%).



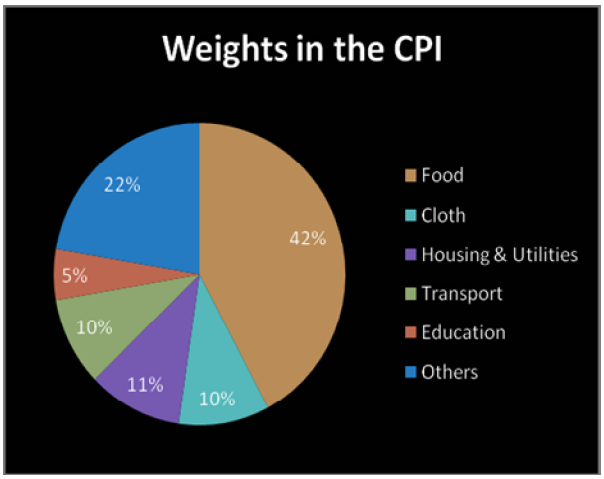
A similar analysis of the prices of different food items in the CPI reveals that oils and fats witnessed the largest price increase (120 %) between December 2005 and June 2008 (chart 3). Prices of Vegetables, wheat and meat products also doubled over the last 30 months. Only prices of soft drinks and sugar products experienced a relatively mild price increase.

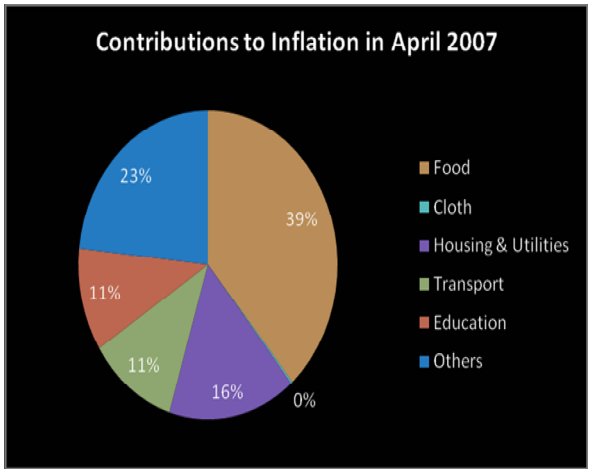


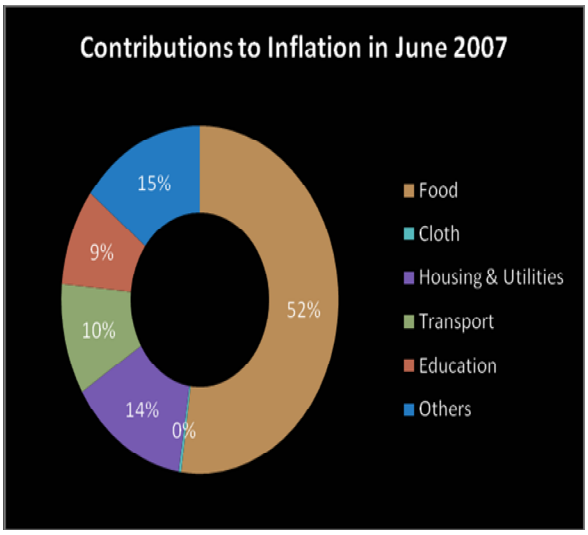
A decomposition analysis of the year-on-year inflation rate reveals an interesting picture. Food items, with 42% weightage in the CPI, accounted for only 39 % of inflation in April 2007. But in the recent months, food prices accounted more than two-thirds of inflation (Chart 4). This is because food prices have increased (yoy basis) the most over the last year (59 % in May 2008 and 57% in June 2008 compared to about 7% during the corresponding months in 2007). Prices of wheat and meat products contribute nearly half of the inflation. The reason for this is that (i) wheat and meat products are given a significant weight in the CPI index (11% and 14% respectively) and (ii) their prices have increased the most over the last 12 months (97.4 % yoy basis in May and 95.6% in June 2008 compared to just 2-3% during May and June 2007). Prices for wheat and meat products have increased by 47 % and 49 % respectively since the beginning of the 2008.

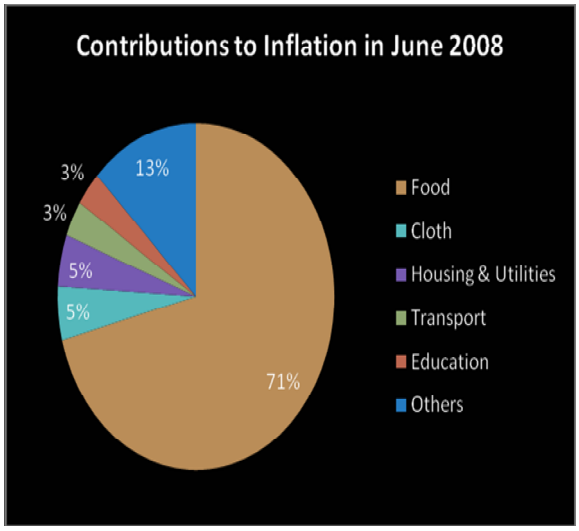
Petroleum products have a 1.6 % weight in the CPI consumption basket. Retail price of gasoline-A93 has increased by 23.9%, gasoline-A76 by 27.4% and diesel by 18.9% in 2007. Therefore, increase in the fuel prices could have pushed up general price index only by 0.3 to 0.4 percentage points out of 9% in 2007. This implies that the direct contribution of rise in petroleum prices to overall inflation is limited. However, the price of transport, with a weightage of 10 % in the CPI, increased by 11.9 % in June 2008 as compared to June 2007. In the last six months, the price of transport increased by an average of 4.8%. This suggests that transport prices contributed about 10% to overall inflation in 2007- more or less same level of its weight. But in the recent months, its contribution to overall inflation has been relatively less as food prices have increased at a relatively faster rate.

Chart 4





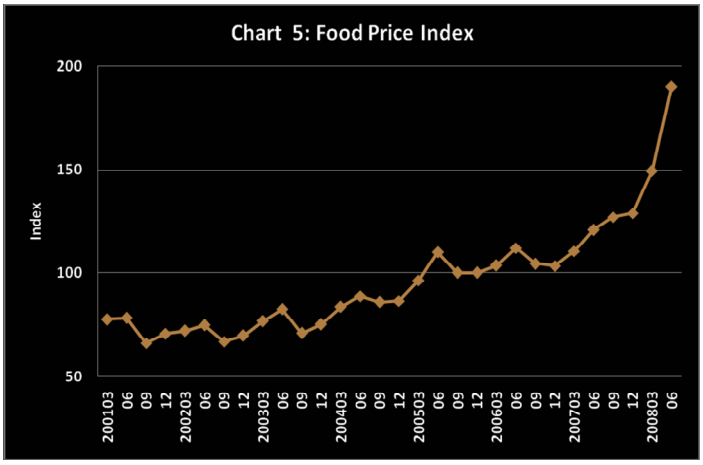




The above analysis indicates the current inflation rate is the highest in the last decade in Mongolia. The analysis also shows since food items have the largest weightage in the CPI and since the prices of food items have risen at a relatively higher rate compared prices of other items in the CPI, it can safely be stated that the high inflation in Mongolia is primarily due to the increase in food prices.

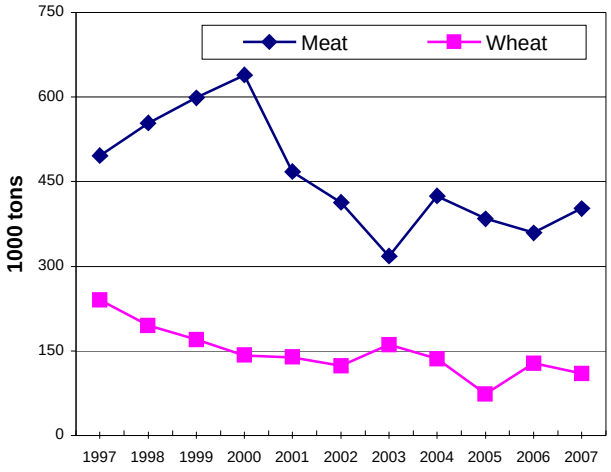
3. Underlying Causes of Rising Food and Oil Prices in Mongolia

An examination of trends in inflation in Mongolia indicates that changes in prices appear to be seasonal. The price of meat, a staple food, usually peaked in June, at the end of the breeding season, after which farmers resume slaughtering livestock and prices decline. Chart 5 confirms this seasonal pattern that the food prices tend to peak in June and go down during July-September. But in 2007 such a seasonal pattern was not observed and the increase in prices of food items has continued into September and beyond.



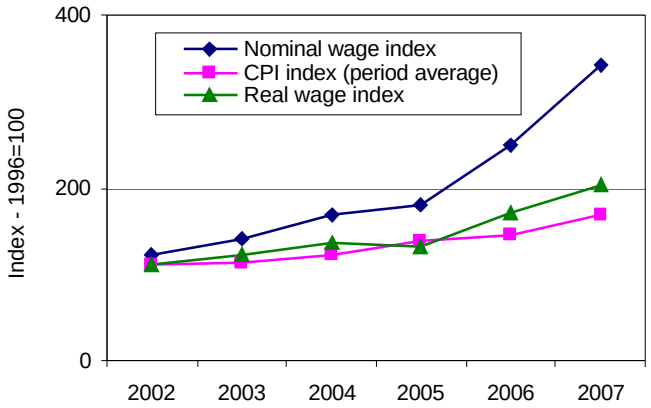
The price of domestically-produced meat has increased by 45% in May 2008 compared to a year ago. This has contributed significantly (6.5% of 33%) to general CPI increase in Mongolia. Meat products account for 36 % of the food consumption and are primarily domestically produced. Meat prices in Mongolia are thus more dependent on domestic than external factors. These include: number of livestock, weather conditions, the overall consumer demand that is driven by income levels, and domestic meat procurement practices. Meat price fluctuates in relation to its supply. In the spring and summer it goes up and in the fall and winter it goes down. Chart 6 shows that unlike previous years when supply of meat declined due to factors such as a '*dzud*', there was no adverse supply shock in 2007. Given this, the increase in meat prices over the last 12 months can be attributed to other factors such as rising transport cost and increased domestic demand. Demand for meat products has increased because of rising household incomes. Mongolia's per capita income has increased rapidly in recent years which has continuously pushed up demand for food items. Urban Mongolia is witnessing an increase in people's affluence due to rapid growth in government transfer payments and wages. Government wage bill increase was lower than GDP growth during 2001–05, but since then the wage bill has started rising very rapidly, reaching about 90% in 2008. This has led to very rapid increases in the civil service's average wage and real wage in recent years (Chart 7). Government consumption has also expanded due to increases in public wages and increased public social

Chart 6: Output of Major Agricultural Products



transfers. The improved fiscal situation, reflecting rising mineral revenues due to very high commodity prices, has enabled the government to increase its social transfers as well as its wage bill. Sustained remittances from Mongolians working abroad, as well as a 5 % VAT cut, effective at the beginning of 2007 combined with unification of the personal income tax at the lowest level of the previous rates (10 %), also simulated domestic demand in the recent months. Rising fuel and transportation costs also contributed to upward pressure on meat price levels.

Chart 7: Indices in Prices and Government Wages



Import prices, especially for food and petroleum products, also explain recent inflationary pressures. Mongolia imports most of its food products, with the exception of meat products. For example, it imports most of its wheat and flour from Russia. International wheat and other food prices have increased significantly in the last one year (Chart 8). The increase of international wheat prices transmit to the price of imported wheat products in Mongolia. Several food-exporting countries have imposed export restrictions, while some key importers have been purchasing grains at any price to maintain domestic food supplies. This has not only resulted in some panic and volatility in international grain markets, but has also attracted speculative investments in grains futures and options markets, which may have driven prices even higher. The domestic production of wheat declined in fall 2007 due to drought in some provinces which contributed to reducing aggregate supply and putting further upward pressure on prices. Consequently the price of flour has almost doubled compared to a year ago and has contributed significantly (11 of 33%) to the general CPI increase in Mongolia. Similarly, most of the vegetables and fruits consumed in Mongolia are imported from China. The global price of vegetables and fruits has increased by 78% compared to a year ago and contributed to 4 percentage points of the general price increase in Mongolia.

Chart 8: Global Food and Oil Price Indexes

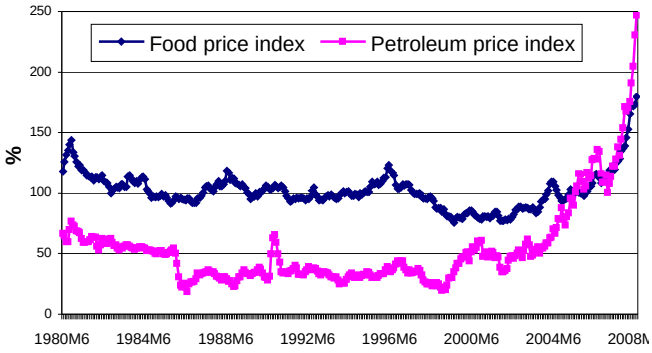
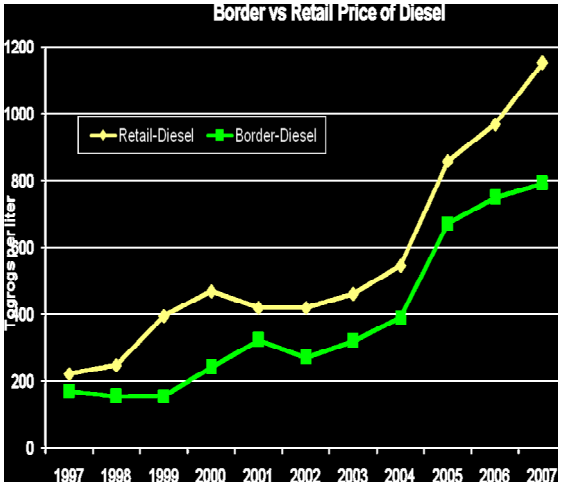
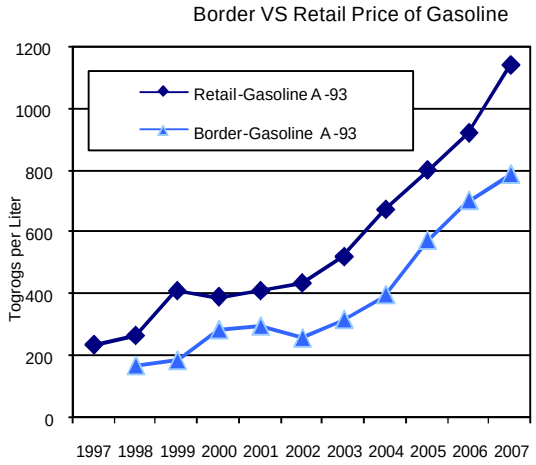


Chart 9: Relationship between Border prices and Domestic Prices





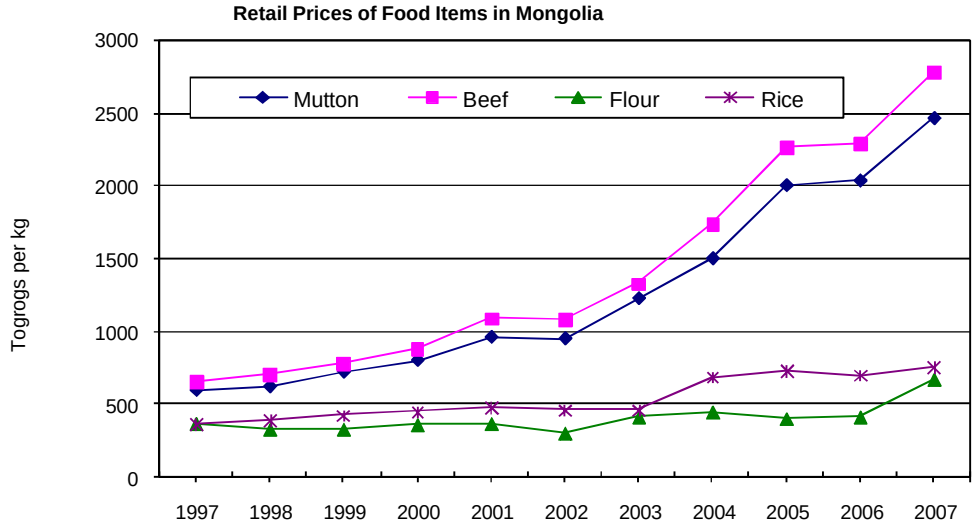
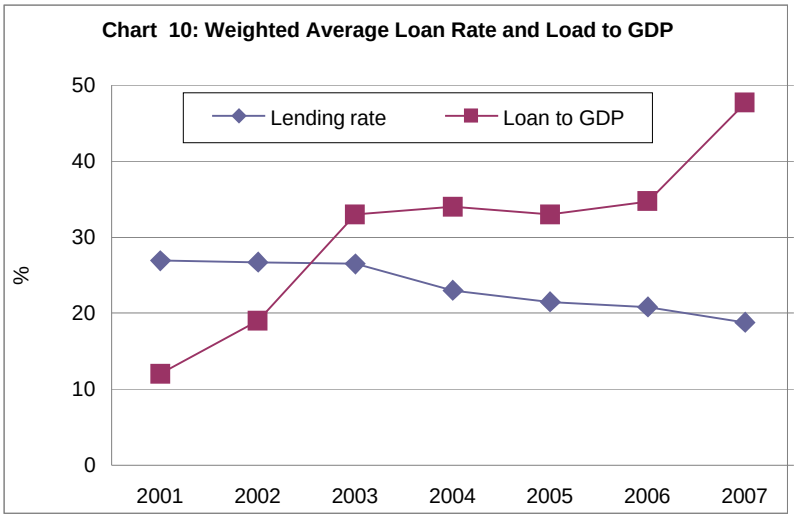


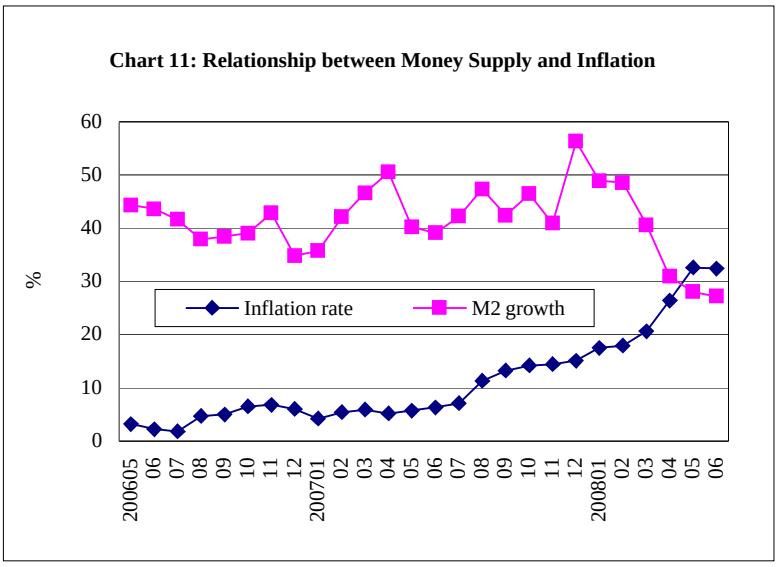
Chart 9 reveals that domestic petroleum prices simply follow border prices. However, the chart also reveals that domestic prices of gasoline and diesel are increasing at a faster rate than border prices. Mongolia imports most of its petroleum products from Russia. About 95 % of its total oil supply is obtained from one Russian state-owned oil company. Higher prices for imported fuel and transport costs have further boosted prices. In the last year, rapid increases in international oil prices increased transport cost and fertilizer and other food production costs. As the Mongolian economic system and its value chain is highly dependent on petroleum, increasing oil prices have pushed up the costs of cultivation, harvesting, processing, refrigeration, shipping and distribution. However, the direct contribution of soaring international oil prices to general inflation levels in Mongolia has been fairly limited. Overall, the imported inflation for food and

oil products is estimated to account for almost half (about 16 percentage points) of the Mongolia's yoy inflation of 33% in May 2008. This indicates that imported global inflation explains part of the Mongolia's recent inflation.

The upward administrative adjustments in the tariffs of key utilities and basic services have also contributed to the CPI increase. In the education sector, public and private university tuition fees have increased by more than 20 % yoy in September 2007. Hospital services charges were also increased by 76 % during this same period. In April 2007, water tariffs were adjusted upward by 74 %. On average, the prices of key utilities increased by 16% in June 2008 compared to a year ago and contributed to 1 percentage point of the general price increase in June 2008.



Rapid growth in money supply - Mongolia's high rate of economic growth is being fuelled by the current high level of international copper and gold prices that has, in turn, resulted in higher foreign exchange inflows. One is also seeing higher FDI inflows due to increased mineral exploration, and fast expansion in the construction and services sectors. Easy access to liquidity, due in part to foreign direct investment inflows and workers' remittances from abroad, has contributed rapid monetary expansion. There has also been a marked expansion in net credit from the banking sector to private sector entities as well as the Government (Chart 10). This, combined with cheaper access to liquidity through lower interest rates (average rate was 5.7% during 2005-07 compared to 13% observed during 2002-04. past years), has added to monetary expansion (chart 10). Consequently M2 money supply grew by 57.3% in 2007, well above the rate of 30.8% in 2006, 37.3% in 2005, and 20.3% in 2004. Reserve money increased by 39.8 % in 2007 and 37.7% in 2006, well above the average rate of less than 20% in the previous years. The acceleration in reserve money reflected strong foreign exchange inflows, which more-than-offset a substantial



decline in net central bank credit to government. M2 as a percentage of GDP has increased from about 30 % in 2001 to 53 % by end 2007. Credit increased by about 70%, with more than 80% of total lending to the private sector. Higher inflation has also led to wage increases in Mongolia. Inflationary pressures from excessive money supply generally materialize after some time lag. This implies that, in addition to global food and oil prices, sustained rapid growth in broad and reserve money remains one of the key drivers of the inflationary surge in Mongolia. Consequently during the last six months or so, the Bank of Mongolia adopted a number of tight monetary policy measures such as gradually increasing its policy rate and raising its reserves requirement to reduce inflation. As a result of these measures, growth rate of M2 decreased from over 50 % in November 2007 to 27 % in June 2008.

On the exchange rate front, the togrog depreciated against the Chinese renminbi (by 7 %) and Russian rouble (by 8 %) in 2007. The nominal effective exchange rate (where the average nominal exchange rates are weighted by trading importance of each of the partner countries) has depreciated by 4 % in July compared to a year ago (yoy). The recent nominal exchange rate depreciation against major trading partner currencies has also played a role in increasing cost of imported goods. This could also have contributed to the recent CPI increase.

Rising wages in the public sector, which act as a benchmark for private sector wages, will tend to push up overall wages in the economy. Production costs for construction have also been pushed up by a short term shortage of cement, which has led to a price increase of more than 70 % since June. Since prices of non food and energy items (i.e. core inflation) have also been increasing significantly in Mongolia in the recent months, there is some evidence that a broad-based second-round effect may also be underway.

It is not possible to untangle all the causes of rising prices without conducting a more detailed statistical analysis or decomposition of price movements. However, it appears from the above discussion that causes of the rise in food and oil prices in Mongolia are multidimensional. First, the rise in food prices appears to be mainly from the increasing domestic demand induced by rapid increase of wages, social transfers, remittances, etc. Secondly, rising inflation in Mongolia is also largely due to imported inflation as Mongolia imports a large portion of domestically consumed food and oil. Thirdly, policies that have been built up over the years such as sustained increase in monetary expansion have also contributed to recent inflationary situations. Fourthly, there have been increases in the prices of administrative non-tradables government services such as increase in hospital charges, school fees, electricity tariffs, and other utility charges. Fifthly, seasonal and cyclical factors have also aggravated the current inflationary situations. It can be safely be stated that a combination of supply factors (increase in production and transport cost due to oil prices), demand factors (increase in per capita income, increase in government social transfers and wage bill and higher inflows of remittances), external factors (rising of international food and oil prices and depreciation of local currencies) and other factors such as speculation & ‘second-round effects’ are all simultaneously pushing up inflation to a higher level.

4. Macro Impact of Rising Food and Oil Prices in Mongolia

The following paragraphs assess the effects of the rises in food and oil prices on GDP growth, inflation, government revenue, government expenditure, exports, imports and current account balances in Mongolia.

Theoretically, oil and food price shocks affect economies through many different channels: the supply side, the demand side, and the terms of trade. The impact will vary depending upon the country context. At the macro level, exporting countries are likely to benefit, while importing countries are likely to suffer from any price shocks. For example, food and oil exporting countries are likely to benefit (at least at the macro level) from rising of food and oil prices. On the other hand, food and oil importing countries are likely to face the brunt of the price shocks. In the food importing countries, supply could be accelerated through greater domestic investment in the agricultural sector. In the oil importing countries, supply could suffer as production costs rise in the wake of an oil price shock. Within the oil importing countries, the effects of high oil prices on GDP will be proportionately higher for high-energy intensity countries. If the oil intensity of production does not fall significantly, the supply side impact for a given increase in oil prices will also rise.

Oil and food price shocks also affect overall domestic price level. The inflation increases will depend on the share of food and oil in the consumption basket as well as on the "second round" effects -- i.e., increase in transport cost, production cost and whether workers and enterprises can compensate for income loss through higher wages and prices. The increase in domestic prices might affect household consumption adversely, which in turn affects the rate of poverty reduction and achievement of the MDGs. The rising of domestic inflation and thus interest rates might affect investment scenarios adversely. The squeeze on consumption and investment demand might also affect GDP adversely.

Chart 12: GDP Growth and Inflation rate

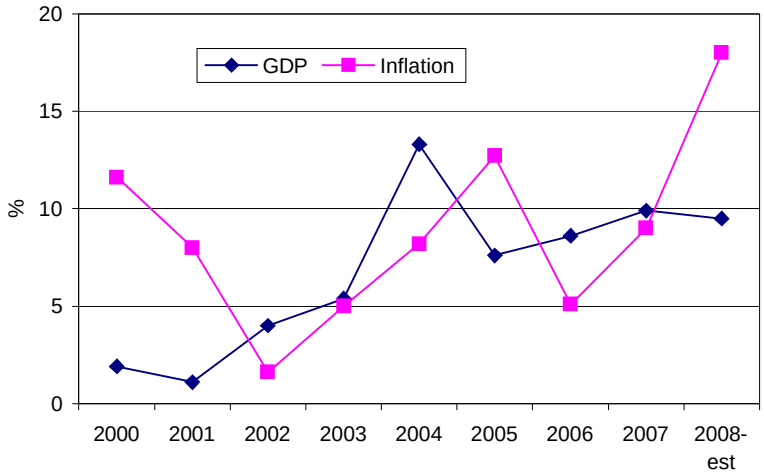


Chart 12 illustrates that price rises in recent years, particularly oil prices do not appear to have affected growth significantly in Mongolia. During the last 6 years, the crude price increased more than five times, but the economy continued to expand in a significant manner. The real GDP growth was over 6 % per annum. In fact, there has been some acceleration in GDP growth during 2005-2007. However, the steep increase in oil and food prices in 2008 and the resultant tightening

monetary policy regime are expected to decrease GDP growth slightly in 2008 and next few years.

The chart 12 also indicates that increase in the prices of petroleum products during 2002-2007 and food prices in 2007 might have caused inflation in Mongolia to rise modestly until 2007. But the steep increase in oil and food prices in 2008 is expected to push the inflation rate significantly.

Higher food and oil prices affect fiscal situations in several ways. For example, on the expenditure side, there are fiscal costs when food and oil-importing countries do not adjust domestic food and petroleum product prices in line with border prices. Costs also rise when domestic prices adjust to world food and oil prices and governments then raise social benefit payments or other transfers to moderate the impact on consumers. On the revenue side, there could be revenue loss due to lowering and exemption of VAT, import tariffs and other taxes to mitigate the impact of higher world and domestic prices for food and petroleum products. This is particularly so when domestic demand for petroleum and food products is price-elastic. Therefore, it is interesting to analyse the recent fiscal situation in Mongolia.

Chart 13 shows the fiscal subsidy over the last 10 years. The chart confirms that since 2001, fiscal subsidy to energy and urban transport has increased rapidly compared to late 1990s. The subsidy was almost 16 billion togrogs in 2007 and it is likely that it will be go up further in 2008. This shows that the Mongolian government, like other governments in developing countries, does implement safety net programmes by importing or procuring food and oil at specified prices to sell at subsidized prices to consumers.

Chart 13: Fiscal Subsides in Mongolia during 1997-2007

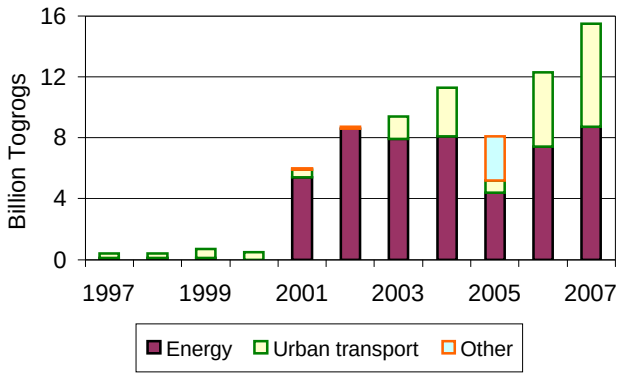
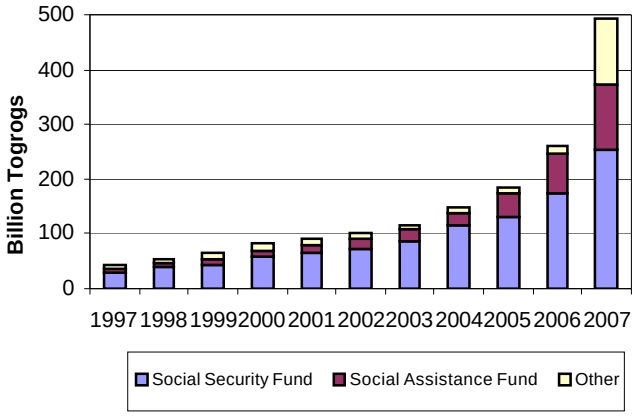


Chart 14 presents the trends in social transfers. While social transfers increased gradually until 2005, they have risen sharply in the last two years. This implies that Mongolia not only provides fiscal subsidy, but also provide social transfers. But there is evidence that these transfers are not related to price hikes. For example, the Child Money Programme (CMP), which is a targeted conditional cash transfer programme launched in January 2005, provided a cash allowance of Tog 3,000 ($2.50) per child under the age of 18 to all families with three or

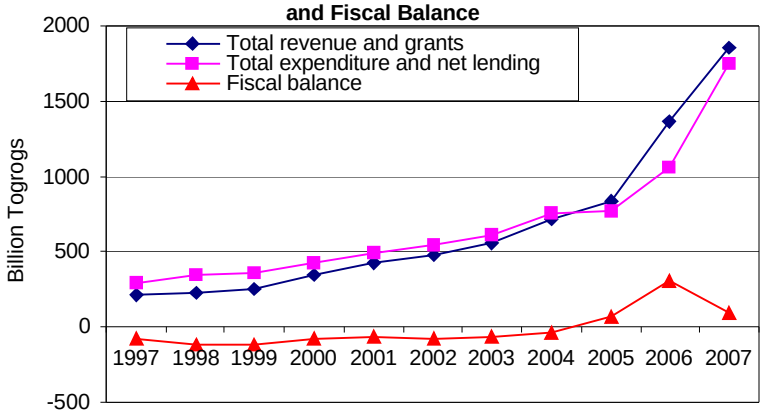
Chart 14: Social Transfers in Mongolia during 1997-2007



more children living under the Minimum Subsistence Level. In May 2006, the parliament adopted a new law which made the provision of 'child money' a universal entitlement, to which all children under 18 years of age would be eligible, and introduced new benefits for newborn children and newly married couples (Tog500,000 and Tog100,000 respectively). Though the recent increase in social transfers not related to price hikes, it would have helped families, who have children or newly married, to mitigate adverse price impacts.

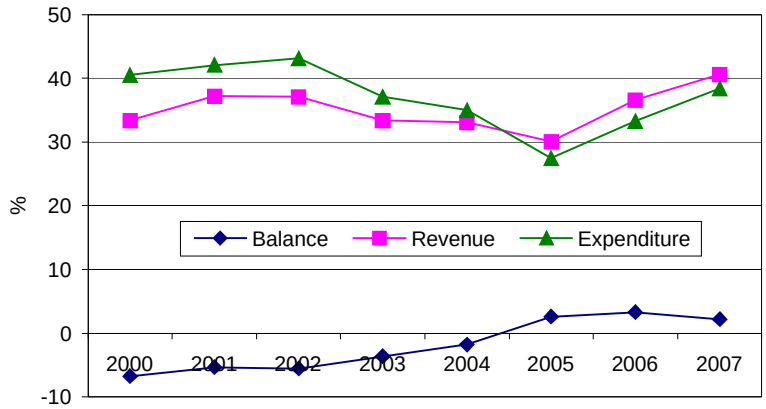
Government expenditure has increased substantially in recent years. Much of the growth reflects the interplay of political pressures and the universal coverage of social benefits, such as the CMP. Allowances for newlyweds and newborns have pushed it up further in recent years (Chart 15).

Chart 15a: Government Revenue, Expenditure and Fiscal Balance



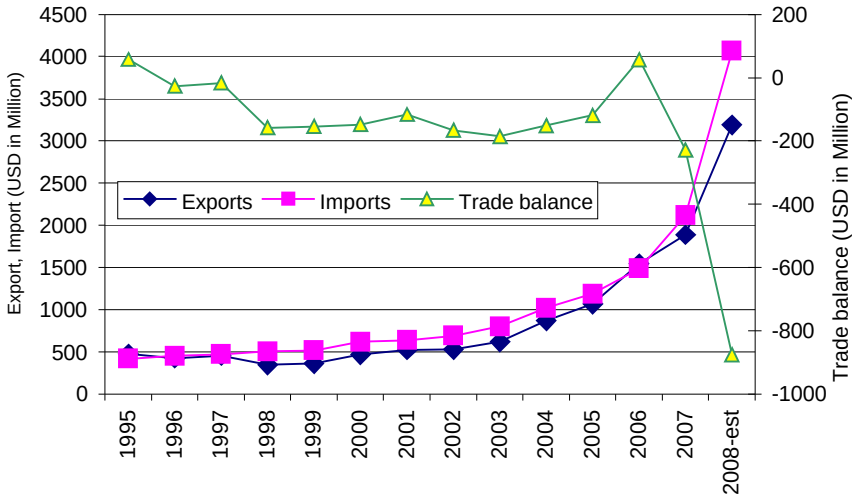
The dramatic increase in public spending in recent years was possible due a 7 fold increase in mining revenues during the last five years due to both higher copper and gold prices, as well as the imposition of a new windfall tax on copper and gold in 2006 (Chart 15). The revenues from copper, gold and coal mining made up about one sixth of total budget revenue a few years back. With increases in copper prices since 2005 and recent mineral tax increases, the non-oil mineral sector now accounts about 37 % of government revenue. Overall, Mongolia's revenue effort compares very favourably with that of countries at similar levels of development. This high and increasing revenue is also due various other factors such as the broadening of the tax bases, improvement in tax administration, high cascading under the VAT, low income tax thresholds, etc. The overall budget balance shifted from a deficit until 2004 to a surplus from 2005.

Chart 15b: Fiscal Indicators as % of GDP



Increases in oil and food prices are expected to affect adversely trade balance in food and oil import countries. This is because the increase in world oil prices would affect adversely the competitiveness of exports in oil importing countries, while increasing the import bills of crude oil. Though Mongolia managed to increase its exports value significantly in the recent years, imports value increased much faster. Consequently, Mongolia's trade deficit has increased significantly in the recent years particularly in 2007 and 2008.

Chart 16: Trends in Exports, Imports and Trade balance



High food and oil prices undermine poverty reduction gains and will make the achievement of the MDGs even more difficult. Food expenditures comprise a large share (52%) of the Poor's total expenditures compared to that of non-poor (43%). The share of heating expenditure in the total consumption expenditure for the poor is high (5%) compared to non-poor (3%). On the other hand, the share of transport and communication expenditure in the total consumption expenditure for the poor is low (3%) compared to non-poor (6%). Overall, erosion of purchasing power due to high food and oil price is relatively high for the poor compared to non-poor.

There are notable differences in consumption pattern between urban and rural households. Urban non-poor households allocate only 36 % of their expenditure on food, 3 % on heating and 6% on transport and communication. In rural non-poor households, food accounts for 53 % expenditure, while only 2 % is allocated for heating and 5% on transport and communication. Urban poor households allocate 46 % of their expenditure on food, 8 % on heating and 3% on transport and communication. In rural poor households, food accounts for 58 % expenditure, while only 3 % is allocated for heating and 3% on transport and communication. This shows that while the rise in food prices affects poor people in both rural and urban areas equally, it is the urban poor who suffer more due to rise in energy prices.

These shares hide huge differences in absolute levels of expenditure between poor and non-poor. Average monthly per capita expenditure for non-poor is Tg 47790 in 2002-03 compared to Tg17214 for poor. Non-poor consumption spending is as high as 2.8 times of the poor (Mongolia LSMS, 2002-03).

It was noted earlier that the share of food in household expenditures has been declining for years, while expenses on transport, medical care, education and housing are rising. A decade back average household used to allocate about 58 % of their consumption budget on food, whereas in

the recent years this share was down to less than 40 %. This implies that the adverse impact due to food price increases would have been even higher if the share of food expenditure remained the same.

Table 3: Household Expenditure by Quintiles

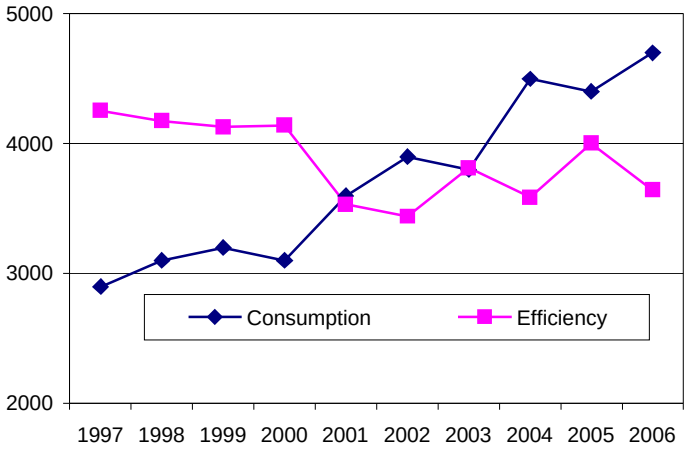
Quintiles	Monthly expenditure per capita /average, in tugrug			Share, %	
	Total	Foodstuff	Fuel	Foodstuff	Fuel
Poorest	20541	14536	317	70.8	2.2
2	34778	21699	969	62.4	4.5
3	49924	27785	1567	55.7	5.6
4	73210	33352	2457	45.6	7.4
Wealthy	190607	45003	5070	23.6	11.3
Average	73 803	28473	2143	38.6	7.5

Source: Household Income and Expenditure Survey, 2006 second half, Household Socio-Economic Survey, 2007 first half

The declining trend in food share might change due to higher food prices. To maintain a basic diet, poor households are forced to increase their food expenditures at the expense of non food expenditures such as medical care and education which could also affect adversely the achievement of the MDGs. As a result of higher food prices, both levels and the share of food expenditure seems to have increased in recent years compared to 2005. This has been corroborated by survey findings given in table 3. The poorest of the poor now spend about 71 % of their consumption budget on food and spend only about 2 % on fuels. On the other hand, rich households spend as much as 11% of their consumption budget on energy, while spending only 24% on foodstuffs. This shows that poor households suffer more due to food prices than energy prices.

The high price of oil and food provide an opportunity to improve food supply and reduce oil consumption. Chart 17 shows that oil consumption (in thousand tonnes) has increased steadily during the last decade with some minor dips in between. On the other hand, its efficiency has declined over the period. Mongolia oil intensity is also much higher than the global average, implying higher dependence on oil and lower efficiency of oil consumption.

Chart 17: Oil Consumption and Its Efficiency



Overall, the macro economic impact of oil price increase appears to be relatively minor, as Mongolia has been able to sustain relatively higher GDP growth, modest inflation (except in the last one year), fiscal surplus (despite large increase in the energy subsidy and social transfers), and sustainable trade deficits. This is in line with the finding of UNDP Regional Report on "Overcoming Vulnerability to Rising Oil Prices: Options for Asia and the Pacific". But situation could change as the recent surge in global oil and food prices is creating economic havoc across the world and reversing human development gains in many developing countries. The oil crisis is expected to have a major impact on the economy, with a disproportional effect on poor

households, who have little or no margin to adjust their spending. It is now expected that many developing countries will achieve lower growth rate in 2008 than previously projected (including Mongolia), thus affecting the Governments' ability to meet their poverty and other targets. The rise of oil and food prices, combined with the burden of subsidies, is also putting a great strain on the national budget of many countries. Resources are diverted away from important longer-term investments as well as essential spending in social sectors such as health and education.

5. Policy Measures taken by Mongolia and other Countries to reduce the impact of soaring prices

In response to the increase in prices, the government of Mongolia established the Price Stabilization Council on 30 November 2007. The council consists of 22 members and is chaired by the Minister of Finance. The members of council are composed of representative from the Bank of Mongolia, line Ministries, Tax office, Customs Authority, the Unfair Competition Agency, Consumer associations, Minerals and Petroleum Authority, Employer's federation, Federation of Trade unions, and General Police Department. The main purpose of the Council is to take necessary measures to maintain the price for meat, flour and fuel stable, not jeopardizing the livelihood of people. The government has implemented a number of short-term measures such as subsidizing reserves for meat, supply of petrol products from Russia, nullified import duties of flour and negotiated discounted prices from Russian side for imports of flour, and conducting regular monitoring of retail prices for certain basic consumer products. As a result of these interventions the retail prices for meat, petrol and flour have been stabilized in the recent weeks.

In addition to these short term interventions, the Mongol Bank and the Ministry of Finance have started to use the main macro tools of the monetary and fiscal policy such as lifting the central bank interest rate, increasing reserve requirements for banks, and reducing government expenditures.

In May 2008 the Government also approved an Action Plan to strengthen the government response to rising inflation. The action plan focuses on three types of interventions:

- Targeted safety nets programmes - This includes designing a food stamps and cards programme for the vulnerable and introducing a targeted subsidy programme for transportation.
- Changes in fiscal and trade policies - This includes tax exemption of oil and food products; subsidizing domestic wheat producing farms by providing farmers with seeds at discounted price; subsidizing public transportation;
- medium-term food supply - creating food and reserves; introducing regulations for streamlining the supply chain by reducing intermediation; diversifying sources of energy supply abroad; negotiating with main trading partners to secure adequate supplies at low prices, increasing storage and reserve capacity; increasing domestic self-sufficiency of oil and flour;

Like Mongolian governments, other countries in the region also adopting a number of safety net and other programmes to mitigate adverse impact on the consumers, while adopting price support and incentives programmes to farmers to boost food supply. In an effort to boost supply of food grains, the Malaysian Government is providing subsidy of RM25 per 100 kg of paddy to rice farmers and announced that it will allocate a $1.3 billion to ensure self-sufficiency in rice production. The Philippines also announced that it will allocate US$1 billion to improve rice production in the country. Indian and Thai Governments actively support food production through price intervention programme. Indian government increased support price of rice and wheat by 40-50% during the last 6 years. Despite this, there have been no revisions to the Indian government sales price of wheat and rice under various food safety net programs since July 2002. Rising procurement costs, without an increase in the sales prices, are pushing up Indian food subsidy spending to about $6.5 billion in 2007. The Chinese government also announced that it will continue to encourage grain production through a series of policies, including direct payments, price supports, and a machinery subsidy. To enhance production, the Government will increase spending on the agricultural sector by 30%. In April 2008 China has imposed a six-months tariff as high as 135 per cent on fertilizer exports in a bid to control rapidly rising domestic agricultural input cost. The Philippines banned conversion of farmland for development and threatened rice hoarders with life imprisonment.

In an effort to stabilize rice prices in the domestic market, many countries lowered their import duty of food. The Republic of Korea cut import duties on wheat while the Japanese Government has decided to start charging flour millers about 30 percent more for imported wheat in April. The Thai Government cut the tariff rate on imported wheat to zero from September 2007. In Bangladesh, wheat imports are currently duty free. However, there is a three percent advance income tax. There is no quantitative restriction on wheat imports. In February 2008, the Indonesian Government reduced the import duty on wheat flour to zero and adjusted the value added tax (VAT) for wheat and wheat flour. The import duty for wheat flour was 5 percent and the VAT for wheat and wheat flour was 10 percent.

In an effort to discourage exports, many countries also impose exports restriction. India in late March banned non-basmati rice exports and set minimum export prices at USD 1200 tonnes. Cambodia also banned rice exports for two months from March 2008. Vietnam banned rice exports until June 2008 and announced in late March that total rice available for export in 2008 would be cut to 3.5 million tonnes from 4.5 million tonnes last year. In Pakistan, the Government imposed new tariffs on wheat exports. China also increased tariffs on many exportable grains.

In an effort to control food inflation, some countries like China and Sri Lankan have imposed price control over retail sales of food. The Indian government has asked large trading companies operating in India to declare their stock levels.

Countries such as Indonesia announced that they will distribute more food grains to consumers at cheaper price. Countries such as Bangladesh and the Philippines are working on boosting their emergency stocks through offering higher prices to farmers.

Table 4: Summary of Policy measures taken by other governments in the region

	Consumer oriented						Producer oriented		Trade oriented		
	Tax	Social		Market			Production support	Market management	Import	Export	
	Taxes / customs	Food subsidies	others	Price controls	Release stocks	Food procurement & other	Producer credit & other	Minimum producer prices & other	Import tariffs & other	Quantitative export controls	Export price control & tax measures
Afghanistan								✓			
Bangladesh		✓		✓		✓				✓	
Cambodia					✓						
China	✓						✓	✓	✓		
India								✓		✓	✓
Indonesia		✓		✓ ✓			✓ ✓		✓		
Malaysia					✓			✓			
Mongolia	✓										
Nepal								✓		✓	
Pakistan							✓		✓		
Philippines		✓					✓	✓			✓
Korea									✓		
Sri lanka				✓							
Thailand					✓						
Vietnam										✓	

Source: FAO website

As crisis is developing rapidly, countries are increasingly focusing on short-term measures to provide immediate relief to the most vulnerable population. Governments like to ensure food security of the people through designing a new and strengthening existing social safety net programmes. They look for an efficient and effective mechanism to reach food to poor people at affordable prices. In this regard, it is interesting to take a look at the ``efficiency and efficacy'' of programmes such as ‘food Stamps system’, ‘food ration’ or public distribution system’, ‘food for work programme’ which have been operating in developing countries as the food access mechanisms for several decades. The following paragraphs assess these systems briefly. A detailed assessment and country experiences will be made available in the forthcoming regional paper.

India’s Public Distribution System for Food

Public Distribution System (PDS) in India is the largest distribution network of its kind in the world of India. It aims to 1) to provide food grains to the poor at affordable prices, 2) support farmers by purchasing food from them at reasonable prices and 3) maintain national food security by holding stockpiles of food in times of crisis.

Background - It was the compulsions at the time of World War II that forced the then British Government to introduce the first structured food rationing system in India. In the face of

renewed inflationary pressures in the economy immediately after Independence, the Government had to reintroduce rationing in 1950. The creation of the Food Corporation of India and the Agricultural Prices Commission in 1965 consolidated the position of the PDS. The Government was now committed to announce a minimum support price for wheat and paddy and procure quantities that could not fetch even such minimum prices in the market. Foodgrains thus procured were to be used to maintain distribution through the PDS with a portion used to create and maintain buffer stocks. From the mid-1960s, PDS has evolved into a price support, rationing and subsidy programme.

Evaluation - The PDS, functioning for more than four decades now, has been evaluated by many experts. The greatest achievement of PDS was claimed to be ``preventing any more famines in India". Overcoming the 1987 drought, considered the worst in the century, with dignity and effectiveness has been seen as the PDS's biggest success. However, the evaluation pointed out several shortcomings in the functioning of PDS. These include the urban and pro-rich bias of the system and its ineffectiveness in reaching the poor; the lack of effective contribution towards household food security; PDS is not cost-effective and its operations are too costly due to movements of grain and high storage losses. Another valid deficiency was its marginal impact, as far as income transfer to poor households is concerned.

Current situations - These evaluations led to a Targeted Public Distribution System (TPDS) to directly and effectively benefit those Below the Poverty Line (BPL) in June 1997. This new system was lauded on two counts: (i) With the introduction of the TPDS, for the first time, an attempt was made to target the really poor and provide them an assured supply of foodgrains; and (ii) The price at which the foodgrains were supplied to the BPL families was within the affordable range of the really poor. Under this Targeted Public Distribution System (TPDS), each poor family was entitled to 10 kg of food grains per month at specially subsidised prices. The system also provides food items to above poverty line (APL) families, but subsidies levels are modest.

Coverage and Cost - the coverage is more than about 160 million families annually. In 2007, there were about 489,000 fair price shops (FPS) through which food is distributed. Most (75%) of the FPS are in the rural areas. The system distributes commodities worth more than Rs. 300 million annually to about 160 million families. The food subsidy incurred by the govt. on basis of PDS amounted to over 6% of Govt. expenditure for 2006-07 up from 2.5 percent in the early 1990s.

Corruption and the dual price system - PDS has a dual price system, one for the people below the poverty line (BPL) and one for the people above the poverty line (APL). Such a price system introduces leakages.

The ration card - Possession of a ration card is widely required not only as a precondition for access to public and private services, but also as a de facto identity card. As such, the ‘bribe’ associated with obtaining a ration card.

Computerization of PDS Operations - A new scheme ‘Computerization of PDS Operations’ introduced in 2006–07 was an improvement on the existing system of ration cards.

Advocacy Programme - An awareness campaign on the rights and entitlements of PDS beneficiaries is proposed through newspaper advertisements, bill boards, posters, and audio-visual media.

Food Stamps/Coupons

'Food stamps' are a form of public food subsidy whereby the government provides coupons to targeted vulnerable groups to get free or cheaper food. Although food stamps are associated with developing countries, the most well known and successful food stamps programme is in the USA. Asia Pacific countries such as Bangladesh, China, India, Indonesia, Fiji, and Philippines have adopted or plan to adopt food stamps as part of their strategy to combat the effects of the recent rise in food prices.

It is widely believed that food stamps are more efficient than cash transfers in addressing poverty and hunger, as they can only be spent on food items. Studies found that food stamp programmes generally improve families' disposable income and food consumption significantly more than one would expect from cash transfers. Food stamps are much cheaper to administer because they absolve the government of responsibility for purchasing, transporting and distributing grain. Because they rely on strict a priori identification of recipients, they also allow greater targeting than distributions systems. In a tight budgetary situation (as many governments are experiencing, due to broader effects of the crisis), the targeting of benefits to the most deserving ensures that the majority of government funding is channelled where it is needed most. If properly implemented, food stamps may be less vulnerable to corruption and other leakage than either cash or food distribution. In summary, food stamps are most likely be a sound policy response where the government has the required infrastructure and administrative structures to implement and monitor the intervention effectively.

In order to design a successful food stamp programme, it is critical to have clarity about what the scheme is intended to achieve, and who the targeted beneficiaries are. Targeting by geographical area is cheap and easy to administer, but may result in abuse and/ or leakage. By comparison, means-testing households may be more accurate but is expensive. It is also critical to ensure that needs are reassessed on a regular basis, as households move in and out of poverty. Since food stamps tend to be more targeted than food distribution mechanisms, a premium must be placed on identifying the most deserving recipients. There needs to be robust monitoring and evaluation mechanisms in place to ensure benefits are being realized and leakages minimized. This is not an appropriate area for economizing, as the potential for wastage is high. In the case of short-term schemes intended to protect the vulnerable at times of crisis, there needs to be a credible exit strategy. Retailers need to be paid promptly (and consideration given to incentive payments for accepting vouchers). They should be accessible, and willing to serve beneficiaries and have a clear understanding of their roles and responsibilities. The coverage of commodities is important. Free choice may be desired by beneficiaries. But a focus on locally produced staples may help local farmers' livelihoods. In terms of scale and cost, most food stamp programmes have tended to aim at covering about one fourth or fifth of beneficiaries' food costs. Finally the benefits from food stamp schemes can be maximized if they can be linked to other social safety net programmes.

Food-for-Work Programme

The Food-for-Work (FFW) is the most widely used type of public work programmes in Asia. It is particularly appropriate when faced with the combination of widespread and/or seasonal food deficits and high unemployment rates. FFW is also common when drought, dislocation in the local area temporarily disrupts productive activities of a farming community. It can help improve food security by addressing temporary household food insecurity while supporting key construction and rehabilitation activities that lead to longer term, more sustainable food security results.

FFW programs commonly aim to produce or maintain potentially valuable public goods necessary to stimulate productivity and thus income growth. Among the most common projects are construction or repair of farm-to-market and urban roads, schools, health clinics, irrigation systems, public water and sanitation systems and other infrastructure and environmental protection and conservation activities. FFW's self targeting feature is useful in rehabilitation following disaster situations, where needy individuals will contribute their labour for food while helping to return the community's infrastructure to normal. Good practice dictates that the community should participate in the FFW decision-making process and should view the activity as creating a valuable community asset, such as tree planting on common property. There is a danger, however, that such programs could discourage private economic activities and crowd out private investment.

A key step in designing FFW programme involves (1) carrying out a needs assessment; (2) determining whether FFW is appropriate; (3) identifying the target group; (4) developing the FFW objectives; and (5) determining the distribution mode and frequency. The suitability of the FFW should be assessed with regard to the needs and preferences of the targeted individuals, households, and community.

6. Conclusions and Recommendations

The analysis indicates that the current inflation rate is the highest in the decade in Mongolia. It is also the highest in the region. Since food items have largest weight in the CPI and also as prices of food items have risen at a relatively higher rate compared prices of other items in the CPI, the high inflation in Mongolia is primarily due to the increase in food prices.

The causes of the rise in food and oil prices in Mongolia are multidimensional. First, the rise in food prices appears to be mainly from the increasing domestic demand induced by rapid increase of wages, social transfers, remittances, etc. Secondly, rising inflation in Mongolia is also largely due to imported inflation as Mongolia imports large portion of its domestic consumption of food and oil. Thirdly, policies that have been built up over the years such as the sustained increase in monetary expansion have also contributed for recent inflationary situations. Fourthly, increase in the prices of administrative non-tradables government services such as increases in hospital charges, school fees, electricity tariffs, and other utility charges. Fifthly, seasonal and cyclical factors which are more specific to the moment have also aggravated the current inflationary situations. Therefore it can be concluded safely that a combination of supply factors (increase in production and transport cost due to oil prices), demand factors (increase in per capita income, increase in government social transfers and wage bill and higher inflows of remittances), external

factors (rising of international food and oil prices and depreciation of local currencies) and other factors such as speculation & secondary effects are all simultaneously pushing up inflation to a higher level.

The macro economic impact of the oil price increase is relatively minor, as Mongolia has been able to sustain relatively higher GDP growth, modest inflation (except in the last year), fiscal surplus despite large increases in the energy subsidy and sustainable trade deficits. But situation could change as the recent surge in global oil and food prices is creating economic havoc across the world and reversing human development gains in many developing countries. The oil crisis is expected to have a major impact on the economy, with a disproportional effect on poor households, who have little or no margin to adjust their spending. It is now expected that many developing countries will achieve lower growth rate in 2008 than previously projected (including Mongolia), thus affecting the Governments' ability to meet their poverty and other targets. The rise of oil and food prices, combined with the burden of subsidies, is also putting a great strain on the national budget of many countries. Resources are diverted away from important longer-term investments as well as essential spending in social sectors such as health and education.

The poorest households spend about 70% of their income on food and their ability to meet most essential expenditures for health and education is severely compromised. In addition, diminished purchasing power has severely impaired the capacity of the poor households to seek health care, and children education, particularly for girls. The high food price is likely to undermine the poverty reduction gains. Without an urgent intervention Mongolia might miss some of the MDG targets.

To contain inflationary pressures, the government should

- continue to closely monitor and analyse causes and impacts of rising inflation
- continue to subsidise food and oil consumption while reducing government spending that contributing excessive aggregate demand
- increase interest rates to lower private spending
- allow appreciation of the Togrog against currencies of trading partners (China and Russia)
- control money supply through higher reserve requirements or open market operations

To protect poor people and vulnerable people, the government should

- Design a targeted safety net programme for the vulnerable such as food for work programme or food stamps system or public distribution system
- Expand the existing safety nets programmes and social transfer schemes taking into consideration of their fiscal implications and administrative capacity
- Identify the worse affected households and establish targeted food and oil subsidy programmes
- Ensure coordination and synergies between various safety net schemes
- Scale up of health services to the poor

- Maintaining a strategic food and oil reserves
- Monitor the stocks of food and oil with private traders through strengthening public oversight function
- Provide incentives for farmers to increase wheat production
- Establish targeted agricultural input subsidy programme to the small farmers.
- Provide targeted subsidies for transportation
- Reduce tax rates (VAT and tariffs) on oil and food products
- Introduce price control programme