MONGOLIA MONTHLY ECONOMIC UPDATE

WORLD BANK

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The World Bank's *Mongolia Monthly Economic Update* provides an update on recent economic and social developments and policies in Mongolia. It also presents findings of ongoing World Bank work in Mongolia. The *Mongolia Monthly* is produced by a team from the World Bank's Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Region Vice-Presidency, with key inputs from other members of the Mongolia country team. Questions and feedback can be addressed to Altantsetseg Shiilegmaa (ashiilegmaa@worldbank.org). Copies can be downloaded from http://www.worldbank.org.mn.

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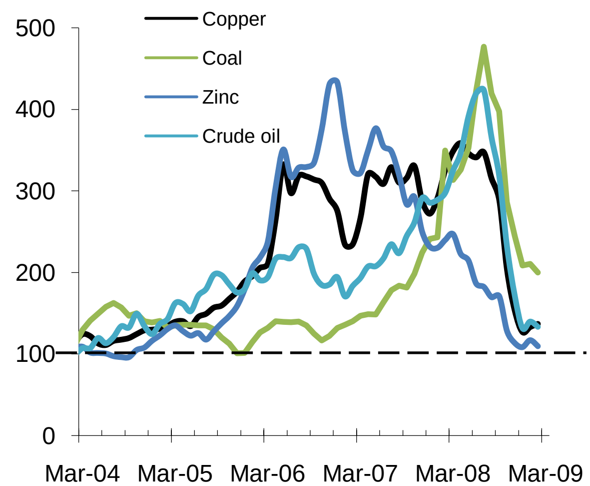
1. The crisis has hit Mongolia hard

The global downturn has hit Mongolia hard, predominantly due to the slump in mineral prices which returned the prices of Mongolia's main exports back to their 2004 levels (Figure 1). In particular the price of copper fell 60 percent to $3500/tonne in March from $8700/tonne in April 2008.

Figure 1. Global prices of Mongolia's main exports have fallen back to their 2004 levels

Index=100 in January 2004



Source: World Bank

The shock to the budget was especially severe, because during the "boom" years, the budget had become increasingly dependent on revenues from mining – at its peak, mining revenues contributed nearly 40 percent to total revenues. As mining revenues went up, overall expenditures rose dramatically too. To get a sense of how fiscally unsustainable such a rising expenditure trend could be in the event of a collapse of the mining revenues, we exclude all mining-related revenues from the budget to arrive at the "non-mining fiscal balance". This non-mining balance went into a very large 15 percent of GDP deficit in 2008 (Figure 6).

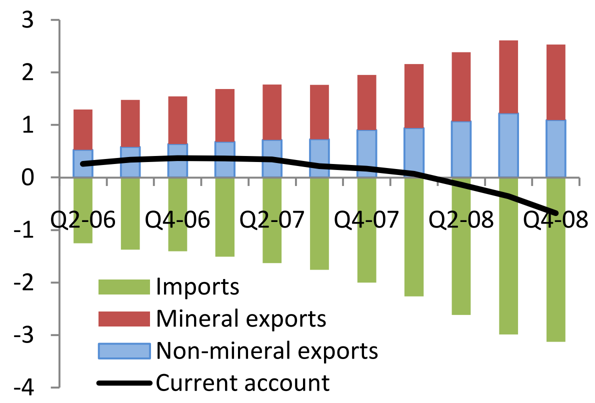
In the absence of sufficient fiscal savings from previous years, the government's fiscal position became precarious once fiscal revenues declined as a result of the sharply lower commodity prices. To keep the fiscal deficit within financeable limits, the government was faced with the difficult choice of cutting spending or raising revenues. Since the latter is difficult during an economic downturn, the government has had little choice but to resort to the former.

At the same time, driven by large social transfers and consumption, domestic demand outstripped GDP growth in the last three years, leading to a widening trade and current account deficit as a share of GDP. The added impact of lower commodity prices has meant that the 2008 current account recorded a 12.9 percent of GDP deficit,[1] compared to a 4.4 percent of GDP surplus in 2007 (Figure 2a). The latest trade data show that imports (corrected for seasonal effects) have now started to fall, which has at least arrested the deterioration of the trade deficit around $1 billion in the twelve months to February (Figure 2b).

[1] Revision of a preliminary estimate of 9.6 percent of GDP deficit.

Figure 2a. The current account deficit in 2008 was worse than initially estimated…

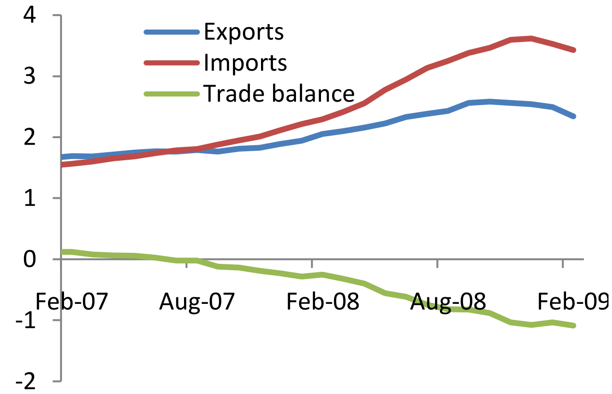
$ billion, 4-quarter rolling sum(1)



(1) Sum over previous four quarters to adjust for seasonal effects.
Source: Bank of Mongolia, World Bank

Figure 2b. … Latest data show the trade deficit has stopped deteriorating

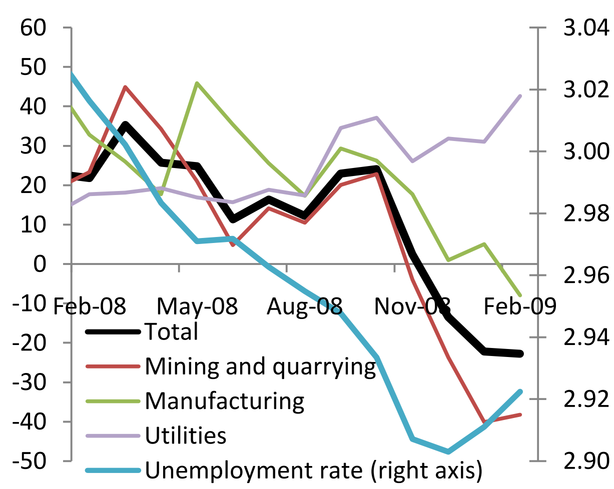
$ billion, 12-month rolling sum(2)



(2) Sum over previous twelve months to adjust for seasonal effects.
Source: Bank of Mongolia, World Bank

Figure 3. Falling external demand has led to declining real activity declining and increasing unemployment(1)

% yoy change(2) % of labor force(3)



(1) Defined as working-age population currently not working in a paid job and not self-employed, actively looking for job and registered at the Employment Office. (2) Nominal change, 3-month moving average. (3) Seasonally adjusted.
Source: National Statistical Office, World Bank

Given the current global economic crisis, short-term export prospects are grim. Mongolia's export destinations (mainly China, Europe, the US and Canada) are facing a prolonged slowdown.[2] As a result, Mongolia's growth is expected to slow to 2.7 percent in 2009, down from 8.9 percent in 2008. The manufacturing and mining sectors have slumped, and unemployment is up (Figure 3). In 2009, the mining sector will show stagnation in real terms, continuing its downward trend from 2004. Poverty reduction, which has already suffered a setback due to the eroding effect of inflation on social transfers and local remittances, could be further impacted as a result of this slowdown (see also Section 2).

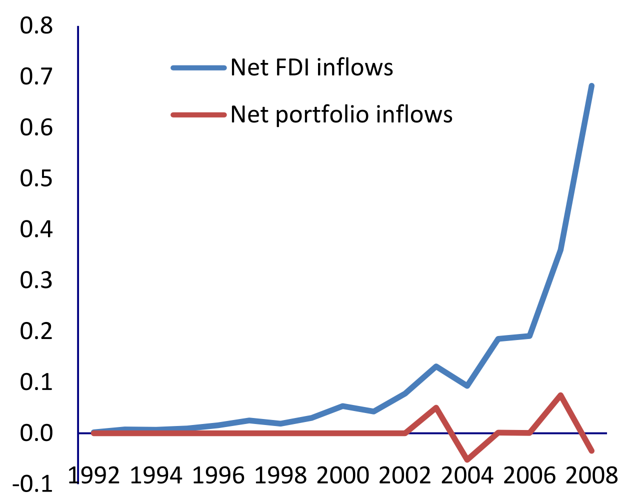
[2] It is uncertain at this stage how large an impact China's fiscal stimulus will have on Mongolia. As it contains large investments in infrastructure, which is relatively intensive in it use of copper, some market analysts argue that the stimulus package would have a positive, but muted, impact on copper prices. On the other hand, it does not contain direct support to the textile industry and hence its impact on cashmere prices may not be large. See the World Bank's *China Q1 Quarterly Update*, March 2009, available at http://www.worldbank.org/china.

There are large uncertainties about the level of FDI inflows in the near term. These had grown strongly from a small base during the last few years (Figure 4a), but the latest data point to a leveling off (Figure 4b). Anecdotal evidence suggests that some mining projects are coming on stream and sentiment in Ulaanbaatar is positive. And once one (or even two) of the large mining investment agreements currently being negotiated materializes, investor sentiment will pick up significantly.

At the recently held meeting with external development partners, the Government outlined a number of policy actions for the mining sector which could further boost this sentiment.[3] To reduce the perceptions of instability in the policy environment, the Government intends to formulate draft standard mining investment agreements, building on the recently gained experience in the negotiations on the Oyu Tolgoi project. The Government also plans to adopt new regulations for the mining cadastre and promote responsible mining practices, enhance regulatory capacity and monitoring in the mining sector, and increase the number of Mongolians trained in relevant mining skills.

Figure 4a. FDI inflows have risen strongly since the transition ….

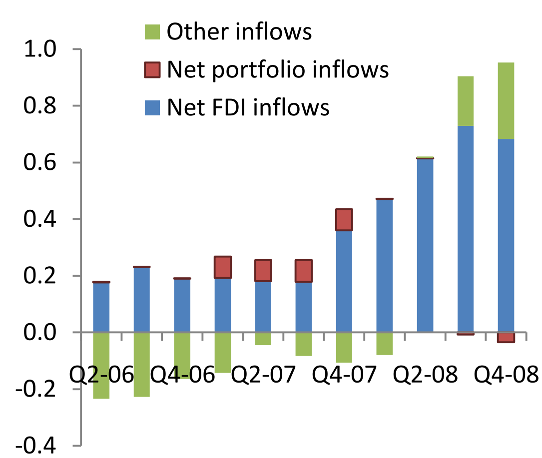
$ billion



Source: Bank of Mongolia, World Bank

Figure 4b. … although it seems to be leveling off, there is reason for cautious optimism

$ billion, 4-quarter rolling sum[(1)]



(1) Sum over previous four quarters to adjust for seasonal effects.

Source: Bank of Mongolia, World Bank

[3] The Government presented these medium-term measures for the mining sector, alongside key medium-term policy actions on fiscal reform, social protection and the banking sector which are discussed elsewhere in this update, at the external partners conference in March 2009 (available at http://siteresources.worldbank.org/INTMONGOLIA/Resources/MOF_presentation_ENG20090314.pdf)

2. Hopeful signs of improvement

The Government of Mongolia and the IMF reached an agreement on an 18-month Stand-By Arrangement (SBA) with $229 million in balance of payments support for the Bank of Mongolia. The SBA is a non-concessional loan to be repaid in four years (with two years grace), but gives Mongolia exceptional access to IMF resources. This agreement, approved by the IMF at its April 1 Board meeting, recognizes the extraordinary external shock coming from the collapse of copper prices.

The Government subsequently organized an external partners conference co-chaired by the World Bank to request support to fill the fiscal gap, projected to be $204 million over two years: $140 million for 2009 and $64 million for 2010.[4] The Asian Development Bank, Japan and the World Bank pledged a total of $160 million and expectations are that the remainder will be filled soon by other donors.

This quick and substantial support for Mongolia from its development partners was only possible because of the strong measures the Mongolian authorities, in particular Parliament, the Bank of Mongolia and the Ministry of Finance, had taken. These strengthened the confidence of the development partners in the Government's commitment to the stay the course on this painful path of correcting and improving fiscal, monetary and exchange rate policies.

Parliament amended the budget, containing the deficit below six percent

Showing its commitment to restoring fiscal responsibility, Parliament approved in March an amended budget that projects a 5.4 percent of GDP fiscal deficit (MNT 341 billion) in 2009, less than the 6 percent deficit mandated under the SBA. Although the original 2009 budget (approved in November 2008) already projected a 6 percent deficit, its projected revenues turned out to be too optimistic. This became obvious in the 2008 budget outturn and the January and February 2009 budget performance (Figure 5)**.** Without action, the budget deficit would have likely hit 12 percent of GDP. The process of fiscal adjustment will require a further reduction of the fiscal deficit to 4 percent of GDP in 2010, and is likely to continue beyond 2010.

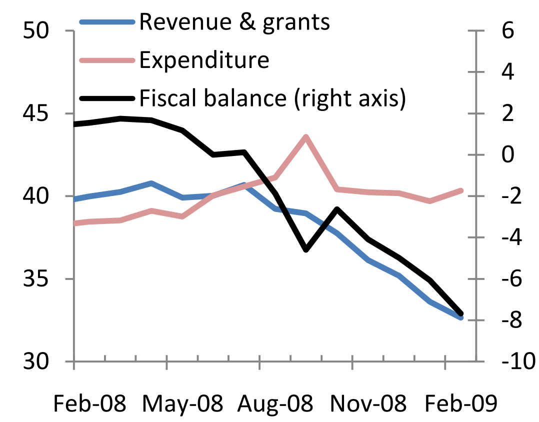
The amended 2009 budget (of March), taking the large revenue shock into account, adopted large expenditure cuts. The main differences of the amended 2009 budget relative to approved 2009 budget (of November) are the following (see also Table 1 and Figure 6).

[4] The IMF projects a 6 percent of GDP fiscal deficit in 2009. 2.4 percent of GDP will be financed via domestic and already committed foreign sources leaving a 3.6 percent of GDP financing gap ($140 million). For 2010, the projection is a 4 percent of GDP deficit with 2.6 percent of GDP of identified financing, leaving a 1.4 percent of GDP financing gap ($64 million).

First, public investment was cut by MNT 127 billion. Priority was given to projects of high socio-economic importance and also to projects funded by international organizations and foreign governments. New investments, projects for which bidding had not started, and projects for which no feasibility studies had been conducted were excluded. In the past, Parliament often inserted additional capital projects without feasibility studies, even though these were required by the Public Sector Management of Finance Law (PSMFL). In this way, Parliament increased the public investment program budget by 52% in 2007 (1.9% of GDP) and by 21% in 2008 (1.6% of GDP).[5]

Figure 5. The fiscal deficit has continued to widen, so the budget amendment targeting 5.4% deficit is a good development

% of GDP, 12-month rolling sum[(1)]



(1) Sum over previous twelve months to adjust for seasonal effects. Revenue, expenditure and balance based on actual budget outcomes. Monthly GDP estimated using linear interpolation.
Source: Bank of Mongolia, World Bank

Second, although infrastructure maintenance, defined as capital repairs plus Road Fund, has fallen in nominal terms, it has fallen by less than capital expenditure. It is important to monitor and analyze the budget further from an infrastructure maintenance perspective, as international experience demonstrates that the underfunding of maintenance during a downturn can be extremely costly for future growth and budgets.

Third, expenditure on wages and salaries of public servants has been cut by MNT 12 billion and a hiring freeze has been imposed. The Government proposed a 20 to 30 percent wage cut in the budget proposal submitted to Parliament in February, but in the amended budget this wage cut was undone[6] and other expenditures were cut to offset.

Fourth, projected interest payments on foreign loans were reduced and are now estimated at MNT 51 billion. Given Mongolia's existing interest payment commitments, we estimate that this would allow Mongolia to borrow up to $50 million on commercial terms under current market conditions. This would not breach the ceiling of $200 million for such borrowing allowed under the SBA. This also means that the MNT 1.5 trillion anti-crisis action plan, approved by Parliament in February 2009 and to be financed by a $1.2 billion sovereign bond issue or by entering into less than advantageous long-term export contracts, will be revised. This plan and its proposed financing created some confusion among external

[5] See *Mongolia Q1 Quarterly Economic Update*, February 2009, available at http://www.worldbank.org.mn.
[6] The expenditure savings are now due to the downsizing of some types of civil service positions such as assistants to MPs, not filling newly approved vacancies and the cancellation of some bonuses.

partners, when they were requested to commit to financial support for the government budget under the IMF agreement.

Fifth, the universal social transfers under the Child Money Program[7] were cut by 33 percent (MNT 47 billion out of MNT 142 billion). However, there was no attempt, in this amendment at least, to target these transfers to the poor. Three quarters of its financing come from the Mongolian Development Fund, financed by mining revenues. This makes the program very much dependent on the minerals prices cycle, which is not optimal. The introduction of targeting is urgently needed, so that the poor can be better protected from the downturn. The size of transfers for newlyweds was cut from MNT 500,000 to MNT 300,000, leading to an overall reduction in transfers of MNT 7 bn. In June, Parliament is expected to discuss new amendments to the 2009 budget, which would include steps to consolidate the various welfare programs, make them easier to administer, make them more predictable for the Mongolian households, and avoid overlap of payments.

Table 1. Selected components of the general budget

MNT billion, unless otherwise specified

	2008 outturn	Approved 2009 budget	Amended 2009 budget
Revenues and grants	2,156	2,224	1,973
% of GDP	*35.2*	*34.3*	*31.3*
Mining-related revenues	632	365	316
% of total revenues	*29.3*	*16.4*	*16.0*
Expenditure	2,462	2,620	2,314
% of GDP	*40.2*	*40.4*	*36.8*
Non-mining balance	-938	-760	-657
% of GDP	*-15.3*	*-11.7*	*-10.4*
Overall balance	387	299	161
% of GDP	*-5.0*	*-6.1*	*-5.4*
Specific items			
Domestic investment	497	493	366
Maintenance	48	59	44
% of capital expenditures	*7.6*	*10.4*	*10.5*
Wages and salaries	543	598	586
Child money (from state budget)	38(1)	107	38
Child money (from NDF)	105(1)	36	57
Newly weds	18(1)	18	11
Newly born	6.5(1)	6.5	6.5

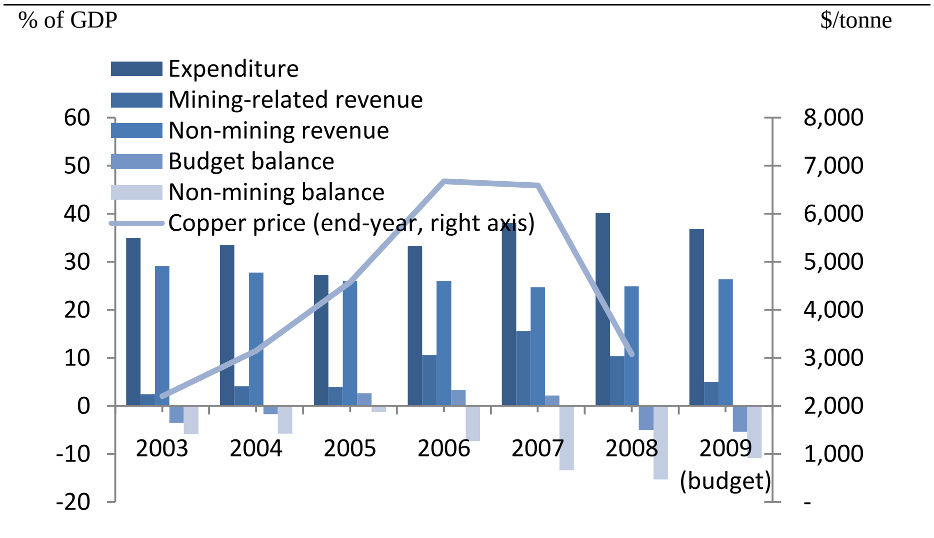
(1) According to 2008 amended budget.

Source: Mongolian authorities, World Bank calculations

[7] In 2007 and 2008, the CMP paid MNT 136,000 per child per year, consisting of MNT 3,000 per month from the state budget and MNT 25,000 per quarter from the Mongolian Development Fund (MDF). The approved 2009 budget recognized that the MDF would not have a sufficient balance for the quarterly payments and the burden was shifted back to the state budget, keeping the total payment at MNT 136,000. The amended 2009 budget restored the former situation – the state budget projects a MNT 3,000 per month payment, whereas the MDF will pay quarterly installments until the fund has run out of money.

The recently published poverty profile of Mongolia[8] underlines why priority concern for the poor is so important. The profile shows that, even during the past years of stellar economic growth, poverty seems not to have been reduced substantially. The poverty headcount declined little to 35.5 percent in the 2007/08 survey, down from 36.1 percent in the 2002/03 survey, with large regional differences and between the Ulaanbaatar and the rural population. The data also indicate that inequality has increased.[9]

Figure 6. Components of the general budget



Source: Ministry of Finance, World Bank

Building on the momentum created during the budget amendment, the Ministry of Finance presented the outlines of a realistic medium-term economic policy framework at the external partners meeting. To avoid a repeat of the "boom and bust" spending pattern that Mongolia has just experienced, Government plans to submit to Parliament a draft law on Fiscal Responsibility, which will ensure that mining revenues are better managed in the future.

Similarly, building on the measures taken for the budget amendment—in particular the exclusion of non-priority projects and projects without feasibility studies—the Government will considerably strengthen the procedures to select and develop investment projects to be financed by the state budget. Finally, it will prioritize the protection of infrastructure maintenance to be financed by the state budget.

8 Mongolian National Statistical Office (2009), *Poverty profile in Mongolia: Main outputs of Household Socio-Economic survey 2007-2008*, March 2009.

9 One caveat may be that the poverty estimates factor in the food and commodity price inflation in 2008 on the consumption side, but may have missed the parallel increase in incomes and asset values of rural inhabitants during the same period. Future analysis of the poverty data by the World Bank will try to address this question.

The second set of medium-term measures recently announced deals with social protection. Government plans to consolidate existing social transfer programs into one social protection program, establish a complaint mechanism, and introduce objective targeting mechanisms, so that social grants will effectively reach the poorest families.

In conclusion. the March budget amendment and the Minister's outline of a medium-term strategy are steps in the right direction. It is also a hopeful and positive signal that the expenditure cuts were supported by both parties, in the run up to the Presidential elections in May. However, there remain considerable risks to the budget in the months ahead, such as more revenue shortfalls or expenditure surprises.

The Bank of Mongolia has taken steps to restore confidence in the currency

Strong and highly necessary policy measures were also taken by the Bank of Mongolia (BoM). A combination of previous rapid credit expansion, very high domestic inflation, falling commodity prices, a *de facto* fixed exchange rate, and rumors of banking failures had eroded confidence in the local currency. This was reflected by deposit flight out of the tugrug in late 2008 and early 2009, together with strong depreciation pressures (see Box 1). Initially, the BoM tried to cope with the situation by selling its international reserves and rationing its foreign exchange reserves to essential imports. This immediately led a substantial deviation between the official BoM exchange rate and the parallel market rate (Figure 8a).[10]

[10] The word "parallel market" is a designation of the non-bank foreign exchange market. It does not imply any illegal activity.

Box 1. Developments in the banking sector, 2004-2009

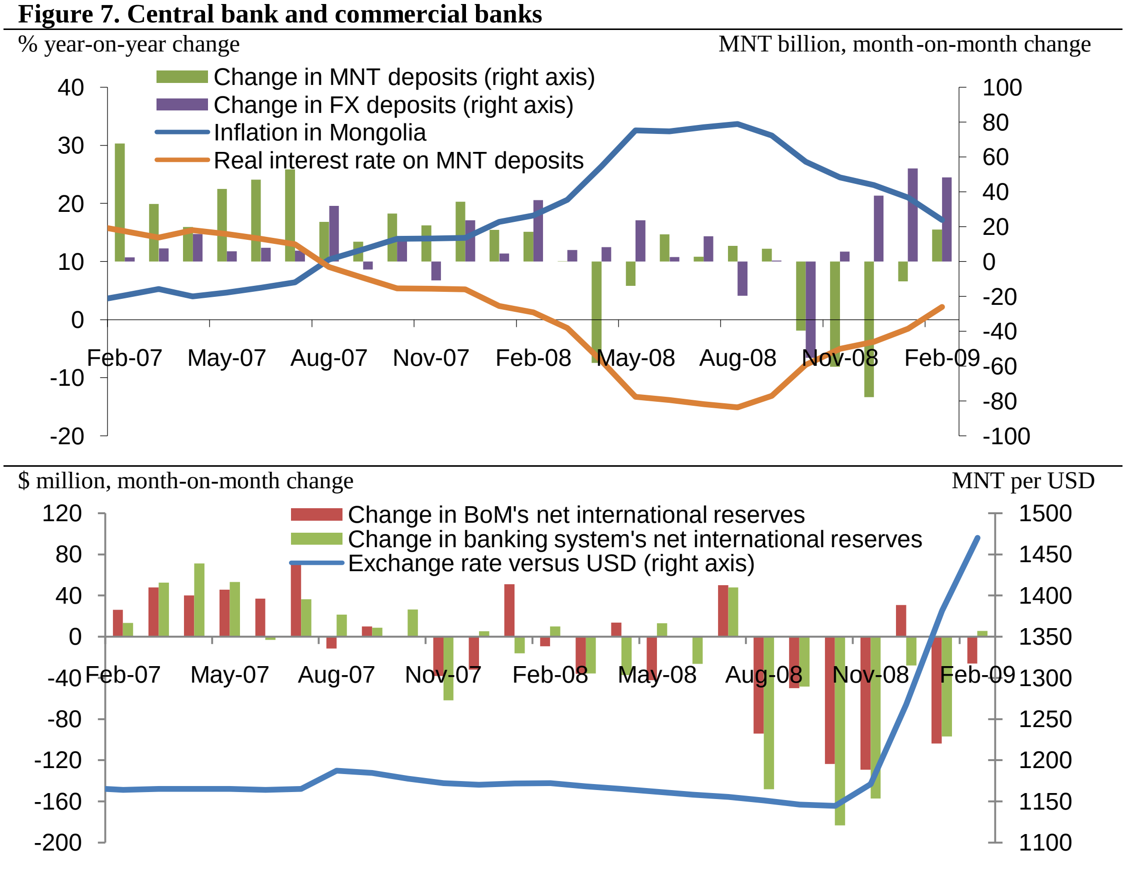
Three distinct phases of the banking sector can be identified since 2004 when the commodity price boom started, and leading up to the recent stress in the banking sector and lack of confidence in the local currency.

The first phase, from 2004 to mid-2007, can be considered a period of *sustainable growth*. Commodity prices started to rise. Narrow money and loans grew in line with nominal GDP growth, non-performing loans were falling (as a share of total loans), inflation was in single digits and the loans-to-deposits ratio was below 100 percent and stable. From about 2006, the BoM started to peg the exchange rate to the USD initially to avoid a strong appreciation.

Although new banks had been established in the years before, the banking sector was relatively concentrated as a small number of large banks accounted for the majority of loans and deposits. However, a proliferation of unregulated and financially weak savings and credit cooperatives led to the failure of 32 of them in 2006, affecting half of all assets held at these institutions. The resolution of these failures took a long time, which led to simmering popular distrust in the financial system. By 2007, there were 16 registered banks, which accounted for 95% of total assets in the financial system. Ten were foreign owned.

The second phase, from mid-2007 to mid-2008, exhibited the tell-tale signs of *overheating*. Economic growth continued to be high, buoyed by still increasing commodity prices (approaching their peak) and strong remittances inflows. Loan and M1 growth started to exceed nominal GDP growth and deposit growth. Increasingly, loans were directed to real estate, construction and mortgage lending, leading to a feed-back cycle of rapidly growing housing prices and more housing-related lending. Although NPLs started to increase, this was masked by the strong loan growth. As the currency was effectively pegged, the pressure on the balance of payments amplified due to high imports. Inflation accelerated to double digits. At its peak it was the highest in the East Asian region and was accompanied by the emergence of negative real interest rates on MNT deposits. This made it easier to repay the loans (undermining NPL ratios as a relevant measure of financial health), but it also led to deposits being shifted out of MNT accounts and into FX deposits, on which relatively high interest rates were offered. For instance, interest rates on US$ savings went as high as 12 to 18 percent in some banks.[a]

Figure 7. Central bank and commercial banks



Source: Bank of Mongolia, World Bank

a Mongolia effectively has a dual-currency economy, where individuals tend to store their wealth in USD for "big-ticket" purchases where price rises are not sensitive to domestic price developments, and in MNT for food and services.

Box 1. Developments in the banking sector, 2004-2009 (continued)

The third phase started in mid-2008 with the collapse of commodity prices and would lead to a *loss of confidence*. Growth had started to slow down, including in those countries important for remittances to Mongolia. These remittances had traditionally supported real estate investments, but now, their decrease led a housing price bust. Livestock-related prices such as cashmere also dropped. The combined effect was an increase in non-performing loans and loans with principal in arrears. Meanwhile, the pressure on the exchange rate kept growing due to a sudden drop in export revenues, while imports kept rising. Other major commodity exporters let their currencies depreciate as their terms of trade deteriorated, but the BoM tried to hold on to the *de facto* currency peg to the US dollar, leading to loss of almost $500 million of FX reserves between July 2008 and January 2009. Despite this support, the currency depreciated by about 38 percent between the end of October and the middle of March. The public began to see the exchange rate movements as a one-way bet against the MNT, as pressure on the exchange rate mounted. This sentiment, combined with continued negative real interest rates and the failure of the fourth largest bank, Anod, caused a loss of MNT deposits. Tugrug deposits were converted into FX deposits further fueling the depreciation of the MNT. The blanket deposit guarantee in November seems to have partially stopped the deposit flight, although it mostly benefitted FX deposits.

Going forward, risks remain. The latest data shows that loans-to-deposits ratios are still above 100 percent and loans with principal in arrears have increased further, pointing to more NPLs down the road. However, the Bank of Mongolia is taking a number of appropriate policy actions (below).

To restore confidence in the tugrug, the BoM raised its key policy rate to 14 percent from 9.75 percent on March 11. This leaves real interest rates still negative, but a lot closer to zero. More importantly perhaps, the extent of the move signals a fundamental shift in policy, aiming to change the public’s expectations, in particular the one-way bet against the tugrug. This would make it easier for the BoM to manage the exchange rate while preserving its FX reserves.

Although higher interest rates make it more costly for customers to borrow, in order for banks to issue new loans, they need to attract new deposits. This can only happen if those who are willing to save find the rates attractive enough to deposit their money in the banks.

In addition to the raising of the policy rate, the Bank of Mongolia took several other steps to restore confidence. First, since March 31, the BoM has started to buy and sell FX reserves via an auction and published the results on its website. Compared to the administrative rationing in place before, this greatly improves transparency. It also will reflect more accurately the actual demand and supply of foreign exchange (see Box 2).

Second, the BoM appointed an auditor to undertake a portfolio audit and develop a restructuring plan for Anod Bank. This will help to set new standards in dealing with future bank failures, if any..

Third, the BoM increased the capital adequacy ratios for commercial banks to 12 from 10 percent. This strengthens banks’ risk-bearing capacity.

Fourth, the BoM revised and clarified the deposit guarantee law to cover current accounts, savings accounts, time deposits and interbank deposits. To prevent abuse and unnecessary fiscal costs, deposits of “related parties” and those of holders of subordinated debt are excluded. The deposits guarantee law was instated in November 2008 to stop the deposit flight, but it had left many customers in uncertainty about which deposits were included.

Fifth, the BoM started enhanced monitoring of key financial system variables, such as liquidity and changes in credit quality.

Box 2. The foreign exchange market

The foreign exchange rate consists of the Bank of Mongolia (international reserves as of end-February: $508 million), commercial banks (international reserves as of end-February: $498 million) and the parallel market. Major players at the parallel market are Naiman Sharga, Uran Uurgach and Tsetseg Tuv with an approximated volume of $200,000 per day on average.

In response to the fall in mineral prices and subsequent pressure on the exchange rate, the BoM did not allow tugrug to depreciate to absorb shock. Rather, it defended the currency and even attempted to appreciate it by selling US dollars to the commercial banks, in exchange for tugrug. However, demand for foreign exchange quickly outstripped supply, and the BoM had to start rationing foreign exchange by administratively allocating it to priority goods. Increasingly the official BoM exchange rate started to diverge from the exchange rates prevailing at the commercial banks and at the parallel market.

As part of the agreement with the IMF, the BoM has now abolished this rationing system and has adopted an auctioning mechanism to set exchange rates, starting from March 31. An open auction is to be held on Tuesdays and Thursdays at 10am between the BoM and commercial banks. Import companies can participate in the auction through their representative banks. The purpose of selling of foreign exchange at this stage will be to finance import payments only. The auction settlements will be non-cash and banks must allocate their transaction payments in their accounts held at the BoM prior to the start of the auction.

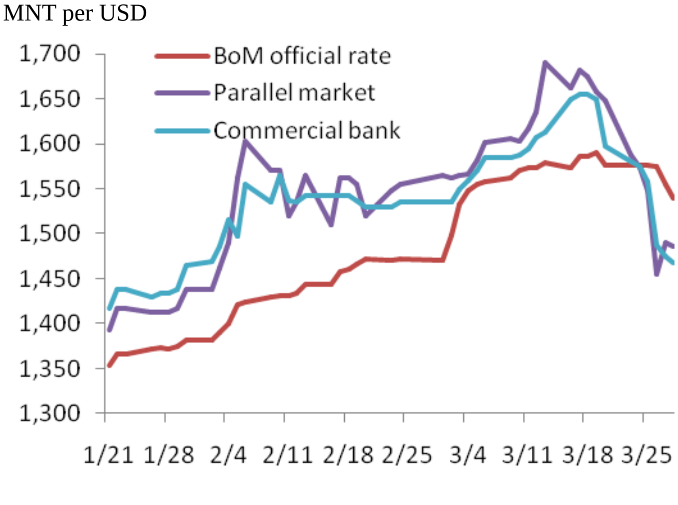
Foreign exchange sales will be executed at the highest bid price. The closing price is determined as the lowest price settled. Foreign exchange purchases will be made at the lowest ask price. The closing price for sales will be the highest price settled. The average rates will be determined by the weighted average of all executed auction rates.

Banks are required to submit their foreign exchange reserve adequacy ratio to the BoM one day prior to the auction. Bids must be within the limits set by the BoM and up to five bids can be submitted. Banks are prohibited to collude against the BoM. If the BoM notices any conspiracy among the participants, the auction will be cancelled and action will be taken. Any act of collusion will involve imposing a fine up to MNT 1 million. A repeat breach will cause a MNT 1 million fine, plus suspension of auction participation privileges for the next eight auctions. A subsequent breach would require the BoM to permanently suspend the participation privilege of that commercial bank in the auction.

During a trial auction, the BoM sold USD 876,000 to commercial banks at MNT 1585. At the first real action on March 31, the BoM bought USD 673,000 at MNT 1497 (weighted average). It is too early to tell if the recent appreciation is caused by an increased confidence in the tugrug or increased supply of US dollars in parallel markets from cross-border trade-related activities (due to the seasonal opening of border crossing between China and Mongolia). But so far it seems that the BoM’s move has removed the incentive to bet against the MNT and the BoM has actually started to add to its FX reserves.

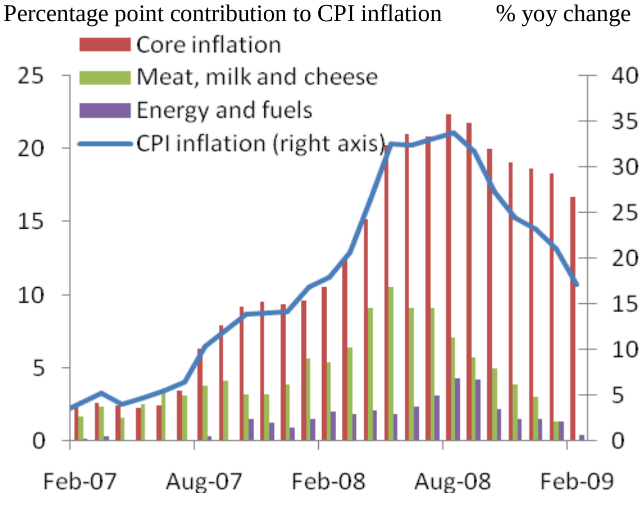
Source: Bank of Mongolia, World Bank

Figure 8a. After a long slide, the MNT has started to appreciate against the USD…



Last observation: March 28, 2009.
Source: Mongolian Financial Association, World Bank

Figure 8b. … And lower inflation will help bolster confidence in the MNT



Source: National Statistical Office, World Bank

These measures seem to have had a positive impact. For instance, foreign exchange rationing has stopped, and between mid and end-March, the tugrug has appreciated by 2.9 percent (official rate), 11.3 (commercial banks) and 11.7 percent (parallel market), due to the increased supply of US dollars in the market, suggesting that the policy shift might have worked.

Going forward, CPI inflation will continue to come down, which will also bolster confidence in the tugrug. Inflation now stands at 17 percent year on year in February, half of its peak in August 2008. Food and fuel prices are stagnant, leaving core inflation as the only driver (Figure 8b). Inflation is currently projected to be 9 percent yoy at end-2009 as a result of the domestic slowdown and lower global food and fuel prices.

The Government's key actions for the medium term include improving the Bank of Mongolia's supervision capacity and enhancing risk management in the banks. To strengthen the legal environment, it will submit to Parliament a number of key amendments, including to the laws on foreclosure of collateral which currently overly protect borrowers and impede loan recovery.

These are hopeful signs for monetary exchange rate policies, and the banking sector, but not a reason for complacency. For instance, a further and continued growth slowdown may affect credit quality further, which may lead to a significant deterioration of the bank balance sheets. Raising interest rates has been unpopular with potential borrowers, but reversing it may lead to renewed deposits flight and an overshooting of the exchange rate. And banks are exposed to both interest rate risks and exchange rate risk, as half of corporate borrowing is in foreign currency.

3. Caution is needed going forward

The Government and Parliament have taken the necessary, but painful, steps to address the economic crisis, and have started to lay out a medium-term plan to make Mongolia more resilient to future boom and bust cycles. These are positive moves, which inspire hope. But there are still many risks.

First, the seasonality of revenues leads to very tight financing conditions for the government in the first half of 2009. Second, the fiscal and monetary adjustments taken will be unpopular and could be reversed under populist pressures. In this regard, the May Presidential elections could put strains on the bipartisan coalition which has supported these adjustments. Third, expenditure cuts could fail to protect the maintenance of key infrastructure, leading to increased risks in the years ahead. Fourth, the poor will be hurt if not adequately protected by a targeted social transfer system to replace the current universal transfers as a matter of urgency. Fifth, based on current data and projections, Mongolia is at low risk of external debt distress, but there is little headroom for additional borrowing. Finally, copper and other commodity prices could fall further, which will put even further strains on the budget, slow down the recovery and negatively impact FDI inflows.

In conclusion, the new policy stances taken, both on the budget and on monetary policies, are clearly in the right direction, but will need to be maintained over time to truly become credible and restore confidence more permanently. And the global environment continues to look grim, which, for a small, open economy like Mongolia is enough reason to remain cautious about the hopeful signs we just outlined.

Table 2. Mongolia: Key Indicators

	2003	2004	2005	2006	2007	2008e	2009f
Output, Employment and Prices							
Real GDP (% yoy change)	7.0	10.6	7.3	8.6	10.2	8.9	2.7
Industrial production index	..	..	..	100.0	110.4	113.4	..
(% yoy change)	..	..	..	..	10.4	2.8	..
Unemployment (%)	3.4	3.6	3.3	3.2	2.8	2.8	..
Consumer price index (% yoy change)	4.6	10.9	9.6	5.9	14.1	23.2	9.0
Public Sector							
Government balance (% of GDP)	-3.7	-1.8	2.6	8.1	2.8	-5.0	-6.0
Non-mining balance (% of GDP)(1)	-5.9	-5.8	-1.3	-7.3	-13.4	-15.3	-10.4
Domestic public sector debt (% of GDP)	3.1	1.4	0.1	1.0	0.5	0.0	0.0
Foreign Trade, BOP and External Debt							
Trade balance ($ mn)	-199.6	-99.2	-99.5	136.2	-52.4	-596.5	-331.0
Exports of goods ($ mn)	627.3	872.1	1066.1	1543.9	1950.7	2532.5	1863.0
(% yoy change)	19.7	39.0	22.2	44.8	26.4	29.8	-26.4
Copper exports (% yoy change)	..	..	14.7	94.8	27.7	3.0	..
Imports of goods ($ mn)	826.9	971.3	1165.6	1407.7	2003.1	3128.9	2194.0
(% yoy change)	21.6	17.5	20.0	20.8	42.3	56.2	-29.9
Current account balance ($ mn)(2)	-102.4	24.1	29.7	221.6	264.8	-502.7	-261.8
(% of GDP)	-7.1	1.3	1.3	7.0	6.7	-9.6	-6.5
Foreign direct investment ($ mn)	131.5	128.9	257.6	289.6	360.0	682.5	316.5
External debt ($ mn)	1240.3	1311.8	1360.0	1413.9	1528.7	1600.5	1795.8
(% of GDP)	87.3	73.7	59.7	44.3	38.9	33.1	46.8
Short-term debt ($ mn)(3)	0.0	0.0	0.0	0.0	0.0	0.0	..
Debt service ratio (% of exports of g&s)(3)	13.4	9.4	7.6	5.4	4.3	3.5	4.3
Foreign exchange reserves, gross ($ mn)	203.5	207.8	333.1	718.0	1,000.6	656.7	822.1
(month of imports of g&s)	2.3	1.8	2.5	4.6	5.0	2.1	3.7
Financial Markets							
Domestic credit (% yoy change)	157.3	25.8	18.8	-3.1	78.4	60.6	..
Short-term interest rate (% per annum)(4)	..	15.8	3.7	5.1	8.4	9.8	..
Exchange rate (MNT/USD, eop)	1168.0	1209.0	1221.0	1165.0	1170.0	1267.5	1640.0
Real effective exchange rate (2000=100)(5)	96.9	95.4	101.8	107.1	109.0	130.2	..
(% yoy change)	-4.8	-1.5	6.7	5.2	1.8	19.5	..
Stock market index (2000=100)(6)	151.5	120.8	203.6	382.0	2048.0	1181.6	..
Memo:							
Nominal GDP (MNT bn)	1,660	2,152	2,780	3,715	4,600	6,130	6,294
Nominal GDP ($ mn)	1,448	1,,814	2,307	3,156	3,930	5,258	4,035

(1) Non-mining balance excludes revenues from corporate income tax and dividends from mining companies, the Windfall Profits Tax and royalties. (2) The 2009 projections for the external sector are based on the previous 2008 current account estimate, rather than the recently published final 2008 figure (which was mentioned in the text). (3) On public and publicly guaranteed debt. (4) Yield of 14-day bills until 2006 and of 7-day bills for 2007. (5) Increase is appreciation. (6) Top-20 index, eop, index=100 in Dec-2000.

Source: Bank of Mongolia, National Statistical Office, Ministry of Finance, IMF and World Bank staff estimates