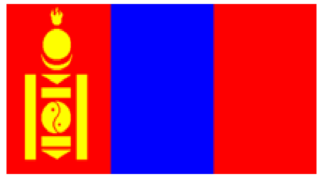
January 2011



Mongolia Quarterly Economic Update

The World Bank

The World Bank's *Mongolia Quarterly Economic Update* assesses recent economic and social developments and policies in Mongolia. It also presents findings of ongoing World Bank activities in Mongolia. The Update is prepared 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, consisting of Munkhnasan Narmandakh, Tehmina Khan, and Altantsetseg Shiilegmaa, and led by Rogier van den Brink. This Update also received contributions from Richard Allen, Heike Gramckow, Zahid Hasnain, Hironori Kawauchi, Alexander Pankov and Trang Van Nguyen. Copies can be downloaded from http://www.worldbank.org.mn. For further information, comments and questions, please contact Sunjidmaa Jamba (sjamba@worldbank.org).

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Abbreviations and acronyms

bn	Billion
BoM	Bank of Mongolia
CPI	Consumer Price Index
FX	Foreign currency
GDP	Gross Domestic Product
HDF	Human Development Fund
LC	Local currency
LHS	Left hand side
MFA	Mongolian Financial Association
mn	Million
MNT	Mongolian togrog
MoF	Ministry of Finance
mom	Month-on-month
mt	Metric ton
NPL	Non-performing loan
NSO	National Statistics Office
OT	Oyu Tolgoi
RHS	Right hand side
USD	United States Dollar
WPT	Windfall Profit Tax
yoy	Year-on-year
ytd	Year-to-date

Executive Summary[1]

The economy continues to recover with most sectors rebounding strongly from the sharp drop in output late 2008 and early 2009. Preliminary estimates suggest that real GDP grew by 6.1 percent year-on-year in 2010, following an outturn of minus 1.3 percent in 2009. However, winter arrived in Mongolia with the agriculture sector still feeling the impact from last year's dzud[2]. The sector has now experienced double-digit contractions for the third quarter in a row.

Consumer prices continued their upward trend, with the latest December data showing a rise in the headline UB inflation to 14 percent yoy following 12 percent yoy increase the previous month. On the inflation front, a perfect storm is gathering, created by a powerful combination of external and internal pressures. Global monetary policies and food supplies, and rising food inflation in China and Russia, from which Mongolia imports several food products such as vegetables and grain, suggest that continued inflationary pressures can be expected from the external environment. Domestically, Mongolia's booming economy is running into capacity constraints, while the adverse impact of the recent dzud continues to be felt through high meat prices. Finally, the 2011 budget approved a large increase in public spending, including substantial cash handouts to the population. Hence, we expect continued strong upward pressure on prices during 2011.

The exchange rate against the US dollar has been slowly appreciating back to the pre-crisis level. In December 2010, the average monthly exchange rate against the US$ appreciated by 3.0 percent, compared to the previous month, or 15 percent compared to December 2009.

The latest fiscal data show continuing improvement in Mongolia's public finances, reflecting the underlying improvement in the economy and the recovery in commodity prices. The outturn for 2010 is a balanced budget. However, the recently approved 2011 Budget of Mongolia envisages a steep increase in government spending, together with a sharp rise in the fiscal deficit to an unprecedented 9.9 percent of GDP. It sets the record of the largest budget in the history of Mongolia (MNT 4.0 trillion) amounting to more than half of GDP. Our analysis shows that it will compound already existing inflationary pressures caused by the sharp economic rebound and the lack of spare capacity in the economy. This pro-cyclical spending pattern goes against the spirit of the new Fiscal Stability Law and will make it difficult to make the transition to a cyclically-adjusted fiscal deficit of no more than 2 percent of GDP starting 2013.

And while the 12-month rolling trade deficit improved considerably over the past year, narrowing to US$ 146 million in June 2010, from US$ 1086 million in February 2009, in recent months it started to widen again, reaching US$ 379 million in December 2010. Imports are rising sharply as the economy expands, driven by fuel, transport equipment and machinery as the construction of the Oyu Tolgoi copper mine and related infrastructure projects are ramped up. As a result, the current account deficit widened to around 9.8 percent of GDP in the third quarter of 2010, after narrowing to 7.4 percent in the previous quarter on 4-quarter rolling sum basis.

[1] The analysis is based on the most recent data (December 2010) from the Bank of Mongolia (monthly bulletin, loan report and monthly consolidated banking system balance sheet), the National Statistical Office, National Tax Authority and the Ministry of Finance.

[2] Unusual winter conditions with extremely low temperatures and high wind velocity.

In the banking sector, NPLs and loans in arrears still stand high at 16 percent of total outstanding loans in December. While real interest rates on deposits are falling, MNT deposits continue to rise fuelled by currency appreciation expectations and supported by the deposit guarantee law. However, interest rates on US dollar deposits are also very high, with time deposits offering rates reaching 14 percent, reflecting the continued perception of risk by the market. There is a significant increase in private overseas borrowing. This development merits close monitoring by the central bank: they are likely to be unhedged, and could leave borrowers vulnerable to unexpected reversals in capital inflows. It is vital that the banking restructuring reforms, driven by the need to improve bank balance sheets, move forward in order to strictly enforce the existing regulatory policies without fear or favor.

The latest survey conducted in informal labor markets in December 2010 revealed a reduction in number of casual workers by about 40 percent compared to September due to the seasonal closure of construction labor markets, and reduced outdoor sales activities due to cold weather. Workers' real informal market wages on average decreased by about 30 percent from September to December 2010. Reduced job opportunities during the winter months, combined with rising inflation, explain the decline in real wages of the most vulnerable in society.

Mongolia has made significant progress in improving budget transparency, but there is still considerable room for improvement vis-à-vis public investment management. The recommendations of a recent World Bank technical assistance mission to Mongolia on improving the public investment planning and budgeting system are delivered at a critical time when several draft laws on public finance issues — the Integrated Budget Law (IBL) and the Law on Development Policy and Planning, as well as a revised law on public procurement — are under discussion, and the implementation of public-private partnerships (PPPs) is being considered. Mongolia also plans to establish a Development Bank during 2011. The Bank will use a portion of the proceeds from the Fiscal Stability Fund to finance its long term infrastructure needs. In this Update, we discuss some of the principles that should be taken into consideration when setting up the Development Bank, based on international experience.

Finally, although Mongolia's laws are easily accessible online and court processes are generally impartial and transparent, the predictability of court decisions is limited and the courts, enforcement and registration agencies are often perceived as corrupt by the public. However, the Ministry of Justice and Home Affairs of Mongolia has adopted a program to increase awareness and training on legal rights and how to access these.

Real sector developments

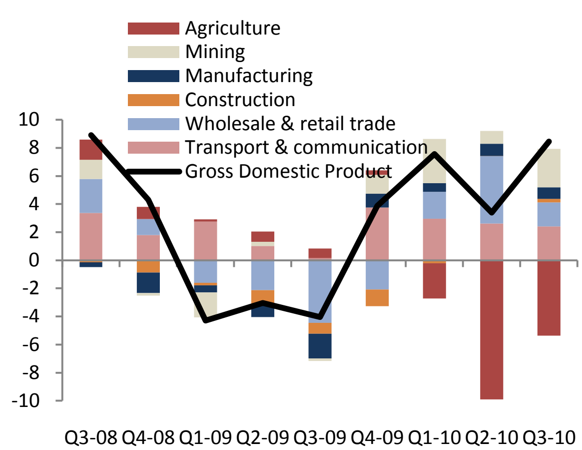
The economic recovery has become more broad-based, extending outside the mining sector

The recovery continues to become broad based with most sectors continuing to grow strongly including **wholesale and retail trade** (up 23 percent yoy), **construction** (up 16 percent), **manufacturing** (up 11 percent), **transportation and storage** (up 9 percent) and **mining** (up 6 percent). These strong outturns reflect positive base effects associated with the sharp drop in output late 2008 and early 2009 when the economy contracted by 1.3 percent (following growth of 8.9 percent in 2008). Overall, 2010 GDP rose by 6.1[3] percent year-on-year (yoy) in real terms (Figure 1).

However, winter arrived in Mongolia with the agriculture sector (down 17 percent) still feeling the impact from the recent dzud[4]. The sector has now experienced double digit contractions for the third consecutive quarter in a row. The devastating impact of the dzud, which wiped out 22 percent of the total herd, continues to depress cashmere exports (down 39 percent yoy). Industrial output growth slowed on a 12-month moving average basis as the pace of activity in manufacturing and mining and quarrying operations has slowed in the last quarter as positive base effects have started to drop out of the comparison (Figure 2).

Figure 1 The economic recovery is becoming more broad-based…

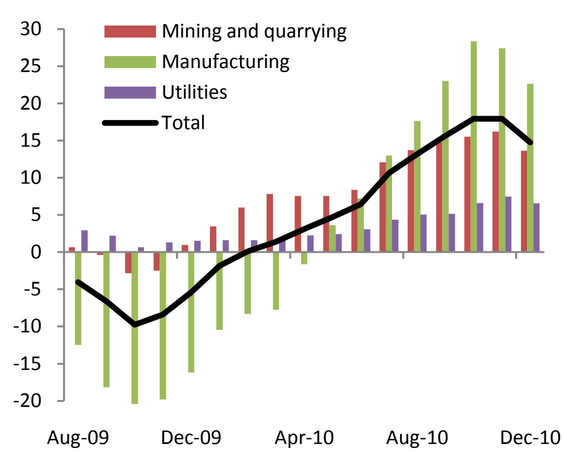
% of GDP, yoy



Source: NSO, WB staff estimates.

Figure 2 …but industrial production is growing at a more subdued pace

yoy real change, 12-month moving average



Source: NSO, WB staff estimates.

Inflation

Inflation remains in double digits

Consumer prices continued their upward trend, with the latest December data showing a rise in the headline UB inflation to 14 percent yoy following 12 percent yoy increase the previous month. Over the

[3] Preliminary estimate by Mongolian National Statistics Office, *December 2010 Bulletin*.

[4] Unusual winter conditions with extremely low temperatures and high wind velocity.

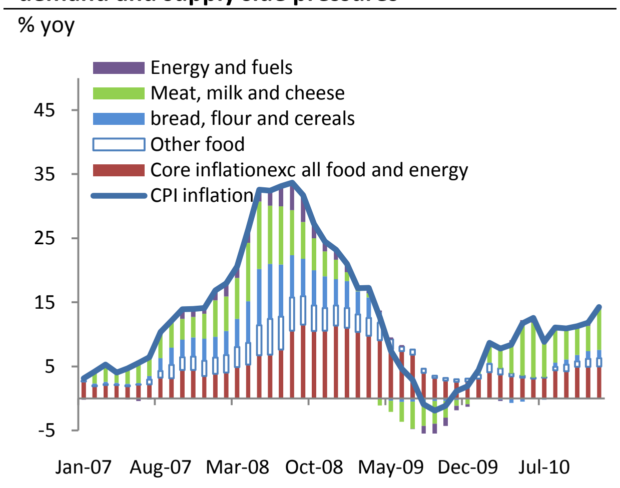
past year inflation pressures have picked up substantially in Mongolia, driven mostly by meat prices and core inflation. This is unlike previous years, when energy, bread, flour and other cereals, and other food prices were also important (Figure 3). Food price inflation accelerated from 3 percent yoy in January 2010 to slightly more than 21 percent in December, contributing about 60 percent of the increase in the overall CPI index.

So far, the increase in food prices has been driven by rising meat, milk and cheese prices. These rose by as much as 40 percent yoy in the middle of 2010 and resulted from the extreme winter or "dzud" conditions of late 2009/early 2010 which decimated one fifth of Mongolia's livestock[5] combined with the ongoing Food & Mouth Disease in the eastern provinces, which supply 30 percent of the meat industry, and rising meat exports (Figure 4) to Russia, China, Vietnam and Iran.

But looking ahead, with Mongolia mostly importing its non-meat food requirements, rising international grain prices will add to the existing meat price inflation pressures. Since 2008, higher cereal prices and subsidies have contributed to a significant increase of total harvests in recent years. Nevertheless, domestic food consumption remains highly dependent on food imports. For example, in 2010 potato imports accounted for 94 percent of domestic consumption.

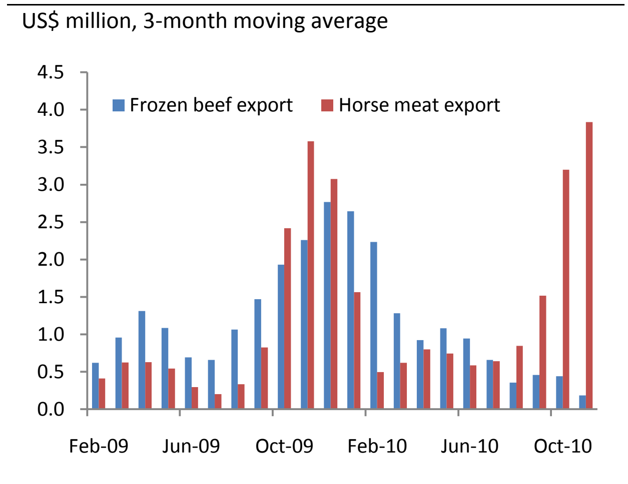
Globally, cereals and dairy prices are not far below their peak in 2008 while meat prices are already higher (Figure 5)**.** Unexpected grain production shortfalls driven by weather events in the Commonwealth of Independent States (CIS) countries and export bans (e.g. in Russia, where close to 40 percent of crops[6] were destroyed by the worst drought in decades), weather disasters elsewhere and disappointing yields in major producers such as US, EU and Canada, led to significant spike in grains prices in 2010. Bloomberg noted that drought in Russia led to the biggest jump in the price of wheat since 1973, affecting a range of food prices (e.g., meat and dairy products).

Figure 3 Inflation remains high, reflecting both demand and supply side pressures



Source: NSO, WB staff estimates.

Figure 4 Meat exports by Mongolia



Source: NSO, World Bank

5 About 9.7 million head of livestock.

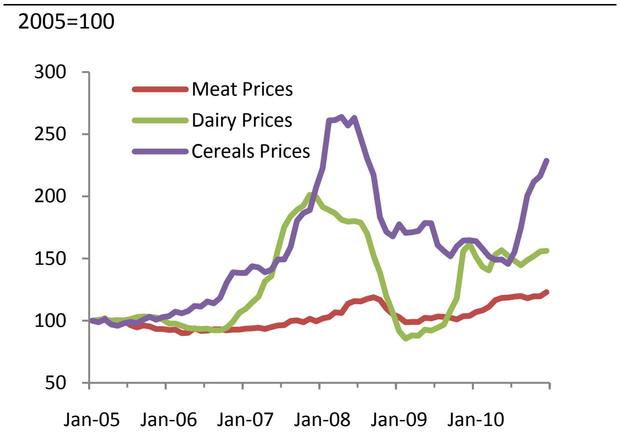
6 The World Bank in Russia, *Russian Economic Report No.23* November 2010.

The outlook is heavily influenced by 2011 harvests, the potential for export bans in thinly traded international food commodity markets, continuing weather disasters (most recently in Australia and Eastern USA), and movements in the US dollar in which global (food and non-food) commodities are priced. The FAO estimates that for major cereals, a substantial increase in production is required to meet utilization and to reconstitute world reserves.[7]

Rising food prices in Russia and China in particular, from which Mongolia imports the bulk of such food, bear close watching. For example, Russia accounts for more than 80 percent of Mongolia's flour imports and China for 80 percent of its tea and more than 90 percent of its potato imports. In Russia, food inflation has risen three-fold in the space of one quarter to around 12 percent in Q4. In the case of flour and bread prices, this has been reflected almost immediately in Mongolian prices (Figure 6). CPI food inflation in China is also rising fast – it stood at 12 percent yoy in November, roughly twice the level in June 2010 – pushed mainly by rising grain and vegetable prices. Grain prices rose by 15 percent yoy in November, while fresh vegetable price inflation has averaged 20 percent in the second half of 2010.

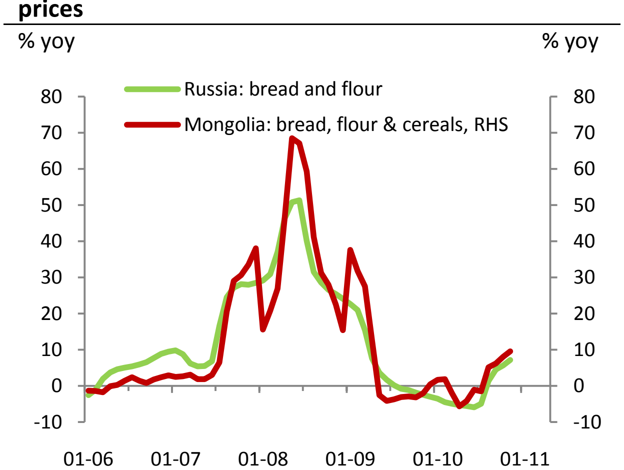
Chinese food prices are closely correlated to Mongolia's food prices with a lag of 3 months, suggesting causality (Figure 7). This could imply that food inflation in Mongolia could rise to 25 percent yoy in the first quarter of 2011. This would have a devastating impact on food security, for both the rural and urban poor. Meat and dairy inflation is currently running at more than 20 percent yoy, and given that the domestic livestock herd will take time to rebuild (possibly years, particularly for the rural poor), prices are likely to remain high for the foreseeable future. On top of that food inflation will be further sustained by rising prices of imported grain and vegetables from Russia and China.

Figure 5 International food prices have picked up



Source: FAO, World Bank

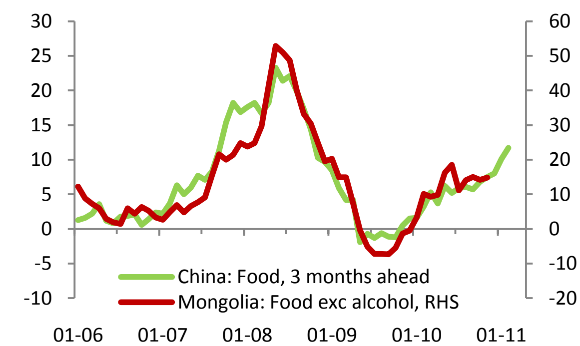
Figure 6 Russia and Mongolia: grain, flour and bread prices



Source: Haver, World Bank

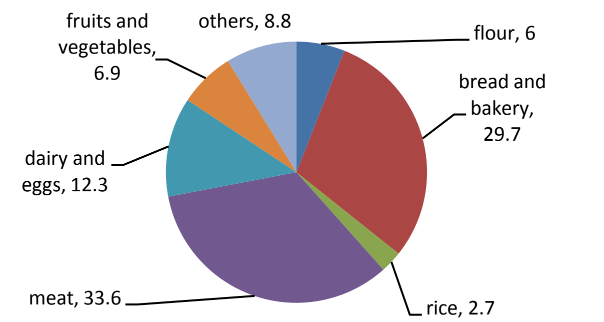
7 Although higher prices this year will increase farmers' incentives to increase grain acreage or planting, they will also be responding to the prices of other commodities that have seen an increase in prices over the past year, notably soybean, cotton and sugar.

Figure 7 China and Mongolia food prices



Source: Haver, World Bank

Figure 8 Food expenditures by category for the median household below the poverty line



Source: NSO, Household Survey 2007/08, World Bank

Rising food prices imply a transfer of income from food consumers (usually urban residents, but also rural poor who buy food) to food producers (both domestic and overseas). The biggest beneficiaries of rising meat and dairy prices in Mongolia are likely to be the already relatively well off and larger herd owners who had sufficient financial capital to purchase fodder for their herds during the dzud, and/or were able to restock their herd rapidly during the summer. However, smaller herders are less likely to be able to take advantage of currently high prices, because they are likely to have already sold any surviving livestock during and after the dzud in order to finance subsistence needs.

In urban areas, poorer residents, who spend more of their incomes on food, will be hit hardest by rising food prices. Overall, food accounts for 40 percent of the CPI consumption basket in Ulaanbaatar (where 40 percent of the total population is located). And roughly 22 percent[8] of the UB population lives below the poverty line. Food consumption patterns from the 2007/8 household survey show that the median household below the poverty line allocates more than 80 percent of its food expenditures (Figure 8) to meat and dairy products (46 percent), and to flour and bread (36 percent).

Add to this Mongolia's expansionary 2011 budget plans, with the large cash handouts and a risk of substantial second-round effects in the form of a wage-price spiral, and we expect continued upward pressure on prices during 2011.The economic rebound in recent quarters has been stronger than expected, the economy is operating at close to capacity and the global environment currently remains supportive for mining exports. Any further acceleration in the inflation rate, which has averaged 11 percent since May up from 4.5 percent in January, will quickly erode the real value of the cash transfers, making these politically less attractive than they seem today. As discussed in the October Quarterly, analysis by the BoM found that spending on subsidies and transfers and an expansionary fiscal policy contributed to the bulk (roughly 20 percentage points) of the increase in the headline inflation rate to around 33 percent yoy in 2008.

[8] Mongolian National Statistics Office, Poverty Headcount 2007-2008

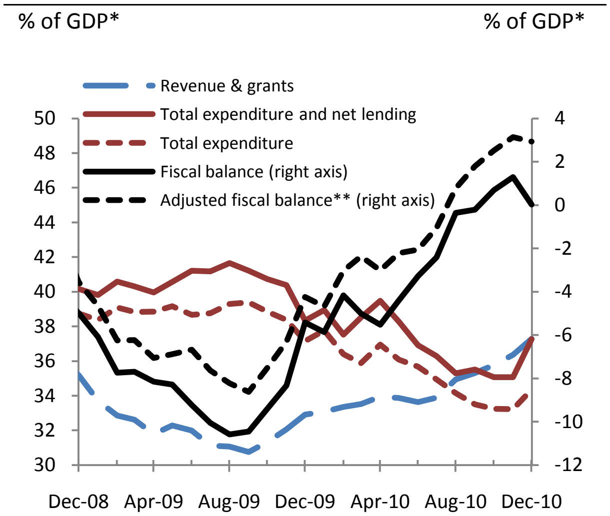
Fiscal developments

Fiscal balances improved strongly in step with mineral-related revenues…

The latest fiscal data show continuing improvement in Mongolia's public finances, reflecting the underlying improvement in the economy and the recovery in commodity prices. On a 12-month rolling basis the fiscal balance in October recorded its first surplus since July 2008. This has since continued to rise reaching 1.3 percent of GDP in November, before falling to 0 percent in December, a significant improvement from the 10.6 percent deficit recorded in August 2010. Excluding net lending, the budget surplus increased to 3.1 percent of GDP, its second highest since June 2008 (Figure 9).

In large part this recovery reflects the support to government revenues from buoyant commodity prices. Total revenuesfor 2010 as a whole were up by 55 percent compared to 2009 while total expenditures were 33 percent higher. The bulk of the increase in revenues was accounted for by receipts under the Windfall Profits Tax, and domestic corporate and indirect tax revenues (Figure 10).

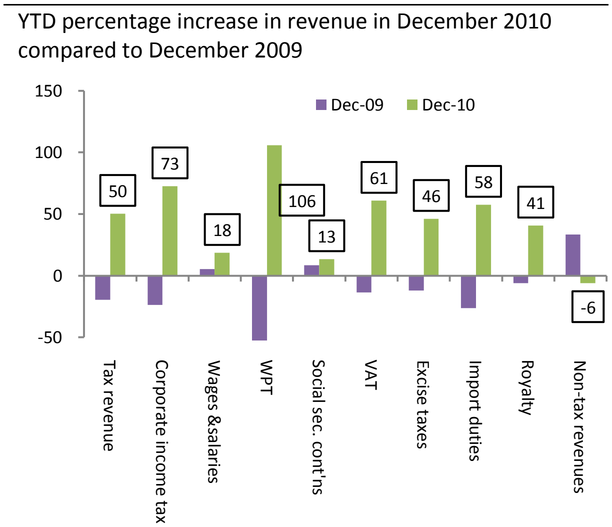
Figure 9 Fiscal balances have improved strongly in recent months …



Note: *GDP interpolated using actual 2008 and 2009 GDP data and NSO projections for 2010 data. ** Adjusted fiscal balance excludes net lending from expenditure, leaving current and capital expenditure only.

Source: Ministry of Finance, World Bank staff estimates.

Figure 10 …as revenues have risen strongly reflecting the recovery in commodity prices as well as domestic demand



Sources: Ministry of Finance, World Bank staff estimates.

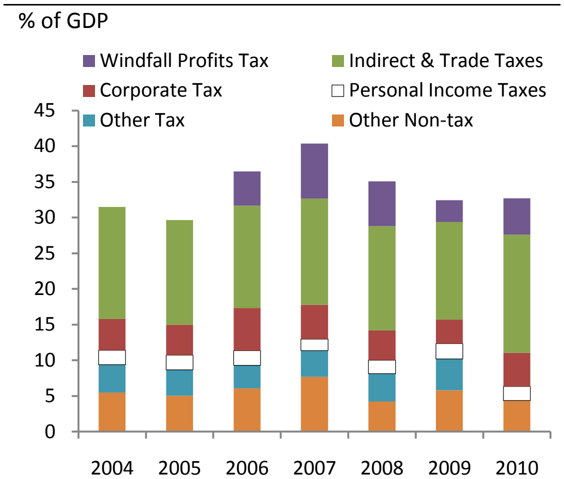
Aside from a rise in government spending in the first two quarters of 2010, which was mainly related to the MNT 70,000 cash transfer per person in February, government spending has been mostly flat in recent months. However, in August another round of cash handouts (MNT 50,000 per person) started which lasted until December. And public sector wages and pensions were increased by 30 percent in October. The wage increase decision has been justified on the grounds that there had been negligible real wage and salaries growth in 2009 as part of the government's crisis response package. On a year to date basis, spending on wages and salaries was some 12 percent higher in nominal terms in December, but with inflation picking up, only 2 percent higher in real terms.

Meanwhile, the Windfall Profits Tax (WPT) has been abolished starting January 1st, despite the revenue and funding pressures from the record high expansionary expenditure plans. At the same time no continuation of budgetary support by the development partners (IMF, World Bank, and others) is planned. The recently approved royalty rate was doubled from 5 percent to 10 percent. The Windfall Profits Tax (WPT)[9] contributed nearly one-fifth of total government revenues in 2007 and 2008, amounting to about 6-8 percent of GDP (Figure 11). Currently, net losses to the budget caused by abolishing the WPT are estimated to be in the region of 2-3 percent of GDP. In December, WPT contributed 14 percent of total revenue on a year to date basis (or about 5 percent of GDP), second only after VAT, which comprises 19 percent of total revenue.

Spending in the 2011 budget will be the largest on record

The 2011 Budget of Mongolia envisages a steep increase in government spending, together with a sharp rise in the fiscal deficit to an unprecedented 9.9 percent of GDP. It sets the record of the largest budget in the history of Mongolia (MNT 4.0 trillion) amounting to more than half of GDP. Our analysis shows that it will compound already existing inflationary pressures caused by the sharp economic rebound and the lack of spare capacity in the economy. This pro-cyclical spending pattern goes against the spirit of the new Fiscal Stability Law and will make the transition to a cyclically-adjusted fiscal deficit of no more than 2 percent of GDP starting 2013 much harder.

Figure 11 Revenues by type (as % of GDP)



Source: NSO

Fiscal rules are adhered to in the 2011 budget…

The increase in spending does not violate the specific fiscal rules as defined in the Fiscal Stability Law. First, the use of the long-term mineral prices to calculate the available revenues is strictly adhered to (rule 1). Accordingly, the 2011 budget assume copper prices of US$ 5,983/t and coal prices of US$ 98.8/t which are considered as core mineral revenue. However, the revisions in the budget do use a higher gold price than in the original draft budget to accommodate some of the higher spending. The projected gold price was raised from US$1250 to US$1350 for ounce. Recall that gold was not part of the mineral basket, given its relatively small share in total exports compared to other commodities. One can argue of course that this price projection adjustment goes against the spirit of the law.

The second rule, relating public debt, is also adhered to. The FSL specified a transition path towards the 2014 ceiling on the NPV of public debt of 40 percent of GDP excluding any borrowing to finance the

[9] A 68 percent tax applied to revenues from prices exceeding base prices of $2600/tonne for copper and $850/ounce for gold.

government's investment share in a mining entity and repayable from future profits of the entity.[10] The transition path would set a ceiling of 50 percent in 2011, 60 percent in 2012, and 50 percent of GDP in 2013. The NPV of the 2010 public debt to GDP ratio is 43 percent, but falls lower if the OT investment share-related borrowing is excluded. Hence, there is room for increased government borrowing under the FSL. Whether this is a wise idea from a macroeconomic point of view is another question. Certainly, with the current sovereign bond problems in the European Union, any significant foreign borrowing will be expensive and/or may fail to attract enough buyers.

The third and fourth rules relate to the structural budget deficit and expenditure growth. The FSL specifies that the structural budget deficit should not exceed 2 percent, while expenditure growth should not be greater than (i) the non-mineral GDP growth rate of that particular year, or (ii) the average of the non-mineral growth rate of the preceding 12 years, whichever is greater. However, these two rules only become binding in 2013, unless there is a natural disaster or the economy enters into a recession. And unfortunately, the FSL did not set out a transition path from the 2010 fiscal deficit of 6.5 percent of GDP to the structural deficit of 2 percent in 2013.

…but the budget plan is inconsistent with the Medium-Term Budget Framework

The FSL requires that certain fiscal policy and management principles should be adhered to. For instance, the budget should be in compliance with the Medium Term Budget Framework (MTBF) approved by Parliament earlier in the summer.

However, the 2011 budget is inconsistent with the guidelines set out in the MTBF. First, the overall deficit target of 9.9 percent of GDP in 2011 (Table 1 and Figure 12) is a significant deviation from the 5 percent deficit ceiling specified in the MTBF and also worse than the 8.6 percent originally tabled before parliament. It is also a sharp deterioration from the balanced budget outturns for 2010. Moreover, if 2011 allows for such a large deficit, then only 2012 will be left to reach convergence with the 2 percent deficit in 2013. This would assume a sharp contraction in spending in 2012, an election year. This seems unlikely.

Table 1 Aggregate indicators for the Budget Framework under the MTBF in comparison to 2011 budget (% of GDP)

	MTBF 2011	MTBF 2012	MTBF 2013	2011 Approved	2010 budget
Floor on total budget revenue	**35.4**	35.4	30.3	**42.2**	36.9
Ceiling on total budget expenditure	**40.4**	39.4	32.3	**52.1**	43.3
Ceiling on total budget deficit	**-5.0**	-4.0	-2.0	**-9.9**	-6.4
Floor on capital expenditure	**6.3**	6.0	4.7	**10.8**	8.5

Source: World Bank , MOF Budget document

Moreover, both expenditure and revenue estimates in the 2011 budget are much higher than that of the MTBF baseline scenario. Under the 2011 budget, general government spending will reach a whopping 52 percent of GDP, compared to the 40.4 percent in the MTBF. Revenues are some 25 percent

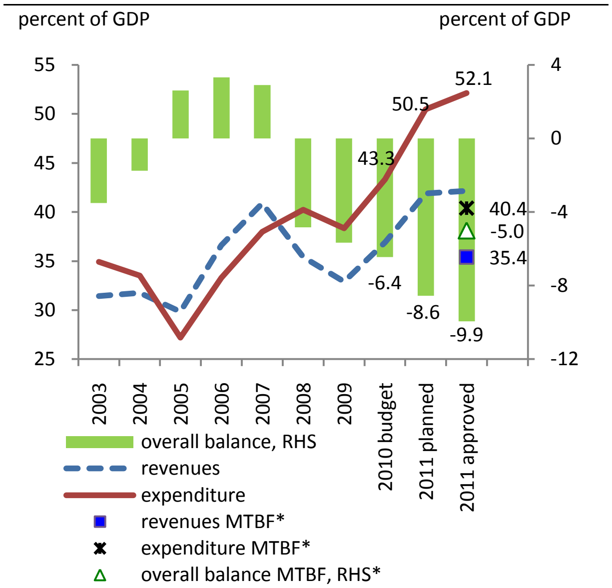
[10] Mongolia borrowed $US 870 million from the domestic counterpart of the OT mining conglomerate to finance its 34 percent investment share in the project. The money will be repaid from dividends that accrue from the project once it starts production.

higher than in the 2010 budget (Figure 13), due to optimistic forecasts of revenue intake from VAT, social security contributions, excises and royalties.

And will push inflation up fast and undermine the competitiveness of Mongolia's non-mineral export sectors

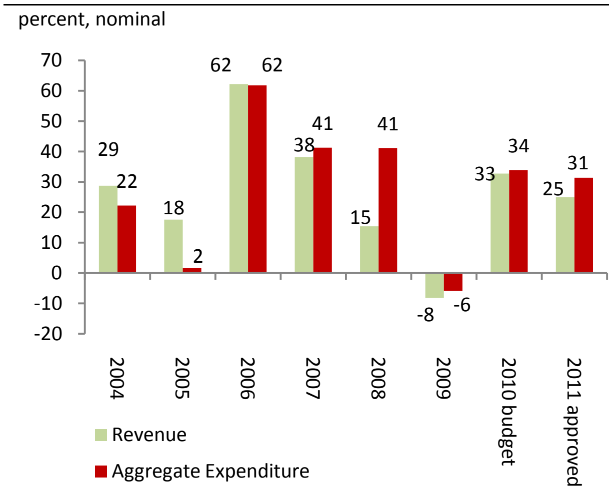
Simulations from a dynamic computable general equilibrium (CGE model) specially calibrated to the Mongolian economy provide an indication of the harmful effects on the economy of the 2011 budget[11]. They suggest that an expansionary fiscal policy, underpinned by rising export revenues which are returned to citizens in the forms of cash transfers or tax cuts, will increase wage and price pressures in the economy and result in a sharp real appreciation of the exchange rate (Figure 14).

Figure 12 Headline budget numbers as percent of GDP



Source: World Bank, Budget document.* The revenue, expenditure and overall budget balance guidelines set out in the Mid Term Budget Framework are also shown in the chart to show how these deviate from the 2011 budget aggregrates. Thus for example, the overall deficit targeted in the 2011 budget is 9.9 percent of GDP, whereas the ceiling set out in the MTBF is 5 percent.

Figure 13 Annual increase in budget aggregates

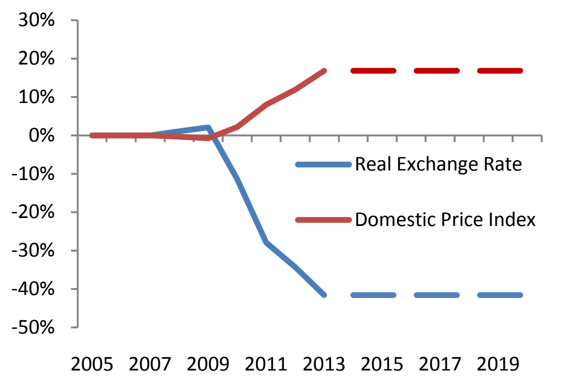


Source: World Bank, Budget document

11 The analysis uses the World Bank's MAMS (Maquette for MDG Simulation) model, which provides a general framework for economy-wide country-level medium to long run analysis. However given data constraints, such models should be seen as providing a general approximation of the economy and the simulations as indicating the broad magnitudes and directions of change.

Figure 14 Real Exchange rate and domestic price index

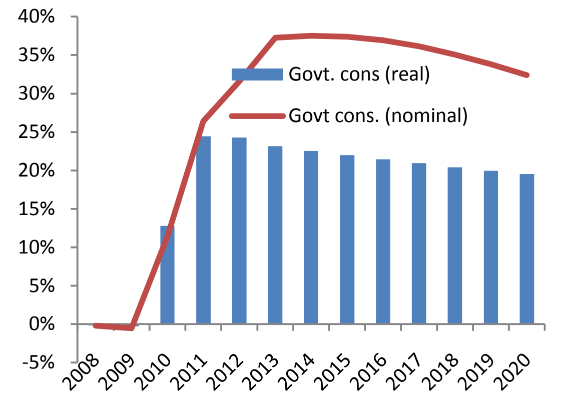
Difference to Baseline, %



Source: World Bank

Figure 15 Government spending

Difference to Baseline, %

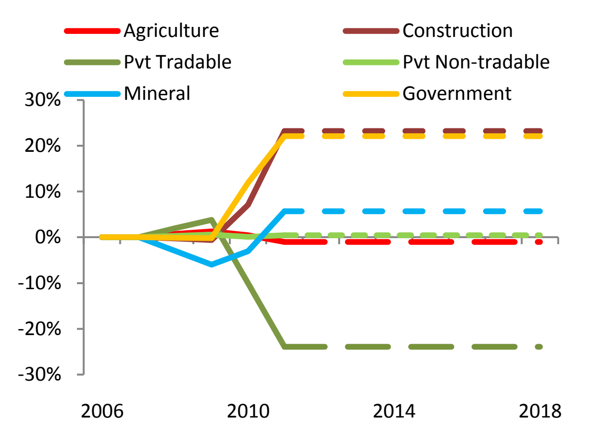


Source: World Bank

The rise in inflation will be in the order of around 17 percent by the end of 2011, on top of the existing inflation (currently at 14 percent). This inflation quickly erodes the real value of government spending (Figure 9), thereby reducing the benefits of the transfers, which will hurt those who are the most in need. In addition, the resulting real appreciation will undermine the competitiveness of the non-mineral traded sector. In Mongolia, it will particularly affect agriculture, and any other sector whose output is traded internationally, such as manufacturing. This is because these sectors are unable to raise the prices of their final output (these are set in international markets) in response to rising domestic input costs. As Figure 10 shows, both agriculture and the private tradable sector (manufacturing) contract, releasing inputs which are then absorbed by the booming non-traded sectors such as construction and wholesale and retail trade.

Figure 16 Real Value added by sector (difference to baseline) if expansionary budget passed

Difference to Baseline, %



Source: World Bank

Financing the deficit could be difficult

The financing of the projected 9.9 percent deficit will be difficult. It depends on the Tavan Tolgoi (TT) agreement under negotiation, withdrawals from the newly established stabilization fund and privatization proceeds.

The financing of the fiscal deficit comes from the following sources. The government plans to issue domestic government bonds worth 1.2 percent of GDP (there are no plans to issue foreign currency denominated debt in the 2011 budget) and expects some financing (around 0.8 percent) to be available from multilateral and bilateral donors. In addition, it projects to earn privatization income of around 1.5 percent of GDP (MNT 115 billion), including proceeds from the privatization of the State Bank. By putting this in the budget, the government is in effect setting a deadline by which privatization needs to be concluded. This weakens the government's hand in negotiations.

More worryingly, the bulk of the financing depends on prepayments from the TT project currently under negotiation, with the government estimating that it will receive advance payments equaling to 6 percent of GDP (MNT 470.1 billion). However, entering project negotiations such as TT with demands for large upfront payments reduces government's negotiation powers considerably, and risk leading to delays in reaching the agreement and/or unfavorable terms.

Moreover, if these prepayments do not materialize the government could pursue borrowing on the international markets. However, such markets are increasingly jittery due to the euro zone woes, and could be difficult to access if and when Mongolia needs the financing. Meanwhile, donor financing is expected to dry up, while resorting to financing from domestic debt financing may crowd out the private sector or carry the risk of inflationary financing.

On a more positive note, the original 2011 budget tabled to Parliament had proposed disbursing 2.1 percent of GDP (MNT 164.6 billion) of resources out of the Fiscal Stability Fund. These plans have been scrapped in the approved budget. This makes sense since money saved in the stabilization fund should first be saved for the inevitable downturn, not immediately spent.

The purpose of the stabilization fund which is to be established this year under the FSL and will start functioning from 2011 is to save any mining revenue that accrues in excess of the structural revenue estimates. These savings would then be used during a downturn to finance the budget. Under the FSL as passed by parliament, a portion of the savings generated by the Fiscal Stability Fund can be used to finance domestic and foreign investments. In particular, the government is allowed to use this money to purchase long term securities by the planned state-owned Development Bank (See Box 1). It is likely that the Development Bank will help to finance long term infrastructure projects such as railways, power and oil processing. Officials estimate that 90 percent of these investments will be imported, which, they argue, would reduce the inflationary impact.

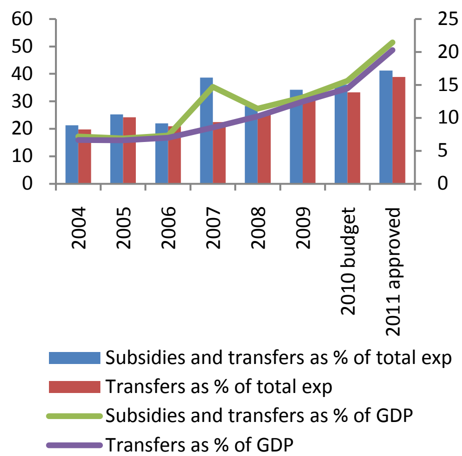
Transfers will account for half of total government spending in 2011

This is the second consecutive budget in which current spending is more than 30 percent higher than the previous year. The 2011 increase is primarily driven by a 22 percent rise in spending on wages and salaries compared to the 2010 budget (reflecting the 30 percent increase in public sector wages and salaries that took place in October 2010) and a 53.5 percent increase in spending on transfers.

This will bring total spending on transfers to account for roughly 40 percent of total government spending in 2011, or 20 percent of GDP (Figure 17). The increase is due to a more than doubling in allocations to the Human Development Fund (Figure 18), which is financed by mineral revenues, to MNT 805 billion (around 10 percent of GDP). Resources from the HDF can only be used by law for four types of benefits: (i) payments for pension and health insurance premiums; (ii) housing purchases; (iii) cash benefits; and (iv) payments for health and education services. The government intends to distribute the majority of this (MNT 700 billion) as cash transfers, amounting to MNT 21,000 per month per citizen in 2011.

Figure 17 Subsidies and Transfers as % of Aggregate Expenditures

% of total govt expenditures



Source: World Bank, Budget document

Figure 18 Spending by type and level of government

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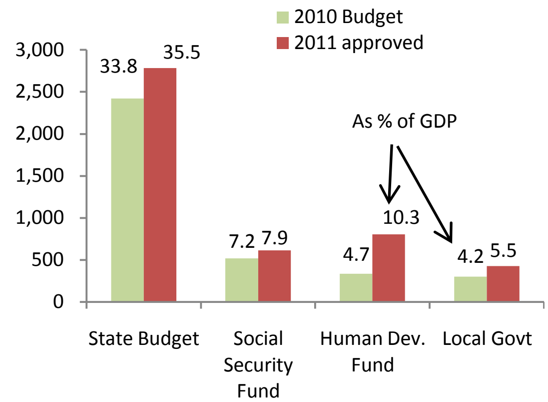


Source: World Bank, Budget document

Table 2 2011 Budget compared with 2010 Budget and MTFF

	2009 Outturns as percent of GDP	Approved 2010 as percent of GDP	% nominal increase in 2010 budget on 2009 outturn	**Approved 2011 as percent of GDP**	**% nominal increase in 2011 on 2010**	MTBF 2011	% nominal increase in 2011 on 2011 MTBF
Total Revenue & Grants	32.9	36.9	32.7	42.2	24.9	35.4	19.1
Current Revenue	32.6	36.6	32.9	42.0	25.6		
Tax Revenue	26.8	31.6	39.9	37.0	27.8	30.3	21.9
PIT	2.1	10.8	49.6	2.2	44.9		
CIT	3.4	4.3	50.6	5.5	40.1		
WPT	3.1	4.9	87.4	0.9	-78.9		
Non Tax Revenue	5.8	4.9	0.6	5.0	11.6	4.8	5.6
Total Exp. & Net Lending	38.6	43.3	33.0	52.1	31.4	40.4	29.0
Current Exp	29.5	32.6	30.8	40.2	34.5		
Wages &Salaries	9.5	9.0	12.2	10.1	22.2		
Goods & Services	6.5	7.2	31.3	8.1	22.8		
Subsidies & Transfers	13.0	15.6	42.2	21.5	50.1		
Capital Exp	7.6	8.5	32.0	10.8	39.0		
Domestic Investment	6.5	7.3	31.7	8.8	31.8		
Capital Repairs	0.2	0.4	145.3	0.6	61.4		
Overall balance	-5.7	-6.4	34.9	-9.9	68.6	-5.0	98.9

Source: World Bank, MOF Budget document

Capital investment and repairs are consistent with the medium term budget plans

With regard to capital expenditures capital spending as a share of GDP will be at 10.8 percent in 2011 up from a planned 8.5 percent in 2010. The capital expenditure plans for 2011 are also consistent with the 6.3 percent of GDP indicative floor on capital expenditures set in the 2011 MTFF. Meanwhile, spending on repairs has been increased by around 60 percent compared to 2010 levels which is a wise move. Going forward, the government should continue to build on the policy reforms of recent years aimed at improving public investment management by ensuring that badly planned public investment projects with no or inadequate feasibility studies do not find their way into the budget as has been the tendency in recent years.

And decentralization gets a welcome push

In keeping with the decentralization policy, local investment to be allocated for each aimag has been increased to MNT 800 on average from MNT 560 million allocated in the previous budget proposal. In addition, Ulaanbaatar city will be authorized to make MNT 68 billion of investments in 2011 according to the proposal. The exact amount of local investment shall be defined based on the macroeconomic indicators, population and territorial size, regional GDP and revenue collection capacity etc.

Risks

This is a risky budget. Inflation will increase significantly if the budget is implemented. The economic rebound in recent quarters has been stronger than expected and the economy is currently operating at close to capacity. Even if the global environment remains supportive for mining exports, any further acceleration in the inflation rate, which has averaged 12 percent since May up from 4.5 percent in January, will quickly erode the real value of the cash transfers, making these politically less attractive than they seem today. As discussed in the October Quarterly, analysis by the BoM found that spending on subsidies and transfers and an expansionary fiscal policy contributed to the bulk (roughly 20 percentage points) of the increase in the headline inflation rate to around 33 percent yoy in 2008.

Moreover, there is a substantial risk of second-round effects in the form of a wage-price spiral as a direct consequence of the expansionary fiscal policy and if higher inflation expectations become entrenched. For example, the envisaged MNT 21,000 per person transfers for next year will follow on the heels of MNT 120,000 already distributed in 2010 and the 30 percent wage increase in the public sector. If forward looking inflation expectations, on which price and wage decisions are based, are raised and become entrenched, and then a wage-price spiral can develop, requiring a tightening of monetary policy simply to anchor inflation expectations.

High domestic inflation also causes the currency to appreciate in real terms, hurting the export sectors. For instance, this would hurt both agricultural exports, on which the rural population depends and an already small manufacturing sector. With the 2011 budget, Mongolia would be following a well-trodden path adopted by many other resource rich economies, such as the Netherlands in the 1960s, after which the infamous “Dutch Disease” is named. These countries provided huge subsidies and transfers to citizens that resulted in upward wage price spirals that eventually proved difficult to control, fed domestic asset price bubbles (e.g in housing) and severely undermined profitability in the traded sectors. The eventual bust e.g in the case of the Netherlands was severe, requiring comprehensive and painful structural reforms, and the decline in the non-mineral traded sectors difficult to reverse.

Another bout of extremely high inflation could also, again, undermine confidence in the currency and the financial system. Mongolia's banking system remains fragile and a number of problems including undercapitalization, high levels of non-performing loans, and systemic problems of poor governance and risk management systems combined with poor oversight remain to be fully addressed. Rising inflation, if not matched by pre-emptive tightening of interest rates, will push real interest rates close to zero or into negative territory, as happened in the run-up to the previous bust. So far, parliament has suspended discussion of monetary policies and left the Central Bank without a clear mandate. Raising interest rates can choke off growth in the private sector and near term prospects for growth and employment, and will not be popular. However, faced with excessive government spending the Central Bank will have no alternative.

There are significant risks in the global environment. Our simulations indicate that with the current budget proposals Mongolia is setting itself up for a replay of the 2006-8 boom years, leaving it vulnerable to a bust similar to the one that occurred in 2008-9. The external risk factors which could set this downturn in motion again include continuing uncertainty in international financial and debt markets, a severe slowdown in growth in developed countries, an external terms of trade shock (commodity prices once again seem to be entering a super cycle and it is hard to ascertain the degree to which commodity price increases over the past year are warranted by fundamentals or not) and a domestic confidence shock to the banking sector that is currently weighed down by high levels of non-performing loans on its books.

Budgeting and public investment planning

Aside from managing fiscal policy well, Mongolia needs to ensure that there is no depletion of the real wealth of the country as mineral resources are exploited. This should be done by creating other forms of wealth through improving budgeting and public investment planning.

There have been signficant improvements in budget transparency

Fortunately, Mongolia has made significant progress in improving budget transparency. The International Budget Partnership's Open Budget Survey (OBI) assesses the availability and the comprehensiveness of budget documents in each country and rated Mongolia as one of the best performers in improving transparency and accountability. In a short period of time, Mongolia has gone from being a country that provided scant budget information to one that provides much more comprehensive information. Its score fell just short of placing it in the "significant information" category, outperforming high-income countries like Italy and Portugal.

Table 3 Open Budget Index Scores: top performers

	2006	2008	2010
Afghanistan	NA	8	21
Angola	5	4	26
Argentina	40	56	56
Azerbaijan	30	37	43
Croatia	42	59	57
Egypt	19	43	49
Georgia	34	53	55
Ghana	42	50	54
India	53	60	67
Liberia	NA	3	40
Malawi	NA	28	47
Mongolia	**18**	**36**	**60**

Source: International Budget Organization: *Open Budget Survey 2010*.

The Open Budget Survey is not a perception survey or an opinion poll. The Survey uses internationally accepted criteria to assess each country's budget transparency and accountability with compilation from a questionnaire completed and reviewed for each country by independent budget experts who are not associated with the national government. The compiled objective scores and rankings of each country's relative transparency constitute Open Budget Index (OBI). The Survey also examines the extent of effective oversight provided by legislatures and supreme audit institutions, as well as the opportunities available to the public to participate in national budget decision-making processes.

When the 40 countries for which there are comparable data for 2006, 2008, and 2010 are examined, progress has been particularly notable among several countries, including Mongolia. Mongolia's OBI score has improved from 18 in 2006 to 60 in 2010 (Table 3).

The remarkable improvement in Mongolia's OBI score is primarily due to the fact that the government began to publish budget documents that had previously not been available to the public, including the Executive's Budget Proposal in 2007 and the reintroduction of public Year-End Reports in 2008. Moreover, between the 2008 and 2010 Surveys, the Executive's Budget Proposal was expanded from a 50-page document to a 300-page document, thus providing more comprehensive information on revenues and expenditures. Additionally, the Mongolian supreme audit institution recently began making its Audit Reports available to the public on its new website. Budget reforms implemented since the mid-2000s have received technical or financial support from international partners.

However, there is scope for further improvement. Some of the budget documents, such as the Year End Report and Audit Report, were made available in 2004 but not again until 2008. The 2002 Public Sector Management and Finance Law requires disclosure of budget information to Parliament and other government bodies, but does not specifically require dissemination to the public. Nor has Mongolia passed a Freedom of Information law, despite intense domestic and international pressure since the early 2000s.

A new Integrated Budget bill could redress the lack of legal requirements for public dissemination as well as the absence of channels for public participation in the budget process. Also, demands for greater access to information by citizens and civil society groups play a critical role in enhancing transparency in Mongolia's mining sector. Mongolian civil society organizations remain particularly concerned about the continuing lack of transparency in government procurement practices.

But public investment management systems remain inadequate…

However there remains considerable room for improvement vis-à-vis the public investment process. A composite index of the efficiency of the process[12] underpinning public investment management (PIM) ranks Mongolia squarely in the middle of 71 low and middle income countries. The index is based on an assessment of four key phases associated with the PIM process, namely:

- Strategic guidance and project appraisal: This assesses whether broad guidance is available (e.g from a medium term strategy), strategic plans are made and costs estimated and ensures that

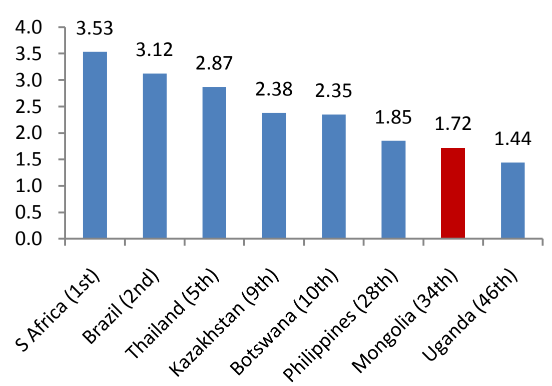
[12] This is in contrast to traditional methods of assessment, usually outcome based indicators such as electricity generation losses as a percent fo total electricity generation, percentage of paved roads in good conditions. See Dabla-Norris, Brumby, Kyobe and Papageeorgious (2010).

investments chosen are based on national development priorities. After this first test, projects require further scrutiny of their financial and economic feasibility to ensure that no "white-elephants" are selected.

- Project selection and budgeting: Whether the process of appraising and selecting a public investment project is in line with the budget cycle, or if in the absence of proper integration into the budgets, governments resort to borrowing without taking into consideration sustainability of such an approach, assets are inappropriately maintained and the asset portfolio mismanaged.
- Project implementation: This covers a wide range of issues including whether budget execution is timely, the efficiency of procurement processes, the quality of internal budget management, and control.
- Project audit and evaluation: Ex-post evaluation is frequently missing in developing countries, but is critical in providing guidance regarding future design and implementation of public investment projects as well as transparency and accountability.

As Figure 19 below shows, Mongolia ranks 34th out of 71 countries on the overall index. The best performers not only include countries such as South Africa and Brazil with fairly sophisticated PIM systems but also countries in Mongolia's neighborhood, such as Kazakhstan and Thailand. In comparison to these countries, Mongolia's PIM system suffers from particularly poor appraisal, selection and ex-post evaluation processes (Figure 20).

Figure 19 Efficiency of the public investment management system: scores and rankings for low and middle-income countries



Source: Dabla-Norris, Brumby, Kyobe and Papageeorgious (2010). Country Rankings are given in parentheses. A score of 4 indicates the best public investment management process.

Figure 20 Efficiency of the public investment management system: scores by subcategory, selected economies

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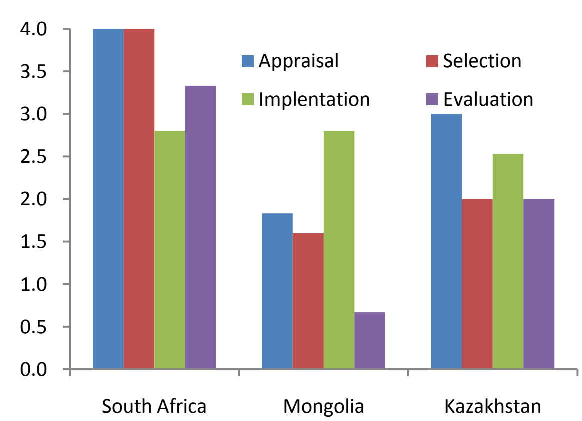


Source: Dabla-Norris, Brumby, Kyobe and Papageeorgious (2010). A score of 4 indicates the best public investment management process.

…with reforms urgently required to transform mineral wealth below the ground into sustainable capital assets above ground

An effective public investment planning, budgeting, and management system is an essential requirement if Mongolia is to meet the challenge of developing the Southern Gobi mines and of ensuring that the mineral assets below the ground are transformed into sustainable capital assets above ground. As is now well recognized, Mongolia's current system is inadequate and needs to be urgently improved.

The World Bank recently commissioned a technical assistance mission to Mongolia with the objective of providing recommendations to the government on improving the public investment planning and budgeting system. The recommendations, are delivered at a critical time when two draft laws — the Integrated Budget Law (IBL) and the Law on Development Policy and Planning — are under discussion, and the implementation of public-private partnerships (PPPs) is being considered.

Specifically, Mongolia needs to:

- Establish a strong planning function at the center of government to ensure that there is a comprehensive medium-term strategy for economic and social development — including the Southern Gobi mines — that takes into account the considerable inter-sectoral coordination required, the adherence to environmental and social safeguards, and the various options for infrastructure financing;
- Ensure integration between planning and budgeting, with clearly defined roles and responsibilities, and process flows, so that planned projects can be adequately financed and maintained;
- Develop a robust system for appraising and selecting large public investment projects;
- Given the likely importance of private financing for infrastructure, establish a framework for selecting PPP projects that is well integrated with the public investment planning process, consistent with the medium-term fiscal framework, and incorporates a rigorous evaluation of contingent liabilities and other fiscal risks associated with PPP projects.

As the government and parliament debate the proposals for new legislation on budgeting and planning noted above, the World Bank has the following recommendations to address the four main challenges identified above:

- A new law on planning is required to give the necessary importance and authorization to the planning function.
- The National Development and Innovation Committee (NDIC) should be elevated to the rank of a ministry, possibly under the Deputy Prime Minister, to enable it to effectively coordinate with the other line ministries.
- Elevating the planning function has to go hand-in-hand with ensuring effective integration with the budgeting process and maintaining the integrity of the capital and recurrent budget under the authority of the Ministry of Finance (MoF). These provisions need to be clearly specified in the IBL and the planning law. The mission aide memoire provides several re-drafting suggestions to specific articles in the two draft laws.
- Mongolia should prepare a medium-term rolling public investment program (PIP) that lists large, strategically important high priority projects that have passed a preliminary feasibility study (PFS). The mechanisms for preparing the PIP, with the precise roles and responsibilities, need to be specified in both the Law on Development Policy and Planning and the IBL.

- Only projects that are jointly certified by the NDIC (as having passed the PFS) and by the MoF (as being within the medium term fiscal envelope) should enter into the PIP.
- All potential PPP projects should undergo first a PFS and second a value-for-money (VFM) test.
- The Concessions Law should be amended to give primary responsibility to the NDIC for undertaking the PFS and VFM tests for PPPs. The methodology for the VFM would be jointly authorized by the NDIC and the MoF.
- The MoF should be given the formal right to approve any financial incentives and guarantees that the government offers as part of the final PPP contract terms; and to stop the approval of any contract which it regards as unsatisfactory from the point of view of fiscal risk and debt sustainability.

The government should consider imposing in the IBL a cap on its aggregate exposure to fiscal risks through PPPs, perhaps initially at 2 percent of government revenues, a figure which could be increased as experience of implementing PPPs grows.

…while a viable Development Bank with sound governance, operational and financial structure will be essential to financing infrastructure needs

As discussed earlier, Mongolia also plans to establish a Development Bank which will use a portion of the proceeds from the Fiscal Stability Fund to be established in 2011 to finance its long term infrastructure needs. The broad principles that should be taken into consideration when setting up the Development Bank, as well as lessons from other countries are discussed in Box 1.

Box 1 A Development Bank for Mongolia

The government of Mongolia has recently issued a decree announcing the establishment of the Development Bank of Mongolia (DBM). A charter, setting out the broad goals of the DBM, its financing structure, operational modalities, and governance and oversight arrangements, was also issued with the Decree. The charter states that: "The Development Bank shall provide medium-term and long-term loans and other services directed at promoting development of priority sectors as defined in the development plan of Mongolia, increasing value add exports and enhancing economic competitiveness."

Development banks can be a useful financial tool not only for developing countries but also for developed countries. They fill the financial gaps by providing long-term, low-interest credit to projects in prioritized industries and sectors which cannot be serviced by commercial banks for reasons of size and/or complexity. Some East Asian development banks have been unusually successful[13], compared to similar banks in South Asia, Latin America and Sub-Saharan Africa, whose bad debts are as high as 50 percent of total lending. The World Bank[14] has attributed this success to the ability of the government to insulate these banks from political pressures to finance bad projects, and to provide better incentives for, and capabilities to, screen and monitor projects. Additional success factors were a preferential regulatory regime (e.g., tax exemptions) and lower capital procurement costs.

For example, the Japan Development Bank (JDB) and the Korea Development Bank (KDB) started as 100

[13] Jennifer Amyx and A. Maria Toyoda, *The Evolving Role of National Development Banks in East Asia*, International Centre for the Study of East Asian Development, Kitakyushu, Working Paper Series, Vol. 2006-26, December 2006.

[14] World Bank, *The East Asian Miracle*, 1993, New York: Oxford University Press.

percent government-owned financial institutions with appropriate supervision by cabinet and parliament. The China Development Bank (CDB), which is relatively new, has a modern corporate governance structure and it attracts a skilled work force with advanced degrees. The ownership structure of the Development Bank of Singapore (DBS) is an exception: it is treated as a commercial bank under the Bank Law and is owned mainly by private sector, but is nonetheless seen as an instrument of national econom ic policy.

The following four factors are key for the success of a development bank:

- A sound legal framework and governance structures, characterized by an accountable board of directors, an appropriate "arm's length" relationship with government, and fully transparent and audited financial operations.
- Sufficient human capacity (e.g., availability of competitive skilled management and workers, existence of relevant training programs).
- Efficient process for selecting viable projects (e.g., alignment between priorities of the development bank and government policy, strong screening and monitoring of projects).
- Sound financing structure (e.g., stable status of the bank as a state-owned entity, sustainable operational resources from the government and the bank's own activities).

Mongolia has just initiated the process of creating the DBM, but important parameters remain to be determined. For instance, the initial capitalization and the arrangements for financing the bank's operations and providing government guarantees have not been fully developed at this stage. Its governance structure should consist of an independent board of directors and a supervisory board of shareholders, with appropriate external and internal audit requirements, with the important details (e.g., the number of independent directors) still to be decided. An internationally competitieve selection process has been used to recruit experienced staff with previous work experience at the Korea Development Bank, to manage the Mongolian Development Bank. A draft Development Bank Law has been submitted to the parliament.

The success stories from the region should not blind the Mongolian authorities to the considerable challenges they face in establishing a viable development bank. Many of the countries in East Asia have a tradition of strong and independent institutions, a powerful state and a large cadre of qualified officials, which cannot be fully replicated in Mongolia. A more relevant comparator might be the development banks in other parts of the world, where the success rates have been much lower, and where lessons such as the need for a genuinely independent board of management, and a sound capital structure, should be given priority.

Source: World Bank staff.

External sector

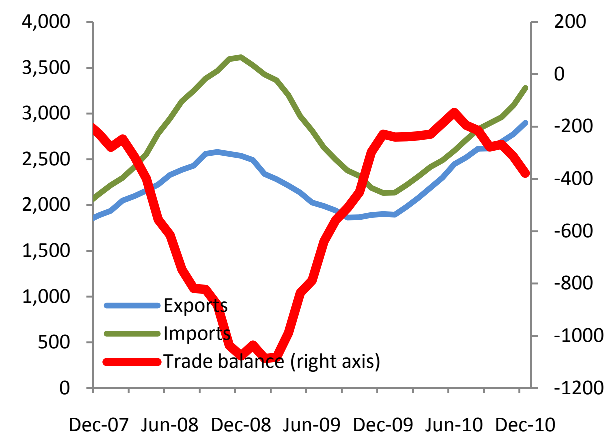
Trade deficit widening as imports increase faster than exports

While the 12-month rolling trade deficit improved considerably over the past year, narrowing to US$146 million in June 2010, from US$1086 million in February 2009, in recent months it started to widen again, reaching US$ 379 million in December 2010 (Figure 21). Imports are rising sharply as the economy expands, driven by fuel, transport equipment and machinery (Figure 22) as the construction of the Oyu Tolgoi copper mine and related infrastructure projects are ramped up. In December the dollar value of goods imports was up by 54 percent year-on-year, compared with contractions of 47 percent in August 2009. The overall increase in the industrial production of mining, construction and agriculture sectors suggest increased imports of diesel and petroleum.

Exports are up by 52 percent yoy in December 2010 supported by upward momentum in metal prices and large coal and copper imports by China, an export destination for 80 percent of Mongolia's total exports. The latest data show sharp increases of coal shipments (Figure 23) contributing 40 percentage points to overall export growth. By value coal exports increased by 188 percent and 140 percent in volume as Chinese coal use at power generators and coal mining activities in Southern Mongolia continues to rise. Chinese metal imports from Mongolia, however are leveling off and copper's contribution to export growth fell from 53 percentage points in February to 8 percentage points in December. In December 2010 copper volume decreased by 3 percent despite a dollar value increase of 54 percent (Figure 22).

Figure 21 The trade deficit has widened…

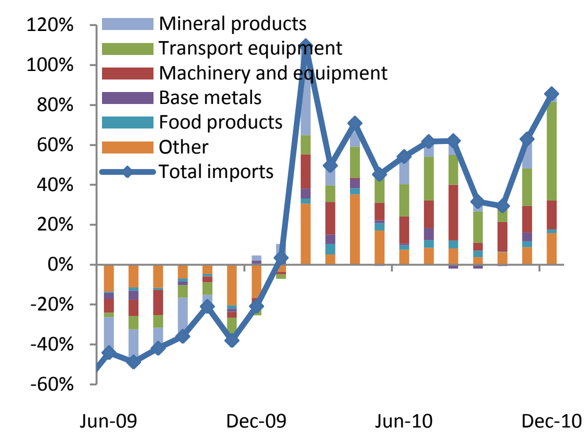
$ million, 12-month rolling sum[15]



Source: National Statistical Office, Bank of Mongolia World Bank

Figure 22 as transport and machinery equipment and fuel imports have increased

Percentage point contributions to year-on-year growth



Source: National Statistical Office, World Bank

Coal exports accounted for 30 percent of total goods exported in 2010 compared to 16 percent in 2009. Coal has surpassed copper (27 percent) as the largest export commodity.

Commodity prices have continued their rise (Figure 24) with base metal prices rising 6.0 percent in December, up for a sixth straight month, and 26 percent for the year. Copper prices rose by 8 percent to above $9,600/ton in early January,as the market continues to be affected by supply constraints, the latest being closure of the main port of the Collahuasi mine in Chile. However, it is unclear how long prices will remain high as demand moderates in China, and the sustainability of global recovery is still in doubt with the ongoing sovereign debt crisis in Europe.

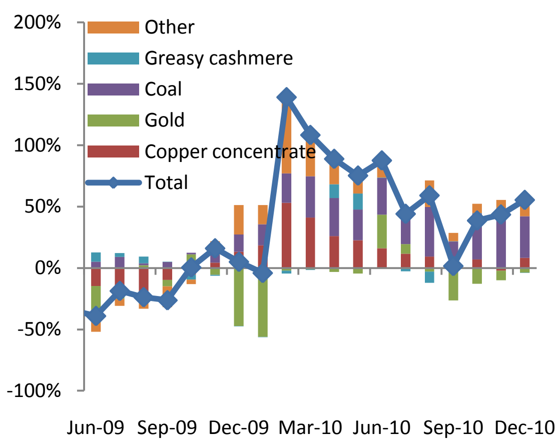
Gold and cashmere exports remain depressed (Figure 23). Gold exports are down by 47 percent compared to August 2009 despite gold prices touching record highs again in recent months. As the Windfall Profit Tax will be abolished in January 2011, gold producers are likely to be holding on to their stock until the 68 percent tax is removed. And internationally, gold prices are likely to increase further driven by investor concerns about financial stability about the EU sovereign debt crisis, and by the

[15] Monthly trade data tends to be highly volatile and also is affected by seasonal factors. For this reason, 12-month rolling sums are illustrated.

metal's continuing appeal as a currency and inflation hedge. Cashmere export (combed goat down and greasy cashmere) remains dismal despite unit price increases reflecting the devastating impact from dzud on the supply side.

Figure 23 Coal exports have performed strongly while copper and gold exports remain downbeat

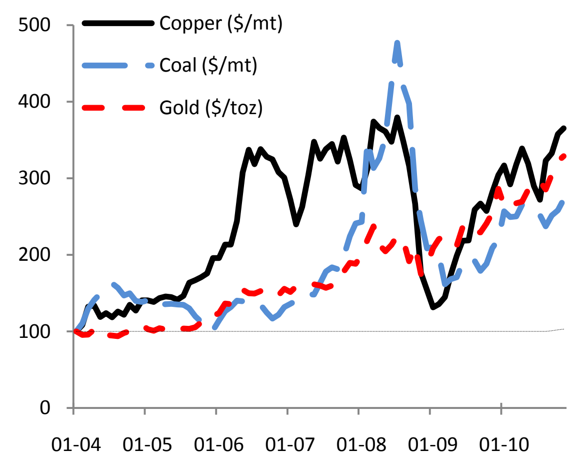
Percentage point contributions to year-on-year growth



Source: National Statistical Office, World Bank

Figure 24 Commodity prices continue to rebound…

Index=100 in January 2004



Source: World Bank, Datastream

Table 4 Driver of change of major export commodities between December 2009 and December 2010

	% change in $ value	% change in volume	% change in unit price	% of total exports
Copper	54	-3	58	27
Gold	-47	-57	23	6
Coal	188	135	23	30
Combed	1	-40	67	2
Greasy	14	-13	32	4
Zinc				
Crude				

Source: National Statistical Office, World

The current account balance is also deteriorating in line with the trade balance

As a result of the increased goods trade deficit, the current account deficit widened to around 9.8 percent of GDP in the third quarter of 2010, after narrowing to 7.4 percent in the previous quarter on 4-quarter rolling sum basis (Figure 25).

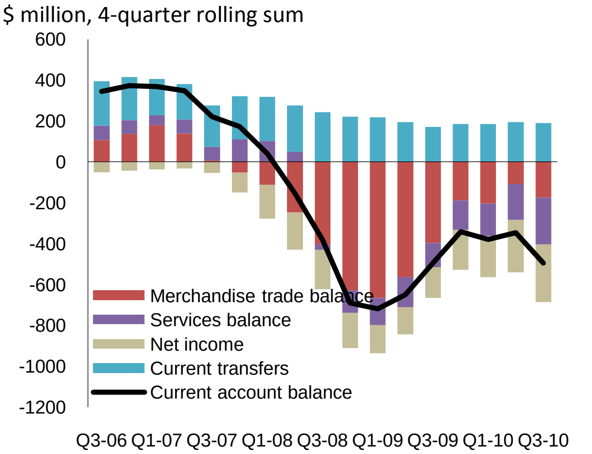
The deficit in services trade widened to 4.6 percent of GDP (compared with 3.8 percent in Q3 of 2010) as transport and other business service receipts[16] remain depressed. Overall for the third quarter of 2010, the 4-quarter rolling sum current account deficit increased to US$ 495 million from US$ 346

[16] Includes miscellaneous business, professional and technical services such as accounting, legal, consultancy services etc.

million in Q2 of 2010. It was primarily financed by net capital inflows in the financial account,[17] which amounted to US$ 1292 million in the third quarter of 2010. Net foreign direct investments increased by about 27 percent in the third quarter compared to the previous quarter, mainly due to investment inflows into the mining sector. Net borrowing from abroad continued to increase, due to the donor disbursement and loans to the commercial banks. Net remittances decreased by 8 percent on 4-quarter rolling sum basis; however, the inflow increased by about 8 percent in the third quarter of 2010 compared to the previous quarter (Figure 26).

Figure 25 The current account deficit has widened as the economy has picked up[18]

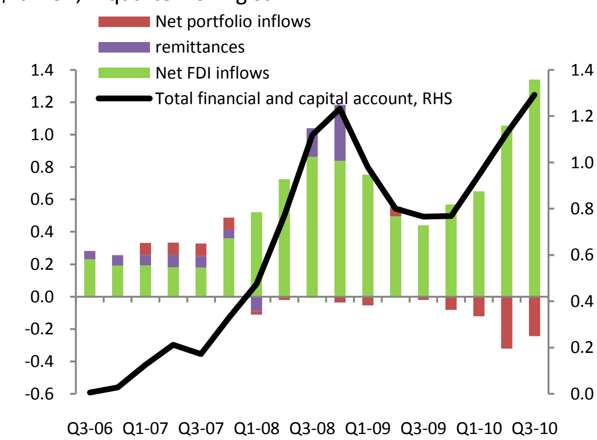
$ million, 4-quarter rolling sum



Source: Bank of Mongolia, National Statistical Office, World Bank.

Figure 26 and FDI inflows have increased susbstantially

$ billion, 4-quarter rolling sum



Source: Bank of Mongolia, National Statistical Office, World Bank.

Regarding the global economic outlook, another chapter in the drama in peripheral Europe unfolded in the last months of the year, as Ireland, in response to skeptical markets, requested an EU/IMF package of financial support. However, rather than calming the markets, the announcement led to intensified debt-market weakness and contagion across fiscally vulnerable sovereigns, including Spain, Italy and Belgium. Although, the European Central Bank continues its program of sovereign bond-buying, it remains to be seen whether this is merely the eye of the storm or a more permanent turning point. The final chapters of the euro area sovereign debt crisis have yet to be written. Even these countries in Europe that are now under intense market scrutiny do not have the worse debt dynamics than the US or Japan (whose public debt stood at close to 100 and 200 percent of GDP in 2009 respectively).

Risks to the global economic outlook contain fears of a liquidity crunch in international financial markets in the near term. Banks facing funding pressures, notably in Europe and US, are competing with sovereign borrowers for funds in international financial markets. According to Bank for International

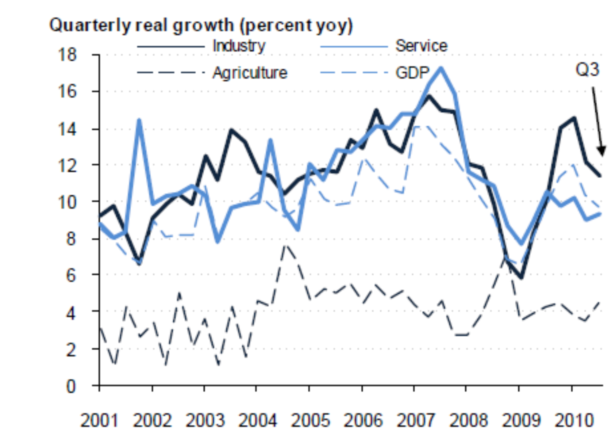
[17] The financial account records all transactions between a domestic and foreign resident that involves a change of ownership of an asset. It is the net result of public and private international investment flowing in and out of a country, such as FDI, portfolio investment, and lending and borrowing.

[18] Monthly trade data is strongly affected by the seasons in Mongolia, and has strong month-to-month fluctuations. For this reason, 4-quarter rolling sums are illustrated.

Settlements (BIS), globally banks owe around US$ 5 trillion to bondholders and other creditors, which will come due through 2012. Sub-investment grade rated sovereigns such as Mongolia[19] may find it costly to raise funds in the international financial markets.

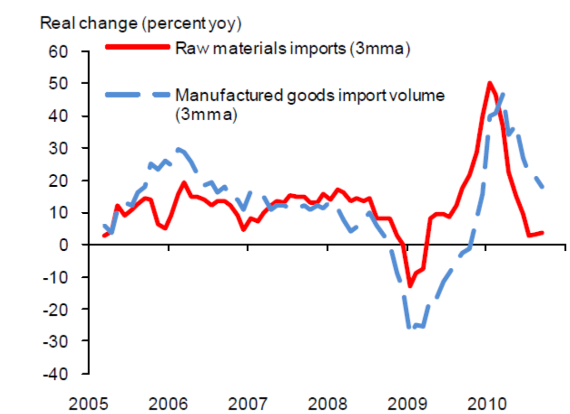
As China purchases 80 percent of Mongolia's exports, Chinese growth and import slowdown should also be on the watch. China's third quarter growth has moderated somewhat, and its composition shifted**.** GDP growth declined from 10.6 percent in the first half to a still strong 9.6 percent yoy in the third quarter. The domestic economy has cooled (Figure 27) as the stimulus impact has faded and monetary policy tightened. Investment and urban consumption have decelerated, and so have imports. Growth may ease further in the medium term as global growth decelerates and the macro stance is normalized further. After the stimulus-driven surge earlier on, slower investment and heavy industrial production caused imports to decelerate this year, particularly raw material imports (Figure 28). Imports of machinery and equipment have held up better and car imports have also remained strong. On current trends and policies, the external surplus is on course to rise in 2011 and the medium term.

Figure 27 China is slowing as monetary tightening takes effect



Source: CEIC, World Bank staff estimates

Figure 28 The expansion of import volumes has slowed alongside investment



Source: CEIC, World Bank staff estimates

The exchange rate against the USD continues to appreciate

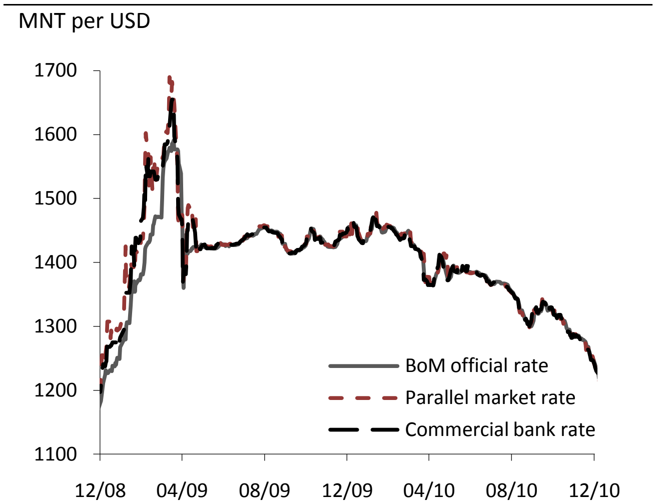
The exchange rate against the US dollar has been slowly appreciating (Figure 29). In December 2010, the average monthly exchange rate against the US$ appreciated by 3.0 percent, compared to the previous month, or 15 percent compared to December 2009.

International reserves of the Bank of Mongolia rose to a fresh record high level of US$ 2 billion in December. The BoM purchased about US$ 700 million from commercial banks and did not sell any amount through the exchange rate auctioning system. Other sources for reserve increases were

[19] Mongolia is rated B by Fitch Ratings, five levels below investment grade and on par with Bolivia, Mozambique, Rwanda and Ukraine. The ratings by S&P is a little better (BB-) but is still at the same level as Bangladesh, Gabon, Philippines etc. Bond yields for low rated sovereigns, e.g those ranked as B, have averaged 8% since June 2010.

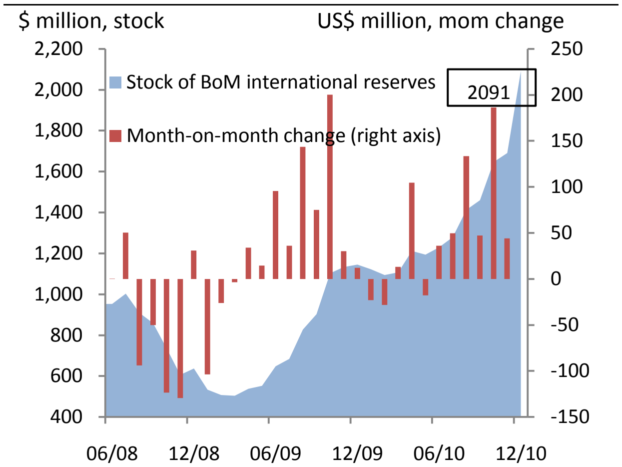
monetary gold, project funding from international institutions and deposits from commercial banks (Figure 30).

Figure 29 The exchange rate remains stable



Note: Parallel market rate is mid-point of bid and ask rates. Positive spread over official rate indicates relative depreciation. Ask-bid spread measured as percentage of mid-point of the two. Last observation: December 31, 2010.
Source: Mongolian Financial Association, World Bank.

Figure 30 BoM international reserves are at record levels



Note: Number in box is end-December stock of BoM international reserves in US$ million.
Source: Bank of Mongolia, World Bank.

Banking sector

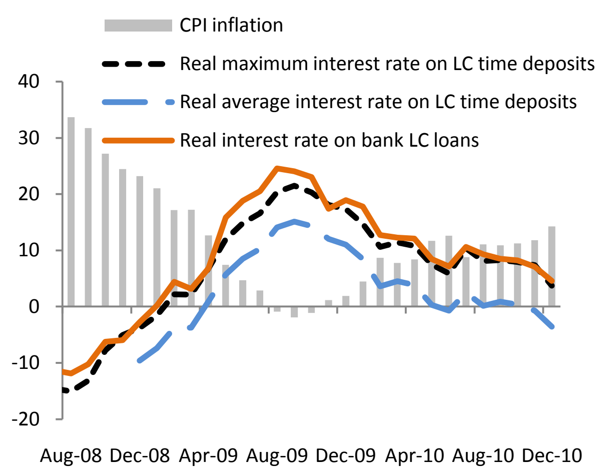
Although real interest rates on deposits are falling, MNT deposits continue to rise fuelled by currency appreciation expectations and supported by the blanket deposit guarantee

Nominal interest rates on both lending and deposit rates remain high mainly due to the search for funds by banks facing liquidity difficulties. However, in real terms, interest rates are falling as a result of the acceleration in the inflation rate. The real weighted average interest rate on LC deposits turned negative in the last two months of the year, as it briefly did in June (Figure 31), while real lending rates have also been trending down, currently standing at about 5 percent.

The volume of MNT deposits has continued to rise in recent months, hitting a new peak of above MNT 2 trillion in December, up 62 percent from a year ago (Figure 32). This is mainly due to the domestic currency appreciation, high deposit rates and the "blanket guarantee law" covering bank deposits. However, nominal interest rates on US dollar deposits are also high with time deposits offering rates reaching 14 percent, reflecting the continued perception of risk by the market. Consequently, deposits in foreign currency also hit a new peak of MNT 754 billion, up 21 percent from a year ago, despite more depositors shifting into domestic currency accounts in expectation of further exchange rate appreciation.

Figure 31 Real economy-wide interest rates continue to trend downwards as inflation rises

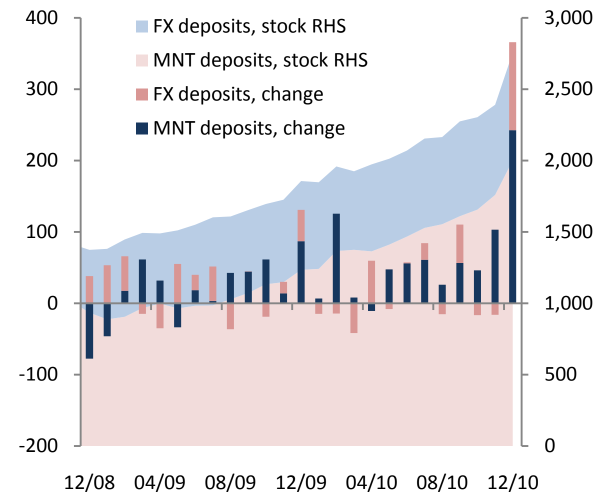
Percent (annual rate)



Source: Bank of Mongolia, National Statistical Office, World Bank.

Figure 32 MNT deposits reached a new peak in December while the stock of FX deposits has been relatively stable

MNT billion, month-on-month change MNT billion, stock



Source: Bank of Mongolia, World Bank

Private external borrowing is increasing while domestic banks struggle with high lending rates, large NPLs and low loan growth.

The *nominal* stock of loans outstanding has been growing since December 2009, rising by 23 percent yoy in December 2010 (Figure 33).However with the annual rate of inflation picking, *real* total lending growth is picking up much more slowly and is currently around 10 percent.

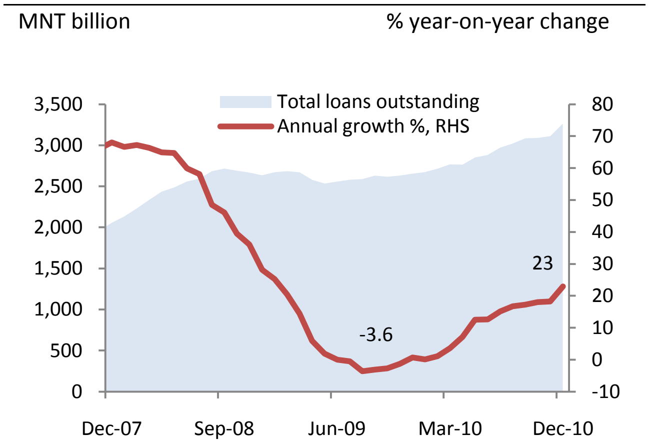
With the economy rebounding and domestic credit still tight, external borrowing by the private sector has increased substantially, reaching US$ 918.6 million as of the third quarter of 2010[20]. With domestic banks' ability to expand lending constrained by the large amount of NPLs still on their books, firms have taken their business elsewhere. Together with commercial banks, firms have borrowed 36.4 percent of gross external debt taking advantage of the large spreads between external and local borrowing rates. The domestic weighted average lending rate ranges between 18-21 percent, which is much higher than the central bank bill rate (11 percent) and banks are still buying central bank bills (which are much less risky than private lending). Consequently, bank holdings of central bank bills reached a record high level of MNT 1.1 trillion in December compared with MNT 456 billion a year ago (Figure 34).

The increase in private overseas borrowing merits close monitoring by the central bank: they are likely to be unhedged, and leave borrowers extremely vulnerable to unexpected reversals in capital inflows. It is vital that the banking restructuring reforms, driven by the need to improve bank balance sheets, move forward in order to strictly enforce the existing regulatory policies without fear or favor.

[20] Bank of Mongolia. *Gross External Debt Position* 2010.

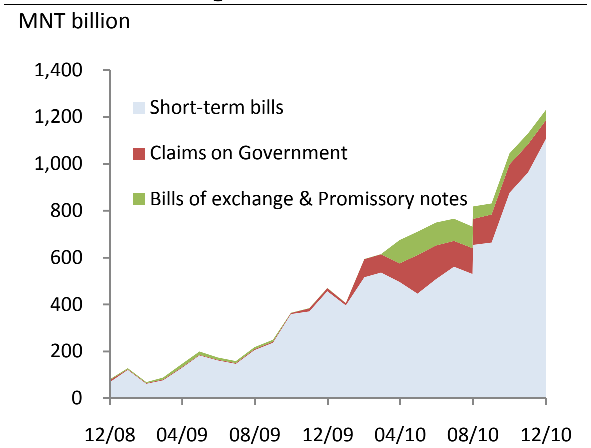
In case of adverse currency movements, borrowers will find themselves holding debt denominated in a foreign currency with assets denominated in a depreciating local currency (akin to what happened in the East Asian crisis in 1997/8). Although Mongolia can be regarded as a new "frontier" market attracting capital inflows, these can be highly volatile and quickly reverse themselves. Global financial investors may pull out at the first sign of trouble in either international markets (a case of rising market aversion at a time when global investors remain jittery because of sovereign debt problems unfolding in Western economies) or because domestic economic developments (e.g if public finances look unsustainable) warrant concern.

Figure 33 Total lending grows slowly…



Source: Bank of Mongolia, World Bank.

Figure 34 …while purchases of Central Bank bills reached record high



Source: Bank of Mongolia, World Bank

Banking sector reform remains a priority

It is therefore vital that the banking restructuring reforms move forward in order to clean up bank balance sheets and so that domestic financial intermediation role is fully functional. This would set the stage for improved credit availability and better risk assessment and management procedures, and also make the system less vulnerable to possible future shocks. Although the steady increase in recorded NPLs seen in 2009 appears to have reversed, solvency concerns remain important, particularly for a number of medium-sized and small banks. NPLs and loans in arrears stand at 16 percent of total outstanding loans in December, down from a peak of 24.6 percent in November 2009 (Figure 35). Excluding the two failed banks, NPLs and loans with principal in arrears as a percent of total loans outstanding amounted to 16.4 percent as of end-November, down from a peak of 19.7 percent in September 2009. Banks are starting to contribute more retained profits to their stock of capital: MNT 66 billion as of December compared with a contraction of MNT 143.4 billion for 2009 as a whole.[21]

Loans in arrears increased to MNT 90 billion (3 percent of the total loans) from MNT 76 billion in September. Meanwhile, concentration of bank lending remains high with the 50 largest borrowers accounting for almost 30 percent of total loans (roughly MNT 871 billion, Figure 36).

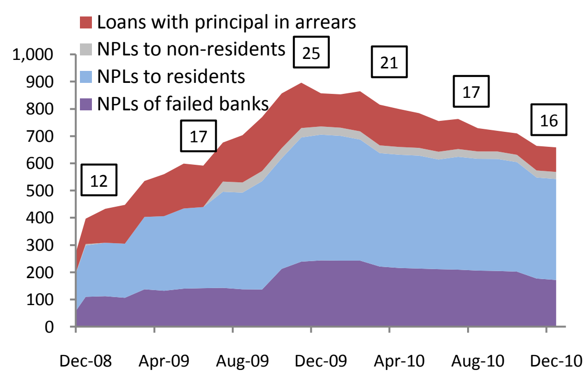
The latest Q3 Loan Report from the Bank of Mongolia Loans in manufacturing, mining and quarrying, and construction sectors arecharacterized by the highest NPL ratios (Figure 37). However, quarterly

[21] Consolidated Loan Report, Q3, 2010, Bank of Mongolia

changes (2010 Q3 compared to 2010 Q2) show further worsening in NPLs and loans in arrears in all of major sectors, particularly in manufacturing, mining and quarrying, and construction sectors while NPLs decreased in wholesale and retail sector reflecting the increased import activities (Figure 38).

Figure 35 NPLs continue to decrease, but slowly…

MNT billion

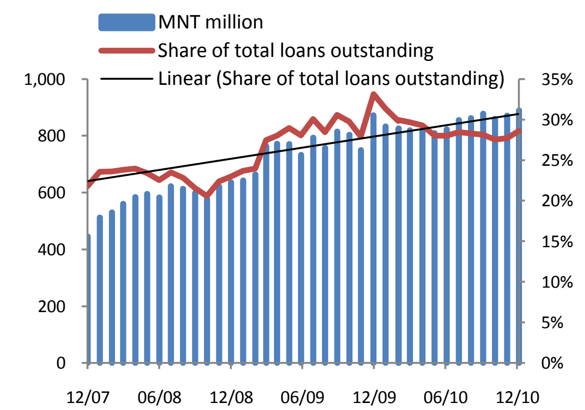


Note: number in boxes is sum of NPLs and loans with principal in arrears as a percent of total loans outstanding

Source: Bank of Mongolia, World Bank

Figure 36 ..yet loans to largest 50 borrowers account for roughly a third of total loans outstanding

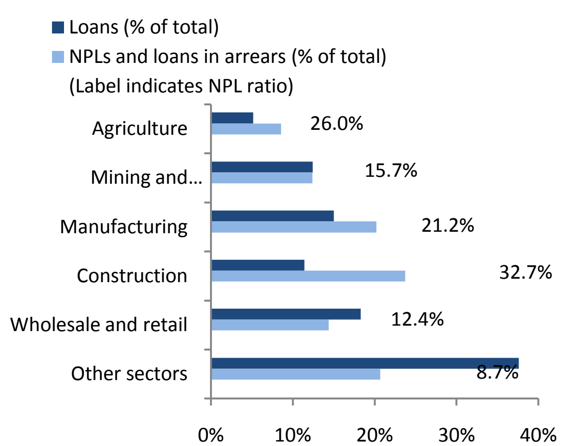
MNT billion



Source: Bank of Mongolia, World Bank.

Figure 37 Highest NPL ratios are still in the construction and agriculture sectors

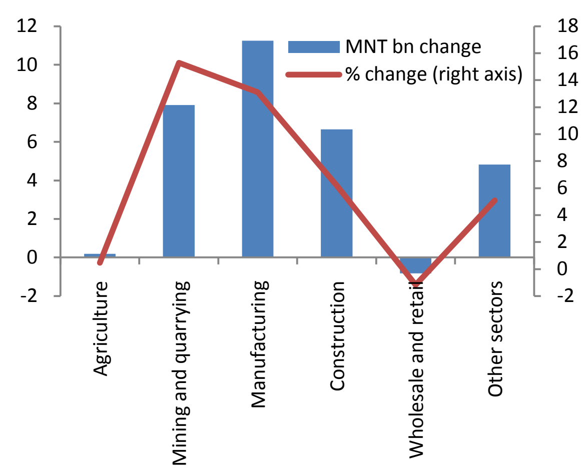
Percent



Source: Q3 2010 Loan Report, Bank of Mongolia, World Bank.

Figure 38 but the levels of all sectoral NPLs worsened on quarterly basis in 2010 Q3 except for wholesales

MNT bn Percent



Source: Q3 2010 Loan Report, Bank of Mongolia, World Bank

Out of the total banking sector liabilities of MNT 5.2 trillion around MNT 3.5 trillion comprises deposits and current accounts for which the government has issued a blanket guarantee. The continued existence of blanket guarantees reduces the incentive for bank owners to inject much needed private capital into the banking system. It also creates an uneven playing field in the sector, with weaker, undercapitalized banks able to compete for deposits with well managed and capitalized banks Given the upcoming mining boom, with demand for credit already increasing substantially, it is essential that all banks are well-capitalized, and able to extend credit and mobilize savings on similar terms. Financial and commercial transactions of larger mining companies are likely to be executed by foreign banks rather than local banks in the future if local banks are not deemed sound enough. Accordingly, bank restructuring – to the benefit of the economy – is imperative.

Labor Markets and Poverty

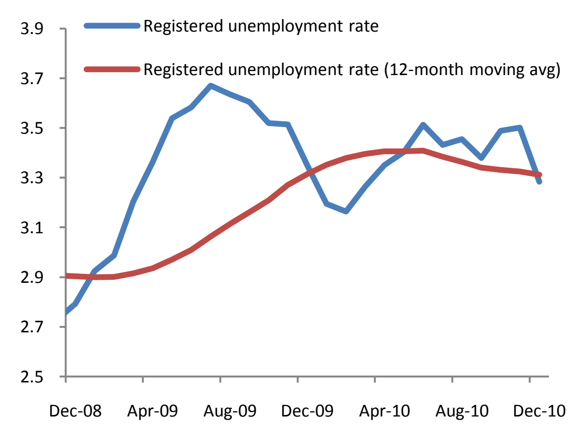
Unemployment, as measured by the labor force survey fell to 8.6 percent

The official unemployment rate, which includes only those who are registered with the Labor and Social Welfare Service Center, decreased to 3.3 percent in December (Figure 39). This is only slightly down on 3.7 percent in July 2009. The overall number of registered unemployed also stayed around 40 thousand persons since the second half of 2010.

Nevertheless, as explained in previous Updates, these numbers likely grossly underestimate the impact of the economic downturn on both the level of unemployment and real wages. According to the Q3 Labor Force Survey[22] of 2010, which also takes into account those who are not officially registered as unemployed with the Labor and Social Welfare Service Centers, the unemployment rate stood at 8.6 percent (10.5 percent in urban and 6.5 percent in rural area), down from 10.5 percent in September 2009, with some 103 thousand people unemployed from the total labor force[23] of 1,193 thousand.

Figure 39 Registered unemployment* has remained about the same in the second half

% of labor force



Note: * 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.
Source: National Statistical Office, World Bank

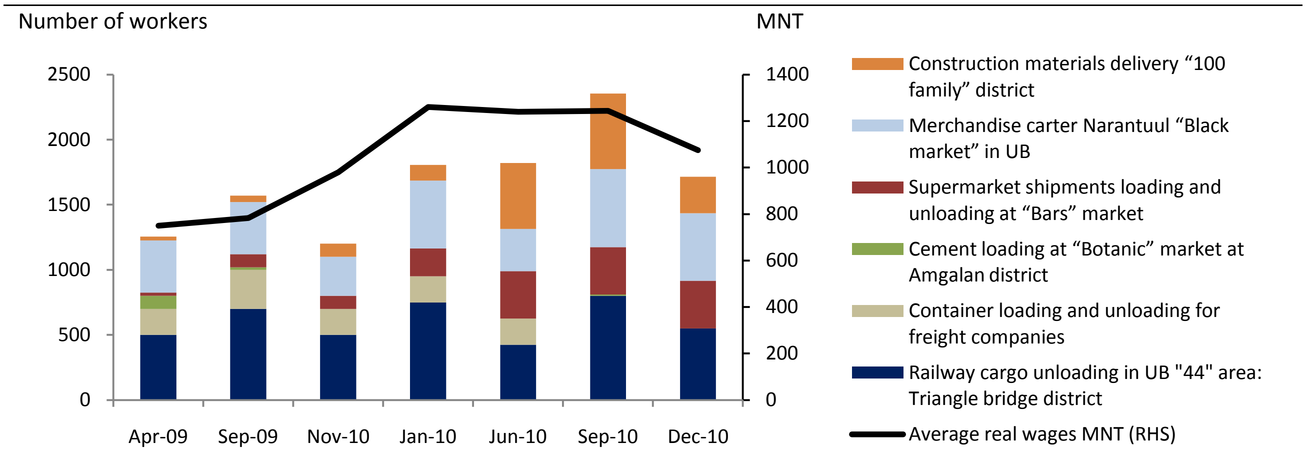
[22] NSO has been conducting "Labor Force Survey (LFS)" on quarterly basis according to the "Methodology on measuring employment and labor force statistics" approved by 01/68/94 joint order of the Chairman of National Statistical Office and Minister of Social Welfare and Labor in 2009.

[23] The active population comprises all persons above 15 years of age whose activity status, as determined in terms of the total number of weeks or days during a long specified period or the preceding 12 months or the preceding calendar year, was either employed or unemployed.

Real wages in informal markets

The latest survey conducted in informal labor markets in December 2010 revealed a reduction in number of casual workers by about 40 percent compared to September due to the seasonal closure of construction labor markets and reduced outdoor sales activities due to cold weather. Workers' real informal market wages on average decreased by about 30 percent from September to December 2010. Reduced job opportunities during the winter months, combined with rising inflation, explain the decline in real wages of the most vulnerable in society. (Figure 40). Consequently, over 52 percent of those surveyed indicated that their earnings do not meet their basic needs while the rest relies on these markets for only food and shelter. The latest survey also indicates a continued influx of unskilled workers from rural regions into these informal markets still reflecting the migration from the countryside due to the dzud (28 percent of survey participants were migrants from rural areas vs. 23 percent in September). Compared to the same period from 2009, the total number of workers and real wages increased on average, especially in railway cargo unloading area, due to increased work opportunities offered by improved trade activities and the economic recovery (Figure 41 and Figure 42).

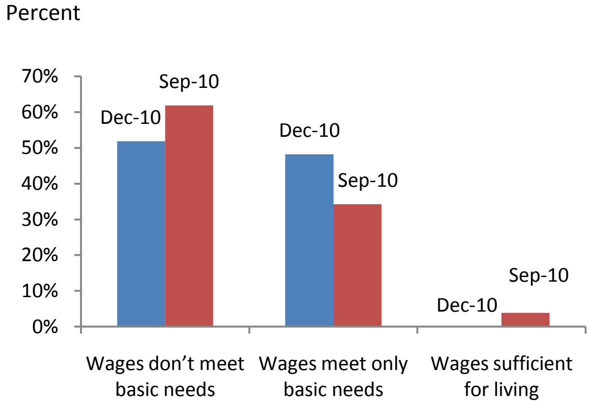
Figure 40 Number of workers decreased in selected informal labor markets in UB



Source: Data from World Bank-commissioned special surveys conducted in April, September, and November 2009, January, June, September and December 2010.

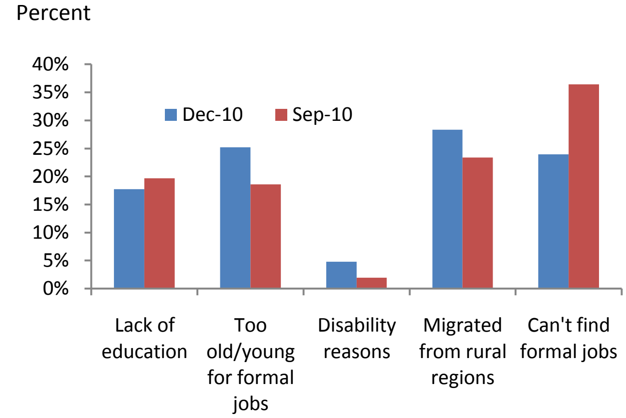
The World Bank commissioned these quarterly surveys to evaluate the changes in real income in Ulaanbaatar's informal labor markets during the recent years of crisis and recovery. These labor markets are an important source of income for migrants, unskilled, unemployed, students and the poor. The surveys have highlighted the substantial impact high inflation has had on real incomes. In mid-2008, when the consumer price index increased by over 32 percent yoy, the survey indicated that real effective incomes had fallen by about 60 percent in some informal urban labor markets. This was due to inflation eroding nominal wages as well as mounting job losses. Employment conditions also worsened for informal workers in rural regions. In particular, herders and informal mining workers were faced with decreasing job availability, falling wages and an increase in living expenses.

Figure 41 Adequacy of wages relative to basic consumption needs



Source: December 2010 informal survey results

Figure 42 Reasons for working in these markets



Source: December 2010 informal survey results

Access to justice in Mongolia

Mongolia's laws are easily accessible online and court processes are generally impartial and transparent but there is still considerable room for improvement vis-à-vis public access to legal and justice sector information, predictability of descionmaking processes and ttansparancy of public investment management. Although courts are neither costly nor time-consuming to use, only higher court judicial decisions are publicly available and court decisions are not consistent. The predictability of court decisions is limited and the courts, enforcement and registration agencies are perceived as increasingly corrupt. In a 2009 survey conducted by the Asia Foundation, respondents indicated the judiciary as the second most corrupt institution in the country[24]. The report also indicated that public confidence in the Independent Anti-Corruption Agency is decreasing and frequent bribe-seeking by judges or clerks was reported. The latest Transparency International (TI) Report for 2010 shows public perception of corruption by government officials, members of parliament and the judiciary continues to be widespread. Mongolia ranked 116th in the recent TI report, which is a slight improvement over 2009 when it ranked 120th.[25]

Supported by the World Bank's Judicial Reform Program, the Ministry of Justice and Home Affairs of Mongolia has adopted a program to increase public awareness and training on legal rights and how to access these. This program will be an important step in building a free, open and transparent society and is discussed in Box 2.

[24] See Asia Foundation, Mongolia Corruption Benchmarking Survey, 2010. Online: http://asiafoundation.org/resources/pdfs/MongoliaCorruptionBenchmarkingsurvey122009.pdf.

[25] See Transparancy International. Corruption Perception Index 2010 Results. Online: http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results .

Box 2 Increasing Access to Justice in Mongolia through Public Education and Special Services for Minority Populations

Public trust in the law and ability of the justice sector to uphold the law is essential to a country's economic development as well as to building a more stable society and improved social equality. This also means that people need to understand the law and how to access the justice sector. Public legal awareness has a pivotal role to play in making this happen especially for underserved and minority populations.

In April 2010, the Ministry of Justice and Home Affairs of Mongolia developed and adopted "The Mid-Term Program on Public Legal Awareness". Supported by the Bank's Judicial Reform Program, the Program aims to create a sustainable legal training and awareness system to effectively disseminate information to increase awareness of legal rights and how to uphold them. The Program builds upon cooperation between governmental, non-governmental organizations, the media; and active public participation to create greater legal awareness and increased access to justice services.

The program is also focusing on the development and implementation of a bilingual (Mongolian and Kazakh) national public information strategy especially aiming at increasing access to information and services to poor and vulnerable rural and urban populations. The Bank is currently supporting the development of laws in Braille which for the first time will allow the blind direct access to legal texts.

A number of special programs have started in Bayan-Ulgii Aimag, the most western region of Mongolia and home to many different ethnic groups. The majority of the Bayan-Ulgii aimag population are Kazakh (88.7 %); other minority ethnic groups such as Uriankhai, Durvud and Tuva comprise 11.3% of the population. Language issues create a major barrier to legal awareness and access to justice for all of these groups. Court hearings, trials and formal criminal interrogations are conducted in Kazakh; laws, other legal documents and information so far are available in Mongolian only. The project finances special legal awareness campaigns in kazakh language in the remote soums. In addition, translation of key laws and treaties into Kazakh are under way, as is the development and publication of a mongol-kazakh legal glossary.

Special legal education programs are being implemented to increase legal awareness and access to justice for Uriankhai, Durvud and Tuva minority groups which live in the remote Nogoon-Nuur, Sagsai, Bugat soums. 50-60 percent of Uriankhai, Durvud and Tuva families belong to very poor households. Most of them are neither fluent in the official Khalkha Mongolian dialect nor in Kazakh. They speak mostly their own local ethnic dialect which is significantly different from Khalkha Mongolian and Kazakh. As a result members of these minority groups have little understanding of the Mongolian legal system and their capability to express themselves before law enforcement bodies and the court is poor.

Support is focused on strengthening the capacity of the Association of Social Development Support for Uriankhai, Durvud and Tuva ethnic groups in Bayan-Ulgii Aimag (ASDS) to enhance legal awareness and access to justice for these minority groups. The Association was established by a group of socially active citizens-representatives of those three ethnic groups. It has already well established relationships with relevant public and government organizations, NGOs in the target area and a capable staff.

The project has supported the ASDS in establishing a legal aid center "Rights of native people" which started its operation in November 2010. The basic legal services offered are:

- Providing the copies of laws and legislative acts;
- Assisting with writing requests to Government agencies and institutions and complaints/claims to the court;
- Assisting with retirement claims and civil registration procedures;

- Legal advice on Contract Law, Social Security Law, Land Law and Family Law;
- Drafting labor agreements and lease agreements.

In addition to providing services at this center, staff also went to Tsengel and Altai soum, to provide legal assistance to Uriankhai,Durvud and Tuva residing in these two remote soums.

Source: World Bank staff.

Table 5 Mongolia: Key Indicators

	2003	2004	2005	2006	2007	2008	2009	2010
Output, Employment and Prices								
Real GDP (% yoy change)	7	10.6	7.3	8.6	10.2	8.9	-1.3	6.1p
Industrial production index	..	..	..	100	110.4	113.4	109.6	120.5
(% yoy change)	..	..	..	..	10.4	2.8	-3.3	10.0
Unemployment (%, eop)	3.4	3.6	3.3	3.2	2.8	2.8	3.3	3.3
CPI Ulaanbaatar (% yoy change, eop)	4.6	10.9	9.6	5.9	14.1	23.2	1.9	14.3
Public Sector								
Government balance (% of GDP)	-3.7	-1.8	2.6	3.3	2.8	-4.8	-5.7	0.0*
Non-mining balance (% of GDP)(1)	-5.9	-5.8	-1.3	-7.3	-13.4	-15.1	-13.3	-10.1*
Public Sector Debt (% of GDP) (2)	88.0	73.7	59.7	44.3	39.4	33.8	56.4	62.7
Foreign Trade, BOP and External								
Trade balance ($ mn)	-199.6	-99.2	-99.5	136.2	-52.4	-613	-195	-378p
Exports of goods ($ mn)	627	872	1066	1542	1889	2534	1885	2899
(% yoy change)	19.7	39	22.2	44.8	22.4	34.0	-26.0	53.8
Copper exports (% yoy change)	..	..	14.7	94.8	27.7	3.0	-39.9	53.6
Imports of goods ($ mn)	826.9	971.3	1021.1	1485.6	2117.3	3244	2137	3277
(% yoy change)	21.6	17.5	16	25.4	42.5	53.2	-34.1	53.3
Current account balance ($ mn)	-102.4	24.1	29.7	221.6	264.8	-722	-411	-805**
(% of GDP)	-7.1	1.3	1.3	7	6.7	-14	-9.8	-14**
Foreign direct investment ($ mn)	131.5	128.9	257.6	289.6	360	836	496	422**
External debt (% of GDP) (3)	87.3	73.7	59.7	44.3	38.9	33.7	47.1	40.0
Foreign exchange reserves, gross ($ mn)	204	208	333	718	1001	658	1328	2091
In month of imports of g&s	2.4	2	2.6	4.3	3.8	3.0	4.3	7.6
Financial Markets								
Domestic credit (% yoy change)	157.3	25.8	18.8	-3.1	78.4	52.5	-7.6	47.1**
Short-term interest rate (% per annum)(4)	..	15.8	3.7	5.1	8.4	9.8	…	…
Exchange rate (MNT/USD, eop)	1168	1209	1221	1165	1170	1267.5	1442.8	1234
Real effective exchange rate 2006=100)(5)	94.2	93.9	99.6	102.8	104.8	124.4	102.4	…
(% yoy change)	-4.8	-0.4	6.1	3.2	1.9	18.7	-17.7	…
Stock market index (2000=100)(6)	151.5	120.8	203.6	382	2048	1182	1229	1872
Memo:								
Nominal GDP (MNT bn*)	1660	2152	2780	3715	4600	6020	6055	8255
Nominal GDP ($ mn*)	1448	1814	2307	3156	3930	5258	4203	6690
GDP per capita ($*)	583	722	900	1214	1491	1921	1552	2470

(1) Non-mining balance excludes revenues from corporate income tax and dividends from mining companies, the Windfall Profits Tax and royalties. (2) From the June 2010 IMF-World Bank Debt Sustainability Analysis (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, end of year, index=100 in Dec-2000. * Estimates after 2009 based on NSO reweighted nominal GDP data. ** IMF data from September 2010 SBA review

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