Questions to the IMF RR

1. The IMF has recently assessed Mongolia's economic policy being "too expansionary." What is the basis for such an assessment?

The rapid growth in budget spending is the main factor. Budget spending is increasing by 67 percent this year and by 2012 will be double the level it was last year. This doubling of government spending in two years is what we mean by "too expansionary." This massive increase in spending will lead to macroeconomic instability, cause higher inflation (which will have an especially hard impact on the poor), and increase the economy's vulnerability to a global shock (at just the time that a risk of such a shock is high).

2. The IMF has also said that a policy rate hike of 0.5 percent is not sufficient to contain overheating and inflation. How much more is needed?

The tightening steps by the central bank are welcome and we would like to see more. As a complement to interest rate hikes, so-called macro-prudential measures should be implemented. These include steps such as increasing capital adequacy ratios, tightening liquidity ratios, and increasing provisioning requirements, just to cite a few examples. Such measures are designed to slowdown credit growth (the "macro" part of macro-prudential) and help safeguard the banking system against an eventual economic downturn (the "prudential" part). It is worth noting that bank lending has increased sharply this year—rising by more than 50 percent—which is adding to overheating pressures. Moreover, with the economy booming, now is the time to take proactive measures to prevent the buildup of future risks.

3. Tightening of monetary policy could eventually have positive implications for the economy as a whole, but lending rates would also go up and this will have the hardest toll on the poor and SMEs. How could this be handled? Do you have any suggestions?

I partly agree.

Regarding inflation, however, I disagree. Inflation has a much harder toll on the poor than the hike in interest rates. So, the monetary tightening aimed at containing inflation will help protect the poor.

Regarding SMEs, however, I agree. The tightening of monetary policy will raise lending rates and squeeze SMEs and other borrowers out of the market. This, in the end, is how monetary policy works to cool the economy. This is an unfortunate but inevitable consequence of excessively expansionary fiscal policy. It is also an example of how loose fiscal policy ends up crowding out the private sector.

A much better policy mix would be to have substantially lower budget spending. This in turn, would make space for more private sector activity, financed by bank lending.

4. Following the IMF and World Bank advice and the BOM's statement that a budget cut in the order of Tog 1 trillion would help contain inflation in single digits, the parliament passed the 2012 budget with a Tog 1.1 trillion cut from the initial proposal. Is this cut sufficient to keep inflation below 10 percent?

No, the cut is not sufficient. It is welcome and will certainly help reduce inflation pressures, but the bottom-line remains that fiscal policy is too expansionary. Government spending in the 2012 budget is double the level of 2010; a staggering increase. Our advice was to stick to the 2012 spending approved in the medium-term budget framework adopted during the last parliamentary session. This called for spending on the order of Tog 4.9 trillion—or Tog 1.4 trillion less than the approved budget.

Our main argument is that the sharp increase in spending is overheating the economy and making it vulnerable to a global shock (at precisely the wrong time). An additional point worth highlighting, however, is that the spending in 2012 will make it difficult to meet fiscal stability law's numerical rules in 2013. Indeed, there would need to be a cut in nominal spending to meet the deficit rule in 2013. In real terms, the cut would likely be on the order of 10-15 percent. Doubling spending from 2010 to 2012, just to have to cut in 2013 does not make economic sense and is tantamount to putting the economy on a roller coaster ride.

5. Although the BOM believes that inflation can be kept below 10 percent in 2012, there is a concern over the political promise of Tog 1.0 million per individual. The Government has proposed the citizenry a choice of TT shares or Tog 1.0 million in cash. If many people opt in for cash, there will be inflationary pressure. What are your views in this regard? What should be done?

We consider spending in 2012 to already be too high, so of course any increase in our view is not warranted as it would just add to inflationary pressure. In addition to the negative impact of higher spending on the economy, it is also extremely risky.

Why? Because the global economy is in a dangerous phase and, for Mongolia, this means that there is a much higher than normal chance of a sharp drop in commodity prices. If this were to happen, the government would not be able to finance its budget deficit and would have no choice but to cut spending sharply (as happened in 2009). This would actually serve to amplify the impact of the global shock on the Mongolian economy. And is a good illustration of what we mean by boom-bust policies.

6. The whole world is excited about Mongolia's rapid growth. In your view, how realistic (broad-based) is this growth? Ordinary people have not reaped much benefits of this growth at all. What should be done to make this growth more broad-based?

Prudent management of mineral wealth is critical for spreading prosperity to all Mongolian citizens and avoiding the "resource curse." At the moment, this is not happening. Instead, fiscal policy is driving up wages, which makes Mongolian firms less competitive; pushing up inflation, which is hurting the poor and making it tougher to do business; and necessitating a tighter monetary policy, which is squeezing the private sector.

7. Regarding the global economic outlook. What are the implications for Mongolia? Particularly, what is the outlook for the commodities market? Copper prices have been falling recently; what are the drivers of this fall? Does Mongolian economy have an ability to react these developments?

The global economy is at a dangerous spot, with significant downside risks to the outlook stemming in large part from the sovereign debt crisis in Europe. A significant slowdown in Europe would of course have a negative impact for global growth and commodity prices.

Mongolia does have the ability to insulate itself, at least partly, against such shocks. Doing so would require a clear break with the boom-bust policies that are now being pursued. For example, if spending were substantially lower—as we have been advocating—then the government would have the room to respond to downturn in global prices by an increase in spending. This would help offset the impact of the shock. Instead, as argued above, the situation now is such that the budget would actually have to be cut if commodity prices fell sharply.

On the positive side, however, the flexible exchange rate regime is working well. This marks a big difference from the last crisis and will provide a welcome shock absorber. Thus we fully support the continuation of the present exchange rate regime. In addition, international reserves are near their all-time high, which will provide another welcome buffer.

8. What is the role of the budget stabilization fund in this case?

A budget stabilization fund would be useful in this case. However, in reality this requires running a budget surplus to accumulate financial assets. Instead, the government is running large deficits this year and next. So rather than building financial buffers, the 2011-12 budgets are making the economy more vulnerable.

9. How could Mongolia improve its management of mineral revenues? What are the most important issues in this regard? Some people say that symptoms of the Dutch disease, such as universal welfare benefits, inflationary pressure, and economic overheating have already arrived to Mongolia.

Regrettably, the present path of fiscal policy is leading straight to the Dutch disease and Resource Curse. Inflation is too high and rising, especially if you look at underlying inflation (excluding food and administered prices). Underlying inflation momentum has been running at double-digit pace for most of the year and has accelerated in the last few months. Wages, moreover, rose some 35 percent last year and are set to go up another 50 percent next year. This will make Mongolia less competitive and will drive up the cost of doing business.

Regarding universal transfers, introduction of a targeted poverty benefit would provide a more effective means to fight poverty and, at the same time, would actually save money. We welcome, therefore, its inclusion in the 2012 budget and encourage the government to move forward with the necessary supporting legislation.

10. Would you please give an example of resource-rich countries most comparable and relevant to Mongolia? What were their mistakes and achievements?

On the positive side, there are countries such as Norway and Chile. Chile, while more developed than Mongolia, provides a good example and indeed the landmark fiscal stability law passed last year in Mongolia shares many features with the Chilean system. The key is now to stick strictly to the letter and spirit of the law. As a related aside, this is one reason we are concerned about the Development Bank of Mongolia. There is a risk that it could be operated in a way that, in effect, it would serve as a vehicle for circumventing the numerical limits in the Fiscal Stability Law.

11. In your view, which sectors other than mining and opportunities can be development drivers for Mongolia?

As a macro-economist, I would emphasize the importance of creating an environment conducive to private sector growth. This means healthy and stable growth with moderate to low inflation. How to do this? The key is a prudent fiscal policy that is counter-cyclical, and thus helps smooth out fluctuations in growth due to global swings in commodity prices; a monetary policy that is geared toward containing inflation; and a flexible exchange rate regime to help absorb shocks and facilitate the adjustment of the economy over the long run.

Thank you.

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