Mongolian Economy: Key Short-term Challenges and Risks

Overheating. The economy is overheating or, put more simply, is growing too fast. It may sound funny to say an economy is growing too fast, but more is not always better when it comes to growth. Growing too fast in the short run leads to significant problems, such as high inflation, exchange rate volatility, wage pressures, Dutch disease, and the list goes on. These could also heighten fears about "hard-landing" especially if external shocks hit the economy. This macroeconomic instability, in turn, has substantial long run costs that include making it more expensive to do business in Mongolia, discouraging investment, and making Mongolian firms less competitive globally. The inflation, moreover, has a particularly hard impact on the poor. So in sum, the overheating today leads to higher poverty and lower growth in the future. This is a bad tradeoff.

Global risks. The global economy is at a particularly dangerous point, and there is a real risk of a substantial slowdown in world growth similar to what happened in 2008. While the biggest concern is the European Sovereign Debt Crisis, no part of the world would be immune from the fallout. For Mongolia, the biggest implication would be from a significant drop in copper and coal prices, just like 2008, which would hit the economy extremely hard. In fact, Mongolian policymakers are repeating the very same mistakes that led to the 2008-9 economic crisis at the worst possible time. The return of boom-bust policies at this dangerous juncture in the global economy makes the Mongolian economy vulnerable to another crisis. The upcoming elections in Mongolia are another source of uncertainty and could lead to a political accident that triggers an abrupt loss of confidence. Fortunately, the economy is not at that point yet but urgent policy action is needed to put the economy on safer footing.

Fiscal policy. The main cause of the overheating and economic volatility is fiscal policy. Specifically, the large and risky increases in government spending. Government spending increased 60 percent last year and is set to rise a further 30 percent this year. This is staggering growth and implies a doubling of government spending in just 2 years. This is simply too much demand and leads directly to higher inflation, a substantial increase in imports, exchange rate volatility, and a squeezing-out of the private sector. So first and foremost, what the Mongolian economy needs is for an immediate scaling back of government spending to a much more prudent rate of growth.

Exchange rate. The flexible exchange rate regime is working and must be maintained. Indeed, the flexible exchange rate is the single most important policy difference between today and the last crisis. Going back to targeting or controlling the exchange rate, as was the case in 2008, would be a big mistake and make conditions even riper for a repeat of the last crisis. Exchange rate volatility is unpleasant, so the public and political concern in this area is understandable. The central bank can continue to intervene to smooth excessive volatility. What it should not do, however, is target a specific level of the exchange rate. It simply does not work, and the main effect is a loss of international reserves. While reserves buffers are much higher than in 2008 and even higher if we factor in the welcome swap line with the People's Bank of China), they are not enough to defend an exchange rate target. While such a policy may seem to work for a short-period, as reserves are run-down the speculative attack would accelerate and the end-result is a large, abrupt, and painful jump in the exchange rate as was seen firsthand in the 2008-9 period. That mistake should not be repeated.

Inflation. Inflation has been stubbornly high in Mongolia, which is not surprising given the phenomenal growth in government spending. Headline inflation is often volatile in Mongolia, due mainly to food price shocks. It is helpful, therefore, to look at a measure of underlying inflation that removes the impact of changes in food and administered prices. This measure has been much more steady and has hovered around 15 percent most of last year and was running at over 16 percent in December. This is also too high and, moreover, is above the policy interest rate. So while the nominal level of the interest rate may seem high—12 ¼ percent—it is actually extraordinarily low in an economic sense. Specifically, adjusted for inflation, the policy interest rate has been negative for much of last year and is still negative today—on the order of -4 percent. A further hike in the policy rate, therefore, is warranted and would help contain inflation. It does so through two complementary channels. First, it slows credit growth by making it more expensive for firms to borrow, thereby reducing demand as a partial offset to the demand impact of surging government spending. Second, it will also help ease the depreciation pressure on the togrog by making it more attractive to hold togrog deposits. And, clearly depreciation of the currency is contributing to inflation by raising the price of imports. Although raising interest rates to contain inflation works, in part, by strengthening the currency, this is fundamentally different and should not be confused with targeting the exchange rate. The exchange rate would remain flexible and evolve in line with market conditions, it is just that the interest rate hike itself alters the market conditions..

Policy mix. The loose fiscal and tight monetary policy is not a good mix. In effect, it results in a bigger government and a smaller private sector. So yes, monetary policy works by squeezing the private sector to offset the excessive expansion in the government sector. A much better mix, therefore, is to significantly reduce government spending and create more space for the private sector. Fiscal policy therefore must take the lead and start by lowering spending in 2012 budget. At the end of the day, Mongolia will need a much more prudent fiscal policy to succeed in converting its coal and copper resources into an inclusive growth path that spreads prosperity to all Mongolians.