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IMF Executive Board Concludes 2012 Article IV Consultation and Third Post-Program Monitoring with Mongolia

On November 16, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the 2012 Article IV Consultation[1] and Post-Program Monitoring[2] with Mongolia.

Background

Mongolia has made impressive progress in developing its economy. Spearheaded by the FDI-financed development of the mining sector, growth averaged 8 percent per annum over the past 10 years, among the highest in the region. As a result, per capita GDP increased five-fold, to about US$3,000, and Mongolia has gained access to international capital markets. The authorities are addressing the key challenge of medium-term natural resource management and Dutch Disease by putting in place a fiscal framework anchored

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

[2] Post-Program Monitoring provides for more frequent consultations between the Fund and members whose arrangement has expired but that continue to have Fund credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 200 percent of quota would engage in Post-Program Monitoring.

by the 2010 Fiscal Stability Law (FSL), the 2011 Integrated Budget Law (IBL), and the 2012 Social Welfare Law (SWL).

Growth is decelerating from the very rapid pace in 2011. The expansion of the economy slowed to 10 percent during the first nine months of 2012 (year-on-year), down from 17 percent in 2011. Growth has been buoyed by expanding coal and copper production, the ongoing development of new large mining projects, a relatively mild winter boosting agriculture, and highly expansionary fiscal policy.

Meanwhile, inflation remains high and the balance of payments is under pressure. Inflation is around 15 percent, primarily due to rapidly rising government spending. Strong domestic demand is driving up imports, and the resulting balance of payment pressures are compounded by slowing foreign direct investment (FDI) inflows and slowing export growth. In recent months, coal exports to China slumped amid China's overall decelerating imports.

Monetary policy has been tightened. Over the past year, in response to inflation rising substantially above the official target of less than 10 percent, the central bank increased its policy rate and reserve requirements. These tightening measures contributed to a marked slowdown in credit growth, from 72 percent in 2011 to 36 percent in September 2012 (year-on-year).

But fiscal policy has remained excessively expansionary. The overall fiscal balance worsened by 5⅓ percentage points of GDP in 2011, to a deficit of 4¾ percent of GDP. Revenue surged, thanks to the value added tax and customs duties collected on imports of capital goods for mining sector development. But this was more than offset by a 62 percent increase in government spending. Government spending continued to soar during the first half of 2012.

Over the past year, the togrog/U.S. dollar exchange rate has depreciated by 7 percent. At the same time, Mongolia's Net International Reserves (NIR) declined by a third (US$0.7 billion) to a two-year low of US$1.5 billion. The effect of the balance of payment pressures on gross international reserves (GIR) has been offset by BOM drawings on the swap line with the central bank of China (US$0.2 billion) and by BOM deposit taking from the DBM (US$0.4 billion) and commercial banks (US$0.2 billion). Thus, GIR remains near an all-time high of US$2.6 billion (6.3 months of prospective non-mining imports).

The near-term outlook for growth is favorable, but inflation is projected to remain in double digits. The external position is projected to remain under pressure. Coal export capacity will expand further, and copper exports are projected to rise. However, imports will also rise, owing to the DBM's public investment projects.

Mongolia's medium-term prospects are promising. Coal and copper production will be ramped up and activity outside the mining sector is also projected to remain buoyant, although this would need to be supported by continued reforms to strengthen the business climate.

However, a number of challenges need to be addressed as the new government embarks on implementing its Action Plan for 2012–16. Importantly, policies need to be set against the continued uncertainties in the global economic outlook. Potential spillovers to Mongolia are significant, possibly affecting export volumes, commodity prices, and FDI inflows.

Executive Board Assessment

The Executive Directors commended the authorities for an impressive record of economic growth over the last few years, but noted that there is scope to make growth more inclusive. Directors considered that the key policy challenge going forward will be to meet large investment needs without undermining macroeconomic stability. They agreed that this task would be facilitated by the recently revamped legal underpinnings of the fiscal framework.

While taking note of Mongolia's favorable outlook for the medium term, Directors noted that inflation remains high, and that booming domestic demand is putting pressure on the balance of payments. Against this background, they emphasized that fiscal policy needs to be tightened, and that the 2013 budget will be key to safeguarding domestic and external stability. Accordingly, Directors encouraged the authorities to fully observe the Fiscal Stability Law in the 2013 budget design and implementation, including the 2 percent of GDP structural deficit ceiling. In light of a likely revenue shortfall and the uncertain external environment, Directors recommended cautious revenue projections and lower budget spending, mainly by deferring lower-priority capital projects.

Directors emphasized the need for a clear policy to ensure that the Development Bank of Mongolia (DBM) can help meet the long-term infrastructure needs of Mongolia in a macro-economically sustainable manner with minimal fiscal risks. In particular, public investment projects financed by the DBM should be taken into account when setting the path of fiscal policy, consistent with the new fiscal framework. Directors welcomed efforts to explore the establishment of a sovereign wealth fund, which could be an important complement to the fiscal framework.

Directors considered the tightening of monetary policy over the past year to be appropriate. With inflation still in excess of the authorities' target, they saw no scope to loosen the monetary stance unless fiscal policy is tightened and inflationary pressures abate. Directors welcomed the authorities' commitment to allowing the exchange rate to move in line with market conditions. They noted, however, that expansionary fiscal policy has put net international reserves on a downward trajectory that is not sustainable.

Directors commended the authorities' efforts to strengthen and deepen the financial sector, including the phased increase in capital adequacy ratios of systemically important banks. They encouraged further steps to develop a government bond market, reduce banking sector risks including those arising from unhedged foreign currency lending, deepen the foreign exchange market, strengthen the monetary transmission channel, and address deficiencies in the regime to combat money laundering and the financing of terrorism. To promote a more diversified economy, Directors stressed the importance of continued reforms to strengthen the business climate and clarify the foreign investment regime.

Mongolia: Selected Economic and Financial Indicators, 2009–13

				Proj.	
	2009	2010	2011	2012	2013
Real sector (percent change)					
Real GDP growth	-1.3	6.4	17.5	11.2	16.8
Mineral	0.2	7.4	11.2	6.8	50.6
Non-mineral	-1.8	6.0	19.9	12.8	5.4
Consumer prices (period average)	6.3	10.2	7.7	14.1	10.9
Consumer prices (end-period)	1.9	14.3	9.4	12.9	10.2
GDP deflator	1.8	20.0	12.1	10.0	8.9
General government budget (in percent of GDP)					
Revenue and grants	30.3	37.1	40.3	37.1	35.2
Expenditure and net lending	35.5	36.6	45.1	42.3	37.6
Current balance	2.8	9.8	11.0	5.1	9.3
Primary balance	-4.7	1.0	-4.4	-4.1	-0.5
Overall balance (including grants)	-5.2	0.5	-4.8	-5.2	-2.4
Non-mineral overall balance	-10.2	-7.0	-14.3	-12.2	-9.7
Structural balance 1/	…	…	-6.9	-6.0	-3.1
Money and credit (percent change)					
Broad money	26.9	61.6	37.1	28.8	27.2
Broad money velocity (GDP/BM)	2.3	1.8	1.7	1.7	1.7
Interest rate on 7-day central bank bills, end-period (percent)	10.0	11.0	12.3	…	…
Balance of payments (in millions of US$)					
Current account balance (including official transfers)	-410	-931	-2,774	-3,605	-2,839
(In percent of GDP)	-9.0	-14.9	-31.8	-36.3	-24.1
(In percent of GDP, excluding mining related imports)	-5.8	-5.7	-11.3	-16.7	-6.7
Trade balance	-194	-278	-1,008	-1,840	-983
Exports	1,876	2,899	4,780	4,420	5,811
Imports	-2,070	-3,177	-5,788	-6,260	-6,794
Foreign direct investment	496	1574	4,620	2,789	1,907
Gross official international reserves (end-period)	1,328	2,288	2,447	2,319	2,273
(In months of next year's imports of goods and services)	4.0	3.6	3.6	3.2	3.2
Trade prices					
Export prices (US$, percent change)	-8.2	3.7	8.3	-0.5	-0.5
Import prices (US$, percent change)	-14.1	8.8	13.1	-0.7	-1.5
Terms of trade (percent change)	6.9	-4.7	-4.3	0.2	1.0
Public and publicly guaranteed debt (in percent of GDP)					
Total public debt	46.6	45.3	51.7	56.7	54.2
Domestic debt 2/	3.4	16.3	25.6	27.4	23.9
External debt	43.2	28.9	26.1	29.4	30.2
(In millions of US$)	1,974	1,938	2,074	2,775	3,492
Exchange rate					
Togrogs per US$ (end-period)	1,443	1,257	...	...	...
Togrogs per US$ (period average)	1,441	1,348	...	...	...
Nominal effective exchange rate (end-period; percent change)	-15.8	3.4	...	...	...
Real effective exchange rate (end-period; percent change)	-11.2	11.2	...	...	...
Nominal GDP (in billions of togrogs)	6,591	8,415	11,088	13,566	17,257

Sources: Mongolian authorities; and IMF staff projections.

1/ As defined in the Fiscal Stability Law, which uses smoothed instead of actual commodity prices to calculate revenue.
2/ Domestic debt in 2009-2011 includes the Oyu Tolgoi tax prepayment.