



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 Munkhnasan (Nasaa) Narmandakh and Sriram Lakshman led by Rogier van den Brink from the World Bank's Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Region Vice-Presidency. This Update also received contributions from Masami Kojima. Copies can be downloaded from <http://www.worldbank.org.mn>. For further information, comments and questions, please contact Sunjidmaa Jamba (sjamba@worldbank.org).

Contents

Executive Summary.....	5
Real sector developments	7
Labor Markets and Poverty.....	8
Inflation.....	10
Fiscal developments.....	14
External sector	17
Banking sector.....	19
Economic outlook	22

Figures

Figure 1 The economy expanded by double digit growth in Q2 2011.....	7
Figure 2 Manufacturing and mining sector growth slowed down.....	7
Figure 3 Registered unemployment*	8
Figure 4 Poverty declined substantially	9
Figure 5 Livestock numbers increased, in particular among the poorest households	9
Figure 6 Inflation picked up again in Q2 and through July	11
Figure 7 Food prices were on the rise after the effects of meat reserves wore off	11
Figure 8 Inflation rose to 6.4% in China largely on higher food prices.....	11
Figure 9 China and Mongolia food prices	11
Figure 10 Pump prices of gasoline and diesel prices in June 2011	12
Figure 11 Representative refining margins in Singapore.....	13
Figure 12 Fiscal balances continued to improve strongly.....	14
Figure 13 Revenues have risen strongly reflecting broad based economic recovery	15
Figure 14 Current transfers and wages and salaries constituted bulk of the expenditure	15
Figure 15 The trade deficit widened further.....	18
Figure 16 driven mostly by machinery and equipment imports.....	18
Figure 17 Coal and copper exports rose strongly while gold and greasy cashmere exports fell.....	18
Figure 18 Commodity prices continued their rebound.....	18
Figure 19 The exchange rate appreciated in July.....	19
Figure 20 BoM international reserves are at record levels	19
Figure 21 Issuance of central bank bills continues to increase.....	19

Figure 22 The current account deficit has widened	20
Figure 23 and investments increased substantially.....	20
Figure 24 Both local and foreign currency deposits continued to reach new highs in June	21
Figure 25 Real economy-wide interest rates fell as inflation picked up.....	21
Figure 26 Credit continued to surge	21
Figure 27 Loans to 50 largest borrowers continued to increase	21
Figure 28 NPLs still remain high as NPL volume increased in July by 9 percent since January	22
Figure 29 Proportion of NPLs increased in mining and construction but declined in agriculture.....	22

Tables

Table 1 Mongolia's Neighbors : Fuel policies.....	12
Table 2 Drivers of change among major export commodities: July 2010 – July 2011.....	18
Table 3 Mongolia: Key Indicators.....	24

Boxes

Box 1 Progress in Poverty Reduction in Mongolia	9
Box 2 Does a domestic oil refinery help ease fuel shortages?	12
Box 3 Cash Distribution: Alaska	15

Annexes

Annex 1: The Dutch Disease: Some Lessons for Mongolia.....	25
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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
US\$	United States Dollar
WPT	Windfall Profit Tax
Yoy	Year-on-year
Ytd	Year-to-date

Executive Summary¹

The Mongolian economy is experiencing rapid growth in 2011: the second quarter saw the economy growing at a whopping 17.3 percent year on year, compared to 9.9 percent in the first quarter. Transportation and construction grew at 39.9 percent and 38.4 percent, respectively, while retail and wholesale trade grew at 24.7 percent, with Mongolians spending more on consumption as a result of higher incomes. The mining and manufacturing sectors recorded respectable growth rates of 8.3 and 12.9 percent yoy in the second quarter, respectively.

Reflecting the higher growth, unemployment declined from 13 percent in December 2010 to 8.7 percent in June. Informal labor markets for unskilled workers are also booming, with real wages nearly doubling between December 2010 and June 2011. Since poverty was reduced considerably during the previous period of high economic growth rates (2002-8), we think that current trends in the economy bode similarly well for poverty reduction. However, recall that sharply rising inflation towards the end of the previous boom undermined some of the gains made, particularly for the poor. Hence, keeping a lid on inflation by reigning in excessive government spending and avoiding loose monetary policy will be the key to successfully reducing poverty during the current economic boom.

Unfortunately, Mongolia is again experiencing high levels of inflation. UB inflation was up 11.4 percent yoy in July, up from 5.5 percent in the previous month. Core inflation, excluding volatile energy and food prices, increased even faster, by 13.7 percent yoy. And as the livestock herd continues to recover from the dzud and China's food prices, especially meat, continue to rise (34 percent yoy in July), food prices are likely to remain high.

This inflation is being stoked by increased government spending (up 27 percent, with most of it on wages and transfers), as well as high spending by the private sector—producers and consumers alike—as reflected in the large import bill relative to last year: imports are up by 106 percent.

A booming mining industry, especially the Oyu Tolgoi copper mine, spurred these imports, especially of transport equipment and machinery. This pushed Mongolia's trade deficit to US\$ 1349 million in July 2011. On the export side, coal has surpassed copper as the largest export, comprising 38 percent of all exports, having grown 129 percent yoy in July. China is the sole destination for Mongolia's coal exports and it is the largest thermal coal consumer in the world. Mongolia's exports of coal are expected to grow with new coal mines coming on board. Crude oil exports were up 42 percent yoy in June owing to higher oil prices, while copper volumes are declining, as are Chinese metal imports from Mongolia. Gold, greasy cashmere, and combed goat down were other poor performers in the export sector.

Credit in the banking sector is growing very fast. The stock of outstanding loans grew by 46 percent yoy in real terms in July 2011. It is therefore imperative that the BoM enforces prudential norms on all Mongolian banks, and ensures that they maintain adequate buffer capital to absorb potential losses. The stock of the Non-Performing Loans currently stands at MNT 382 billion including those of the two failed banks. Together with loans in arrears, the ratio to total outstanding loans is about 10 percent in July and decreasing. However, because the volume of outstanding loans is rising fast, this should not be a reason for complacency.

¹ The analysis is based on the most recent data (July 2011) from the Bank of Mongolia (monthly bulletin, loan report and monthly consolidated banking system balance sheet), the National Statistical Office, and the Ministry of Finance.

The volume of MNT deposits reached a record MNT 2.6 trillion in July, a 73 percent yoy increase. However, since real interest rates on local currency deposits are currently again in negative territory because of rising inflation, the attractiveness of local currency deposits must stem from the public's expectation of an appreciating currency. Compared to July 2010, the average monthly exchange rate against the US\$ appreciated by about 9 percent, or about one percent compared to the previous month. Nominal interest rates on US\$ deposits are high by international standards: for certain time deposits they are as high as 14 percent. Such high rates are a cause for concern, as they may reflect liquidity problems rather than an unusually high profitability of project lending.

On a 12 month rolling basis, the fiscal surplus reached 2.7 percent of GDP yoy in July. Annual revenues and grants grew by 46 percent in real terms in July yoy, in addition to increases in royalties, VAT, customs duties and corporate income tax. On the expenditure side, there was a very large increase (27 percent yoy) in expenditures in July, with capital expenditures up by 57 percent and current transfers up 48 percent, owing to cash handouts to citizens through the Human Development Fund (HDF).

Such large increases in public expenditures risk throwing Mongolia back to a pro-cyclical fiscal stance. To counteract this tendency, the Fiscal Stability Law (FSL), passed in 2010, locked in counter-cyclical policies. However, because the core of the FSL—the structural balance of minus 2 percent of GDP—only starts in 2013, risks exist concerning its implementation, especially with elections around the corner in 2012. The FSL was supported by a large majority in parliament and will assist Mongolia in avoiding the typical pitfalls of growth for resource rich countries, especially the Dutch Disease. In the Netherlands, the Dutch Disease was eventually “cured” through a similarly broad-based political agreement centered on fiscal and wage restraint. If the Dutch example holds a lesson, it would be for Mongolia's parliament to hold the course to implementing the letter and the spirit of the law, and to pass a supportive new budget law in the fall session.

Mongolia's economic outlook depends heavily on global macroeconomic factors: the current uncertainty and poor growth prospects for the global economy are cause for concern. If there is another global recession, Mongolia's small, open economy will be affected. In that case, China's policy reaction will be crucial for Mongolia. If China reacts as fast and as strongly as it did in 2008/9 then the effects of a global recession on Mongolia will be mitigated, largely owing to Chinese demand for minerals from Mongolia. Beyond this, it is up to Mongolia to capitalize on its excellent long term prospects by continuing the reform agenda it embarked on during the 2008/9 crisis.

Real sector developments

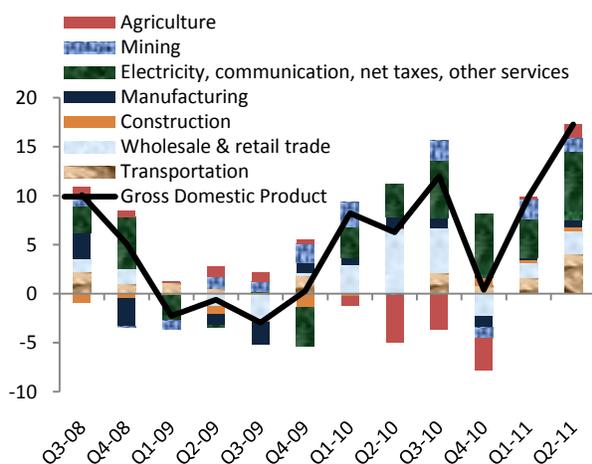
The economy grew by 17 percent in the second quarter of 2011

The latest quarterly GDP numbers show a sharp expansion of the economy in the first two quarters of 2011. Driven by transportation (39.9 percent yoy), construction (38.4 percent), and wholesale and retail trade (24.7 percent), the Q2 2011 quarterly GDP growth numbers reached 17.3 percent yoy. These high growth numbers reflect the massive mining infrastructure developments in the country and increased consumption due to rising incomes (Figure 1). The rate of growth of industrial production (calculated on a 12-month moving average basis to control for seasonality) moderated to 6 percent after growing in the double digits since July 2010 (Figure 2). Mining sector growth also slowed down from 12 percent in June to 3.3 percent in July.

The National Statistics of Mongolia revised the outturn for 2010 GDP growth to 6.4 percent year-on-year (2005 constant prices) from its earlier estimation of 6.1 percent yoy. The newly released data confirm the earlier picture: the year ended with a broad based recovery, led by wholesale and retail trade (39 percent yoy growth), construction (17 percent), and transportation (7 percent) sectors. However, the agriculture sector contracted by 17 percent yoy in 2010 due to the severe impact from dzud.²

Figure 1 The economy expanded by double digit growth in Q2 2011...

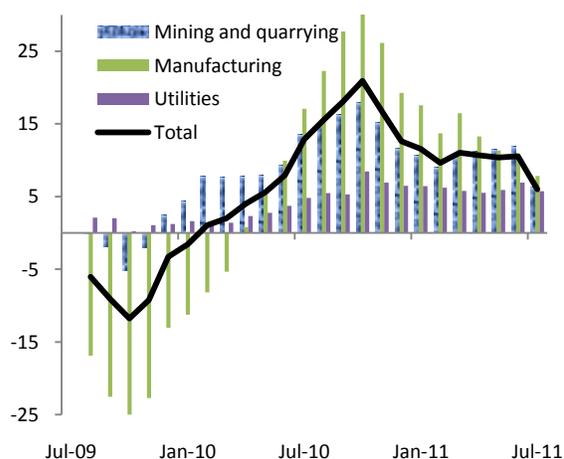
Percentage point contribution to yoy growth



Source: NSO, World Bank staff estimates.

Figure 2 Manufacturing and mining sector growth slowed down

yoy real change, 12-month moving average



Source: NSO, World Bank staff estimates.

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

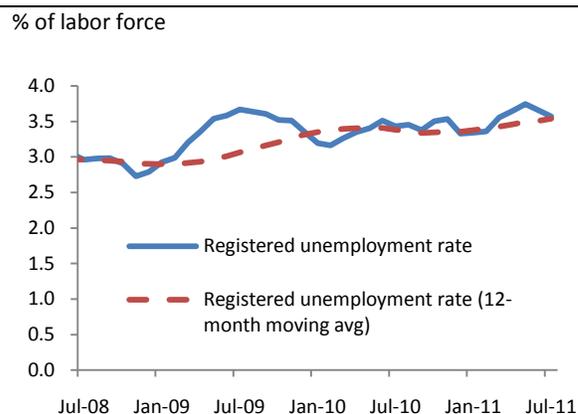
Labor Markets and Poverty

Unemployment fell to 8.7 percent

The Labor Force Survey³ of 2011, estimates the unemployment rate at 8.7 percent in the first quarter of 2011 down from 13 percent in December 2010, with some 97 thousand people unemployed from the total labor force⁴ of 1,121 thousand.

The formal unemployment rate, which only takes into account those who are officially registered as unemployed with the Labor and Social Welfare Service Centers, increased to 3.6 percent in July (Figure 3). This is slightly up from 3.3 percent in the beginning of the year adding some 3,400 newly registered unemployed.

Figure 3 Registered unemployment*



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

Real wages in UB informal markets

The latest survey conducted in informal labor markets in July 2011 confirms the rapid economic growth story. The survey found an almost 40 percent increase in the total number of casual workers since March, concentrated in the construction sector and cargo loading areas. Informal, casual laborers are mostly occupied by carrying carts, unloading and loading cargo and transporting small shipments for daily income. Compared to March, workers' real informal market wages almost doubled in Q2 2011. In addition, real wages were not unduly affected by inflation. However, substantial shares (about 21 percent) of those surveyed continue to indicate that their earnings do not meet their basic needs, although this number is down almost 20 percent from March 2011. The latest survey also indicates that 34 percent of those surveyed became casual laborers because they are either too young or too old for official work opportunities. The influx of unskilled workers recently moved from rural regions into these informal markets constituted 22 percent of survey participants. This suggests that rural employment opportunities are still in a dismal state due to the impact from dzud.

³ The NSO has been conducting the "Labor Force Survey (LFS)" on a 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.

⁴ 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'.

Box 1 Progress in Poverty Reduction in Mongolia

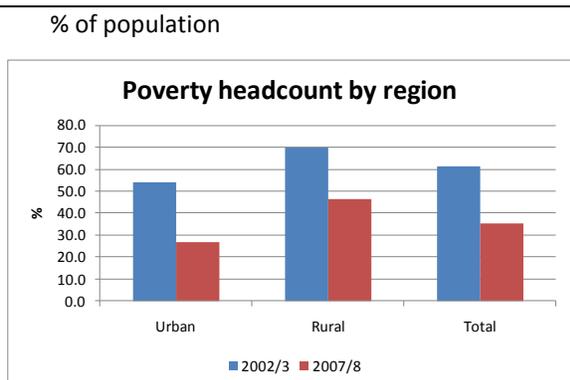
(The full policy note can be downloaded at <http://www.worldbank.org.mn>)

Mongolia’s economy experienced significant growth in GDP per capita from 2002 to 2008. However, because the official poverty numbers for these two years use different poverty lines, the percentage of the population living in poverty seems hardly to have changed. In what follows, we present the results of an analysis that uses the same poverty line for the two years. It shows that poverty declined substantially from 2002/3 to 2007/8.

Using the official poverty estimate for 2007/8 as the benchmark and working our way back to 2002/3, we find that poverty fell from 61.1 percent in 2002/3 to 35.2 percent in 2007/8. Rural poverty declined from 69.7 to 46.6 percent, and urban poverty fell from 54.1 to 26.9 percent.

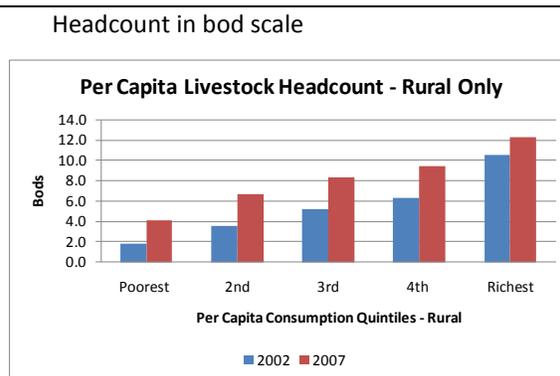
Using the official poverty estimate for 2002/3 as the benchmark and working our way forward to 2007/8, we find that poverty fell from 36.1 percent to 14.8 percent. Whatever the starting point, poverty declined substantially during this period. This finding is consistent with high economic growth, considerable increase in national herd size and real increases in several commodity prices observed over the period. It reflects an increase in real consumption for households across all quintiles (Figures 4 and 5).

Figure 4 Poverty declined substantially



Notes and Source: See policy note

Figure 5 Livestock numbers increased, in particular among the poorest households



Notes and Source: See policy note

An increase in livestock numbers is probably one of the driving factors behind reduced poverty in rural areas. However, the country also made progress with other social indicators, including access to savings, educational attainment, incidence of illness, and access to solar energy and telecommunications. The approach we used only adjusts the poverty line for changes in the cost of living, thus maintaining the same benchmark in real terms over time in addition to holding the standard of living represented by the poverty line fixed between the two data points. Over longer periods of time, when an economy has changed so much that people consume significantly different baskets of goods and services, the poverty line would need to be reset. However, this is at the expense of being able to compare poverty estimates over time. The official estimates for Mongolia reset the poverty line in order to strengthen the 2007/8 poverty line relative to the one generated for 2002/3 and found little change in poverty. Using a fixed poverty line, we find that Mongolia experienced a large reduction in poverty.

Source: World Bank staff.

Inflation

Consumer price inflation increased to double digits

Consumer prices increased in the second quarter, followed by July data showing an increase in the headline national inflation to 11.4 percent yoy, up from 5.5 percent yoy increase in the previous month (Figure 6). Core inflation, excluding energy and food prices, increased by 13.7 percent yoy. Earlier, in April, concerned by the momentum of the month-to-month core inflation, the Bank of Mongolia had raised its policy rate to 11.5 percent in an attempt to avoid real interest rates falling into negative territory, as happened in the run-up to the previous bust.

Overall food prices picked up again by an increase of 9.3 percent after government intervention in the meat market subsided. For instance, meat prices decreased by almost 50 percent yoy in January as the government utilized its meat reserves of about 16,000 tons. However, prices started to pick up again in recent months. In July, meat prices increased by about 3 percent from June, and by 4 percent on a year-to-year basis. Mutton, the main household consumption meat, was up 5 percent yoy. Cereal prices were largely unchanged between the first and the second quarter of this year. However, cereal prices are considerably higher than a year ago: grade 1 flour is almost 40 percent higher (Figure 7).

While the additional supply of reserve meat helped to contain food inflation earlier in the year, prices are likely to rise towards the second half of the year given the continued rise in food prices globally, in particular in China and Russia from where Mongolia imports the bulk of its food. Global food prices remain high, partly due to increasing fuel prices, touching 2008 levels, and partly due to shrinking food supplies. In China, food prices continued to increase in July by 15 percent yoy, especially meat and poultry prices, which grew by 34⁵ percent yoy (Figure 8). Typically, Mongolia's food inflation lags China's food inflation by about 3 months (Figure 9). Meat prices in Mongolia are likely to remain high for the foreseeable future, as domestic livestock herds will take time, possibly years, to recover from dzud, and meat demand from China remains strong. Rising food prices hit the urban poor hard (roughly 22 percent⁶ of the UB population), because they spend most of their income on food.⁷

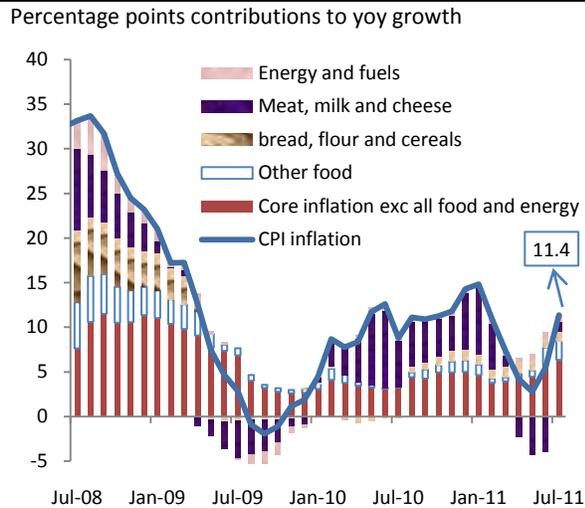
Mongolia experienced a severe fuel crisis in recent months. Mongolia imports about 90 percent of its petroleum from Russia. These imports stopped when Russia suddenly curtailed its fuel exports. Subsequently, Mongolian gas stations imposed a limit of 30 liters of gasoline per customer and several kinds of petroleum products ran out completely. This particularly affects mining, agriculture and construction) because these sectors have only a short operational season before the onset of winter. In response, Mongolia is negotiating a long-term guarantee of petroleum supplies with Russia. Mongolia also plans to build an oil refinery. However, international experience suggests that having ample oil refinery capacity is not a panacea: the key is to have domestic prices determined by market forces (Box 2).

⁵ Bureau of National Statistics, China

⁶ Mongolian National Statistics Office, Poverty Headcount 2007-2008

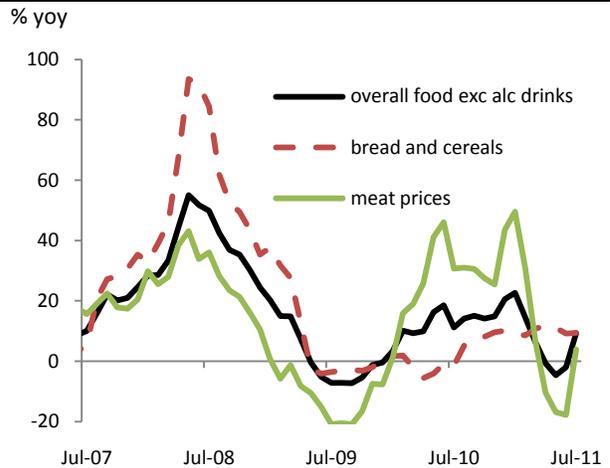
⁷ Food consumption patterns from the 2007/8 household survey show that the median household below the poverty line allocates more than 80 percent of its food expenditure to meat and dairy products (46 percent), and to flour and bread (36 percent).

Figure 6 Inflation picked up again in Q2 and through July



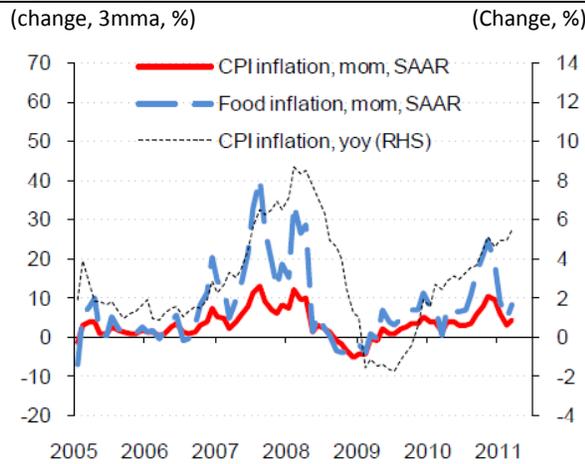
Source: NSO, World Bank staff estimates.

Figure 7 Food prices were on the rise after the effects of meat reserves wore off



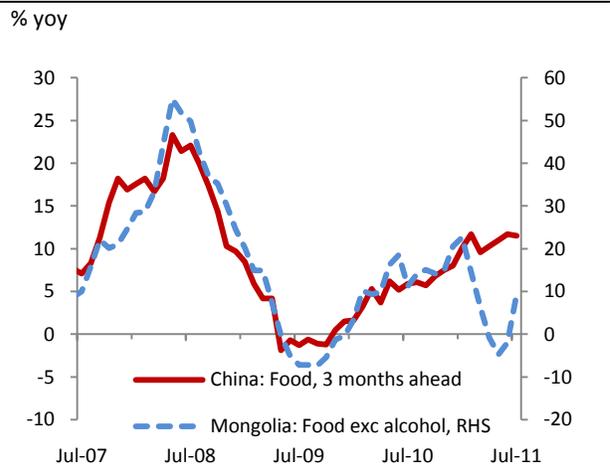
Source: NSO, World Bank staff estimates.

Figure 8 Inflation rose to 6.4% in China largely on higher food prices



Source: CEIC, World Bank staff estimates.

Figure 9 China and Mongolia food prices



Source: NSO, World Bank staff estimates.

Box 2 Does a domestic oil refinery help ease fuel shortages?

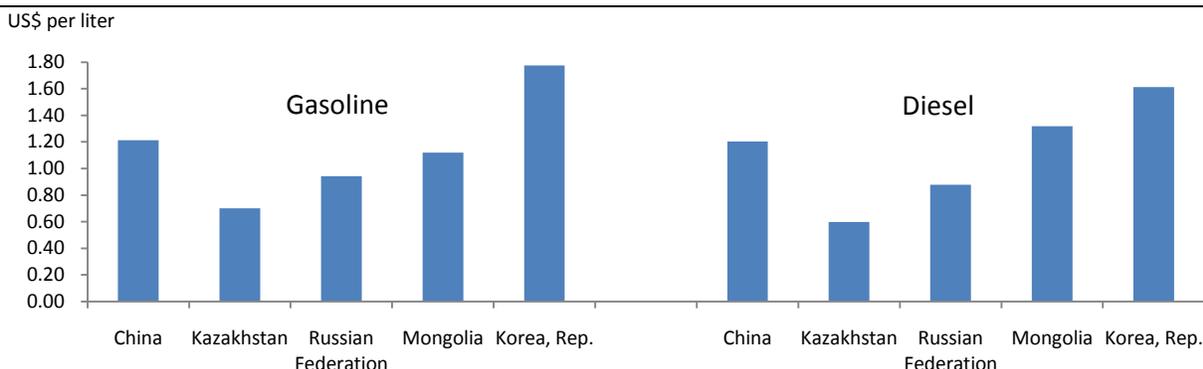
Mongolia suffered from serious fuel shortages in recent months, disrupting public transport services, mining operations and other businesses. Being landlocked with no domestic supplies has undoubtedly exacerbated the problem. The sentiment that Mongolia needs its own oil refinery has been growing, and several proposals to build one are being examined by the government.

The aforementioned problem was caused by fuel shortages in Mongolia’s immediate neighbors, who then restricted fuel exports to ensure adequate supplies in their own domestic markets. Gasoline shortages in the Russian Federation, for example, began to appear in April, and grew rapidly to the point of closing down most service stations in the mountainous Altai region by end-April.

Why do China, Russia and Kazakhstan, Mongolia’s three neighbors, regularly experience fuel shortages when all of them produce crude oil, have multiple domestic refineries (54 in China, 3 in Kazakhstan, and 40 in Russia), and two of them, Kazakhstan and Russia, are net oil exporters?

These countries have one policy in common: they often set relatively low ceilings on domestic fuel prices. Figure 10 shows end-user prices in June in the three neighboring countries—all of which had set price ceilings—and Mongolia. Prices in the Republic of Korea are shown as a comparator. Korea does not artificially depress domestic prices. These end-user prices are not directly comparable because they include taxes and transportation and distribution costs, but it is clear that prices in Kazakhstan and Russia were particularly low. The prices in Mongolia

Figure 10 Pump prices of gasoline and diesel prices in June 2011



were also relatively low; given that it is land-locked and has high transport costs.

However, as a result of the low domestic prices, the refineries in China, Kazakhstan and Russia have an incentive to export refined products, or reduce the processing of crude oil, in order to maximize profits or minimize financial losses. In an attempt to counteract this, governments then combine the ceilings on domestic prices with export bans or duties. China, Kazakhstan, and Russia have all imposed heavy restrictions on fuel exports (Table 1). While Russia has not banned gasoline and diesel exports outright, the export duties have been steadily increased to such prohibitively high levels that they have been described as having nearly the same effect as an export ban by industry analysts. The end result of these distortions is regular fuel shortages, especially when the domestic refineries are faced with a price environment in which they can only make losses and reduce their output. And the impact of these domestic distortions can spill beyond the borders, as Mongolia has unfortunately just experienced.

Table 1 Mongolia’s Neighbors : Fuel policies

Fuel	China	Kazakhstan	Russian Federation

Gasoline	Falling export	Export ban for both gasoline and diesel between May 2010 and Jan 2012	Export duty of \$416/tonne, or \$0.55/liter in effect
Diesel	Export ban imposed in May 2011		Export duty of \$310/tonne, or \$0.36/liter in effect

This analysis is in regard to refined oil products, but what about crude oil? No country has outright banned the exports of crude oil, although Russia imposes a high export duty: \$472/tonne in June 2011 and \$445 in July. Does it then make sense for land-locked Mongolia to have its own oil refinery?

The answer depends on the conditions of the refinery and government policies to support its profitable functioning. There are landlocked countries without refineries that have not had any fuel shortages, and there are landlocked countries with refineries that have suffered from chronic fuel shortages. Copper-producing Zambia offers a useful lesson: Zambia has one refinery, which processes imported crude oil. However, the refinery has experienced regular outages, and the resulting fuel shortages have on occasion shut down mining operations. The government recently announced that it would commit at least \$40 million to build strategic fuel reserves.

In addition, because of tighter fuel specifications and shifting fuel demand around the world, small, simple refineries are becoming increasingly uneconomic. Finally, because of international competition, refining margins are under pressure and can often turn negative even for large, complex refineries. For instance, since January 2009, refining margins in Singapore, a major refining center in Asia, have been particularly low for refineries of all configurations and sizes (Figure 11).

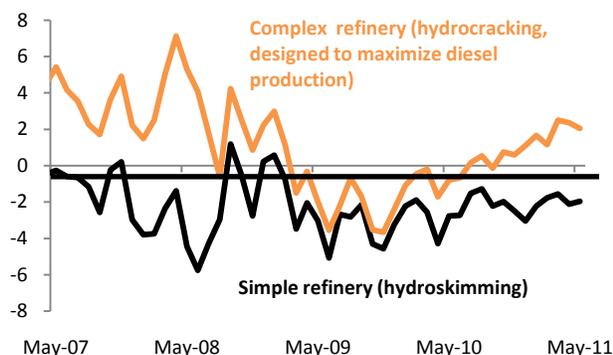
The experience of other countries suggests that building a refinery that is far smaller than what would be considered economic by global standards could present financial challenges, even in a land-locked country. Careful consideration should be given to stock maintenance, because even the best-run refineries have to shut down for regular maintenance—and relying on one refinery means having that source of refined products cut off during the maintenance period.

Finally, artificially low domestic prices have led to fuel shortages even in large major oil exporters with significant refining capacity. In addition to the countries mentioned above, these include Argentina, Iran, Iraq and Nigeria. These cases demonstrate that even if a country has substantial domestic crude oil or refinery capacity, the temptation to lower prices below market-determined levels can result in economically costly shortages.

Sources: Local newspapers for fuel prices, BMI, Dow Jones Energy Service, Reuters, ISH Global Insight Daily Analysis, Xinhua News Agency, and Central Asia online.

Figure 11 Representative refining margins in Singapore

Refining margin per barrel



Source: International Energy Agency

Fiscal developments

Fiscal balances continued to improve strongly in step with mineral-related revenues but there was a steep increase in government expenditures...

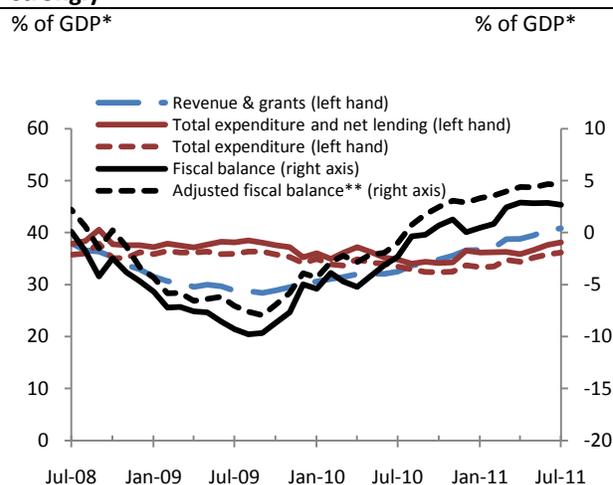
On a 12-month rolling basis, the fiscal surplus increased to 2.7 percent of GDP in July, compared to a 2.3 percent deficit in July last year. Excluding net lending, the budget balance swung into a peak surplus of 4.6 percent of GDP (Figure 12). Revenue performance has improved markedly since December 2009. For example, in July 2011, the annual growth in total revenue and grants was 55 percent in nominal terms and 46 percent in real terms. Royalties continued to grow in the second half, up 70 percent yoy in July, on the back of an increase in the royalty rate on the main mineral commodities (from 5 to 15 percent). In addition, customs duties (up 79 percent), VAT (up 83 percent), and corporate income tax (up 27 percent in real terms yoy) also showed very positive trends, countering the loss of the Windfall Profit Tax⁸ (WPT) this year (Figure 13). Part of the mineral revenues is not available for current expenditures, as it is being set aside in a stabilization fund in accordance with the Fiscal Stability Law (FSL) of 2010. The FSL's Stabilization Fund is projected to collect MNT 220 billion of those "excess" revenues, viz. mineral revenues attributed to prices that are higher than the long term mineral price projection. The FSL is a landmark policy accomplishment, aimed at insulating the budget from volatile mineral prices.

Total expenditures increased substantially in real terms: 27 percent in July yoy. Capital expenditures were up a whopping 57 percent and current transfers went up by 48 percent as a result of the cash distribution to every citizen (MNT 21,000) out of the HDF or Human Development Fund (MNT 160.5 billion) in addition to tuition fee support to students (MNT 41.3 billion). Wages and salaries continued to rise (up 23 percent in real terms yoy) and together with current transfers they amounted to almost 56 percent of the total expenditure in July (Figure 14). Spending categories that went down included net lending (by 55 percent) and subsidies (5 percent).

...however financing cash handouts from the Human Development Fund is causing complications

In spite of economic growth and revenue performances, the financing of the 2011 Budget is still presenting a challenge primarily due to the complex manner in which the HDF functions. The HDF is the vehicle through which wealth distribution is made, and its revenues and expenditures are earmarked. Its

Figure 12 Fiscal balances continued to improve strongly



Note: *GDP interpolated using actual 2010 and IMF estimates of 2011 GDP data ** Adjusted fiscal balance excludes net lending from expenditure, leaving current and capital expenditure only.

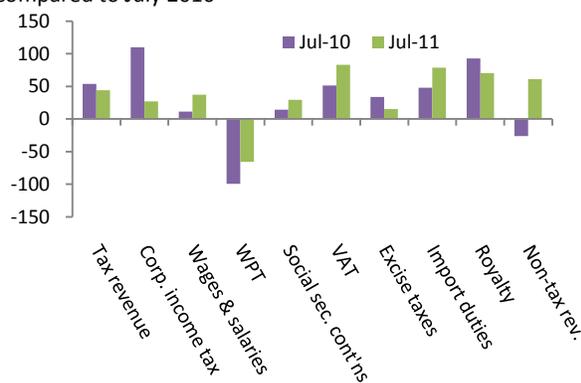
⁸ A 68 percent tax applied to revenues from prices exceeding base prices of \$2600/tonne for copper and \$850/ounce for gold until December 31, 2011.

sources of revenue are royalties from mining companies, dividends from strategic mining deposits as well as pre-payments from Oyu Tolgoi and Tavan Tolgoi. Its earmarked expenditures are monthly cash handouts for citizens and tuition fees for students. The 2011 Budget identified prepayments from the Tavan Tolgoi mining project as a principal source for financing the HDF from which the monthly cash payments to each citizen are being made. However these prepayments have not materialized yet. As a result of the HDF funding rules, Erdenes MGL, charged with depositing funds in the HDF, has had to resort to borrowing MNT 25 billion from commercial banks. At the same time, the government is seeking to receive more tax prepayments from the other mega project, the already negotiated OT project.

Besides finding additional funding for the HDF, the spending plans pushed by the parliament in this pre-election year include issuing bonds to finance cashmere and wool production in addition to funding subsidized credit lines for SMEs. The amendment to include these plans is expected in the fall session although positive budget outturns may not require the bond to be issued at all. The government has so far issued MNT 114.965 billion in domestic bonds with no plans to issue foreign bonds for this year.

Figure 13 Revenues have risen strongly reflecting broad based economic recovery

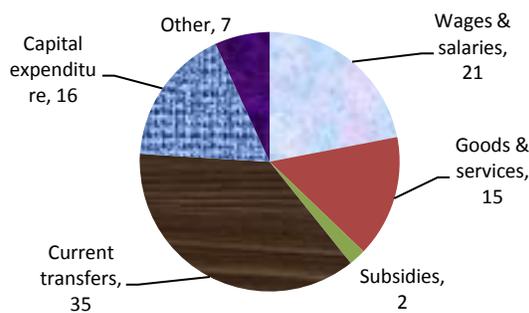
YTD percentage real change in revenues in July 2011 compared to July 2010



Sources: MoF, NSO, World Bank staff estimates

Figure 14 Current transfers and wages and salaries constituted bulk of the expenditure

% of total expenditure



Sources: MoF, NSO, World Bank staff estimates

Reportedly, the inspiration for the political promises to distribute cash to each citizen from mineral revenues came from Alaska. The economic and social impact of cash distribution in the case of Alaska has unfortunately not been adequately researched, but we discuss the consensus assessment in Box 3.

Box 3 Cash Distribution: Alaska

Distributing cash to every citizen, unconditionally and untargeted, is quite a rare phenomenon. Currently, Alaska and Mongolia do it. Alaska has been doing this since 1982. Mongolia started in recently, because of popular pressure on politicians to finally deliver on an escalation of political promises between the two main political

parties made during the 2008 elections.

We do not know the impact of these monthly cash handouts on household behavior in Mongolia, since it has been too recent. We do think, however, that it is stoking inflation, hurting the poor and making exports less competitive. We also know that the two major parties have committed to not promising cash handouts ahead of the next elections, in addition to discontinuing the program thereafter. They now both agree, at least publicly, that it was a bad idea.

What do we know about Alaska? There, the wealth distribution takes the form of an annual payment to each resident, financed from the dividends of the Alaska Permanent Fund.

The Permanent Fund collects 25 percent of the petroleum royalties and stood at a record \$40.1 billion in June 2011 (data from Alaska Permanent Fund Corporation). The size of the dividend averages about US\$1,800, but annual payments have varied from a low of \$331 in 1984 to a high of \$3,269 in 2008. In 2009, when the dividend was US\$1,305, it added 3 percent to per capita income and US\$900 million in extra purchasing power. That was 1.8 percent of Alaska's GDP.

Mongolia's cash handouts are relatively larger. With elections looming next year, the Mongolian government is distributing an extra 7 percent of per capita income⁹ or over 10 percent of GDP in 2011 as cash transfers to its citizens.

The first lesson from Alaska is that once such a scheme is in place, it is very difficult to reverse. Popular support for these handouts is so strong that it is politically taboo to even suggest tampering with it. Consequently, the constituency around cash handouts for residents is so strong that the original objective of the Permanent Fund—to permanently sustain *public services* once the oil revenues disappear—has now been completely subverted to permanently providing *cash* to the residents. When the oil revenues run out, and they are on a declining trend, there will be no alternative source to fund public services, other than tax increases.

What has been the economic and social impact of Alaska's cash distribution? One study tried to link the cash distribution to improved health outcomes. Surely, higher incomes should lead to better health outcomes? Surprisingly, in the short run, Alaska's cash handouts actually increase mortality. "During the week that direct deposits of Permanent Funds dividends are made, mortality among urban Alaskans increase by 13 percent" (Evans and Moore, 2010, p. 2). Why is this? Because lump sum payments like this produce the "full wallet" syndrome, causing people to suddenly increase consumption. This does not result solely in the increased consumption of alcohol and drugs, but in increased consumption in general, which leads to more heart attacks, strokes and traffic accidents.

Additionally, universal cash hand-outs also provide disincentives to work. Unfortunately, this effect and other potential social and economic impacts of the Alaskan dividend distribution have not been studied. The explanation for this lack of research is a political one: Alaskans feel that the use of the dividends is a private matter, not to be researched.

However, researchers do tend to believe that the payouts have helped to reduce poverty among Native Americans and improve the income distribution in general. But those outcomes could of course also have been achieved, and more efficiently, through targeted transfers, so they hardly make a case in favor of universal hand outs.

The most compelling case against the Alaska pay outs is that have undermined citizens' sense of community and their interest in the public good and good governance. This is the view of Scott Goldsmith, Professor of Economics at the University of Alaska, who has studied the scheme for a long time. He concludes:

"After 29 years the dividend has become an integral part of the Alaska experience. Many, if not most, Alaskans view it as an entitlement—a distribution from their share of the natural resource wealth of the state. An entire

⁹ Per capita GDP for 2011 is US\$ 3,046 according to the IMF staff projections reported in IMF Country Report No. 11/76 of March 2011.

generation of Alaskans has been raised having received a dividend annually since birth without necessarily understanding the purpose for which it was created. This generation has also never experienced paying for the state services they have received because petroleum revenues have covered all costs. This has fostered a distorted sense that the role of the state is to provide public services at no cost and also to hand out cash to all citizens. Some would compare this generation of Alaskans to trust fund babies. Furthermore, because there are no personal taxes and receipt of the dividend carries no public responsibilities, the two together undermine the sense of community that comes from the need to collectively choose and fund public services. They also foster a disconnection between government and residents, leading to a deterioration of the quality of government.” (Goldsmith, 2010, p. 19)

The first principle of good policy-making is “do no harm”. Based on the Alaskan experience, Mongolia’s senior politicians are correct in saying that the cash handouts were a bad idea and should therefore be discontinued after the 2012 elections. However, popular pressure to continue some form of cash distribution will be strong. Introducing a cash benefit targeted to the poor, and other truly needy Mongolians, would then be the sensible alternative.

Source: William Evans (Department of Economics of the University of Notre Dame) and Timothy Moore (Department of Economics of the University of Maryland, 2010. "The Short-Term Mortality Consequences of Income Receipt".

[http://nd.edu/~wevans1/working_papers/income_short_term_mortality_revision_jpubecon_final%20\(2\).pdf](http://nd.edu/~wevans1/working_papers/income_short_term_mortality_revision_jpubecon_final%20(2).pdf)

Scott Goldsmith, 2010. "The Alaska Permanent Fund Dividend: A Case Study in Implementation of a Basic Income Guarantee." Anchorage, Alaska: Institute of Social and Economic Research, University of Alaska.

http://www.iser.uaa.alaska.edu/Publications/bien_xiii_ak_pfd_lessons.pdf

<http://www.apfc.org>

External sector

Imports increased to a record level as the trade deficit continued to widen

The trade deficit continued to widen, reaching US\$ 1349 million in July 2011 (Figure 15). Imports continue to increase, mainly driven by transport equipment and machinery (Figure 16) as the mining sector expands, in particular the Oyu Tolgoi copper mine. The dollar value of goods imports more than doubled in July yoy.

Mongolian exports were up by 52 percent yoy supported by large coal shipments to China as coal mining activities in Southern Mongolia continue to rise. Constituting almost 40 percent of the value of total exports, coal exports increased by 129 percent yoy and contributed the highest percentage points (37 percent) to overall export growth. The sector has become the fastest growing sector, surpassing copper exports in becoming the top export earner for the country. As of July, the export value of coal (US\$ 900 million) surpassed the total export value in 2010 (US\$ 878 million). China, the largest thermal coal consumer in the world, remains the only destination for coal from Mongolia where coal production doubled in the last 5 years. It is expected to grow even faster in the near future when large scale coal mining projects start production. Copper’s contribution to export growth fell from 15 percentage points in March to 8 percentage points in July (Figures 17 and Table 2).

Crude oil is up 42 percent yoy benefiting mostly from higher prices. Chinese metal imports from Mongolia however are leveling off. In July 2011 copper volume decreased by 2 percent yoy, but increased in dollar value by 33 percent.

Gold exports remain dismal (down 37 percent yoy) despite the abolition of the WPT since January 2011. Volume of greasy cashmere declined in June and July, and combed goat down remained depressed despite its unit price increase.

Figure 15 The trade deficit widened further...

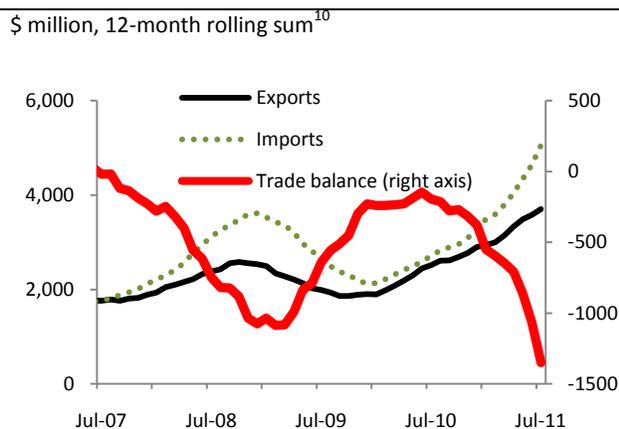


Figure 16 driven mostly by machinery and equipment imports

Percentage point contributions to year-on-year growth

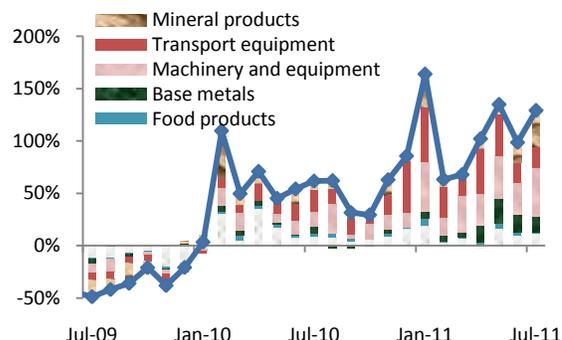


Figure 17 Coal and copper exports rose strongly while gold and greasy cashmere exports fell

Percentage point contributions to year-on-year growth

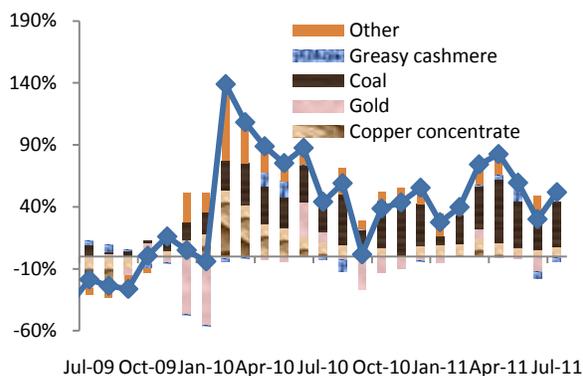


Figure 18 Commodity prices continued their rebound...

Index=100 in January 2004

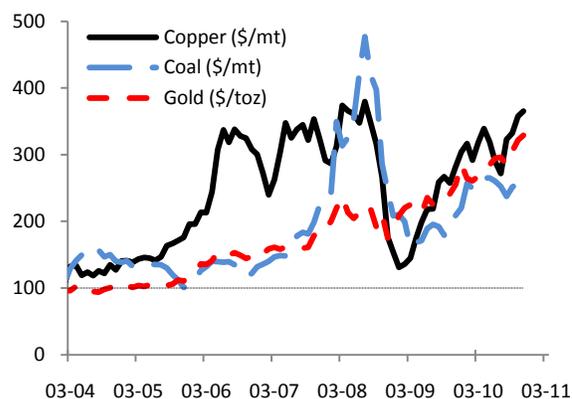


Table 2 Drivers of change among major export commodities: July 2010 – July 2011

	% change in \$ value	% change in volume	% change in unit price	% of total exports
Copper concentrate	31	-2	33	25
Gold	-37	-47	19	3
Coal	129	19	92	38
Combed goat down	-7	-46	72	1

¹⁰ Monthly trade data tends to be highly volatile and is also affected by seasonal factors. For this reason, 12-month rolling sums are illustrated.

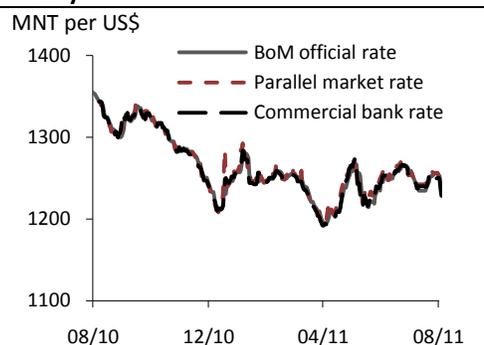
Greasy cashmere	9	-19	35	5
Zinc concentrate	21	14	6	4
Crude petroleum oils	42	5	35	5

Source: National authorities; and World Bank staff estimates.

The exchange rate and the balance of payments

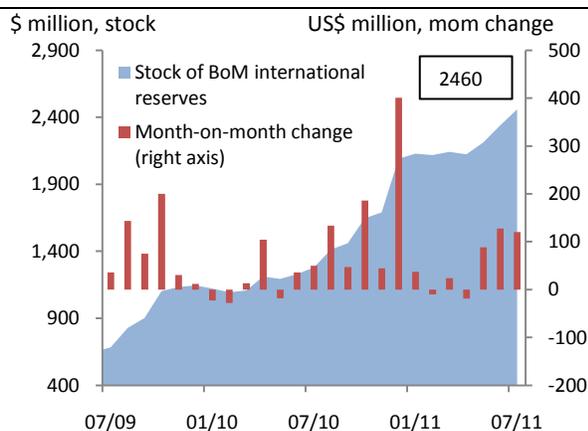
In July 2011, the average monthly exchange rate against the US\$ appreciated by about 9 percent compared to July 2010, or about one percent compared to the previous month (Figure 19). International reserves of the Bank of Mongolia have reached an all-time high, US\$ 2,460 million, with the monetary impact largely sterilized by issuance of central bank paper (Figures 20 and 21).

Figure 19 The exchange¹¹ rate appreciated in July



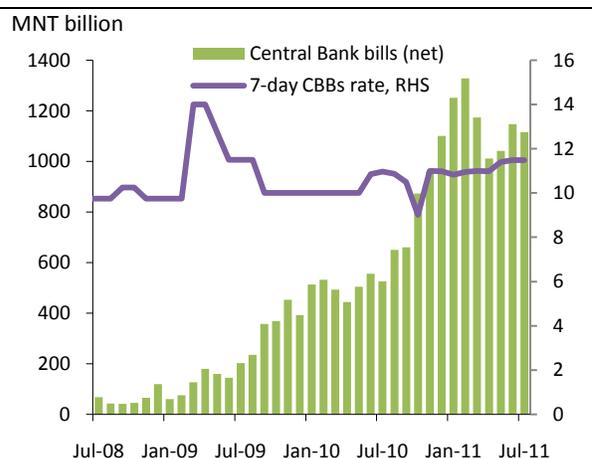
Last observation: August 7, 2011.

Figure 20 BoM international reserves are at record levels



Note: Number in box is end-July stock of BoM international reserves in US\$ million.

Figure 21 Issuance of central bank bills continues to increase



Source: Bank of Mongolia, World Bank

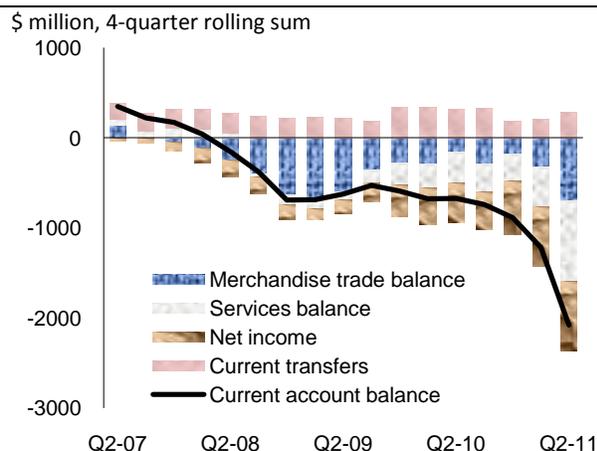
As a result of the increased goods trade deficit, the current account deficit widened to US\$ 2081 million in Q2 2011, four times higher than in Q2 2010 (US\$ 673 million) on a 4-quarter rolling sum basis (Figure 22). The deficit in services trade almost tripled to US\$ 896 million (compared with US\$ 342 million in Q2 of 2010) as freight transportation and travel service receipts¹² worsened substantially.

¹¹ 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.

¹² Includes miscellaneous business, professional and technical services such as accounting, legal, consultancy services etc.

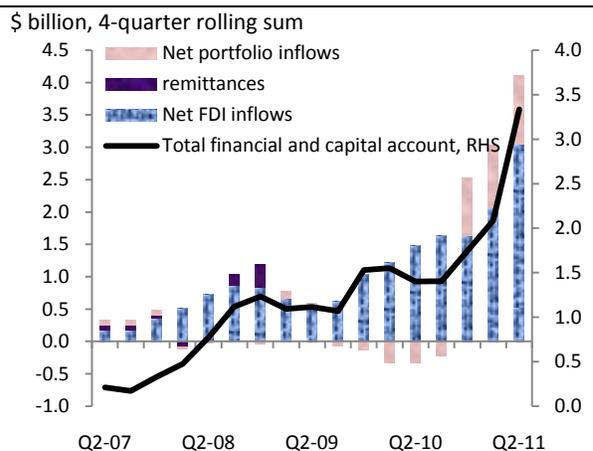
The current account deficit was primarily financed by net foreign direct investment, which doubled from last quarter amounting to US\$ 1,409 million in Q2 2011. Net remittances decreased by 41 percent than in Q2 2010; however, the actual inflow more than doubled in Q2 2011 (Figure 23).

Figure 22 The current account deficit has widened¹³



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

Figure 23 and investments increased substantially



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

In the global economy, a series of setbacks rocked the markets including Standard & Poor's downgrading of the US debt rating, growing concerns about the possibility of sovereign debt defaults in the euro zone, rising oil prices, and supply chain disruptions from Japan. Economic growth in the U.S. and Europe is predicted to remain weak going forward.

Banking sector

MNT and US dollar deposits reached all time highs and credit grew apace with pre-crisis levels

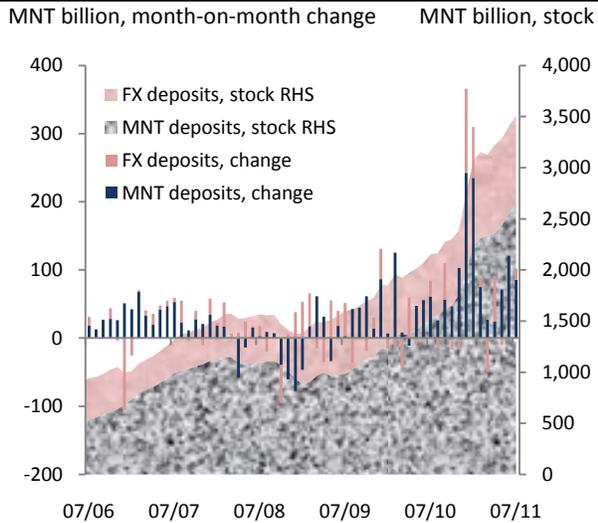
Reflecting the current episode of high economic growth, the volume of MNT deposits hit a new peak of above MNT 2.6 trillion in July, up 73 percent from a year ago (Figure 24). Deposits in foreign currency also hit a new peak of MNT 867 billion in July despite the expectation of further currency appreciation. Nominal interest rates on US dollar deposits are very high by international standards with time deposits offering rates reaching above 14 percent, reflecting the continued perception of risk by the market. In addition, as inflation picked up, real interest rates declined in July (Figure 25).

The stock of loans outstanding has now reached almost MNT 4.7 trillion, rising by a nominal 58 percent yoy in July 2011 or 46 percent in real terms. With credit growing as fast as we have seen prior to the last crisis (Figure 26), it is critical that the BOM ensures full compliance of Mongolian banks with current prudential norms, particularly with respect to having adequate capital buffers to absorb the

¹³ 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.

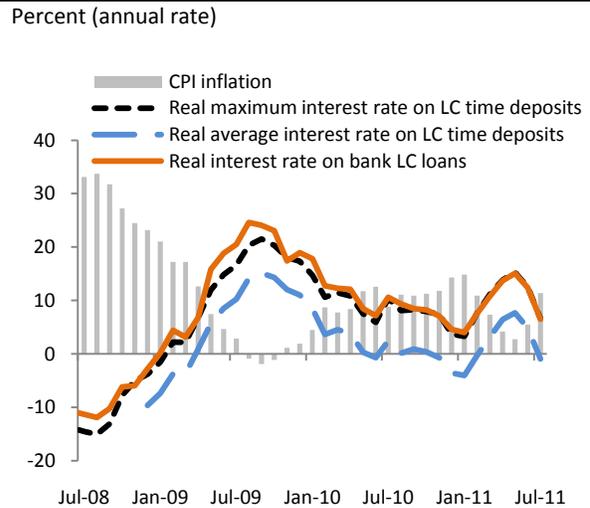
losses from current and possible future NPLs (non-performing loans)¹⁴. The domestic weighted average lending rate ranges between 18-21 percent, compared to a Central Bank bill rate of 11.5 percent.

Figure 24 Both local and foreign currency deposits continued to reach new highs in June



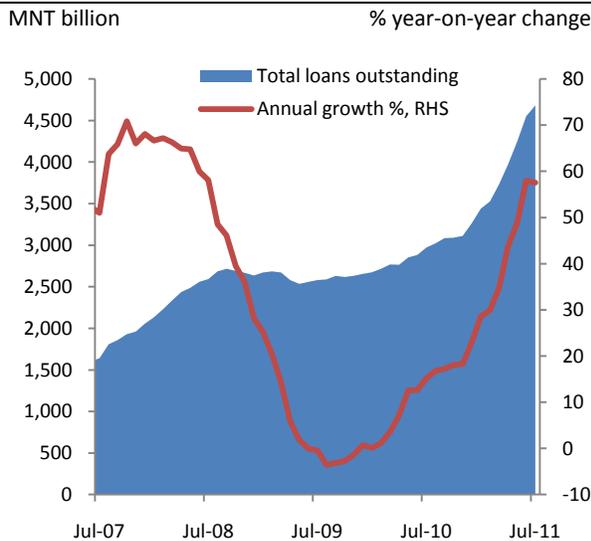
Source: BoM, World Bank

Figure 25 Real economy-wide interest rates fell as inflation picked up



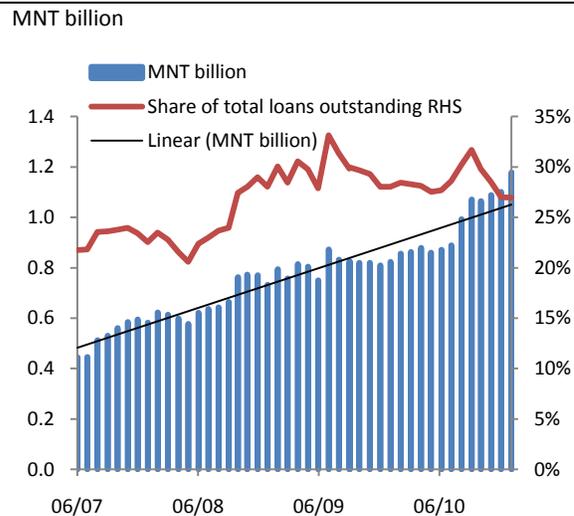
Source: BoM, National Statistical Office, World Bank.

Figure 26 Credit continued to surge...



Source: Bank of Mongolia, World Bank.

Figure 27 ... also to 50 largest borrowers



Source: Bank of Mongolia, World Bank

¹⁴ According to the bank loan classification regulation, loans with principal in arrears mechanically become NPLs after 90 days.

NPL ratio declined as total loans expanded, but NPL volume increased by 9 percent from the start of the year

The stock of NPLs still stands at a relatively high at MNT 382 billion from MNT 361 billion in January. Together with loans in arrears, the ratio to total outstanding loans was about 10 percent in July. This is an improvement from a peak of 24.6 percent in November 2009 (Figure 28). However, as total outstanding loans are increasing fast, NPL ratios hide the fact that the NPLs in terms of absolute volume terms are up by 9 percent between January and July. This includes the NPLs of the two failed banks (MNT 178 billion). The government has paid MNT 100 billion for one of the failed banks and has so far recovered about MNT 30 billion. The MoF expects that another MNT 50 - 60 billion could be recovered by 2013. Quarterly changes in the Loan Report from the Bank of Mongolia (2011 Q1 compared to 2011 Q2) showed improvement in the agriculture sector, reflecting a recovery from dzud effects, while NPLs and loans in arrears worsened in mining and quarrying and construction sectors (Figure 29).

Meanwhile, the loan stock of the 50 largest borrowers increased by 43 percent yoy, as the concentration of bank lending remains high, accounting for 27 percent of total loans (Figure 27).

Figure 28 NPLs still remain high as NPL volume increased in July by 9 percent since January

MNT billion

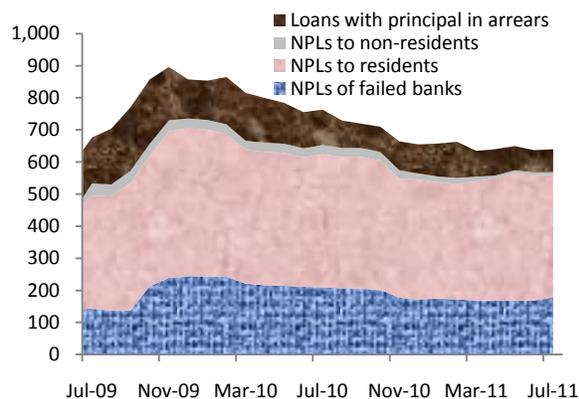
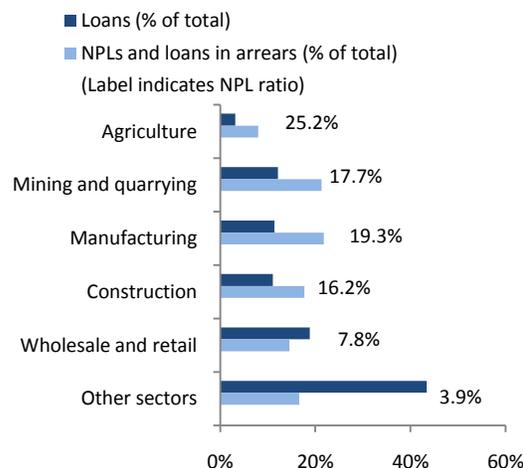


Figure 29 Proportion of NPLs increased in mining and construction but declined in agriculture

MNT bn



Economic outlook

Mongolia’s medium-term prospects continue to look excellent, both from an economic growth perspective as well as from a fiscal management perspective. The landmark fiscal legislation under the Fiscal Stability Law locks in strong counter-cyclical policies. These counter-cyclical fiscal policies are a key instrument to combat the “Dutch Disease” (Annex 1). The Dutch Disease was “cured” through a political agreement centered on fiscal and wage restraint between the main economic stakeholders. Even though initially unpopular, these conservative policies ultimately rewarded the political leadership associated with them, as they provided the basis for a thriving economy in the medium term.

It is imperative that Mongolia show strong political commitment to stay on course to implementing the letter and the spirit of the FSL, and that parliament passes an equally supportive new budget law in the fall session, especially with elections around the corner in 2012. Because the core of the FSL—the structural balance of minus 2 percent of GDP—only starts in 2013, there are risks concerning its implementation.

Mongolia's economic outlook depends heavily on global macroeconomic factors: the current uncertainty and poor growth prospects for the global economy are cause for concern. If there is another global recession, Mongolia's economy will surely suffer. In that case, China's policy reaction will be crucial for Mongolia. If China reacts as fast and as strongly as it did in 2008/9 then the effects of a global recession on Mongolia will be mitigated, largely owing to Chinese demand for minerals from Mongolia. Beyond this, it is up to Mongolia to capitalize on its excellent long term prospects by continuing the reform agenda it embarked on during the 2008/9 crisis.

Table 3 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	6.1
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	46.6	43.0
Foreign Trade, BOP and External								
Trade balance (\$ mn)	-187	-152	-120	57	-228	-710	-252	-379
Exports of goods (\$ mn)	616	870	1065	1543	1889	2535	1885	2899
(% yoy change)	17.5	41.2	22.2	44.9	22.4	34.2	-26.0	53.8
Copper exports (% yoy change)	..	..	14.7	94.8	27.7	3.0	-39.9	53.6
Imports of goods (\$ mn)	801	1021	1184	1486	2117	3245	2138	3278
(% yoy change)	16.0	27.5	16.0	25.4	42.5	53.2	-34.1	53.3
Current account balance (\$ mn)	-102.4	24.1	29.7	221.6	264.8	-690	-592	-887
(% of GDP)	-7.1	1.3	1.3	7	6.7	-12.9	-9.0	-10.7
Foreign direct investment (\$ mn)	131.5	128.9	257.6	289.6	360	839	570	1630
External debt (% of GDP) (3)	87.3	73.7	59.7	44.3	36.1	31.0	43.3	30.8
Foreign exchange reserves, net (\$ mn)	129	164	298	687	975	637	1145	2091
Financial Markets								
Domestic credit (% yoy change)	91.0	37.2	41.7	42.3	68.1	28.2	0.7	23.2
Short-term interest rate (% per annum)(4)	.11.5	15.8	4.8	6.4	9.9	14.5	10.8	10.9
Exchange rate (MNT/US\$, eop)	1168	1209	1221	1165	1170	1268	1443	1256
Real effective exchange rate (2006=100)(5)	94.2	93.9	99.6	102.8	104.8	124.4	102.4	147.1
(% yoy change)	-4.8	-0.4	6.1	3.2	1.9	18.7	-11.1	11.3
Stock market index (2000=100)(6)	152	121	204	382	2048	1182	1229	2931
Memo:								
Nominal GDP (MNT bn*)	1660	2152	2780	3715	4600	6020	6055	8415
Nominal GDP (\$ mn*)	1448	1814	2307	3156	3930	5258	4203	6202
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 March 2011 IMF Article IV Consultation (3) On public and publicly guaranteed debt. (4) Yield of weighted average Central bank bills rate. (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.

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

Annex 1: The Dutch Disease: Some Lessons for Mongolia

(Reprint from 'An Eye on East Asia Pacific')