

MONGOLIA ECONOMIC UPDATE

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Mongolia Economic Update

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Executive summary

The economy is undergoing a sharp adjustment to large imbalances and a weak external environment

Mongolia's growth sharply slowed to 3.0 percent in the first half of 2015. External demand is weakening due to a continued dampening of the commodity market and slower growth in China, translating into a drop in exports. Slowing domestic demand is largely caused by a plunge in investment due to falling FDI. Declining investment and weaker mining exports are translating into sluggish real household income growth, thereby slowing consumption. Adjustment in domestic demand has contributed to reducing the current account deficit and stabilizing inflation. The current account deficit is expected to decline to about 5 percent of GDP in 2015, from 11.7 percent of GDP last year. Inflation also continued to stabilize, moderating to 4.9 percent in September from 9.8 percent early this year. Deterioration in bank asset quality has accelerated with the slowing economy, with the share of non-performing loans rising from 5 percent at the end of 2014 to 7 percent in September.

Tighter economic policies have contributed to the adjustment of the economy

Fiscal policy became tighter compared with previous years. As revenue shortfalls reached over 15 percent of the budget plan, tight expenditure controls have been implemented, containing the budget spending execution at less than 80 percent of the plan. As a result, on-budget expenditures excluding the public investment financed by the Development Bank of Mongolia (DBM) increased by only 2.8 percent in the first eight months compared with the same period last year, a negative spending growth in real terms. Public investment financed by the DBM also stayed tight, reaching less than half of its MNT 1.5 trillion annual spending plan in the first eight months.

Measures were taken to curb the budget deficit, debt, and off-budget expenditures. New deficit and debt ceilings were set for 2015-18 by amending the Fiscal Stability Law (FSL) in January. The 2015 budget was amended in January to curb the structural deficit within 5 percent of GDP. A significant portion of the DBM's off-budget expenditures were also newly included in the budget by including the non-commercial projects financed by the DBM. The definition of the debt controlled by the FSL, however, was changed to general government debt from public debt.

The fiscal plans for 2015 and 2016 entail a risk of overstating revenues. The 2015 supplementary budget reduced budget spending by MNT 560 billion and plans to mobilize additional revenues by MNT 340 billion, to absorb an expected MNT 900 billion revenue shortage. The revenue mobilization plan, however, is likely to be challenging as it largely relies on collecting significant revenues from tax payment arrears in the remaining two months amidst a sharp economic downturn. The revenue projections of the draft 2016 budget also entail elements of uncertainty. The draft budget is based on an optimistic assumption of strong coal exports despite the weak coal market conditions and an expected slowdown in China. The draft budget also relies on resources from privatizing large SOEs that has been delayed in the previous years, and significant new foreign grant inflows from China.

Monetary policy has tightened. The Price Stabilization Program (PSP) has been phased out since early 2015, reducing the outstanding BoM credit to PSP to MNT 386 billion in August, from over MNT 700 billion at the end of 2014. The BoM financing to the subsidized housing mortgage program, however, continued to grow from MNT 1.7 trillion one year ago to MNT 2.8 trillion in August. The BoM also provided a MNT 350 billion loan to the corporate sector late 2014 via commercial banks. With the growing housing mortgage program and the one-off corporate sector support, outstanding policy loans provided by the BoM still remains substantial, reaching MNT 3 trillion in August.

The real effective exchange rate has been on an appreciation trend in recent months, after a significant adjustment over the last two years. Between March 2013 and March 2015, the nominal exchange rate depreciated by 40 percent against the US\$ in response to a large balance of payments deficit. Higher import prices induced by the exchange

rate adjustment have contributed to the current account adjustment, by encouraging consumers to substitute towards domestic products. Exchange rate adjustment, however, has been limited in recent months, with increased central bank interventions. The tugrik depreciated by only 1.4 percent in June-Oct against the US\$, a far stronger performance compared with other commodity-dependent economies, putting the real effective exchange rate on an appreciation path since late 2014.

Growth is expected to slow in 2015-16, but a recovery in foreign investment would begin to support the growth of the non-mining sector in 2016

Growth is projected to slow to 2.3 percent in 2015, revised downward from 3.3 percent of the last projection. The downward revision largely reflects weak crop harvests and the slower-than-expected industrial production in the third quarter. Mining GDP growth will likely remain in double digits in 2015, but is expected to moderate in the second half of the year. Non-mining GDP growth is expected to further slow in the second half as investment and consumption demand remains subdued and FDI stays weak. Weaker crop harvests due to severe droughts are expected to slow agricultural production. There is a risk that agriculture could be hit harder by weaker crop harvests and harsher winter weather conditions.

Growth is expected to further slow to 0.8 percent in 2016 due to a sharp contraction in mining production, despite a gradual recovery of the non-mining sector. Mining production is projected to decline in 2016-17 with lower mineral concentration in ores produced by the OT mine and the weak global commodity market conditions. Mining production is expected to pick up from 2018, on the back of a gradual recovery in the commodity market and an improvement in the ore quality of the OT mine. Non-mining GDP growth is expected to gradually recover in 2016 after a sharp slowdown in 2015. The non-mining sector of the economy will likely remain weak in early 2016, but a recovery in foreign investment in the mining sector is expected to support the industries supplying goods and services needed for large scale mining investment projects in the latter of half of the year.

The fiscal outlook is weak, with the prospect of a slow revenue recovery

The revenue projections for 2015-16 of the current fiscal plans may be difficult to achieve on account of optimistic assumptions and challenging revenue mobilization plans. Non-mining budget revenues are expected to gradually recover in 2016 as consumption and import-related taxes pick up in tandem with increased FDI inflows. However, a drop in commodity exports is likely to continue to dampen mining-related tax revenues, which account for more than 20 percent of total revenues, in the next couple of years. Some of the key revenue mobilization measures for 2015-16 may also prove challenging, including the collection of significant tax arrears this year amid a sharp slowdown of the economy, and optimistic assumptions of a strong coal export increase and an ambitious privatization plan for 2016. Accounting for these uncertainties, potential budget revenue shortfalls could reach over MNT 100 billion in 2015 compared with the second supplementary budget, and up to MNT 400 billion in 2016 compared with the draft 2016 budget. Assuming the current spending plans of the government for 2015-16, the budget deficit following the FSL definition – which includes the budgetary projects of the DBM – is expected to stay over 5 percent of GDP in 2015-16, a higher deficit path than the medium term deficit ceilings of the FSL.

The consolidated budget deficit – which adds DBM's commercial portfolio to the FSL-defined budget deficit – is expected to decline to 8-9 percent of GDP in 2015 and 6-7 percent of GDP in 2016, from 11 percent of GDP in 2014. The DBM is expected to provide about MNT 600 billion to its commercial portfolio in 2015, and to further reduce its commercial spending to MNT 300-400 billion in the next couple of years due to tight financing conditions. Under these assumptions, the commercial projects financed by the DBM is expected to around 3 percent of GDP in 2015, and decline to 1-1.5 percent of GDP in 2016.

Large external financing mitigated the immediate balance of payments pressure, at the cost of higher external public debt

With the balance of payments under pressure from falling FDI, considerable external financing was mobilized by the government and the central bank. US\$ 660 million was newly raised including a US\$ 500 million government guaranteed bond of one commercial bank and a RBM 1 billion sovereign dim sum bond. The central bank also drew down \$630 million from the bilateral currency swap facility with the People's Bank of China in the first nine months, pushing the total external debt-financing of the public sector close to US\$ 1.3 billion in 2015. The large external financing significantly reduced the balance of payments deficit to US\$172 million in the first nine months, from US\$743 million in the same period last year.

The improvement of the balance of payments in recent months relying on external debt-financing came at the cost of higher external debt. Mongolia's external debt rose to 180 percent of GDP in June 2015, from 162 percent one year ago, with the public external debt to GDP ratio jumping to 62 percent in June from 45 percent one year before. With higher external debt, the fiscal and external accounts are more exposed to exchange rate risks and increased volatility in the international financial market.

Rapid increases in external liabilities have substantially increased the government and public debts. The government and government guaranteed debt reached 58 percent of GDP in 2014, a sharp increase from 24 percent of GDP three years ago. The public debt also rapidly increased to 77 percent of GDP from 40 percent over the same period. The liabilities of the government and the public sector are expected to continue to rise towards the end of 2015, due to a large budget deficit and external debt financing.

The balance of payments remains under pressure and the economy is vulnerable to shocks...

Despite the recent improvement led by large external financing, the balance of payments will likely remain in deficit in 2015. Although the current account deficit is expected to significantly narrow to about 5 percent of GDP in 2015, a sharp drop in mineral exports and a large deficit in the services and income accounts will likely keep the current account in the red in the coming months. With weak capital inflows, a continued current account deficit would translate into a deficit in the balance of payments, unless further external financing is mobilized.

Mongolia's external positions are expected to come under elevated pressure in the coming years, with the widening current account deficit and declining reserve buffers. A continued drop in mineral exports is expected to substantially increase the deficit in the current account in the next couple of years. Although a recovery in foreign capital inflows could provide some buffers, a growing current account deficit is likely to strain the balance of payments in the coming years. Compounding the external vulnerability is the first large repayment of public external debt in 2017 amounting to US\$ 1,080 million, which will pose significant challenges to the fiscal and external accounts.

The weak balance of payments will continue to erode international reserves. After rebounding from US\$ 1,267 million in April to US\$ 1,728 million in August on the back of large external borrowing, the gross reserves of the central bank dropped by over US\$300 million in September to US\$1,412 million, reflecting the balance of payments pressure and increased foreign exchange market interventions. Foreign exchange buffers would likely stay under growing pressure in the coming months and the next couple of years unless a significant correction of external imbalances is made through tighter economic policies and continued exchange rate adjustment.

... with substantial external downside risks ahead.

A sharper slowdown in China and the commodity market could further undermine Mongolia's growth and exacerbate its external vulnerabilities. China's growth moderation and rebalancing have already exerted a significant

negative impact on commodity prices. Mongolia's lack of diversification in export products and trade partners leaves the economy highly vulnerable to a sharper slowdown in China and the commodity market. Exports to China constituted 42 percent of the 2014 GDP, with the neighboring economy absorbing 87.9 percent of Mongolia's total exports. Compounding the vulnerability is Mongolia's high export concentration on minerals which account for over 80 percent of total exports. Each 10 percent drop in copper and coal export revenues from the baseline projection could be expected to further widen Mongolia's current account deficit by more than 3 percentage points of GDP in 2016.

There is also a risk that a U.S. monetary policy normalization could further deteriorate external financing conditions for emerging economies including Mongolia. The East Asia and Pacific Economic Report of the World Bank (October 2015) assumes a gradual, smooth tightening of external financing conditions, with an orderly normalization of the U.S. monetary policy. However, there is a risk that the U.S. policy rate "lift-off" will instead trigger abrupt market reactions, causing currencies to depreciate sharply, bond spreads to rise steeply, and liquidity to tighten. Mongolia has increasingly relied on external debt-financing over the last three years, and will face significant future debt rollovers in 2017 and beyond. A sharper tightening in external financing conditions could make it more difficult or costly to mobilize external financing needed for debt rollovers or current account deficit financing. According to the analysis reported in the EAP Update, every 100-basis-point increase in the benchmark 10-year U.S. bond yield is associated with 106-144 basis-point increase in yields in East Asia and Pacific countries on average.

Growing external and fiscal vulnerabilities amid substantial downside risks demand a continued policy adjustment to restore sound economic management.

Mongolia's long-term economic prospects remain promising with an increasingly educated population and vast potential from mineral wealth waiting to be materialized. However, the economy faces significant short-term challenges. External financing needs will remain high due to the growing current account deficit and large external debt repayments in the next couple of years. External financing conditions will likely stay much tighter amid heightened global financial volatility. Meanwhile, the country lacks sufficient fiscal and external buffers to counter possible shocks with public debt increasing and international reserves declining. The economy is slowing, but it reflects inevitable adjustments to external imbalances, falling FDI and a negative terms of trade shock.

While the government has demonstrated its commitment to policy reforms, implementation risks are high as the next election approaches. Maintaining reform momentum and a stable investment environment during the election cycle is important to build a solid footing for a stable and sustainable growth path against possible headwinds.

- **Fiscal consolidation efforts should continue.** Reducing the budget deficit and consolidating off-budget expenditures should remain a primary target of the fiscal policy adjustment agenda in the coming years, particularly in light of the growing debt and the volatile external environment. Credible fiscal adjustment plans are needed for 2015 and 2016 to restore a prudent fiscal path as envisioned by the Fiscal Stability Law (FSL). The 2016 budget should adhere to the fiscal targets demanded by the FSL, by containing and prioritizing budget spending based on realistic revenue projections. Considering the uncertainty over the revenue outlook of the current fiscal plans for 2015-16, additional measures adjustment are likely to be needed to meet the fiscal targets of the FSL.
- **Including the commercial portfolio of the DBM would strengthen the credibility and the effectiveness of the fiscal consolidation plan.** A significant step was taken to reduce off-budget expenditures in 2015 by including the non-commercial projects financed by the DBM into the 2015 budget. The commercial portfolio of the DBM, however, still remains outside the control of the FSL even though such projects are financed by government or

government guaranteed borrowings and the boundary between the commercial and non-commercial projects of the DBM remains unclear. DBM's commercial lending operations are expected to reach close to 3 percent of GDP this year, far exceeding the budgetary spending of the DBM.

- **Quasi-fiscal programs financed by the BoM should be phased out and transferred to the government.** The Price Stabilization Program should continue to be phased out. Central bank financing to the housing mortgage program needs to be phased out and the program transferred to the government. Such quasi-fiscal programs blur the boundary between central bank's balance sheet and the government budget, undermining the role of the central bank as an independent keeper of price stability. New policy lending programs to support specific industries or policy objectives, if needed, should be implemented through the government budget, competing with other spending priorities within the fiscal disciplines of the FSL.
- **Enhanced exchange rate flexibility will help the economy better adjust to external imbalances and shocks and safeguard foreign exchange buffers.** Excessive interventions against market fundamentals are unlikely to be a sustainable measure to contain inflation. Underlying pressure on the currency is likely to build up in light of the weak balance of payments prospects and the overall weakening of emerging market currencies. The cost of intervention is particularly high for a country with inadequate reserves as interventions require losses in reserve buffers. Monetary policy focused on reducing external imbalances combined with flexible exchange rate would help ease underlying pressures on the exchange rate and safeguard foreign exchange reserves.
- **The safety buffers of the banking system need to be further strengthened.** Strengthening the bank supervision and prudential regulations may seem pro-cyclical in the short-term, but maintaining loose prudential regulations could prove more costly should the banking system soundness be continuously eroded by worsening asset quality. The NPL recognition rules and loan-loss provision could be further strengthened. The regulatory forbearances granted to PSP loans (i.e., zero percent risk-weighting) since 2013 should be immediately lifted to enhance the transparency and credibility of the banking system.
- **Better targeting of the social welfare programs would help strengthen the social safety net in an economic downturn.** To make the social welfare program more efficient, small programs could be consolidated by prioritizing program design based on the need to provide comprehensive support to the targeted population. To contain costs of social welfare programs while making them more effective, programs could be made poverty-targeted. For example, benefit amounts for the richer quintiles could be reduced or eliminated, using the readily available Poverty-Means-Tested (PMT) household database. The government may want to consider redesigning the Child Money Program (CMP) which alone accounts for half of total social welfare transfers.
- **A recovery in FDI would help the policy reforms to continue with less adjustment costs and mitigate the balance of payments risks.** Revamped foreign capital inflows and improved investor sentiment is expected to support the gradual recovery of the economy in 2016 against weak external demand. This would provide a good opportunity to solidify policy reform efforts, which otherwise would come at higher adjustment costs. Revitalizing foreign investment would also help reduce balance of payments risks, and support materializing economy's long-term growth potential. This would require implementing stable and predictable policies and regulations on investment including the proper implementation of the Investment Law. Clearing the uncertainty over large foreign investment projects in a swift and transparent manner would also help improve investor sentiment towards Mongolia.

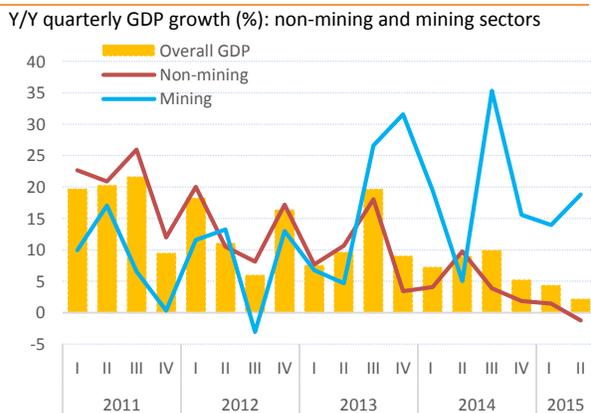
Recent Economic Developments

Sluggish domestic demand and weakening exports drag on growth

Growth slowed to 3.0 percent in the first half from 7.5 percent in the previous six months. Contraction in the non-mining economy dampened overall growth to 2.1 percent in the second quarter from 4.3 percent in the first quarter on a year-on-year basis. Mineral GDP expanded at 16.5 percent in the first half but the rate of growth softened from 24.4 percent in the last half of 2014. Non-mineral GDP contracted by 1.2 percent in the second quarter, down from a 1.5 percent growth in the first quarter. In the first six months, the non-mining sector of the economy contracted by 0.2 percent, from 2.9 percent of the last six months in 2014. (Figure 1)

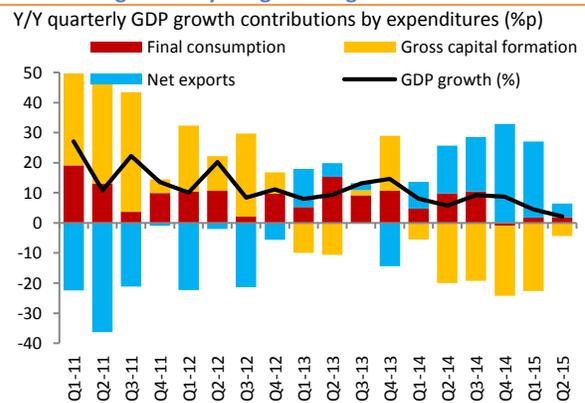
A plunge in investment continued to dampen growth, and external demand also substantially weakened. Fixed investment fell by 43 percent in the first half with foreign direct investment turning into a net outflow of \$27 million from a \$363 million inflow in the same period last year. Sluggish household consumption growth and falling government consumption in real terms dampened final consumption growth to 2.3 percent (y/y) in the same period, down from 7.3 percent of the previous six months. The growth contribution of net exports also substantially declined despite a 7 percent drop in real imports as the export growth in real terms dropped to 1.3 percent in the first six months year-on-year. (Figure 2)

Figure 1. Growth slowed to 3% in the first half.



Source: NSO, WB staff estimates

Figure 2. Falling investment and weakening external demand significantly weighed on growth.

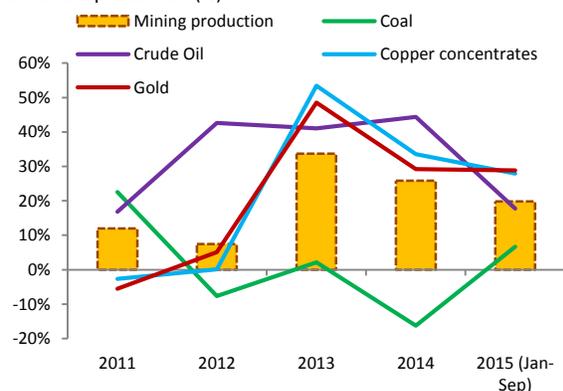


Strong copper production buoyed mineral GDP growth despite a decline in coal production in the first half. Mineral GDP recorded a 22 percent growth in 2014 largely on the back of a 34.5 percent increase in copper concentrate production, with Oyu Tologu (OT) copper and gold mine beginning its first full-year commercial production. Copper concentrate production of OT mine accounted for one-third of total mining production and approximately eight percent of total GDP in 2014. In the first half of 2015, production of copper concentrates increased by 24.9 percent year-on-year, a robust but slower growth than a 56.2 percent growth one year before as OT mine entered into the second year of full production. Coal production declined by 2.4 percent in the same period, reflecting the continued weak coal market conditions. Crude oil production also moderated but maintained a 14.9 percent growth and gold production fell by 15.7 percent. (Figure 3) The mining sector contributed 22 percent of total production of the economy in the first half.

Mining industrial production remained robust in the third quarter. Copper production moderately slowed in the third quarter, increasing by 33 percent year-on-year. Coal and crude oil production also remained robust, growing by 22 percent and 32 percent in the third quarter compared with the same period last year. Gross mining industrial production increased by 25 percent in July-Sep on a year-on-year basis, indicating that the mineral GDP growth will remain strong in the third quarter. Mining production is expected to stay robust in the last quarter of the year but the rate of production growth is likely to moderate.

Figure 3. Production of most commodities remained robust but is gradually slowing.

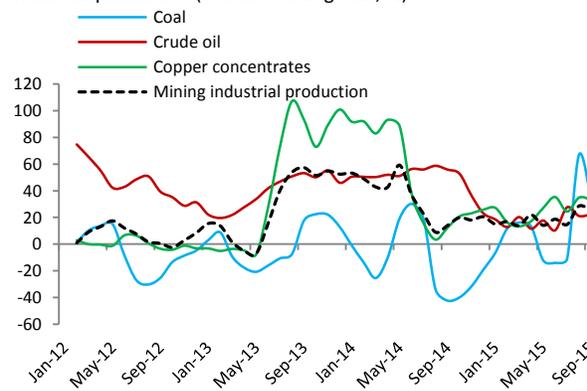
Y/Y annual production growth of key commodities and mining industrial production (%)



Source: NSO, WB staff estimates

Figure 4. Mining industrial production data suggests that the mining production remained strong in the third quarter.

Y/Y monthly production growth of key commodities and mining industrial production (3 month rolling sum, %)



The non-mining sector of the economy sharply slowed amid plunging investment and slower consumption. The market price non-mining GDP contracted by 0.2 percent in the first six months year-on-year. Agriculture growth maintained a robust growth of 9.4 percent (y/y) in the first half despite a drought across the country. However, growth sharply slowed in other non-mining industries. Manufacturing production growth dropped to 1.4 percent (y/y) in the second quarter from 11.1 percent in the first quarter. Wholesale and retail trade was hard hit amid falling imports and fragile consumption sentiment, contracting by 7.6 percent in the first half. Transportation services also declined by 4 percent due to weakening external trades. Construction increased only by 1.3 percent from a year ago amid tighter government capital expenditures and slowing residential property construction. (Figure 5)

Non-mining industries are expected to remain under pressure in the coming months. Manufacturing industrial production fell by 10 percent in the third quarter year-on-year, after a 1 percent contraction in the second quarter. Electricity production also declined by 1 percent in July-September from one year before. (Figure 6) Construction of buildings fell by 24 percent (y/y) in nominal terms. Slower manufacturing production and a continued large decline in imports in July-Sep suggest that the wholesale and retail trade and transportation services will likely remain weak as well.

Unfavorable weather conditions are likely to drag on agricultural production. The newly released agricultural production data shows that crop harvests sharply fell due to the severe drought that lasted in the spring and summer of 2015. Cereal crop harvests of the first nine months reached only 27.7 percent of the last year's level. Harvested vegetables and potatoes were 66 percent and 83 percent of last years' harvests in the first nine months of the year. Accounting for 18 percent of total agricultural production, poor crop harvests are likely to be a drag on the economy. The World Bank team estimates that each 20 percent drop in crop harvests from last year's level would reduce the GDP growth by 0.4 percentage points.

Figure 5. Growth dropped sharply in most of the non-mining sectors of the economy in the first half.

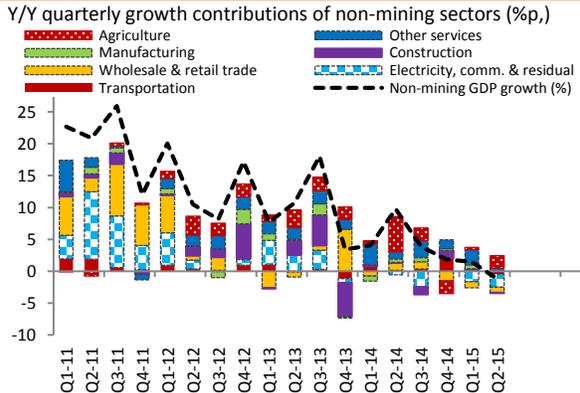
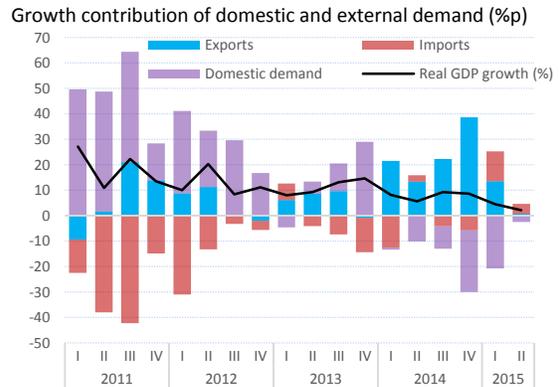


Figure 6. Manufacturing and electricity production growth remained sluggish in the third quarter.



Growth contributions of domestic and external demand are both waning. Strong domestic demand buoyed by FDI inflows and pro-cyclical economic policies propped up double-digit growth in 2011-12, accompanied by a rapid increase in imports that supplied a significant portion of domestic demand. In 2014, the growth contribution of domestic demand turned negative largely due to a plunge in investment demand amid a sharp drop in FDI. Strong exports, however, largely supported growth in 2014 on the back of new copper and gold production of OT mine. In 2015, growth came under heavy pressure from waning domestic and external demand. Domestic demand continued to decline led by a 43 percent drop in investment, reducing imports in real terms. Meanwhile, the growth contribution of external demand (exports) has sharply declined to 6.1 percentage points in the first six months of 2015, down from 30.6 percentage points in the last half of 2014, due to negative terms of trade shocks and falling coal import demand from China. (Figure 7)

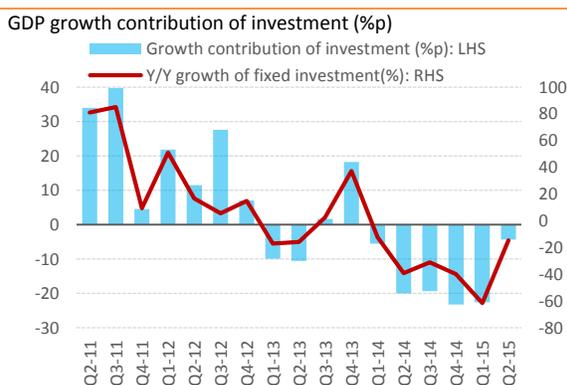
Figure 7. Growth contributions of domestic and external demand are waning.



Source: MoF, DBM, WB projections

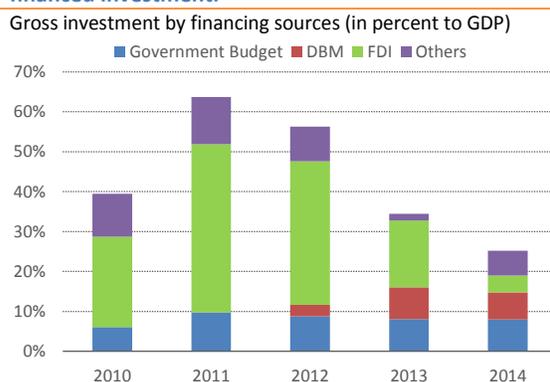
Sharp drops in investment in recent years have been largely driven by substantial declines in foreign direct investment. The composition of financing sources for investment since 2010 shows that Mongolia's investment heavily depends on foreign direct investment (FDI), and a sharp drop in foreign investment has dampened fixed investment since 2013. FDI financed 65 percent of gross investment in Mongolia on average in 2011-12, accounting for around 40 percent of GDP. FDI-financed investment, dropped to 17 percent of GDP in 2013 and further declined to only 4 percent of GDP in 2014. (Figure 8) With FDI sharply falling over the previous two years, public investment financed by the government budget and the Development Bank of Mongolia has rapidly risen relying on domestic and external debt-financing. Public sector investment rose to over 15 percent of GDP in 2014 from less than 10 percent of GDP in 2011 due to revamped capital expenditures by the government budget and the off-budget expenditures of the DBM. (Figure 9) In 2015, investment remains under heavy pressure as FDI inflows further decline and the rapid expansion of public investment cannot be sustained with growing debt and weaker budget revenues.

Figure 8. Investment has rapidly declined since 2014...



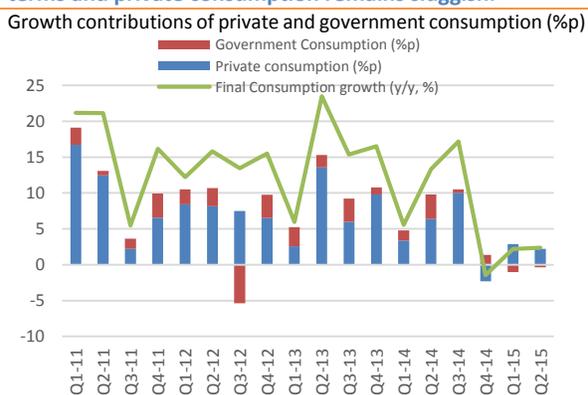
Source: NSO, WB staff estimates

Figure 9. ... mostly driven by sharp declines in FDI-financed investment.



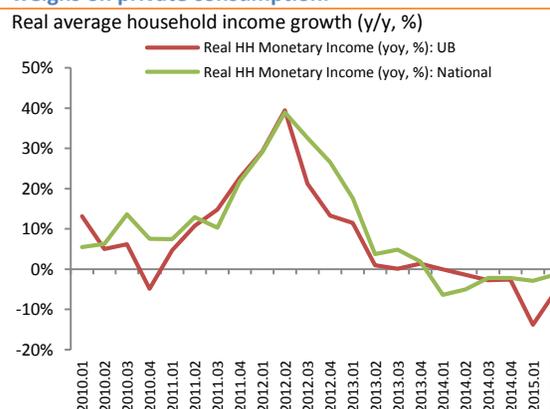
Tighter fiscal conditions and sluggish real income growth weigh on consumption. Final consumption growth slowed to 2.3 percent (y/y) in the first half, down from 7.3 percent in the previous six months. Real government consumption expenditures declined by 4.2 percent amid tight fiscal conditions. Private consumption growth remained positive but slowed to 3.8 percent from 7.5 percent in the last half of 2014, amid negative real income growth of households. (Figure 10) Average household real income began to slow in mid-2013 with double-digit inflation after a rapid growth in 2011-2012. Household real monetary income growth remained below the consumer price inflation since early 2014. The weakening of real household income and expenditures appears more severe in Ulaanbaatar which is likely to be more affected by a slowdown in the secondary and tertiary sectors of the economy. (Figure 11)

Figure 10. Government consumption declined in real terms and private consumption remains sluggish.



Source: NSO, WB staff estimates

Figure 11. Negative real household income growth weighs on private consumption.



Inflation moderates amid lower food price inflation and subdued domestic demand.

Headline inflation has been moderating since July 2014. National consumer price inflation fell to 9.8 percent (y/y) in January from its peak of 14.9 percent in July 2014, and has further moderated to 6.6 percent in August, below the 7 percent inflation target of the BoM. The consumer price inflation substantially declined in September to 4.9 percent, driven by an 11.4 percent drop in the meat price. The core inflation

– which excludes items with volatile prices such as food – continued to edge down to 6.1 percent in September from 7.2 percent in the previous month amid tighter policies and subdued domestic demand.

A sharp drop in the meat price significantly contributed to slower inflation. Food price inflation in UB decelerated to 2.3 percent (y/y) in August, and turned into a negative 1.3 percent in September. Lower meat prices have been behind the falling food price inflation in 2015 due to increased supply of meat. In particular, the meat price dropped by 6.2 percent in August and 10.5 percent in September as compared with the price level in the same months last year, due to increased meat supply from herders expecting harsher winter conditions. Non-food price inflation also slowed to 6.3 percent in September from 11.8 percent nine months ago. Administered price inflation – which includes utility prices, tuition and transportation fees – climbed to 12.3 percent (y/y) in September, picking up from 10.3 percent in July. The prices of electricity and hot water were raised by 4.2 percent and 19 percent respectively in July, followed by a 23.5 percent rise in tuition fees in August.

Inflation will likely stay under downward pressure from weak domestic demand in the coming months. Reduced supply-side pressure has substantially contributed to moderating inflation in 2015, particularly via the lower food price inflation. Subdued domestic demand coupled with a tightened monetary policy stance helped ease the demand-pull inflationary pressure. Without unexpected disruptions in food supply and a loosening of the monetary policy, inflation would likely continue to stabilize towards the end of the year. Despite the continued moderation in inflation, inflation expectations are still high after persistent double-digit inflation in recent years, reflected in demand for double-digit wage growth by workers and trade unions. In 2016, inflationary pressure may rise with large domestic liquidity injection stemming from increased FDI inflows. Continued commitment of the monetary authorities to the price stability would help maintain stable inflation and strengthen the credibility of central bank’s inflation target, which would eventually help lower high inflation expectations that have been persistent in recent years.

Figure 12. Inflation continued to slow to 4.9 % in September, driven by a price drop in the meat price.

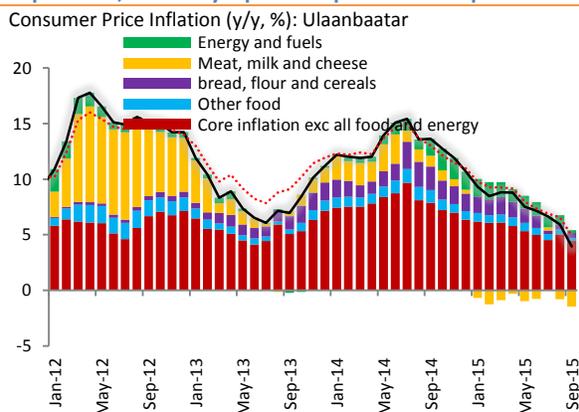
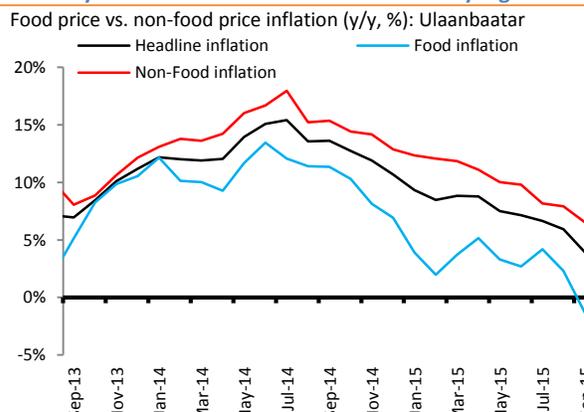


Figure 13. Food price inflation entered into negative territory while core inflation remains relatively higher.



Box 1: Producer price index and imported price inflation

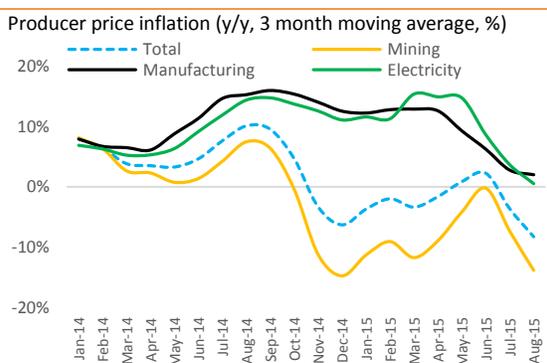
The National Statistics Office of Mongolia (NSO) began to publish the monthly industrial producer price index (PPI) in 2015. The PPI measures the prices of domestically produced goods received by producers, also known as the wholesale prices. The PPI is different from the consumer price index (CPI)

which measures the retail prices of both domestically produced and imported goods that are included in a predefined basket of consumption goods. The new PPI is based on the 2010 price level but its coverage is limited to key industrial sectors including mining, manufacturing and electricity industries.

The recent PPI trend indicates the deteriorating market conditions for the industrial sectors of the economy. In particular, the mining producer prices have sharply dropped since late 2014, reflecting price drops in key commodities such as coal, copper and crude oil. The mining producer price index fell by 22 percent in August, compared with the same month last year. The year-on-year growth in the manufacturing producer price index remained high in 2014 and early 2015, reaching 13 percent in the first quarter of 2015. However, the manufacturing producer inflation slowed in the second and third quarters to 1.5 percent (y/y) in August. (Figure 14)

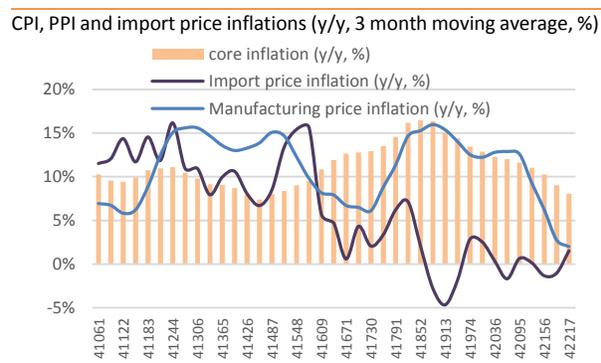
The PPI combined with import price data could provide useful information on underlying sources of inflationary pressures in recent years. Assuming stable retail margins added to the wholesale prices, the manufacturing producer price index trend would indicate how the prices of domestically produced goods broadly affected consumer prices. The import price index converted to local currency values would show the inflationary pressure stemming from foreign inflations (or changes in import prices in tugrik terms). The past trend in the manufacturing PPI published by the NSO and the import price index valued in tugriks indicates that inflation began to pick up in late 2013 in tandem with an import price increase that were likely triggered by a sharp exchange rate depreciation in August 2013. Higher prices of imported goods gradually translated into higher core inflation in late 2013 and early 2014. Core inflation began to rapidly accelerate to double digits in mid-2014 as the prices of domestic goods – which constitutes 70 percent of the consumer price index basket – sharply rose, reflecting higher prices of imported intermediated inputs. In 2015, the core inflation has been on a moderating path amid a continued slowdown in the prices of domestic goods and subdued import price inflation with lower oil prices and slower exchange rate depreciation. (Figure 15)

Figure 14. Industrial PPI inflation slows in 2015, with a sharp drop in the mining producer price.



Source: NSO, BoM, WB staff estimates

Figure 15. Slower price increases in both domestic and imported goods contributed to lower inflation.



Source: World Bank staff

Steps were taken to restore fiscal sustainability in the medium term.

Measures were taken by the government to curb the growing budget deficit and government debt.

Mongolia's fiscal reform agenda was set by the Comprehensive Macro Adjustment Plan (CMAP) that was approved by the parliament in February. The amendment of the Fiscal Stability Law (FSL) in January and the adoption of the Debt Management Law (DML) in February provided a legal framework for medium-term fiscal adjustment.

- **New deficit and debt ceilings were set for 2015-18 by amending the FSL.** A new structural budget deficit ceiling was set at 5 percent of GDP for 2015 and was mandated to be gradually tightened to 2 percent of GDP by 2018, including the budgetary projects financed by the DBM. The ceiling on the present value of the government debt – formerly 40 percent of GDP – was relaxed to 58.3 percent of GDP for 2015 and mandated to be gradually reduced to 40 percent of GDP by 2018.
- **January amendment of the 2015 budget reflected new fiscal ceilings and included DBM's non-commercial projects.** The amended 2015 budget aimed to curb the structural deficit within 5 percent of GDP (overall deficit of 4.9 percent of GDP), as required by the amended FSL. Reflecting slowing economic conditions, budget revenue projections were adjusted downward by 7.4 percent and the on-budget capital expenditures were reduced by 34 percent compared with the original 2015 budget. To curb off-budget expenditures, the non-commercial projects financed by the DBM (MNT 794 billion) were newly added as general government's capital expenditures, which included construction of roads, streets, railways, and a hydroelectric dam. Commercial projects financed by the DBM, however, remain outside the budget.
- **Some fiscal consolidation measures proposed by the government, however, failed during the parliament review of the 2015 budget in January.** Government's proposal to save about MNT 100 billion by reforming social transfer programs (e.g., Child Money Program) failed to get the parliament's approval. The budget revenue projection (MNT 6.3 trillion) proposed by the MoF was revised upward by the parliament to MNT 6.7 trillion to allow more spending, which eventually undermined the credibility of the 2015 budget revenue projections.
- **A unified debt management framework was established with the adoption of the new Debt Management Law.** The Debt Management Law (DML) was adopted by the parliament in February and unified scattered debt management functions into the MoF, regulating legal procedures and requirements for borrowing and guarantees by the general government. The new Debt Management Law also strengthened the debt reporting system. The MOF is required to establish and maintain a centralized government debt information system which will include outstanding public foreign debt, government and government guaranteed debt, information on government securities and foreign debt, and information on projects that are financed by government debt.

FSL's control over debt, however, was loosened. The amended FSL narrowed its debt definition to "general government debt" from "public debt", excluding SOE debts that are not under government guarantees from FSL's debt ceiling. Government guarantees that are collateralized by borrower's government bond holdings were also excluded from the debt ceiling. This allowed the government to seek further external borrowing without breaching FSL's debt ceiling by using non-government entities, particularly major commercial banks which are the major holders of government bonds. In May, this scheme was put into use as one commercial bank (TDB) raised \$500 million in government-guaranteed bonds, collateralized by the government bonds in TDB's balance sheet.

Steps are also being taken to improve the transparency of DBM's operation. The DBM began to publish information of its project portfolio on the website, according to the Glass Account Act. The interim financial statements based on an independent auditing for the first half of 2015 was publicly released in June. DBM's 2015 business plan which was approved by its Board in June is yet to be publicly disclosed. Amendment of the DBM law is currently under discussion. The current amendment proposal of the DBM law follows the guidelines set by the Government Resolution 95 (March 18, 2015) including:

- Budgetary spending of the DBM to be phased out and transferred to the budget by 2018;
- DBM projects that are subject to Public Procurement Law to be identified by the MoF;
- Operational interventions from the government and parliament to be prevented;
- Governance structure to be improved by separating the government's roles as a shareholder and as a regulator;
- Prudential regulations to be developed for DBM's operations and the DBM to be subject to the banking supervision of the BoM.

Fiscal policy became tighter amid large revenue shortfalls.

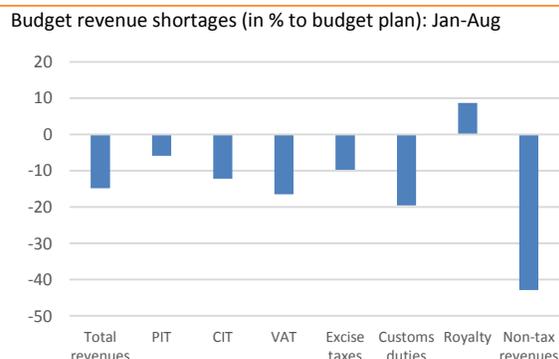
Large revenue shortfalls have been severely constraining the fiscal space. In the first eight months, budget revenue receipts fell short of the budget plan by 16 percent. Shortfalls in tax revenues reached 11 percent compared with the budget plan. (Figure 16) Sharp declines in imports caused 36 percent and 17.6 percent revenue shortfalls in import VAT and customs duties. Revenue shortfalls in corporate income tax reached 10.4 percent compared with the budget plan. Royalties from mining companies fell short of the budget plan by 9 percent in the same period. Non-tax revenues have been experiencing a 36 percent revenue shortage over the same period due to poor revenue outturns from dividend revenues and privatization receipts. Under the current trend, total budget revenues are expected to fall below last year's revenue outturn (MNT 6.1 trillion) and the annual revenue shortage will reach up to MNT 1 trillion.

In response to revenue shortages, tight expenditure controls have been implemented by the fiscal authorities. A government resolution was issued in June, putting tight expenditure controls on discretionary spending items, including purchases of goods, operating expenses, special purpose transfers to local governments, and capital expenditures to new investment projects including DBM's budgetary portfolio. The resolution put spending priority on necessary expenditures including wages and salaries, social insurance and welfare benefits, utility costs and expenses of medical institutions, sanitation expenses, and foreign financed projects. As a result of the spending controls, budget spending execution remained at 78 percent of the plan between January and August. Capital expenditure execution remained at only 45 percent of the spending plan and purchases of goods and contracted work remained at 80 percent of the budget. Meanwhile, expenditures on wages, social insurance spending and social welfare transfers have been almost fully executed. (Figure 17)

With a prolonged delay in adopting a supplementary budget, there has been a growing concern on the limited effectiveness of administrative spending control measures. The government resolution did not have full control over the entire expenditure cycle from commitments to payments. Monthly cash rationing based on revenue outturns has not been able to effectively curb new commitments made by line ministries. As a result, the government seems to have accumulated payment arrears to some contractors, which would inevitably ramp up budget spending towards the end of the year. Increasing payment arrears of the government would also adversely affect the banking sector soundness as many contractors are likely

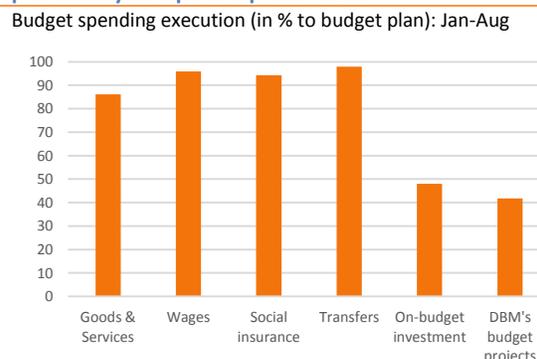
to rely on bank loans for their project financing. To mitigate the pressure on the banking system from the challenging fiscal situation, the government issued promissory notes to some contractors in lieu of delayed payment.

Figure 16. Revenue shortages reached 16% of the budget.



Source: MoF, DBM, BoM, WB staff estimates

Figure 17. Budget spending execution has been tight, particularly in capital expenditures.



The supplementary budget for 2015 was adopted in early November and the draft 2016 budget is under discussion.

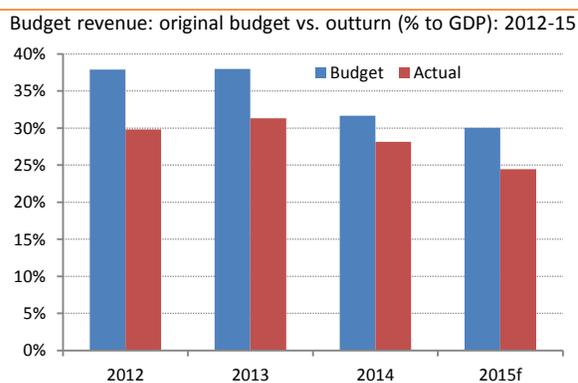
The supplementary budget for 2015 was approved by the parliament in November. Anticipating a MNT 900 billion revenue shortfall compared with the budget towards the end of the year, the second supplementary budget reduced budget spending by MNT 560 billion and mobilize additional revenues by MNT 340 billion. Spending cuts include a MNT 120 billion cut in the wage bill and operating expenses by postponing wage increases, and a MNT 480 billion cut in capital expenditures including a MNT 350 billion reduction of DBM's budgetary spending. Capital expenditure adjustments will be made by postponing new investment projects to the next year. Subsidies and transfers – which include social welfare benefits – were left almost unchanged. The additional revenue mobilization plan of the supplementary budget may prove challenging. The revenue mobilization measures plan to raise MNT 61 billion by increasing the excise tax rate and customs duties on petroleum products amid lower oil prices. The largest revenue mobilization, however, is planned to be made by collecting from tax payment arrears, which could prove difficult to achieve in only two remaining months of the year given the weak economic conditions.

The draft 2016 budget was also submitted to the parliament, aiming to curb the structural budget deficit within 4% of GDP, as required by the Fiscal Stability Law. The draft budget assumed the aggregate budget revenue to reach MNT 6,989 billion, a 15 percent increase from the 2015 revenue estimates of the supplementary budget. The revenue projections expect an 8.4 percent increase in tax revenues and a 48 percent increase in non-tax revenues and foreign grants, compared with the 2015 supplementary budget. Based on the revenue projections, the draft budget proposed to increase the aggregate budget spending by 8 percent to MNT 7.9 trillion from MNT 7.3 trillion of the 2015 supplementary budget. The recurrent expenditures are proposed to be contained at a 5 percent growth by reducing the wage bill. The capital expenditures, however, are planned to increase by 32 percent from MNT 1,530 billion in 2015 to MNT 2,016 billion, including MNT 450 billion of the DBM-financed capital expenditures. Under the budget plan and a 4.1 percent real GDP growth assumption, the structural budget deficit is planned to be contained at MNT 901 billion, equivalent to 3.3 percent of the nominal GDP projected by the budget.

The revenue mobilization plan of the 2016 draft budget entails elements of uncertainty. Assumptions on commodity prices are broadly in line with the projections of international institutions. Assumptions on export volumes, however, could prove challenging. In particular, the revenue estimates assume that coal export volume will increase to 19.5 million tons next year, a 42 percent rise from 13.7 million tons in 2015. This is likely to be optimistic in the wake the weak prospects of the coal market conditions and an expected slowdown in China. Another uncertainty stems from implementation risks to a proposed privatization plan. The draft budget proposed to raise MNT 171 billion by privatizing the State Bank, the Stock Exchange and other state owned entities. The prospect of the privatization plan remains uncertain considering the weak track record of previous privatization plans and lack of public consultation process so far. In addition to the uncertainty, privatization revenues are supposed to be recorded as a financing component according to the 2011 Government Financial Statistics Manual. Mongolia has been recording privatization revenue as a non-tax revenue item since 2013. Including privatization revenue as a financing item in line with international standards would increase the budget deficit by an equivalent amount. Finally, the draft 2016 budget expects MNT 368 billion in foreign grants, a substantial increase from MNT 62 billion in 2015, largely due to new bilateral grants from China that are planned to be finalized next year.

Overestimation of revenues has been a repeated problem in fiscal planning in recent years. In 2012-14, original budgets had to be repeatedly cut due to overstated budget revenues, with budget revenue shortages averaging 17 percent of original revenue projections. (Figure 18) Experience in recent years shows that revenue estimates proposed by the fiscal authorities tend to be revised upward during parliament reviews to allow more spending.

Figure 18. Overstated revenue projections have severely undermined the credibility of budget in recent years.



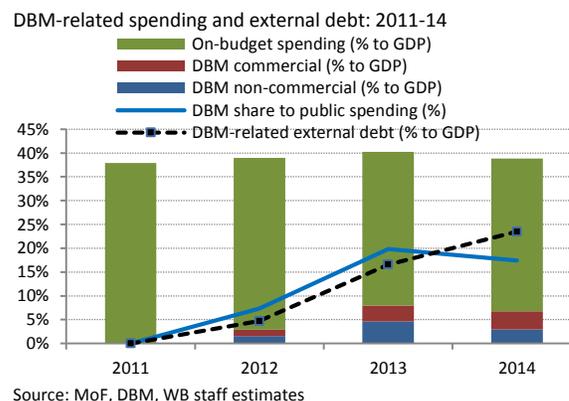
Source: MoF, DBM, BoM, WB staff estimates

Public investment financed by the DBM became tighter.

The Development Bank of Mongolia (DBM) provided around MNT 0.7 trillion to its budgetary and non-budgetary projects in the first eight months. The annual business plan of the DBM plans to finance MNT 794 billion to budgetary (or non-commercial) projects and MNT 715 billion to non-budgetary (or commercial) projects. The budgetary portfolio of the DBM is now included in the central government budget as capital expenditures financed by the DBM. The non-budgetary portfolio of the DBM, however, is excluded from the government budget. (See Box 2 for more details on DBM's project classification). Between January and August, the DBM financed MNT 248 billion to the budgetary projects out of the MNT 794 billion annual plan, reflecting spending control of the fiscal authorities. Meanwhile, the DBM also financed about MNT 440 billion over the same period to its commercial portfolio. The annual expenditures of the DBM are expected to decline to around MNT 1 trillion, from MNT 1,487 billion last year. The 2015 supplementary budget reduced the capital expenditures to be financed by the DBM to MNT 452 billion in 2015, from MNT 794 billion of the original plan. The commercial project financing of the DBM is also expected to be contained at around MNT 600 billion, a more than MNT 100 billion reduction from its original annual plan.

Without proper control and supervision, the commercial portfolio of the DBM could pose macro-economic and fiscal risks. DBM's commercial spending averaged 3.6 percent of GDP in 2013-14 and is expected to reach 3 percent of GDP in 2015 according to the current business plan. External financing of the DBM has been one of the key factors behind rapidly increasing external debt as most of the DBM projects have been financed by sovereign or sovereign-guaranteed borrowings. Government debt that have been raised to finance DBM projects reached US\$ 2.7 billion over the last three years, equivalent to 23 percent of the 2014 GDP. Further external financing of commercial projects in the coming years would inevitably rely on explicit or implicit government guarantees, which would further elevate the government and public debts.

Figure 19. DBM-related spending and external debt have rapidly risen since 2012.



Box 2. The loan structure and financing sources of the Development Bank of Mongolia

The DBM released its Interim Financial Statements and an Independent Auditor's Report for the first half of 2015 on June 30, 2015. This box provides a summary of the composition of loans and the source of financing, based on DBM's interim financial statement and the independent auditor's report.

1. Composition of Loans

The DBM held MNT 4,374 billion of loans and advances in its balance sheet at the end of June, 2015. MNT 2,244 billion of loans (51.3 percent) were loans to budgetary projects, which will be repaid by the state budget. MNT 2,219 billion was commercial loans that were issued to the corporate sector and state owned enterprises (SOEs).

Budgetary projects. Loans that were given to projects to be repaid from the state budget are classified as socially beneficial projects that do not create cash flows of their own. These projects cover areas such as improvement of rural and city roads, civil engineering construction, extension and improvement of power and heat plant, building of new railways and mortgage financing through commercial banks. All of these loans are under direct government guarantees. DBM lending to the budgetary projects were not recorded in the budget until 2015.

Commercial projects. Loans and advances given to the corporate projects are to be repaid from the future cash flows of projects or borrowers. These loans are classified as commercial projects and are not included in the budget. The DBM provided lending to corporate projects which the government considers priority commercial activities (air transport development, support of mining industry, housing, infrastructure, and manufacturing projects). A quarter of commercial projects are currently under explicit government guarantees.

The loans to corporate customers include MNT 623 billion of policy on-lending operations to 10 commercial banks which provided subsidized loans to government programs to support SMEs and strategically important sectors, such as Mongol "888" export promotion projects and leather production projects.

The report also explains that MNT 1,103 billion was lent to seven state owned enterprises (SOEs), as a part of commercial loans. These SOEs include Erdenes Tavan Tolgoi (ETT), Erdenes MGL, State Housing Corporation, SME Development Fund, MIAT Airlines, Baganuur mining SOSC. A US\$ 200 million loan was issued to ETT, a state-owned mining company, in September 2013, under government guarantee. A MNT 175 billion loan was issued to Erdenes MGL, a state-owned holding company of strategic mines, without government guarantee.

Table 1. Composition of DBM loans (MNT billion): June 2015

Composition of loans and advances	Outstanding balance
1. Loans and advances to be repaid from the State Budget: Budgetary Projects	2,244
Under government guarantees	2,244
2. Loans and guarantees to be repaid by corporates: Commercial projects	2,219
Corporate loans under government guarantees	562
Policy on-lending to 10 commercial banks (888 projects, SME support projects etc.)	623
Other loans collateralized by plants, properties and equipment	944
3. Total gross outstanding loans and advances	4,374

2. Financing sources

The financial statement and the auditing report show the composition of DBM's financing sources. (Table 2) As of June 2015, 92 percent of DBM's liabilities were either government bonds or government guaranteed external borrowings. The DBM financed MNT 4 trillion from government or government-guaranteed bonds, including the US\$ 1.5 billion sovereign Chinggis bond (Dec 2012), a US\$500 million DBM euro bond (March 2012), and a JPY 30 billion government-guaranteed samurai bond (Dec 2013). In addition, the DBM borrowed MNT 904 billion from foreign banks, most of which were under government guarantees.

Table 2. Composition of DBM liabilities (MNT billion): June 2015

Composition of DBM's liabilities	Outstanding balance
1. Bonds	1,478
DBM Euro bonds (under government guarantee): March 2012	1,149
Samurai bonds issued in 2014 (under government guarantee): Dec 2013	379
2. Borrowings	3,461
Sovereign Chinggis bond proceeds: Dec 2012	2,557
Borrowing from foreign banks	904
Commerz Bank loans (no government guarantee): April 2014	23.8
Syndicated loans (under government guarantee): Dec 2014	583
China Development Bank (under government guarantee): Aug 2014 – present	261
Vnesheconombank (no government guarantee): June 2015	36.5
3. Others	387
4. Total liabilities	5,376

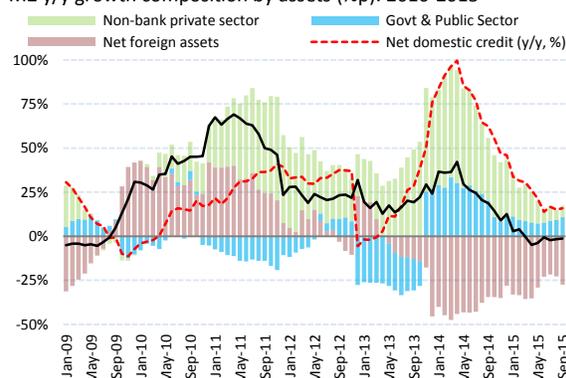
Source: PWC Audit LLC, Independent Auditor's Report on the Interim Financial Statement of the DBM, June 2015
<http://www.dbm.mn/монгол-улсын-хөгжлийн-банкны-2015-оны-эхний-хагас-жилийн-аудитлагдсан-тайлан/>

Monetary conditions have tightened.

Broad money (M2) growth remains subdued in 2015, with slowing domestic credit growth and declining net foreign assets. M2 growth reached over 40 percent year-on-year in early 2014 despite sharp losses in net foreign assets¹ as domestic credit growth skyrocketed to over 150 percent. M2 growth has been decelerating since mid-2014 and remained in negative territory since March, with slowing domestic credit growth and persistent losses in net foreign assets. The growth of domestic credit to the private sector decelerated to 4.9 percent in September from 21.4 percent in January, reflecting the tighter monetary policy stance and subdued loan demand. The net foreign assets of depository institutions (the value of foreign assets of the BoM and banks, less foreign liabilities) continues to drop in 2015, reflecting central bank interventions in the foreign exchange market and persistent foreign currency demand of the private sector amid a continued current account deficit. (Figure 20) The liability composition of broad money shows that local currency deposits have been eroded by slower money supply growth in recent months while the foreign currency deposit growth remained positive year-on-year. (Figure 21)

Figure 20. M2 growth remains weak, with slowing domestic credit growth and falling net foreign assets.

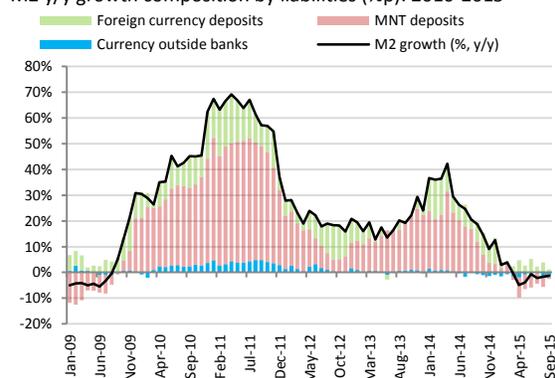
M2 y/y growth composition by assets (%p): 2010-2015



Source: BoM, WB staff estimates

Figure 21. Slower money supply growth has been eroding local currency deposits in recent months.

M2 y/y growth composition by liabilities (%p): 2010-2015



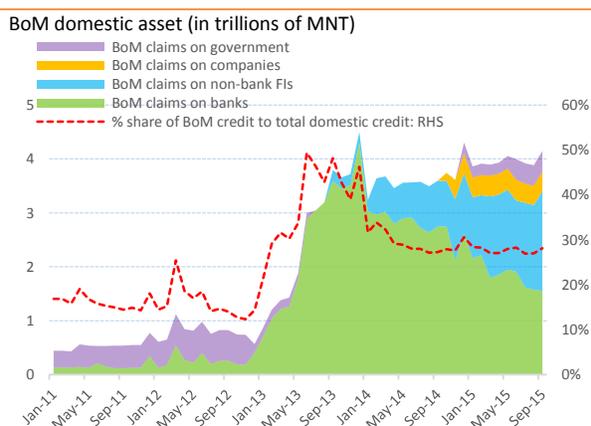
The central bank balance sheet rapidly expanded in the previous two years. BoM's domestic assets sharply increased in 2013 from MNT 566 billion at the end of 2012 to MNT 4.5 trillion one year later, driven by BoM's aggressive quantitative easing programs which injected MNT 3.5 trillion (18 percent of GDP) at its peak in December 2013. As a result, central bank's domestic assets reached 46 percent of total domestic credit at the end of 2013, a substantial jump from 14 percent one year ago. BoM's quantitative easing measures were led by two quasi-fiscal lending programs: (i) the Price Stabilization Program to support the suppliers of key consumptions goods and the construction industry; and (ii) a subsidized housing mortgage program to support affordable housing to middle-income families and to boost the construction sector. The BoM also injected MNT 900 billion into commercial banks as one-year term deposits in 2013.

The phasing-out of the Price Stabilization Program has slowed the balance sheet expansion, but central bank's domestic assets remain substantial with the growing housing mortgage program. Central bank's outstanding domestic assets declined moderately to MNT 4.1 trillion in September 2015,

¹ A drop in net foreign assets of depository institutions means that an equivalent amount of domestic currency deposits was reduced in exchange for foreign currencies needed for external payments, for example imports. This would reduce existing money supply, by absorbing domestic currency liquidity back into the banking system or the BoM.

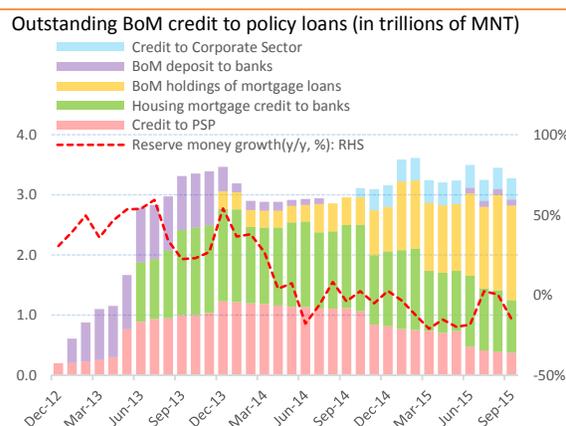
from MNT 4.3 trillion at the beginning of the year. (Figure 22) The central bank began to gradually taper some of its quantitative easing programs in 2014. MNT 900 billion that had been placed at commercial banks was fully withdrawn by mid-2014. Liquidity injection via Price Stabilization Program (PSP) also gradually slowed in 2014 and the program has been phased out without further liquidity injection since early 2015. As maturing PSP loans have been withdrawn, the outstanding BoM credit to PSP substantially declined to MNT 376 billion in September, from over MNT 700 billion at the end of 2014. The outstanding PSP loans are expected to decline to MNT 232 billion by the end of 2015 and to be almost fully withdrawn by the end of 2016. The BoM financing to the subsidized housing mortgage program, however, continued to grow from MNT 1.7 trillion one year ago to MNT 2.4 trillion in September, including MNT 1.6 trillion of securitized mortgage loans that were transferred to BoM's balance sheet from commercial banks. The BoM also provided a MNT 350 billion liquidity support to the corporate sector late 2014 via banks. With the growing housing mortgage program and the one-off corporate sector financial support, outstanding policy loans provided by the BoM still remains substantial, reaching over MNT 3 trillion in September or 22 percent of total domestic credit of the economy. (Figure 23)

Figure 22. Expansion of BoM's balance sheet slowed since 2014 with the phasing out of PSP loans.



Source: BoM, WB staff estimates

Figure 23. BoM's policy credit remain substantial with the growing mortgage program.



The dynamics in the composition of reserve money (or monetary base) illustrate the effect of the monetary and fiscal policies in the past years. Changes in the net foreign assets of the central bank, its foreign asset holdings less its foreign liabilities, show the contractionary effect of BoM's foreign exchange market interventions on the reserve money supply. BoM's net foreign assets have been steadily declining since the end of 2012 when the US\$ 1.5 billion proceeds of the Chinggis bond boosted official international reserves to above US\$ 4 billion. Continuous foreign exchange market interventions by the central bank, however, have reduced the monetary base by absorbing local currency liquidity back into the central bank vault. The net foreign assets turned negative in 2015 as the central bank foreign liabilities exceed its foreign assets. The reserve money supply from BoM's quantitative easing (QE) programs is reflected in the central bank claims on non-government entities which include the financial sector and the corporate sector. In 2013-14, the monetary base has expanded by more than MNT 4 trillion due to central bank's direct liquidity injection to the financial and the corporate sector, accounting for 40 percent of total domestic credit increase of the economy over the same period. Another main factor behind reserve money supply in the past two years was DBM's off-budget expenditures financed by the Chinggis bond proceeds. In December 2012, US\$1.5 billion received from the Chinggis bond was placed (as tugrik deposits) at the central bank, which did not have an immediate monetary supply impact as it was off-set by a large increase of government deposits (i.e., a big drop in net claims on the government at end-2012). However, reserve money supply by the government began to expand in mid-2013 as the

Chinggis bond proceeds were injected into the economy via DBM's off-budget expenditures, shown in steady declines in the net claims on the government. The combination of central bank's quantitative easing programs and large public spending accelerated the reserve money growth to over 50 percent (y/y) by the end of 2013. (Figure 24)

Reserve money growth has considerably slowed in 2015. The growth of reserve money or monetary base began to slow in mid-2014 and remained in a negative territory in most of 2015 due to: (i) declines in the net foreign assets of the central bank with continued foreign exchange market interventions; (ii) the phasing-out of the Price Stabilization Program by the central bank; and (iii) the slower reserve money supply from the government sector amid tighter fiscal conditions. Reserve money growth experienced a large fluctuation in July and September, reflecting fresh reserve money flows from new external borrowing and repayment during the period. (Figure 25)

Figure 24. QE programs and budget deficit substantially contributed to reserve money supply in 2013-14.

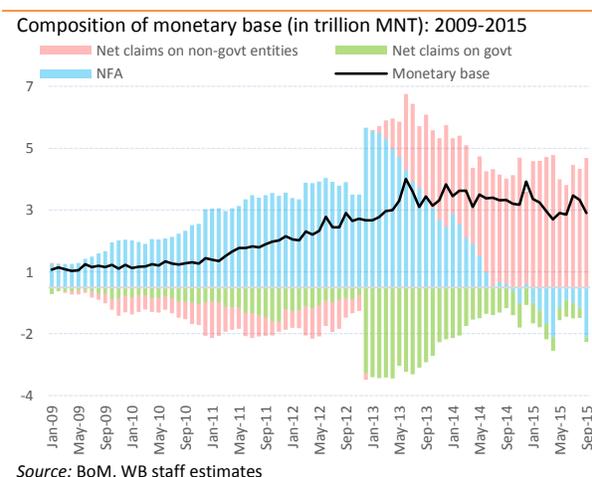
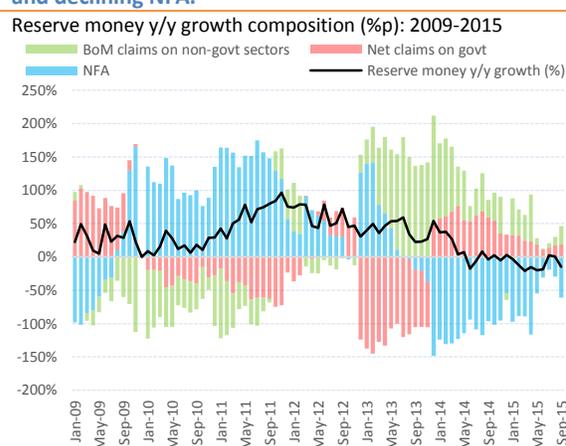


Figure 25. Reserve money growth remained in a negative territory in 2015 amid slowing QE programs and declining NFA.



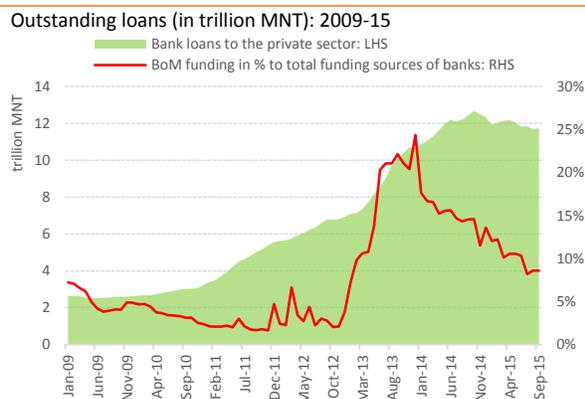
The banking sector remains under strain with tighter funding conditions and deteriorating asset quality.

The year-on-year growth of outstanding bank loans declined to 4.3 percent² in September from 18 percent nine months ago. Bank loan growth rapidly accelerated in 2013 and early 2014 on the back of quantitative easing programs, reaching 60 percent (y/y) in early 2014. As bank loans almost doubled in one and a half years, the share of BoM credit among total liabilities (or sources of funding) of commercial banks sharply rose to 21 percent at the end of 2013 from a mere two percent in late 2012. (Figure 26) Growing dependence on central bank financing became a substantial downside risks to the banking system as commercial bank's balance sheet became significantly vulnerable to an inevitable tapering of quantitative easing programs. In late 2014, the downside risk began to materialize, with bank loan growth steeply declining as the pace of liquidity injection by the central bank slowed compared with the previous period. In

² Our definition of outstanding loans includes mortgage loans that have been securitized by the Mongolia Mortgage Corporation since 2013. 90% of the securitized mortgage loans (RMBSs) were transferred to BoM's balance sheet from commercial banks and are now excluded from commercial banks' balance sheet.

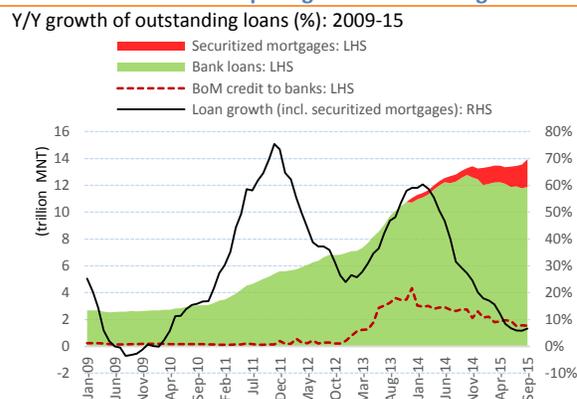
2015, bank loan growth has been further slowing with the withdrawal of PSP loans and weaker loan demand amid slowing growth. (Figure 27)

Figure 26. Rapid expansion of loans relying on BoM funding made banks vulnerable.



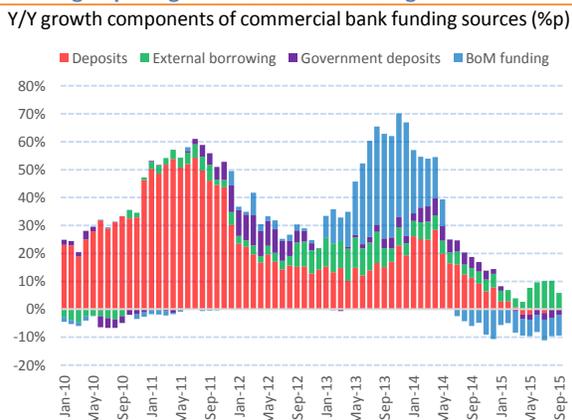
Source: BoM, WB staff estimates

Figure 27. Bank loan growth has been declining since mid-2014 in tandem with a tapering of BoM financing.



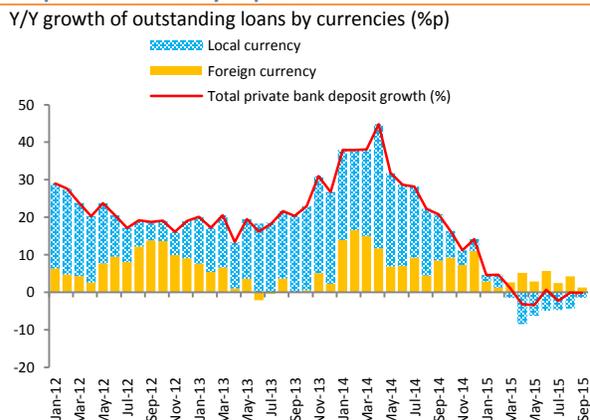
Funding conditions of banks have considerably tightened. In 2013 and early 2014, massive central bank funding bolstered banking sector liquidity but the strong deposit growth remained a significant source of funding for banks. Since late 2014, customer deposit growth has substantially weakened, straining the banking system liquidity. Local currency deposits have been particularly weaker, showing a negative growth since March compared with its level of the last year. The growth of foreign currency deposits – which account for 33 percent of total deposits – has been robust both in US\$ and local currency values. External funding of the banking system substantially increased in May due to fresh liquidity provided by a sovereign-guaranteed bond issuance of one commercial bank. However, this increased liquidity was mostly absorbed by increasing excess reserves so far, with only limited impacts on bank loan growth due to weaker loan demands amid the slowing economy.

Figure 28. Funding conditions for banks are tighter with slowing deposit growth and BoM funding.



Source: BoM, WB staff estimates

Figure 29. Slower deposit growth is mostly driven by a drop in local currency deposits.

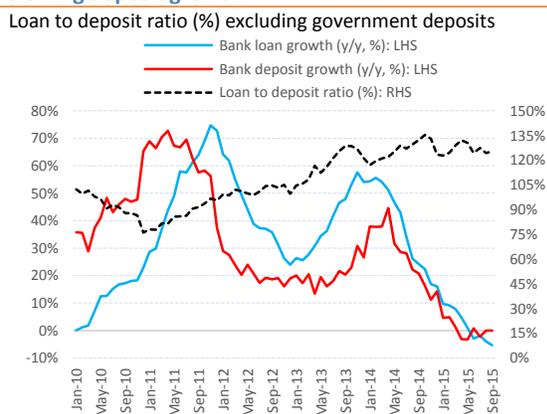


Loan-to-deposit ratio still remains high at 125 percent with loan growth exceeding deposit growth. Loan-to-deposit (LTD) ratio, which is commonly used to assess bank liquidity capacity against possible withdrawals of deposits, rose from 100 percent at the end of 2012 to 135 percent late 2014 due to large

increases in policy loans funded by the central bank. LTD ratio has been gradually declining with the withdrawal of PSP loans and slower loan growth, but still remains high with the loan growth exceeding the deposit growth.

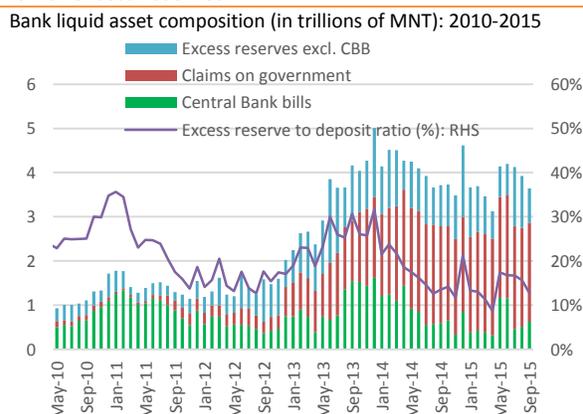
Reserve buffers of the banking system are tighter. Bank reserves excluding central bank bills stood at 19.1 percent of total deposit in September, well above the 12 percent reserve requirement ratio. However, bank excess reserves have been on a declining trend since early 2014. Tighter excess reserve conditions were also reflected in weaker demand for government bonds in 2015, with some of government securities auctions undersubscribed and the interest rates of one-year government bonds hiked up to 14-16 percent.

Figure 30. Loan-to-deposit ratio remains high with slowing deposit growth.



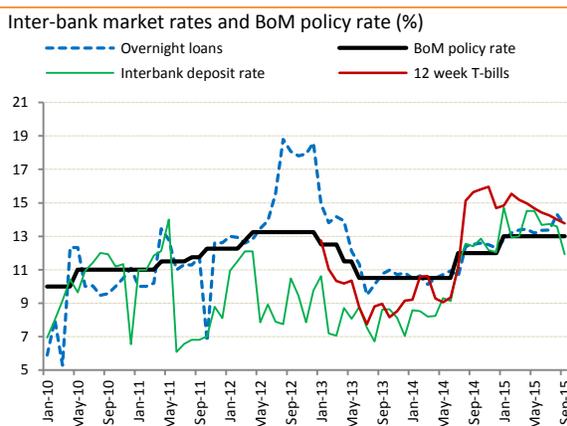
Source: BoM, WB staff estimates

Figure 31. Tighter liquidity conditions are reflected in lower excess reserves.



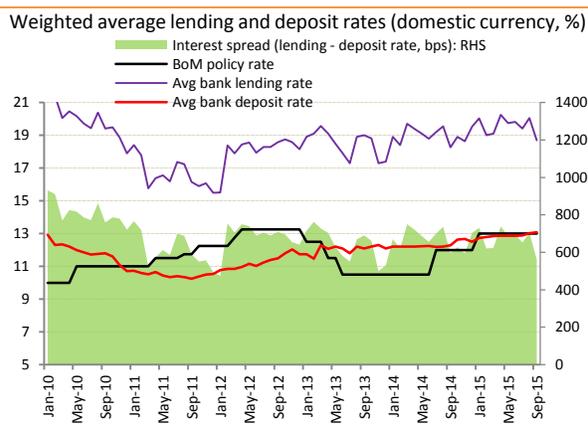
Inter-bank market funding costs have been rising. The interbank market rates have been on the rise since mid-2014 with two hikes in the central bank policy rate in July 2014 and February 2015, from 10.5 percent to 13 percent. Overnight loan rates hiked to 13.7 percent in September from 10.9 in June last year. Reflecting tighter bank liquidity, the one-year government bond yield also rose to over 16 percent in April from around 10 percent one year ago. Government bond yields, however, have been gradually falling since April to 14.4 percent in September, possibly reflecting increased excess reserves since May. Bank deposit rates are gradually rising amid tighter funding conditions and increased competition to attract deposits. Domestic currency deposit rates – which were stable at 12.2 percent on average in most of 2014 – have risen to 13.1 percent in September. Higher deposit rates amid stronger competition among banks would increase banks’ funding costs and likely push up lending rates in the coming months. Bank lending rates have also gradually risen in 2015 reflecting growing funding costs. Weighted average lending rates of new domestic currency loans rose to 20.1 percent in August from 18-19 percent late 2014. However, the responsiveness of bank lending rates to policy rate changes and inter-bank market conditions have been limited, possibly due to: (i) substantial loans were issued at fixed subsidized rates under the Price Stabilization Program and the housing mortgage program; and (ii) the lending rates of commercial loans seem to have been more affected by deposit rates.

Figure 32. Inter-bank rates have been on the rise since mid-2015 in tandem with higher policy rates.



Source: BoM

Figure 33. Average lending rates and deposit rates have also risen recently amid tighter funding conditions.

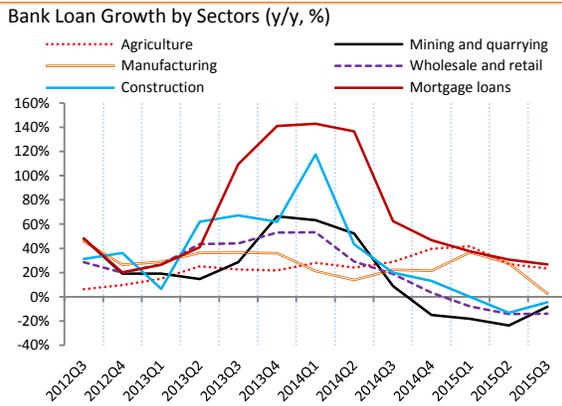


Credit conditions substantially vary across different sectors, with a sharper tightening of credit to riskier sectors. Credit conditions have substantially deteriorated in the mining, construction and wholesale and retail sectors. Outstanding loans to mining companies dropped by 8.12 percent in the third quarter, compared with the last year. Construction industry loans fell by 4.4 percent and the wholesale and retail loans dropped by 14.1 percent in the same period. The mining and construction industries were the main beneficiaries of the previous mining and the policy-driven credit boom and are now severely affected by a downturn in the commodity market and a slowdown in domestic demand. In the meantime, credit conditions to agriculture and manufacturing remained relatively stable. These sectors have experienced a stable loan growth even during the excessive credit boom period. Agriculture and manufacturing loans increased by 23.3 percent and 2.7 percent respectively in the third quarter, compared with the same period last year, in sharp contrast with other key sectors. Diverging credit conditions imply that banks became more cautious in originating loans to such sectors that are more vulnerable to shocks and have been more dependent on policy-driven credit support. (Figure 34)

Mortgage loans continued to expand at more than 30 percent annual growth with central bank funding to the subsidized housing mortgage program. Total outstanding mortgage loans increased by 27 percent in September compared with one year ago and by 16.7 percent over the first nine months this year. The subsidized housing mortgage program has been driving the mortgage credit boom over the last two years. Mortgage loans that were originated under the housing mortgage program have reached MNT 2,481 billion in September, accounting for 75 percent of total mortgage loans. Meanwhile, MNT 1,746 billion of housing mortgage loans were securitized into Residential Mortgage Backed Securities (RMBSs) via Mongolia Ipotek Corporation (MIK), and the BoM purchased 90 percent of the RMBSs. (Figure 35)

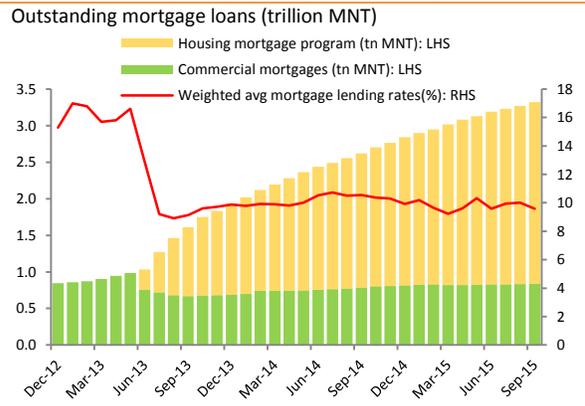
The recent announcement to further boost the mortgage loan demand risks worsening credit quality of new mortgage loans. The Government announced in August to reduce the down-payment requirement of mortgage loans from 30% to 10%, by issuing DBM guarantees on the reduced 20% down payment. This measure intends to boost the gradually slowing mortgage loan demand, thus supporting the property market and the construction industry. This measure, however, would likely lower the quality of new mortgage loans by expanding the loan eligibility to borrowers with higher credit risks.

Figure 34. Credit conditions are tighter in riskier sectors, with sharp drops in loans to mining and construction industries.



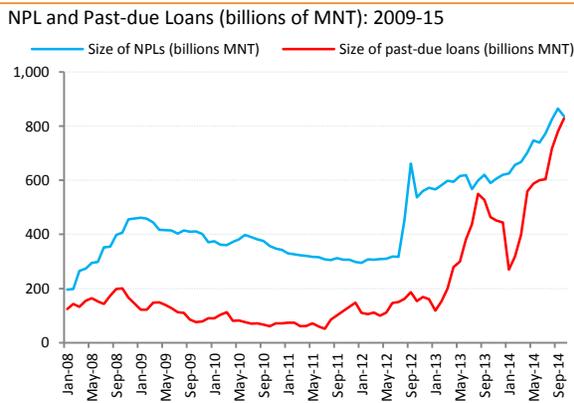
Source: BoM, WB staff estimates

Figure 35. Mortgage loans steadily increased, driven by the subsidized housing mortgage program funded by the BoM.



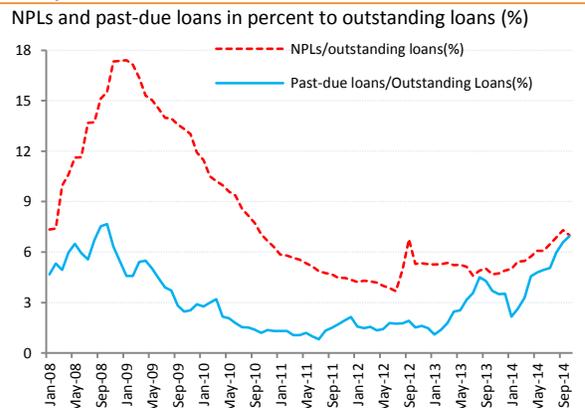
Asset quality deterioration of banks has accelerated. The non-performing loans (NPLs) of banks rose by 34 percent in the first nine months of the year, reaching MNT 830 billion in September. (Figure 36) The ratio of NPLs to total outstanding loans, which was relatively stable in 2014, has also been rising fast in 2015. The NPL ratio rose from 5 percent at the end of 2014 to 7.0 percent in September. (Figure 37) The NPL ratio excluding the NPLs of banks that are in a liquidation process showed a similar trend, climbing to 5.1 percent from 3.1 percent over the same period. A steeper increase in past-due loans is alarming. Past-due loans – which are over-due for less than 90 days – increased more than twofold in the first nine months, reaching MNT 829 billion in September from MNT 317 billion at the end of last year. The loan share of past-due loans reached 7.1 percent in September, a substantial increase from 2.2 percent at the end of 2014.

Figure 36. NPLs and past-due loans are increasing faster in 2015...



Note: NPLs and past-due loans include liquidated banks.
Source: BoM Bulletin, WB staff estimates

Figure 37. ... reflected by steeper rises in the ratio of NPLs and past-due loans to total loans.



In response to deteriorating asset quality, several measures were taken to improve the resilience of the banking system. In July-August 2014, the central bank announced measures to strengthen prudential regulations. These measures included: (i) imposing higher risk weights (120 percent) on foreign currency loans to unhedged borrowers; and (ii) raising the general provisioning ratio of normal loans to one percent from zero. In April 2015, the BoM announced to raise the minimum paid-in capital requirement for banks from MNT 16 billion to MNT 50 billion, effective from 2016 for systemically important banks and from 2018 for small banks.

Box 3. Draft Monetary Policy Guideline for 2016

The new Monetary Policy Guideline for 2016 was submitted to the parliament by the Bank of Mongolia on Oct 1, 2015. The policy guideline proposed the following measures:

a. Monetary policy

- To aim inflation at 7 percent by the end of 2016, and 5 to 7 percent in 2017-2018
- To phase out the Price Stabilization Program and transfer the program to the government
- To implement the housing mortgage program until the government takes over the program
- To maintain the exchange rate flexibility in alignment with macroeconomic fundamentals to support domestic production, exports and overall competitiveness of the economy.

b. Banking supervision

- To maintain capital adequacy and financial stability by off-site and on-site monitoring and necessary corrective measures.
- To improve the banking supervision and prudential regulations following recommendations of international organizations, including bringing regulations on capital adequacy and risk-weights to international standards and strengthening loan classifications.

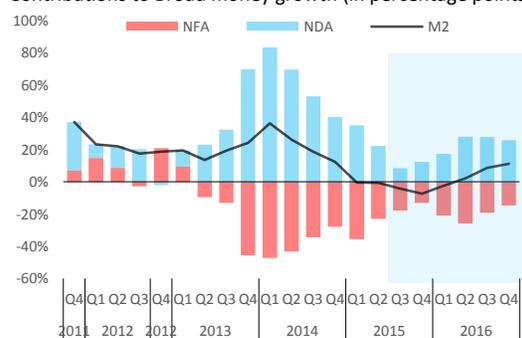
c. Development of financial infrastructure and institutions

- To improve the payments and settlement system in cooperation with the international organizations.
- To work on a legal framework for an asset management institution to manage growing NPLs.
- To improve the financial literacy of the general public

d. The monetary policy guideline pointed out that there is limited room for increasing money supply through net domestic assets. It noted that increasing net domestic assets would escalate pressures on the exchange rate, particularly with declining FDI and exports, balance of payments imbalances, and large budget deficit. The guideline expects that money supply and credit growth would gradually recover in 2016 as the construction of OT underground mine begins with substantial FDI inflows.

Figure 38. BoM projection on M2 growth

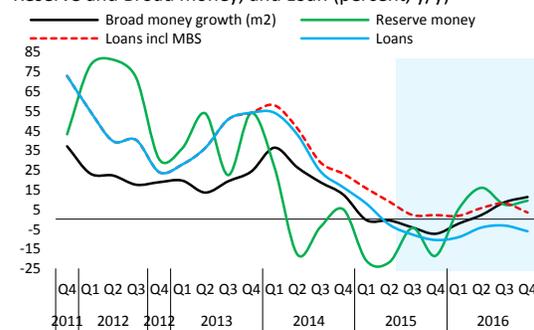
Contributions to Broad money growth (in percentage points)



Source: BoM, Monetary Policy Guideline for 2016

Figure 39. BoM projection on credit growth

Reserve and Broad money, and Loan (percent, y/y)



Source: World Bank staff, BoM, Monetary Policy Guideline for 2016

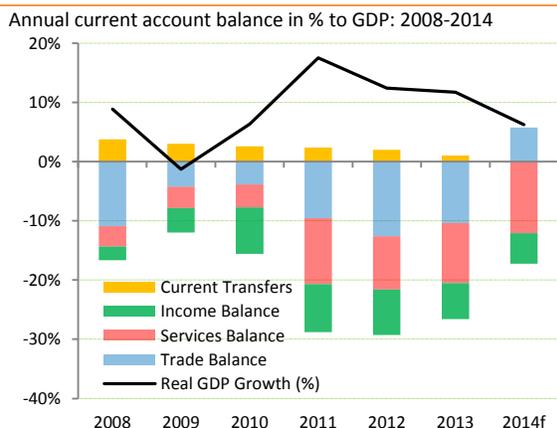
Adjustment in the current account continues with import compression.

The current account deficit continues to narrow. The current account deficit reached an unsustainable level in 2011-2013, averaging 25 percent of GDP, with rapid increases in imports of both investment and

consumption goods. Since 2014, the current account has been undergoing a sharp adjustment as imports continued to drop amid weakening FDI inflows and rapid exchange rate adjustments. The current account deficit declined to 11.7 percent of GDP in 2014 from 25 percent of GDP the previous year, led by a 14.4 percent drop in imports. (Figure 40) Adjustment in the current account has intensified in 2015. The current account deficit narrowed to US\$ 486 million in the first nine months, a sharp reduction from US\$ 1.4 billion in the same period of the previous year.

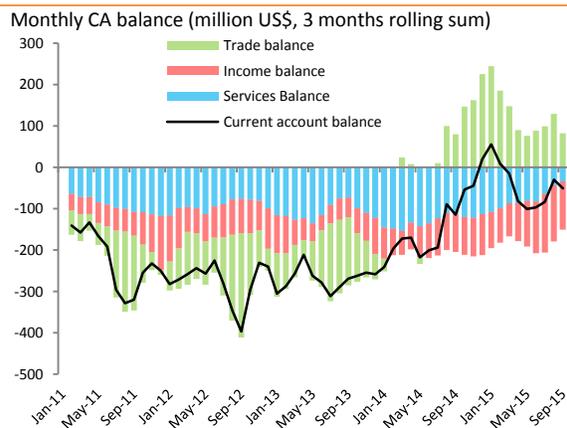
An increasing trade surplus has significantly improved the current account balance. The trade surplus (Free-On-Board terms) rose to US\$ 957 million in the first nine months from a US\$ 318.3 million surplus during the same period one year ago. The services account deficit also narrowed to US\$ 610 million in the same period from US\$ 1,214 million the previous year. The deficits in transportation, travel, and other services all declined compared with a year ago, reflecting the weakening external trade and slowing domestic demand. The deficit in the income account, however, widened to US\$ 964 million from US\$ 691 million over the same period, with growing investment income payments on external debt and foreign direct investment. (Figure 41)

Figure 40. Adjustment in the unsustainable current account deficit began in 2014.



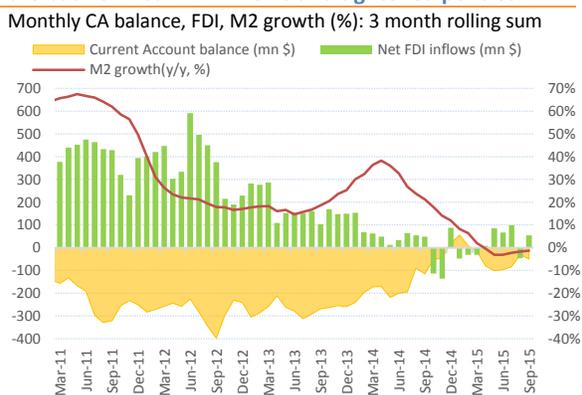
Source: BoM, WB staff estimates

Figure 41. The current account deficit further narrows in 2015 on the back of increasing trade surplus.



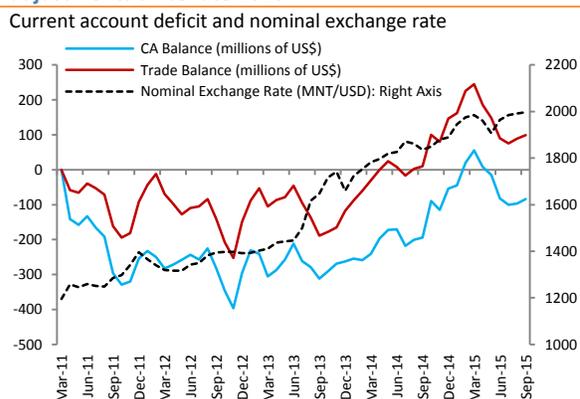
Tighter economic policies and exchange rate adjustments have contributed to the correction of large external imbalances. Economic policies have been tighter in 2015, adjusting domestic demand to a weak external account. Domestic credit growth substantially slowed on the back of the tighter monetary policy stance including the phasing out of the PSP loans. Budget spending growth also slowed amid large revenue shortfalls, tightening the government consumption and investment compared with the previous year. Higher import prices induced by a 40 percent depreciation in the nominal exchange rate since mid-2013 have also significantly contributed to the current account adjustment, by encouraging consumers to substitute towards domestic products.

Figure 42. The current account deficit has narrowed on the back of weak FDI inflows and tightened policies...



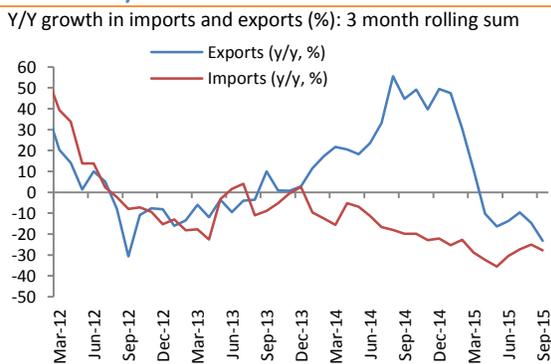
Source: BoM, WB staff projections

Figure 43. ... as well as by rapid exchange rate adjustments since late 2013.



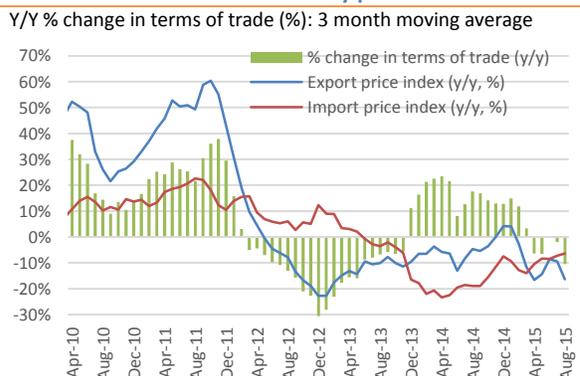
A sharp drop in imports has been driving the improvement in trade and current accounts while exports have been hard hit by the weak commodity market. Imports dropped by 29.4 percent in the first nine months compared with the previous year after a 17.6 percent drop in 2014, amid a continued dampening of FDI and weak real income growth of households. Exports have weakened throughout the year with declining commodity prices. Total exports declined by 12 percent in the first nine months on a year-on-year basis, after displaying a 35 percent increase in 2014 on the back of new copper and gold production of Oyu Tolgoi mine. The weakening of exports intensified in August and September, with total exports plunging by 35 percent compared with the same period last year. Terms of trade³ has substantially deteriorated in recent months with sharp drops in commodity prices.

Figure 44. Import compression continues while exports substantially weaken.



Source: NSO, BoM, WB staff estimates

Figure 45. Terms of trade have deteriorated in recent months due to weaker commodity prices.



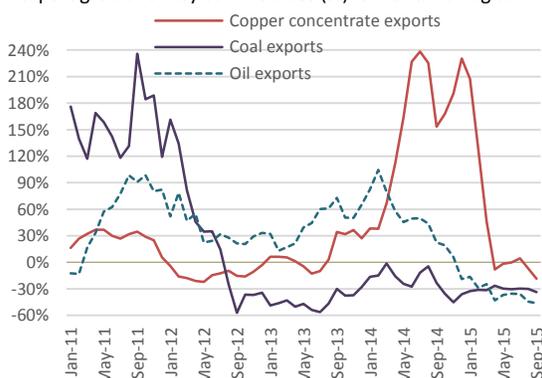
Continued contraction in coal and oil exports and slowing copper exports drag on Mongolia's mineral exports. Coal exports fell by 32 percent in the first nine months compared with the same period

³ Terms of trade (TOT) is defined as a relative price of exports measured in terms of imports. The TOT is measured by a ratio of export price index to import price index, which shows the amount of imported goods that can be purchased by a unit of export goods. Lower terms of trade mean that the same amount of exports can buy less imported goods which would be used for domestic consumption or investment.

last year, with export volume and price down by 22.1 percent and 12.2 percent respectively. Coal exports to China – which absorbed almost all of Mongolia’s coal exports last year – dropped by 34.5 percent compared with the previous year. However, China still accounted for 96 percent of total coal exports in Jan-Sep. The growth of copper concentrates exports has substantially declined in recent months, slowing to 1.9 percent in the first nine months. In September, copper concentrates exports fell by 36.7 percent year-on-year. China purchased 99 percent of Mongolia’s copper concentrates exports. Crude oil exports were hit hard by lower oil prices, falling by 41.4 percent (y/y) in the first nine months. The export volume of crude oil increased by 16 percent but the average export price plunged by 49 percent compared with the same period last year.

Figure 46. Falling coal and oil exports and a slowdown in copper concentrates exports significantly dampen exports...

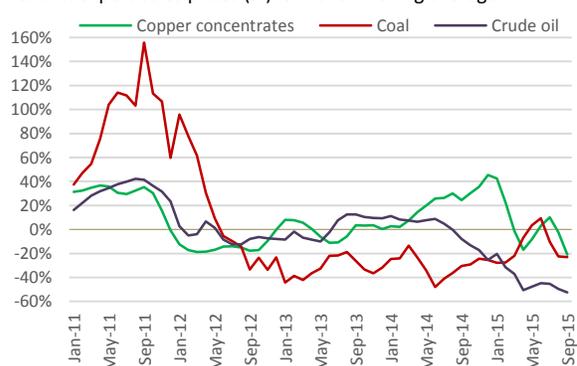
Y/Y export growth of key commodities (%): 3 month rolling sum



Source: NSO, WB staff estimates

Figure 47. .. with the export prices of key commodities weakening in 2015.

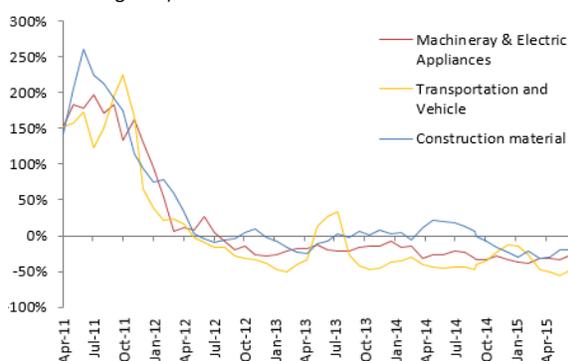
Per unit export sales prices (%): 3 month moving average



Imports have been falling in both capital and consumption goods. Imports of capital goods have been falling since 2012 as sharp declines in FDI continued to dampen investment demand. In Jan-Sep, imports of machinery and equipment dropped by 25.6 percent from last year’s level, following a 29.5 percent drop in 2014. Imports of construction materials fell by 32 percent during the same period. Imports of consumption goods also have been falling since mid-2014, reflecting slowing consumption demand and substitution effects towards domestic products with continued exchange rate depreciation. Imports of non-food consumption goods fell by 17.5 percent and imports of food products dropped by 17 percent in Jan-Sep on a year-on-year basis. Imports of mineral products plunged by 35.5 percent, reflecting over a 40 percent drop in oil prices.

Figure 48. Imports of capital goods have been declining since 2012 amid falling FDI and investment.

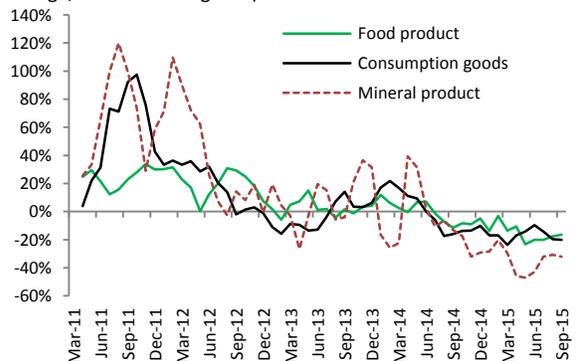
Imports of durable goods and mineral products (y/y % change, 3 month rolling sum)



Source: NSO, WB staff estimates

Figure 49. Imports of consumption goods have also substantially declined since late 2014.

Imports of consumption goods and mineral products (y/y % change, 3 month rolling sum)



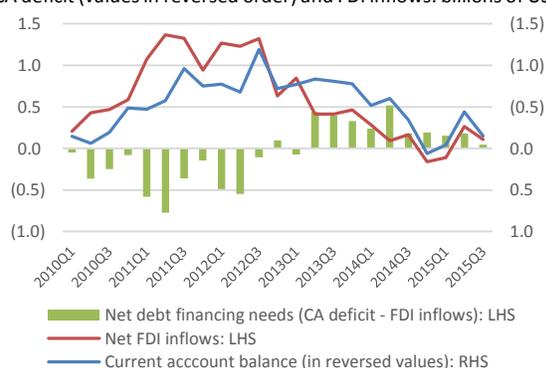
Large external financing mitigated the immediate balance of payments pressure, at the cost of higher external debt.

Despite the narrower current account deficit, the balance of payments has been under pressure from falling FDI. Sharp drops in FDI inflows have been severely undermining the balance of payments since 2013. Net FDI inflows – which had fully financed the current account deficit in 2011-12 – plummeted from US\$ 4.4 billion in 2012 to US\$ 382 million in 2014, far below required financing needs for a large current account deficit. Foreign direct investment has further weakened in 2015: FDI inflows recorded a US\$ 156.5 million net inflow in the first nine months of 2015, down from US\$ 526.4 million in the same period last year. (Figure 50) Inbound foreign investment via equity investment (US\$ 227 million) stayed close to last year’s level, but a US\$ 191 million repayment of inter-company borrowing weighed on the overall net inflow of foreign direct investment.

In response, considerable external financing was mobilized by the government and the central bank. Mongolia has heavily relied on external debt-financing since late 2012 to cover the persistent large current account deficit as foreign investment continued to fall. In the second half of 2014, about US\$ 940 million was raised via external debt-financing by the public sector and the central bank. The DBM raised \$462 million under government guarantees including: a US\$ 162 million long-term loan from China Development Bank and a US\$300 million syndicated loan from Credit Suisse. The central bank drew down the equivalent of US\$ 482 million from the bilateral currency swap facility with the People’s Bank of China (PBoC) in the last six months of 2014. Large external debt-financing continued in 2015. US\$ 660 million was newly raised via sovereign and sovereign-guaranteed borrowing in May and June. One commercial bank raised US\$ 500 million in international bonds at a 9.375 percent rate under a sovereign guarantee in May, which intended to replenish BoM’s international reserves via a five-year currency swap arrangement. The government also directly raised RMB 1 billion (US\$ 161 million) in sovereign dim sum bonds in June, at a 7.5 percent coupon rate. In addition, the central bank drew down over US\$ 630 million from the PBoC swap facility in the first nine months of the year, pushing the total external debt-financing by the public sector close to US\$ 1.3 billion. (Figure 51)

Figure 50. Falling FDI has been putting pressure on the balance of payments, increasing external financing needs.

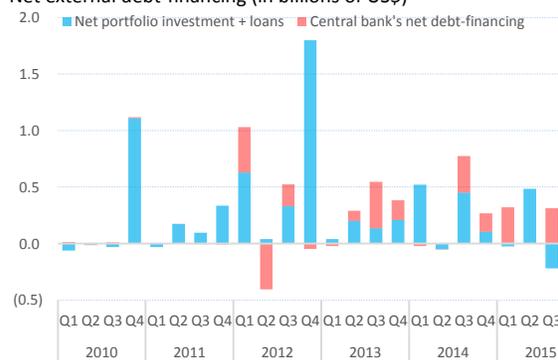
CA deficit (values in reversed order) and FDI inflows: billions of US\$



Source: BoP/External debt statistics (BoM), WB staff estimates

Figure 51. More than US\$ 1 billion was mobilized in Jan-Sep to reduce the BoP pressure via debt-financing.

Net external debt-financing (in billions of US\$)

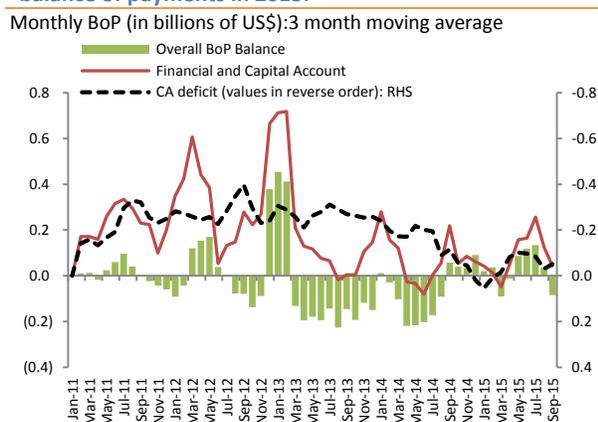


The large external financing has improved the balance of payments significantly in 2015. A US\$ 172 million deficit was recorded in the balance of payments during the first nine months, a significant improvement from a US\$ 743 million deficit in the same period last year. After recording a US\$ 320 million deficit in the first four months in 2015, the balance of payments turned into a US\$ 445 million surplus in

May-Aug due to the substantial mobilization of external financing despite the persistent current account deficit and weak FDI inflows. The balance of payments, however, sharply deteriorated into a US\$ 298 million deficit in September, reflecting a US\$ 300 million external debt repayment of one commercial bank, despite a large drawdown on the bilateral currency swap line with the PBoC.

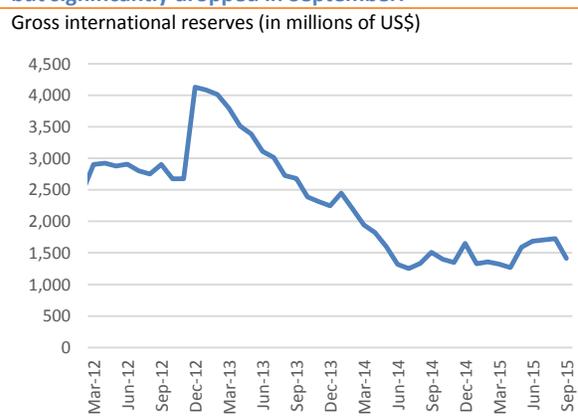
International reserves significantly fell in September. Official gross international reserves rebounded from US\$ 1,267 million in April to US\$ 1,728 million in August, reflecting the balance of payments surplus driven by the large external borrowing. Official gross reserves, however, substantially dropped by more than US\$ 300 million to US\$ 1,412 million in September, eroded by the US\$ 300 million repayment and increased interventions of the central bank in the foreign exchange market. The current reserve level is slightly less than three months of imports of goods and services. (Figure 53).

Figure 52. Large external debt-financing improved the balance of payments in 2015.



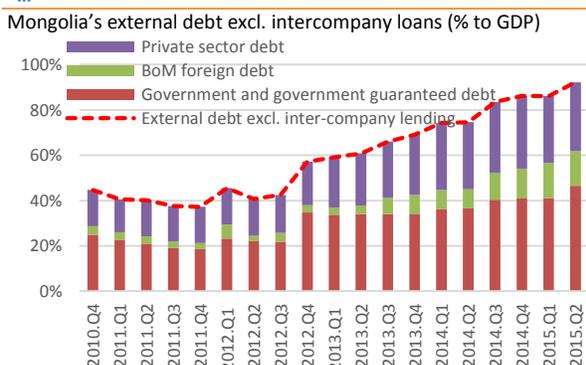
Source: BoM (BoP), WB staff estimates

Figure 53. International reserves rebounded in May-Aug but significantly dropped in September.



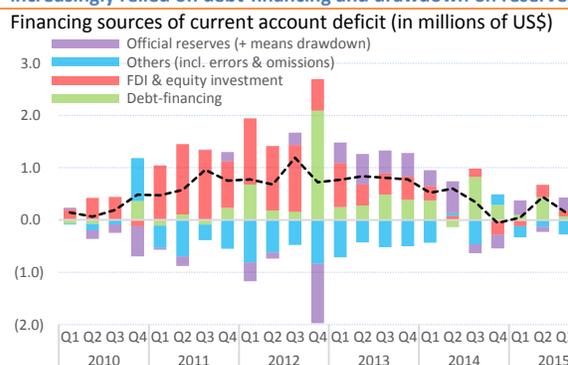
The improving balance of payments came at the cost of higher external debt. Additional external debt-financing made in late 2014 and early 2015 pushed Mongolia's external debt close to 180 percent of GDP in June 2015, from 162 percent one year ago. (Figure 54) While the intercompany loans to foreign-invested companies remained stable at around 70 percent of GDP, the external debt of the public sector rapidly rose over the last twelve months. The ratio of government and government-guaranteed external debt to GDP hiked to 46.5 percent at the end of June, a sharp rise from 41 percent six months ago and from 36 percent one year before, largely due to increased guarantees issued to new DBM loans in late 2014 and international bonds of one commercial bank in May 2015. The central bank foreign liabilities has also been on a steep rise to 15.3 percent of GDP in June 2015 from 8.5 percent twelve months ago due to continued debt-financing mostly from the People's Bank of China. In the meantime, the external debt of the private sector (excluding the sovereign-guaranteed international bonds of one bank) only moderately rose to 30.4 percent of GDP from 29.5 percent one year ago.

Figure 54. External debt has risen since the second half of 2014



Source: BoM (BoP, External debt statistics, IIP), WB staff estimates

Figure 55. ... as the financing of current account deficit has increasingly relied on debt-financing and drawdown on reserves.



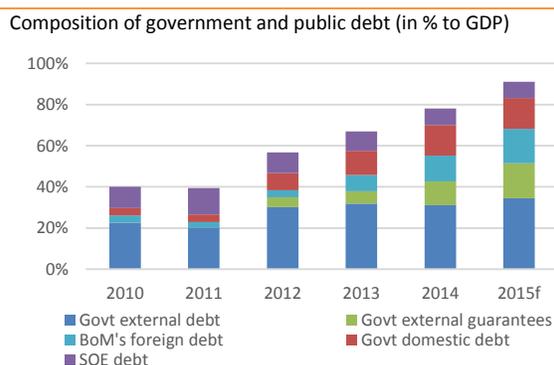
Box 4. High vigilance is needed on growing government debt.

The GDP ratio of general government and government-guaranteed debt – which follows the definition adopted by the government – more than doubled over the last three years from 24.1 percent in 2011 to 58 percent of GDP in 2014. Public debt – which adds SOE debt and the foreign liabilities of the central bank to the general government debt – also rapidly climbed to 76.6 percent of GDP in 2014 from 32.7 percent in 2011 in nominal terms.

Sharp rises in external liabilities led the fast growth of government and public debts. External government debt has risen to 42.7 percent of GDP (US\$ 5 billion) last year from 20 percent of GDP (US\$ 1.9 billion) in 2011. (Figure 57) Substantial sovereign and sovereign-guaranteed external borrowing was taken to finance the off-budget expenditures of the DBM, including the sovereign Chinggis bonds (US\$1.5 billion), DBM Euro bonds (US\$ 580 million) and Samurai bonds (JPY30 billion), and the government-guaranteed external loans of the DBM (over US\$ 460 million). Another guarantee worth US\$ 122 million was issued to a state-owned airline (MIAT) to finance the purchase of an airplane. While overshadowed by the faster growth in external debt, government domestic debt has also risen from 4 percent of GDP to 14 percent of GDP over the same period as the widening on-budget deficit has been mostly financed by the domestic capital market. Outstanding government securities increased significantly from MNT 0.8 trillion in 2012 to MNT 2.5 trillion in 2014. External public debt also rose to 55 percent of GDP in 2014 from 23 percent in 2011, due to the growing foreign liabilities of the central bank in addition to the increasing government external debt.

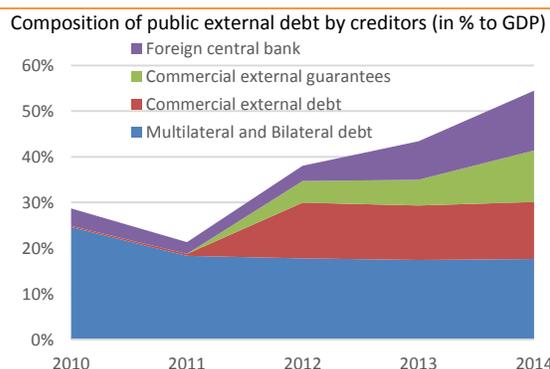
External government debt structure has rapidly changed towards non-concessional debt. Debt to multilateral and bilateral creditors, which are mostly on concessional terms, accounted for almost 90 percent of public external debt until 2012. Commercial borrowing has risen substantially since late 2012 as the government and the DBM heavily relied on external commercial borrowing to finance their growing spending needs. Debt to commercial creditors, including guarantees issued to DBM's external borrowing, rose to 24 percent of GDP in 2014 from almost none three years ago while the concessional debt remained stable at around 18 percent of GDP over the same period. (Figure 56) Debt to multilateral and bilateral creditors now accounts for only one-third of public external debt.

Figure 56. Rising external debt led fast growth of government and public debt in recent years...



Source: MOF, BoM, WB staff estimates

Figure 57. ... with growing reliance on non-concessional debt.



Source: World Bank staff

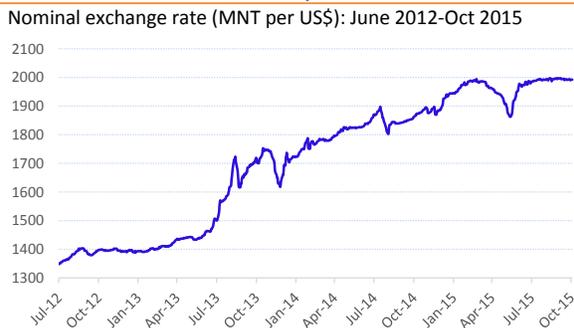
Exchange rate adjustment has been limited in recent months.

The tugrik has been under heavy depreciation pressure since 2013, with the balance of payments deficit reaching an unsustainable level. A sharp adjustment in the exchange rate began in mid-2013. The nominal exchange rate slid by 8 percent against the US\$ in August 2013 when the monthly balance of payments deficit reached its highest level of US\$ 337 million amid a large current account deficit and falling FDI inflows. Since then through early 2015, the exchange rate stayed on a depreciation trend as the external imbalance persisted and the FDI prospects continued to deteriorate. Between March 2013 and March 2015, the local currency value fell by 40 percent against the US\$ in nominal terms, from MNT 1,410 to MNT 1,984 per US\$. Amid escalating depreciation pressures, the central bank continued to supply foreign exchanges to banks from its reserves via foreign exchange auctions, with net sales of foreign exchanges reaching over US\$3 billion in 2013-14.

The rate of currency depreciation slowed in recent months despite the weakening currencies of commodity-dependent economies against the US\$. The depreciation trend was reversed in April and May as the tugrik strengthened by around 7 percent to MNT 1,862 per US\$ amid positive developments on the second phase development of Oyu Tolgoi mine and the issuance of a \$500 million international bond by one commercial bank. As the tugrik appreciation accelerated in late May and early June, the central bank purchased foreign exchange from banks in early June. Since June, the exchange rate came back under depreciation pressure as the positive market sentiment buoyed by the agreement on the Oyu Tolgoi mine development gradually waned and the global commodity market weakened. The tugrik depreciated by 7 percent between mid-June and end-July, sliding back to MNT 1,985 per US\$. As the exchange rate approached MNT 2,000 per US\$, the central bank has supplied a large amount of foreign currencies via foreign exchange auctions since July, which kept the exchange rate in the range of MNT 1,900-2,000 in recent months. (Figure 60) As a result, the tugrik depreciated by 5.5 percent in Jan-Oct and by only 1.4 percent in June-Oct against the US\$, a far stronger performance compared with the currencies of other commodity-dependent economies. Most of the currencies in other commodity dependent countries depreciated at a faster rate than the tugrik in 2015, ranging from 55 percent (Kazakhstan) to 11.4 percent (Botswana) between Jan-Oct. The currency depreciation in the commodity-dependent economies further accelerated since July, reflecting the deteriorating commodity market conditions. The local currencies of Indonesia and Malaysia, which are major resource-rich countries in the region, weakened by 8.3 percent and 21.8 percent against the US\$ in the first ten months of the year. (Figure 59)

The nominal and real effective exchange rates have strengthened since late 2014. The nominal effective exchange rate (NEER) and the real effective exchange rate (REER)⁴ began to appreciate since late 2014 with slower rate of nominal currency depreciation. The NEER and REER moderately weakened early this year but has been back on an appreciation trend since April reflecting the strong performance of the tugrik relative to other currencies. (Figure 61)

Figure 58. Nominal exchange rate fluctuation has been limited in recent months after continued depreciation since mid-2013...



Source: BoM, IMF

Figure 59. ... while the currencies of most resource-rich countries sharply weakened against the US\$.

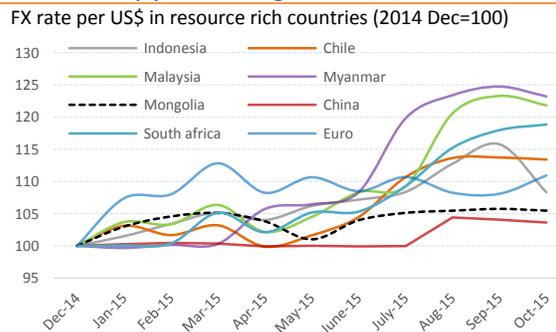
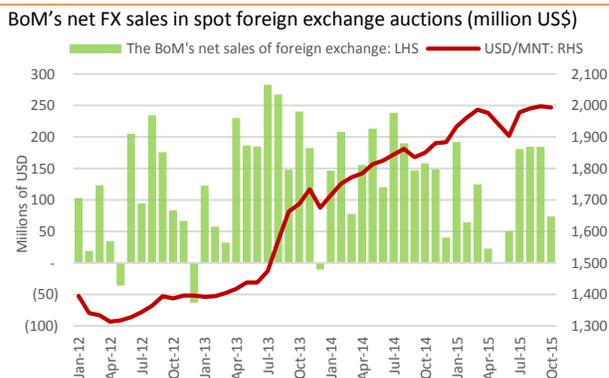
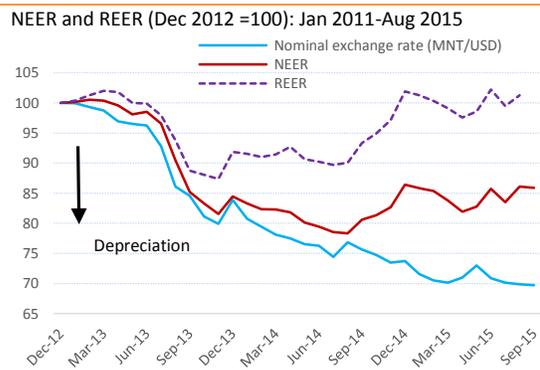


Figure 60. Central bank interventions have increased in recent months.



Source: BoM official website, WB staff estimates

Figure 61. As a result, the NEER and REER has appreciated since late 2014.



⁴ The nominal effective exchange rate (NEER) is a weighted average of exchange rates with major trading partners. The real effective exchange rate (REER) further adjusts the NEER by accounting for Mongolia's relative inflation level to those of trading partners. The NEER and REER are measured as an index and regarded as a measurement of the competitiveness of the local currency, accounting for changes in currency values and inflations of trading partners.

Economic Prospects and Challenges

Growth is expected to remain weak in 2015-16, but a recovery in foreign investment would begin to support the non-mining sector growth

Growth is projected to slow to 2.3 percent in 2015, revised downward from 3.3 percent of the last projection. The downward revision largely reflects weak crop harvests and the slower-than-expected industrial production in the third quarter. Mining GDP growth will likely remain in double digits in 2015, but is expected to moderate in the second half of the year. Non-mining GDP growth is expected to further slow in the second half as investment and consumption demand remains subdued and FDI stays weak. Weaker crop harvests due to severe droughts are expected to slow agricultural production. There is a risk that agriculture could be hit harder by weaker crop harvests and harsher winter weather conditions.

There is a risk that the agricultural production could be hit harder by harsher weather conditions in the coming winter. Mongolia experienced a severe drought in the summer, which reduced cereal crop harvests substantially during the main harvest season. Continuation of poor harvests in the rest of the year would further dampen agricultural production, which accounted for 14 percent of GDP in 2014. Each 20 percent further drop in crop harvest would reduce the GDP growth by around 0.4 percentage points from the baseline projection. There is also an increasing concern about possible harsh winter conditions which could jeopardize the livestock sector in late 2015 and early 2016. The baseline projections assume no significant shocks to the livestock sector as the winter weather conditions remain uncertain. However, each 10 percent drop in livestock production could reduce the GDP growth by 1 percentage point from the baseline projection.

Growth is expected to further slow to 0.8 percent in 2016 due to a sharp contraction in mining production, despite a gradual recovery of the non-mining sector. Mining production is projected to decline in 2016-17 with lower mineral concentration in ores produced by OT mine and the weak global commodity market conditions. Mining production is expected to pick up from 2018, on the back of a gradual recovery in the commodity market and an improvement in the ore quality of OT mine. Non-mining GDP growth is expected to gradually recover in 2016 after a sharp slowdown in 2015. The non-mining sector of the economy will likely remain weak in early 2016, but a recovery in foreign investment in the mining sector is expected to support the industries supplying goods and services needed for large scale mining investment projects in the latter of half of the year.

The fiscal outlook remains weak with the prospect of a slow revenue recovery.

The revenue projections of the current fiscal plans for 2015-16 may be difficult to achieve on account of optimistic assumptions and challenging revenue mobilization plans. Non-mining budget revenues are expected to gradually recover in 2016 as consumption and import-related taxes pick up in tandem with increased FDI inflows. However, a drop in commodity exports is likely to continue to dampen mining-related tax revenues in the next couple of years which accounts for more than 20 percent of total revenues. Some of the key revenue mobilization measures for 2015-16 may also prove challenging, including the collection of significant tax arrears this year amid a sharp slowdown of the economy, an optimistic assumptions of a strong coal export increase and an ambitious privatization plan for 2016.

Accounting for these uncertainties, potential budget revenue shortfalls could reach over MNT 100 billion in 2015 compared with the second supplementary budget, and up to MNT 400 billion in 2016 compared with the draft 2016 budget. Assuming the current spending plans of the government for 2015-16, the budget deficit following the FSL definition – which includes the budgetary projects of the DBM – is expected to stay over 5 percent of GDP in 2015-16, a higher deficit path than the medium term deficit ceilings of the FSL.

The consolidated budget deficit – which adds DBM’s commercial portfolio to the FSL-defined budget deficit – is expected to decline to 8-9 percent of GDP in 2015 and 6-7 percent of GDP in 2016, from 11 percent of GDP in 2014. The DBM is expected to provide about MNT 600 billion to its commercial portfolio in 2015, and to further reduce its commercial spending to MNT 300-400 billion in the next couple of years due to tight financing conditions. Under these assumptions, the commercial projects financed by the DBM is expected to be around 3 percent of GDP in 2015, and decline to 1-1.5 percent of GDP in 2016.

The balance of payments prospects remain weak and the economy is vulnerable to shocks

Despite the recent improvement led by large external financing, the balance of payments will likely remain in deficit in 2015. Although the current account deficit is expected to significantly narrow to about 5 percent of GDP in 2015, a sharp drop in mineral exports and a large deficit in the services and income accounts will likely keep the current account in the red in the coming months. With weak capital inflows, a continued current account deficit would translate into a deficit in the balance of payment, unless further external financing is mobilized.

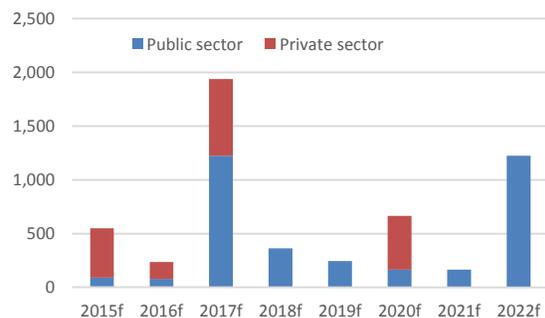
Mongolia’s external positions are expected to come under elevated pressure in the coming years, with the widening current account deficit. A continued drop in mineral exports is expected to substantially increase the deficit in the current account in the next couple of years. Although a recovery in foreign capital inflows could provide some buffers, growing current account deficit is likely to strain the balance of payments in the coming years. Compounding the external vulnerability is the first large repayment of public external debt in 2017 amounting to US\$ 1,080 million, which will pose significant challenges to the fiscal and external accounts.

The weak balance of payments will continue to erode international reserves. After rebounding from US\$ 1,267 million in April to US\$ 1,728 million in August on the back of large external borrowing, the gross reserves of the central bank dropped by over US\$300 million in September to US\$1,412 million, reflecting the balance of payments pressure and increased foreign exchange market interventions. Foreign exchange buffers would likely stay under growing pressure in the coming months and the next couple of years unless a significant correction of external imbalances is made through tighter economic policies and continued exchange rate adjustment.

Higher external debt makes the economy more vulnerable to external volatilities. As a result of new external debt-financing, public and publicly guaranteed external debt is expected to climb to over 60 percent of GDP by the end of 2015. With higher external debt, the fiscal accounts and the balance of payments became more exposed to external shocks, particularly to an abrupt exchange rate depreciation and a sharper tightening of external financing conditions. Each 10 percent further depreciation of the exchange rate against the US\$ in 2016 from the baseline scenario is estimated to raise external public debt valued in tugriks by additional 5 percentage points of GDP in 2016.

Figure 62. High concentration of external debt repayments poses substantial roll-over risks.

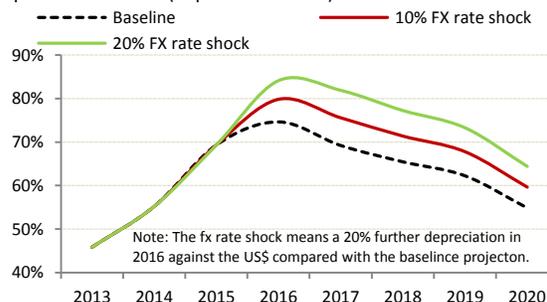
Major external debt repayment schedule (in millions of US\$)



Source: BoM, MOF, WB staff projections

Figure 63. Higher external debt makes the economy more vulnerable to external shocks.

Nominal external public debt projections with exchange depreciation shocks (in percent to GDP)



Note: The fx rate shock means a 20% further depreciation in 2016 against the US\$ compared with the baseline projection.

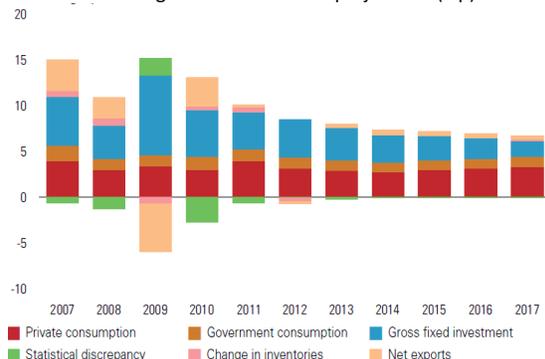
Meanwhile, substantial external downside risks lie ahead

The growth of China, the main trade partner to Mongolia, is itself subject to uncertainty. The East Asia and Pacific Economic Report of the World Bank (October 2015) assumes that China's growth will slow to 6.9 percent in 2015 from 7.4 percent in 2014, and moderate to 6.7 percent in 2016 and 6.5 percent in 2017. Continued reforms will support a further rebalancing of domestic demand. Investment will decelerate, owing to tighter credit and more subdued property sector conditions. However, the baseline projections for China's economy in 2016 and beyond are subject to considerable uncertainty. The pace of the slowdown will depend on both global developments and domestic structural trends. Continued reforms are expected to enable further economic restructuring and rebalancing of domestic demand but accumulated imbalances continue to pose a risk of disorderly adjustments. There is a risk that real and financial vulnerabilities in the Chinese economy cause a sharper-than expected slowdown in spending, especially investment.

Slower than expected growth in China would exacerbate downward pressures on the commodity market. China's growth moderation and rebalancing to date have already exerted a significant negative impact on international commodity prices. Even under the baseline scenario, the broad weakness in commodity prices is expected to persist for the rest of 2015 and most commodity prices are projected to only moderately recover in the coming years. Additional reductions in Chinese demand would likely further reduce commodity prices.

Figure 64. China's growth is projected to continue to moderate in the coming years...

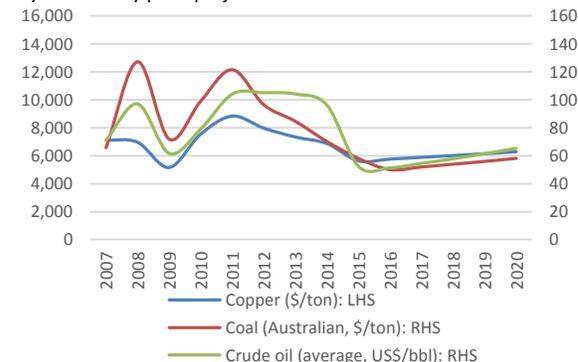
China's real GDP growth contribution projections (%p)



Source: WB staff projections, The World Bank Commodity Markets Outlook (October, 2015)

Figure 65. The commodity market is expected to remain weak in the coming years.

Key commodity price projections



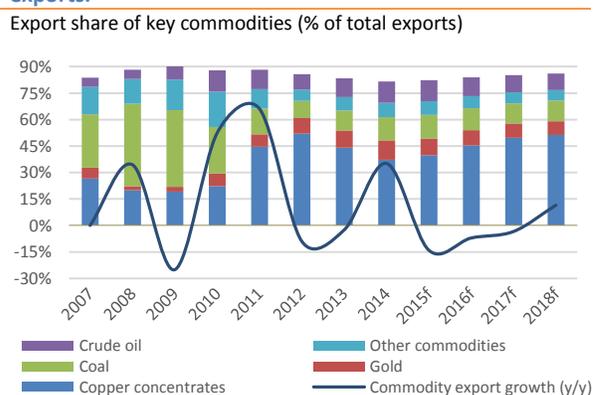
A sharper slowdown in China and the commodity market could further undermine Mongolia's growth and exacerbate its external risks. Mongolia's lack of diversification in export products and trade partners leaves the economy highly vulnerable to a further slowdown in China and the commodity market. In 2014, exports constituted 48 percent of total production of Mongolia and China absorbed 87.9 percent of Mongolia's total exports. Compounding Mongolia's vulnerability is its high export concentration in commodities. Commodity exports accounted for 82 percent of total exports and 35 percent of GDP in 2014. Copper concentrates alone constituted 37 percent of total exports in 2014 and is projected to account for almost half of total exports by 2017. Almost all of copper concentrates have been exported to China. Coal exports – almost fully purchased by China – constituted 13 percent of total exports in 2014. A sharp drop in coal exports to China has been a significant drag on Mongolia's economy and the external accounts in the first nine months of 2015. A 10 percent drop in copper and coal export revenues from the baseline projection would widen Mongolia's current account deficit by more than 3 percentage points of GDP in 2016.

Figure 66. 88% of Mongolia's exports are absorbed by China...



Source: NSO, WB staff projections

Figure 67. ... and commodities constitute 82% of total exports.



There is also a risk that a U.S. monetary policy normalization may trigger abrupt market reactions.⁵ The baseline projections of the World Bank's regional report (EAP Update, October 2015) assume a gradual, smooth tightening of external financing conditions, with an orderly normalization of monetary policy in the United States as the shift in U.S. monetary policy has long been anticipated and the normalization is likely to occur gradually, and only if the U.S. economy remains robust. However, there is a risk that the U.S. policy rate "lift-off" will instead trigger abrupt market reactions, causing currencies to depreciate sharply, bond spreads to rise steeply, and liquidity to tighten.

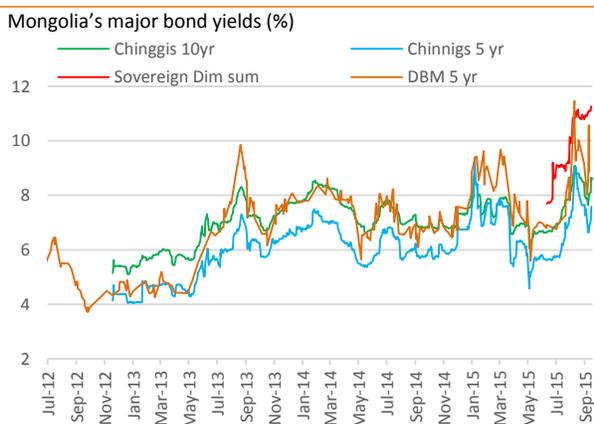
A possible heightened volatility in the international financial market could further deteriorate external financing conditions for developing countries that have relied on debt-financing, including Mongolia. The East Asia and Pacific Outlook of the World Bank (October 2015) pointed out that Mongolia is one of the countries that is most vulnerable to the possibility of a sharp tightening in external financing conditions. Mongolia has increasingly relied on external debt-financing to finance current account deficits over the last three years and will face significant future debt rollovers in 2017 and beyond. A sharp tightening in external financing conditions could make it more difficult or costly to mobilize external finance needed for

⁵ For more discussion on the possible impacts from the U.S. monetary policy normalization, see "World Bank, East Asia Pacific Economic Update, October 2015".

debt rollovers or current account deficits.⁶ Moreover, a possible appreciation of the U.S. dollar would increase the cost of servicing foreign-currency denominated debt which now stands close to 180 percent of GDP.

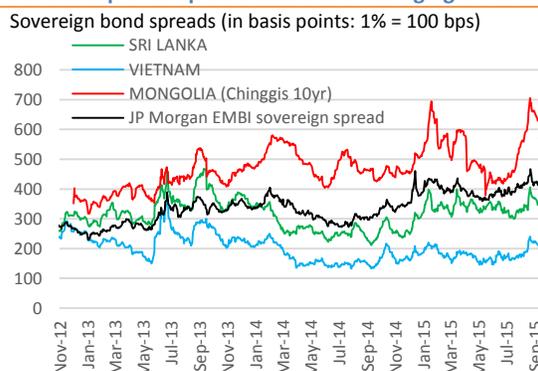
Mongolia’s external financing conditions have considerably tightened in recent years. The benchmark yield of the ten-year sovereign bond of Mongolia (Chinggis bond) has sharply risen from 5.2 percent in December 2012 to around 8.5 percent in early October 2015, an over 300 basis-point increase. The Chinggis bond had been issued at the end of 2012 under extraordinarily favorable market conditions: ample financial liquidity injected by quantitative easing measures in major economies increased investment appetite for higher-yield markets, particularly for emerging economies including Mongolia. The financing conditions, however, became substantially tighter in 2013 amid growing concerns on possible hikes in the U.S. policy rate. Mongolia’s ten-year sovereign bond yield also picked up in mid-2013 with a global tightening and has experienced wide fluctuations following major economic and political developments since then. The bond yield dropped to close to 6 percent in June, reflecting positive investment sentiment formed with the agreement on the second phase development of Oyu Tolgoi mine, but the benchmark yield has steeply risen since July. Fluctuations in Mongolia’s bond spreads – which measure the country risk premium demanded by investors – have been wider compared with other countries with similar credit ratings, reflecting uncertainty in investor sentiment towards Mongolia. (Figure 69)

Figure 68. Mongolia's bond yields rose in recent years.



Source: Bloomberg

Figure 69. Fluctuations in sovereign bond spreads have been sharper compared with other emerging economies.



⁶ The EAP Update suggests that every 100-basis-point increase in the benchmark 10-year U.S. bond yield is associated with 106-144 basis-point increase in yields in East Asia and Pacific countries on average.

Policy Considerations

Macroeconomic policy needs to stay focused on restoring sound economic management

High external and fiscal vulnerabilities and substantial downside risks demand a continued policy adjustment to restore prudent economic management. Mongolia's long-term economic prospects remain promising with an increasingly educated population and vast potential from mineral wealth waiting to be materialized in the future. In the short-term, however, the economy faces significant challenges. External financing needs for current account deficit and external debt repayments are expected to grow in the next couple of years, elevating pressures on the balance of payments. The economy remains vulnerable to possible external shocks from a sharper downturn in China and the global minerals market. External financing conditions will likely stay much tighter than in the previous years. Meanwhile, the country lacks fiscal and external buffers to counter possible shocks with public debt reaching almost 80 percent of GDP and international reserves declining. The economy is slowing but it reflects an inevitable adjustment in domestic demand to external imbalances, falling FDI and a negative terms of trade shock. Growing external and fiscal vulnerabilities call for a continued adjustment on the fiscal and monetary policies to manage domestic demand at a level that can be sustained without risking balance of payments stability, particularly considering its high import dependence. Exchange rate flexibility would help correct external imbalances and safeguard reserve buffers. Revitalizing foreign investment would significantly help reduce the external risks, mitigate contractionary pressures from policy adjustment, and help materialize the economy's long-term growth potential. A combination of prudent macro-economic management and an enhanced investment climate would strengthen market confidence and replenish policy buffers, thereby building more favorable external financing conditions for future debt repayment. The recently released Doing Business 2016 report of the World Bank shows that Mongolia's investment climate continues to improve but there are areas of further improvement.⁷

Room for expansionary policy to support growth is limited as the current economic slowdown largely stems from falling FDI and weakening external demand. External demand is weakening due to a continued dampening of the commodity market and slower growth in China, translating into a drop in exports. Domestic demand is slowing largely because of the decline in investment with falling FDI. Declining investment and weaker mining exports are translating into sluggish real household income growth and slower consumption. With external demand under pressure from weak global economic conditions, growth stimulus measures would have to rely on boosting domestic demand by increasing budget spending or loosening monetary policies. Stronger domestic demand buoyed by expansionary policies, however, would not be sustainable as it would inevitably be accompanied by higher imports, thereby exacerbating the balance of payments risks. Loosening fiscal and monetary policies would come at the cost of higher public external debt and weaker financial soundness, and would further reduce policy buffers that can be used to counter possible shocks. With weak foreign investment and external demand, the growth impact of policy

⁷ According to the Doing Business 2016 report, Mongolia's ease of doing business rank improved to the 56th in 2015 from 59th in 2014, among 189 countries. For a full report, see <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Full-Report.pdf>.

stimulus measures would likely be limited and temporary while further elevating the external and fiscal vulnerabilities of the economy.

Steps have been taken but further actions are needed

Major steps were taken to restore sound economic management framework. The Government adopted a Comprehensive Macro Adjustment Plan (CMAP) in February with the broad-based political support of a grand coalition. The CMAP aims to improve the macroeconomic policy framework, while calling for reducing the balance of payments pressure by unlocking FDI inflows for large foreign investment projects. Under the CMAP, the government revised the 2015 budget in January to include a large portion of DBM's off-budget expenditures, contain the structural budget deficit within 5 percent of GDP, and reduce the budget deficit to less than 2 percent of GDP by 2018. The monetary policy has tightened, withdrawing the policy loans that were issued to the Price Stabilization Program in 2013-14. A major development was made to revive FDI from 2016 as the prolonged negotiation on OT's underground mine development was concluded.

Recovery in FDI would help the policy reforms to continue with less adjustment costs. Revamped foreign capital inflows and improved investor sentiment is expected to support the gradual recovery of the economy in 2016 against weak external demand. This would provide a good opportunity to solidify policy reform efforts, which otherwise would come at higher adjustment costs. Revitalizing foreign investment would also help reduce balance of payments risks, and support materializing the economy's long-term growth potential. This would require implementing stable and predictable policies and regulations on investment including the proper implementation of the Investment Law. Clearing the uncertainty over large foreign investment projects in a swift and transparent manner would also help improve investor sentiment towards Mongolia.

Further actions need to be considered to strengthen the credibility and effectiveness of policy adjustment. The key to a successful adjustment of the economy is to ensure the credibility of policy adjustment. Despite the commitment of the government to policy reforms, implementation risks to policy reforms are high as the next election approaches. Maintaining reform momentum and a stable investment environment during the election cycle is an important task to build a solid footing for a stable and sustainable growth path against possible external and domestic headwinds. Further actions seem necessary in the coming months to deliver the fiscal outcomes envisioned by the FSL, to normalize the monetary policy away from quasi-fiscal operations, and to strengthen the social safety net to protect the poor and vulnerable.

Fiscal consolidation should continue and high caution is needed for further external financing

Fiscal consolidation efforts should continue. Reducing the budget deficit and consolidating off-budget expenditures should remain a primary target of the fiscal policy adjustment agenda in the coming years, particularly in light of growing debt and the volatile external environment.

- **Credible fiscal adjustment plans for 2015 and 2016 are needed to restore the prudent fiscal path envisioned by the Fiscal Stability Law (FSL).** The 2016 budget should adhere to the fiscal targets demanded by the FSL, based on realistic revenue projections. One of the major tasks needed to adopt a credible 2016 fiscal plan would be avoiding overstated revenue projections which have led to repeated downward budget revisions in previous years. Non-tax revenue mobilization

measures need to be carefully reviewed to ensure proper implementation. A spending prioritization plan would also be needed, including giving the highest priority to maintaining or strengthening the social safety net.

- **Including the commercial portfolio of the DBM would strengthen the credibility and effectiveness of the fiscal consolidation plan.** The 2015 budget brings the budgetary portfolio of the DBM onto the budget and monthly implementation of DBM's budgetary projects are now reported along with other expenditures of the general government, a significant improvement compared with previous years. The commercial portfolio of the DBM, however, still remains outside the control of the FSL. The commercial loans, which include substantial corporate loans that are under government guarantees and financial support to state owned enterprises, are expected to reach 3 percent of GDP in 2015. This raises a concern about the effectiveness of the fiscal plan as the commercial projects could still function as an off-budget spending channel. All of the commercial projects of the DBM have been and will likely be financed by sovereign or sovereign-guaranteed borrowing. Considering the significant fiscal implications, excluding the commercial portfolio of the DBM could undermine the credibility and effectiveness of the medium-term fiscal plan.

Monetary policy should stay focused on maintaining price stability and reducing external vulnerability

The tightened monetary policy stance since late 2014 has contributed to stabilizing inflation and narrowing the current account deficit. Continued commitment to price stability would help address upside risks to inflation and firmly stabilize high inflation expectations towards the central bank's target inflation. The central bank's policy tools to stabilize prices, however, would more appropriately be limited to conventional monetary operations and avoid liquidity injection to select industries through a quasi-fiscal program such as the Price Stabilization Program. Measures to address supply-side constraints could be needed in times of severe supply shocks, but such measures would be more appropriately handled by the government budget. Excessive intervention in the foreign exchange market against market fundamentals is unlikely to be a sustainable measure to contain inflation, as the pressures on the exchange rate would likely build up amid the weak external accounts prospects while available foreign exchanges buffers would continue to decline due to interventions.

Existing quasi-fiscal operations financed by the BoM should be phased out and transferred to the government. The phasing out of the Price Stabilization Program, already underway, should continue. The central bank's financing of the subsidized housing mortgage program should also be phased out and, instead, the program should be transferred to the government where it competes with other policy needs. These policy lending programs were launched in late 2012 and 2013 when the political demand for higher spending mounted. As the budget revenue growth gradually slowed amid declining FDI and the weakening exports, the currency issuance power of the central bank was seen as a reliable financing source that could be tapped to support growing spending demand without revenue constraints. This demand was particularly high with the subsidized housing mortgage program as a previous mortgage program financed by the government had to be stopped due to revenue shortages. Such quasi-fiscal lending programs implemented by the central bank blurs the boundary between central bank's balance sheet and the government budget, thereby undermining the role of the central bank as an independent keeper of the price stability. New policy lending programs to support specific industries or policy objectives, if needed, should be implemented by the government budget, competing with other spending priorities within the fiscal disciplines of the FSL.

Transparency of the central bank's monetary operations needs to be further enhanced. Transparent communication of the central bank with the market would enhance the credibility of the monetary authorities.

While conventional monetary operations have been largely transparent and publicly disclosed, transparency of some non-conventional policy lending operations has been limited. In the same context, the Bank of Mongolia Law does not have any legal basis for the Monetary Policy Committee which is a key decision-making body of central banks in most countries. The function of the Mongolia Policy Committee needs to be strengthened, including providing it with the legal authority on key monetary policy decisions.

Exchange rate flexibility needs to be enhanced

Enhanced exchange rate flexibility will help buffer possible shocks and help the economy better adjust to external imbalances. Depreciation of the exchange rate both in nominal terms and real trade-weighted terms significantly contributed to narrowing the current account deficit in late 2013 and 2014, and would help the economy adjust to weaker terms of trade going forward. Exchange rate adjustment would also cushion shocks to the fiscal accounts, export revenues, and corporate profits in local currency terms. Recent increased intervention by the central bank may slow the rate of depreciation and imported inflation in the short term. However, underlying pressure on the currency is likely to build up in light of the weak balance of payments prospects and the overall weakening of emerging market currencies in recent months. The cost of intervention is particularly high for a country with inadequate reserves as it requires losses in reserve buffers. Monetary policy focused on reducing external imbalances combined with a flexible exchange rate would help ease underlying pressures on the exchange rate and safeguard foreign exchange buffers.

The safety buffers of the banking system need to be further strengthened

Further actions are needed to shore up the safety buffers of the banking system in light of continued deterioration of bank asset quality. Strengthening the bank supervision and prudential regulations may seem pro-cyclical in the short-term, but maintaining loose prudential regulations could prove more costly should the banking system soundness be continuously eroded by worsening asset quality. Measures that may be considered include:

- The NPL recognition rules could be further strengthened, in particular by strengthening the rule that allows the first-time rescheduled loans to keep current loan classification, thereby not being downgraded to past-due loans or NPLs.
- Loan-loss provisioning could be further strengthened, in particular by applying the one percent general provisioning to existing loans and imposing higher provisioning ratio in the riskier sectors that show faster deterioration of loan quality.
- The PSP loans have been granted zero percent risk-weighting since 2013, which have resulted in overstated system-wide capital adequacy ratios. This regulatory forbearance should be immediately lifted to enhance the transparency and credibility of the financial statement of the banking system. Continuous monitoring and supervision is needed also on banks' concentration risks including their lending exposures to related parties and to large borrowers, particularly in light of the previous experience with the failure of Savings Bank in late 2013.

Better targeting of the social welfare programs would help strengthen the social safety net in an economic downturn

The social safety net could be strengthened and made more efficient by better targeting the social welfare system to the poor and vulnerable.⁸ Mongolia has a well-established social welfare system, which has significant poverty impact but at a high cost due to the weakly poverty-targeted structure. According to a recent study by the World Bank, the poorest 20 percent received 34 percent of total social welfare transfers while approximately 30 percent of the benefits was received by the richest two quintiles. It is important to note that in European and Central Asian countries, the share of total benefits going to the poorest 20 percent reaches over 40 percent (e.g., Croatia and Kosovo). In the best-performing countries around the world, the poorest 20 percent receive over 50 percent of total benefits (e.g., Argentina, Panama, and Peru). The Food Stamp Program currently remains the only poverty-targeted program. There is an urgent need to strengthen Mongolia's social welfare programs with poverty reduction as a key objective. Specific recommendations include the following:

- **Consolidate fragmented programs.** Small programs could be consolidated by prioritizing program design based on the need to provide comprehensive support to the targeted population so beneficiaries do not need to access to multiple programs. Also, need-based programs need to be strengthened while gradually phasing out entitlement-based programs.
- **Make existing social welfare programs poverty-targeted.** To contain costs of social welfare programs while making them more effective, programs could be made poverty-targeted. For example, benefit amounts for the richer quintiles could be reduced or eliminated, using the readily available Poverty-Means-Tested (PMT) household database. The government may consider redesigning the Child Money Program (CMP). The CMP alone accounts for half of total social welfare transfers and redistributes mineral revenues to all children regardless of the income level of their families. Better targeting the CMP to the poor based on the PMT database could be considered to increase welfare benefits to the poor while the total budget cost remaining intact.
- **The new poverty benefit program stipulated in the Social Welfare Law (2012) could be considered to replace some of the existing social programs.** Allowance for the households in need of social welfare assistance was stipulated in the Social Welfare Law in 2012. The new allowance is intended to provide a cash benefit to poor households identified by the Integrated Household Information Database. This program, however, is yet to be implemented.

⁸ See the Special Focus section at the end of this update for a more detailed treatment on Mongolia's current social welfare programs.

Key Economic Indicators Tables

Mongolia: Key Economic Indicators - EAP Update version

	2012	2013	2014	2015f	2016f	2017f	2018f	2019f	2020f
Real Sector									
Real GDP (% change y-y)	12.4	11.7	7.8	2.3	0.8	3.0	6.4	7.9	11.0
Mineral GDP (% y-y)	8.3	19.4	24.2	11.8	-8.0	-6.7	7.3	8.9	16.4
Non-Mineral GDP (% y-y)	13.3	9.8	3.6	-0.7	3.9	6.0	6.1	6.5	6.9
Consumer price index (% change y-y)	14.2	12.3	11.0	5.0	7.4	6.5	6.4	6.4	6.5
Fiscal Account (in percent to GDP)									
Government revenues & grants	29.2	30.8	28.4	25.8	26.4	25.9	26.0	26.0	25.8
Government expenditures incl. DBM spending	38.9	40.2	38.8	34.4	32.9	31.8	30.7	30.4	30.1
All DBM expenditures	2.8	8.0	6.8	4.8	3.0	2.9	2.5	2.4	2.4
Non-commercial DBM spending	1.5	4.6	2.9	2.0	1.8	1.6	1.4	1.4	1.4
Commercial DBM spending	1.4	3.3	3.9	2.8	1.2	1.3	1.1	1.0	1.0
Government balance incl. DBM spending	-9.1	-9.2	-10.8	-8.6	-6.5	-5.9	-4.7	-4.4	-4.3
FSL-defined balance 1/	-7.7	-5.9	-7.0	-5.8	-5.3	-4.6	-3.6	-3.4	-3.3
Public Debt Indicators (in percent to GDP)									
Public debt to GDP (%) 2/	51.3	67.1	76.6	90.7	98.4	95.5	91.7	87.1	78.2
Domestic public debt to GDP (%)	16.2	19.1	21.5	21.3	23.7	26.3	26.3	24.9	23.3
External public debt to GDP (%)	39.0	46.1	55.2	69.3	74.6	69.2	65.4	62.2	54.9
General government debt to GDP (%)	43.3	49.6	57.7	66.7	72.2	68.3	66.9	64.7	58.3
External general government debt (%)	34.9	37.9	42.7	51.3	52.6	48.4	46.2	44.7	39.2
Current account (million US\$)									
(% GDP)	-3362	-3156	-1405	-650	-1150	-1861	-2104	-2099	-1621
	-27.4	-25.2	-11.7	-5.4	-9.4	-14.4	-15.0	-13.6	-9.4
Trade balance (millions US\$)									
Trade balance (millions US\$)	-1553	-1321	993	1299	744	167	67	246	831
Exports of goods (millions US\$)	4385	4273	5775	4701	4261	4039	4374	4960	5878
Imports of goods (millions US\$)	-5938	-5587	-4782	-3401	-3516	-3872	-4307	-4714	-5047
Capital/Financial Account (million US\$)									
Capital/Financial Account (million US\$)	4929	1438	1060	57	269	975	2145	2160	1732
FDI	4408	2098	276	76	885	2200	2600	2625	2730
Portfolio 3/	2325	-156	277	292	-33	-623	129	126	-376
Trade Credits	53	9	-136	-218	-27	-18	-17	-19	-28
Currency and Deposits 4/	-2473	-1376	-210	-228	-855	-868	-867	-882	-892
Loans	496	737	706	133	245	178	191	200	185
Errors and Omissions	-195	-113	-128	0	0	0	0	0	0
Overall BoP Balance (million US\$)									
Overall BoP Balance (million US\$)	1372	-1831	-473	-494	-831	-886	40	61	111

1/ FSL defined budget balance excludes the commercial projects financed by the DBM, following the government definition.

2/ Public debt includes BoM's foreign liabilities and SOE debt in addition to general government debt.

3/ In 2017, a \$500 million Chinggis bond is assumed to be refinanced and a \$580 million DBM bond to be repaid.

4/ The projections for capital and financial accounts assume no drawdown on the PBoC swapline facility from Oct 2015.

Sources: World Bank staff estimates

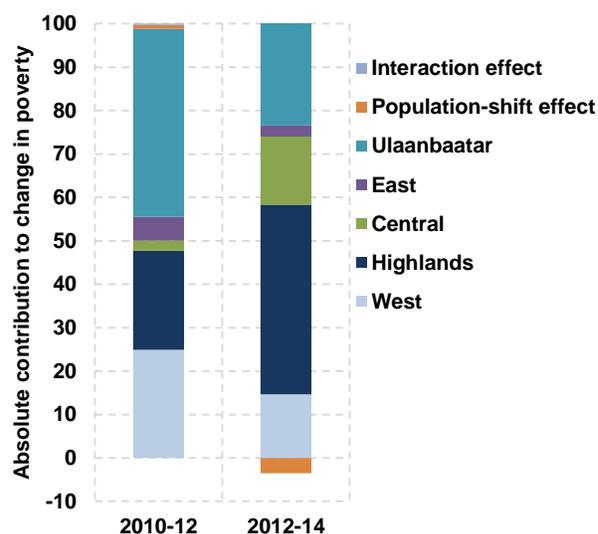
Special Topic 1: Developments in Poverty and Welfare Distribution: 2010-14

Poverty declined from 27.4 percent in 2012 to 21.6 percent in 2014, representing a 5.8 percentage point decline in poverty. This is an impressive pace of poverty reduction even though it marked a slowdown from the 11 percentage points reduction observed between 2010 and 2012. The reduction in poverty was highest in the countryside and rural areas compared to urban areas in general. The highland region experienced the sharpest decline in poverty (13.2 percentage points) while Ulaanbaatar had the slowest decline, at just 3.5 percentage points (Table 1). Consequently, rural areas accounted for slightly more than half of the poverty reduction while the highlands in particular accounted for 44 percent of the poverty reduction (see Figure 70), despite their respective shares of the population in Mongolia being smaller.

Table 3. Trends in poverty: 2010 - 14

	Poverty Headcount Rate (%)			Change 2012-14 (%p)
	2010	2012	2014	
Mongolia	38.8	27.4	21.6	-5.8
Urban	33.2	23.3	18.8	-4.5
Rural	49.0	35.5	26.4	-9.1
Region				
West	52.7	32.3	26.0	-6.3
Highlands	51.9	38.5	25.3	-13.2
Central	29.9	28.3	22.3	-5.9
East	42.3	33.4	31.4	-2.0
Ulaanbaatar	31.2	19.8	16.4	-3.5
Strata 4 locations				
Ulaanbaatar	31.2	19.8	16.4	-3.5
Aimag center	37.3	30.4	23.8	-6.6
Soum center	39.7	27.5	24.7	-2.8
Countryside	56.1	39.7	27.9	-11.7

Figure 70. Decomposition of poverty changes in Mongolia: 2010 - 14



Source: Authors calculations from HSES 2010 - 14

Three major factors explain the recent drop in poverty. First, despite the slowdown in 2014, economic growth remained positive and the economy still grew by about 20 percentage points during 2012-14. Since many people in 2012 were just below the poverty line (see Figure 71), even moderate growth in income or consumption could push them above the poverty line. Second, the pattern of growth was more favorable to the poor, resulting in a higher impact of growth on poverty (see Figure 72). Agriculture cumulatively grew by 36 percent during 2012-14, and was the fastest growing non-minerals sector with the exception of financial services and insurance. Growth was, therefore, highest in areas where the poverty incidence was highest – i.e., in the countryside and highlands regions in particular – delivering significant welfare gains where it had the largest impact for poverty reduction in the country. Third, gains from economic growth in previous periods were preserved rather than reversed. Though non-agriculture employment and real wages stagnated in 2014, they remained above their levels in 2012 (see Figure 73). That meant wage income on average remained higher than in 2012 for the majority of people. The decline in poverty is a result of more

people moving out of poverty than those falling into poverty, which could be attributed to the preservation of real wages in non-agriculture sectors and continued growth in agriculture.

Figure 71. Welfare distribution in Mongolia: 2012 - 14

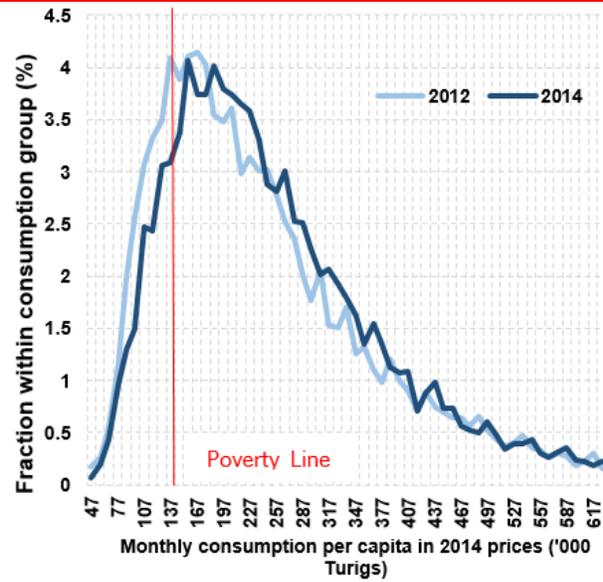
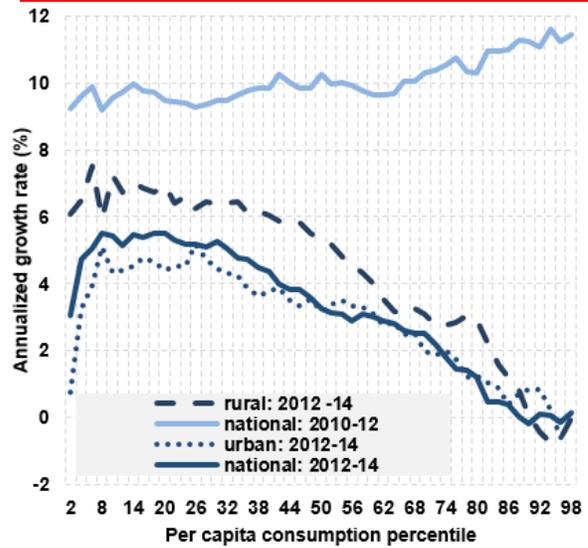


Figure 72. Distributional pattern of consumption growth: 2010 - 14



Source: World Bank staff estimates from HSES 2010 - 14

Figure 73. Trends in monthly real wages: 2010 - 14

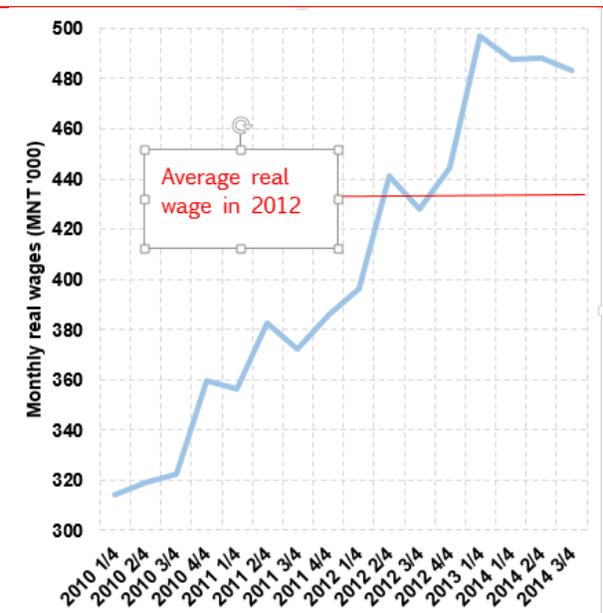
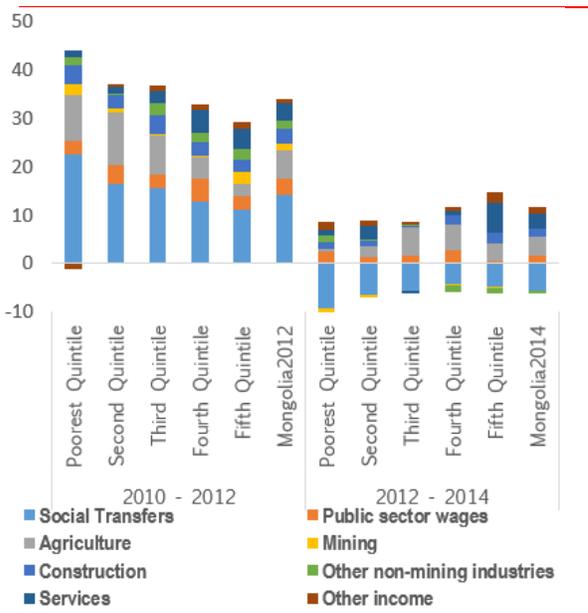


Figure 74. Sector contribution to household income growth in Mongolia: 2010 - 14



Source: World Bank staff estimates from HSES 2010 - 14

The data contains some sobering reminders. Many people who escaped poverty are bunched just above the poverty line. About 11 percent of the population are within 10 percent of the poverty line for example. Small negative economic shocks can easily push these people back into poverty, implying that more than a tenth of the population are highly vulnerable and at risk of falling back into poverty. The risks of stalling in poverty reduction can therefore not be neglected.

Both income and consumption growth slowed down significantly compared to the 2010-12 period, as Figure 72 also shows. Consumption and income growth were very low in urban areas, in particular, indicating slower welfare gains there. A large part of this decline was expected, as the largest contribution to consumption growth during 2010-12 was the universal, one-off, HDF transfers made between 2011 and 2012 which could not have been sustained. The other part could be attributed to slower growth in non-mining sectors outside agriculture, as evidenced by the smaller contribution of the construction, manufacturing and retail sectors to income growth (see Figure 74).

Growth among the middle class almost came to a halt as consumption growth was below 3 percent for the top 50 percent of the population and close to zero for the richest 20 percent. This weak growth in consumption among the middle class exacerbates vulnerability among the population. It portrays weak domestic demand, which has a negative impact on future growth prospects of the country. This could lead to a stagnation or deterioration in real wage growth in retail trade and manufacturing sectors, which could stall poverty reduction in urban areas. This is already manifested in the slower rate of poverty reduction in Ulaanbaatar.

Inequality declined as evidenced by the decline in the Gini coefficient from 0.34 in 2012 to 0.32 in 2014. The decline in inequality is a manifestation of higher growth among the poor and the less well-off well compared to the well-off. Given that consumption growth dropped overall, however, the observed decline in inequality is not a healthy development. A healthier pattern of declining inequality would be one in which average consumption growth increases overall, with a relatively higher increase among the less-off.

Special Topic 2: Review of Social Welfare Programs⁹

The Government of Mongolia, through the Ministry of Population Development and Social Protection (MPDSP) and the General Office of Social Welfare Services (GOSWS), implements some **70 social welfare programs**. While some programs are needs-oriented, others are merit-oriented. All programs are categorically targeted with one exception: the Food Stamp Program, which targets the poorest 5 percent of the population based on a transparent poverty targeting mechanism, using the Proxy Means Test (PMT) methodology.¹⁰

To reduce fragmentation, the Government wishes to review and consolidate its social welfare programs into a more effective and efficient system. As an input to the review process, this note assesses the social welfare program budgets and design and analyzes the coverage and characteristics of program beneficiaries. The review utilizes an analysis of PMT data and social welfare program administrative data (henceforth referred to as the SW Admin/PMT database).

Social welfare programs are defined in the Social Welfare Law (2012) and other legislation detailing the eligibility criteria for beneficiaries. These programs can be categorized into seven program groups according to the way the programs are administered:

- Social Welfare Pensions
- Social Welfare Allowance
- Social Welfare Services, including Community-based Services and Specialized Care Services
- Social Welfare Service Allowance for the Elderly with State Merit
- Allowance for the Elderly
- Allowance for the Disabled
- Allowance for Mothers and Children

In addition to these social welfare programs, MPDSP also executes the Child Money Program (CMP), aimed at redistributing mineral wealth to the next generation. The CMP is funded from the Human Development Fund, separately from the state budget for social welfare. The program provides cash amounts of MNT 20,000 (approximately USD 11) per month to all children from 0 to 18 years old. Despite its objectives and the funding source being separate from the social welfare system, since it is implemented by MPDSP along with other social welfare programs, it is often (although not always) considered to be part of the social welfare system. Given the CMP's large fiscal implications, it is considered critical to include it in this review.

I. Budgets and Expenditures on Social Welfare and Coverage of Programs

In 2013, the government spent 2.78 percent of GDP on cash transfers for social welfare including the CMP (1.37 percent excluding the CMP). This amount is relatively generous compared to the average 1.6 percent of GDP being spent by developing and emerging countries. It suggests that the government is

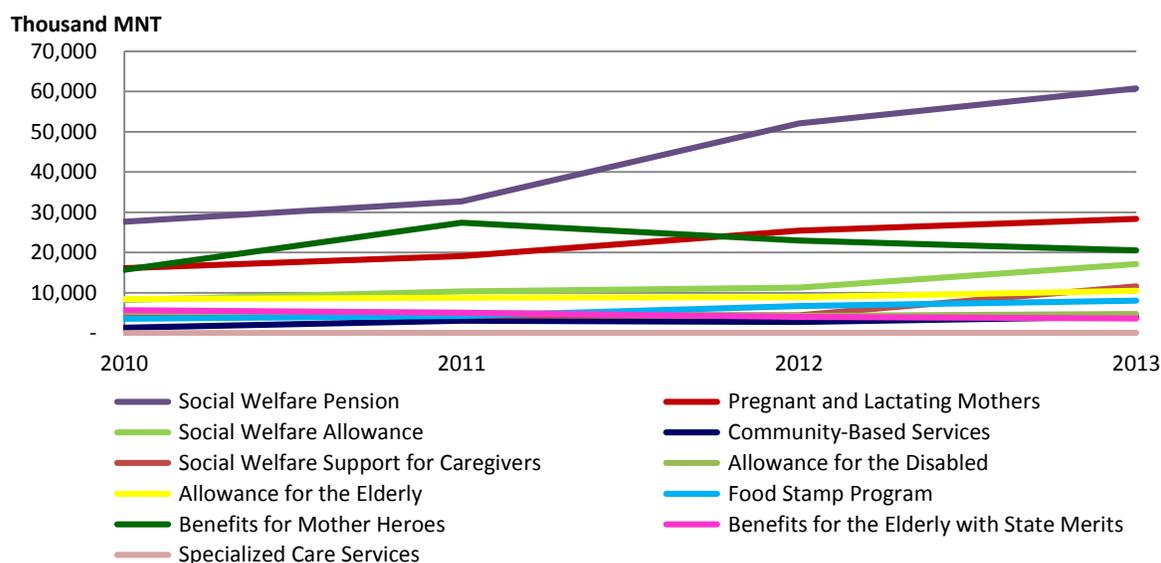
⁹ This special topic summarizes the recent World Bank report, Review of Program Design and Beneficiary Profiles of Social Welfare Programs in Mongolia (Oct. 2015). Click for a full report in [English](#) and [Mongolian](#).

¹⁰ PMT survey methodology was first approved by a joint decree of MPDSP and NSO in 2010 and revised in 2013.

committed to allocating adequate fiscal resources for the social welfare of the population. In 2013, the largest budget allocation for cash benefits by far was for the CMP, comprising approximately half of the total allocation for cash grants but also covering the largest number of beneficiaries. The second largest expenditure was for Social Welfare Pensions (MNT 83 billion, approximately USD 50 million¹¹), followed by the Allowance for Mothers and Children (MNT 67 billion, approximately USD 40 million¹²). The combined amount for these two larger program groups was still less than two-thirds of the budgeted amount for the CMP in 2013.

Excluding the CMP, the expenditures for all programs increased slightly between 2010 and 2013, taking inflation into account (Figure 75). The largest increase was the two-fold increase for Social Welfare Pensions. The expenditures on Benefits for Pregnant and Lactating Mothers increased about 40 percent between 2011 and 2013, although the budget for Mother Heroes benefits decreased about 45 percent.

Figure 75. Inflation-Adjusted Expenditures by Social Welfare Program Category 2010- 2013, Excluding the Child Money Program (taking 2010 as the base year)



Source: GOSWS

In terms of coverage half (49.4 percent) of all individuals in the SW Admin/PMT database received at least one program benefit when the CMP is included. This coverage of the CMP is impressive considering that the poverty rate in Mongolia was 27 percent in 2012. Only a handful of developing and emerging countries have coverage of social welfare benefits higher than the poverty rate (World Bank, 2014). The analysis confirms the overwhelming coverage of the CMP, with 94 percent of children 0-18 years old receiving the program. Interestingly, children 0-18 years old *in every quintile* received the CMP.

Coverage drops considerably, however, when the CMP is not included, with only 19 percent of the population receiving at least one program. Beyond the CMP, the vast majority of individuals (81 percent) did not receive any social welfare program benefits. Around 14 percent received one program, 3.4 percent received two programs, and just above 1 percent received 3 programs. Only 0.5 percent received four or more programs.

¹¹ Using the [1,661 MNT per USD](#) real exchange rate as of December 2013.

¹² This is derived by adding the budget for the Pregnant and Lactating Mothers program and the benefits for the Mother Heroes program, using the [1,661 MNT per USD](#) real exchange rate as of December 2013.

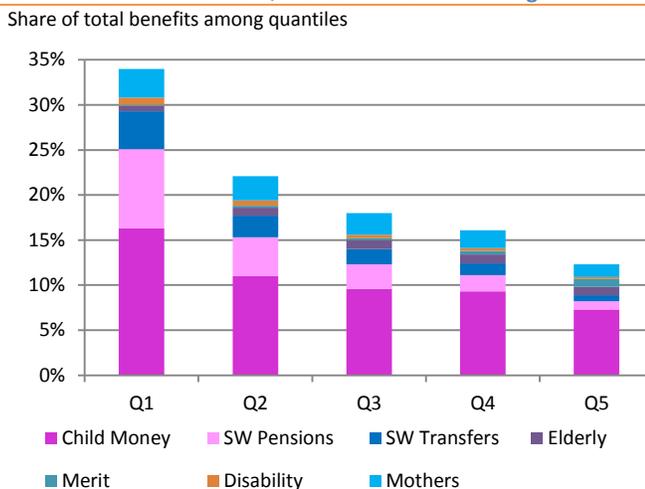
Social welfare programs were generally pro-poor, with a larger share of the benefits going to the poorer segment of the population. According to estimates based on the SW Admin/PMT database, the largest share of total benefits was received by individuals in the lowest social welfare quintiles, estimated by PMT scores.¹³ The poorest 20 percent received 34 percent of total social welfare transfers (Figure 76). On the other hand, approximately 13 percent of the benefits was received by the highest quintile and 17 percent by the second highest quintile. It is important to note that in European and Central Asian countries, the share of total benefits going to the poorest 20 percent reaches over 40 percent (e.g., Croatia and Kosovo). In the best-performing countries around the world, the poorest 20 percent receive over 50 percent of total benefits (e.g., Argentina, Panama, and Peru).

The largest program that contributed to the share received by individuals in the lowest social welfare quintile was the CMP (16 percent). As shown in Figure 76, the next highest contributors were Social Welfare Pensions (9 percent), Social Welfare Transfers including the Food Stamp Program (4 percent), and the Allowance for Mothers and Children (3 percent).

Although most programs were categorically targeted, some programs were more pro-poor than others. The pro-poor programs (with a larger share of program benefits received by quintile groups with lower PMT scores) were Social Welfare Pensions, Social Welfare Transfers, CMP, the Allowance for the Disabled, and the Allowance for Mothers and Children.

In contrast, some programs were less pro-poor (regressive). These programs were: the Benefits for the Elderly with State Merits and the Allowance for the Elderly. In particular, the proportion of Benefits for the Elderly with State Merits that went to the non-poor is stark, with the vast majority of beneficiaries coming from the highest three social welfare quintile groups according to PMT scores (Figure 77). The fact that the Benefits for the Elderly with State Merits were enjoyed by the non-poor is notable since the benefit amounts of this program were the most generous compared to other programs.

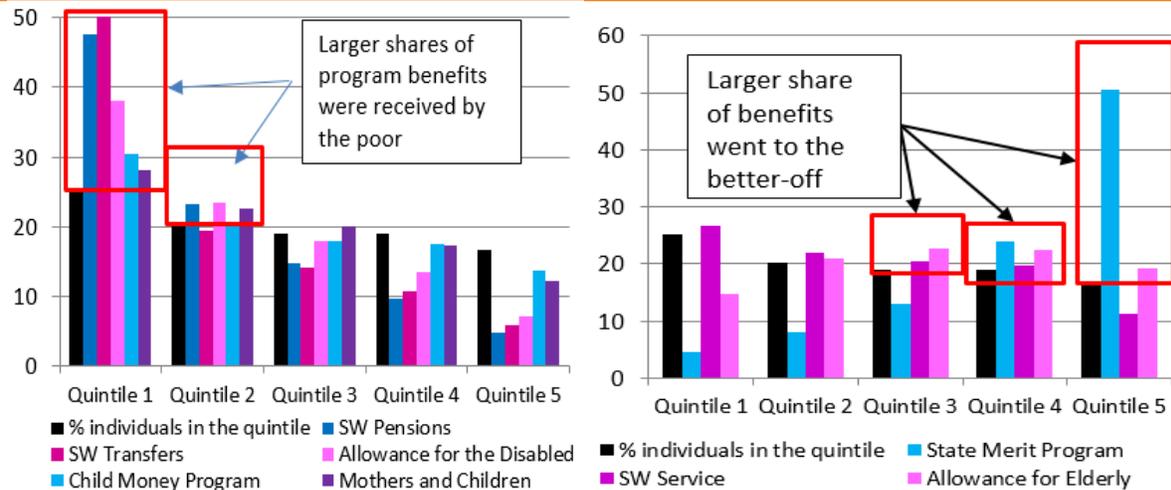
Figure 76. Percentage of Benefits Received by Individuals, According to Household PMT Score Quintiles and Source of Program Benefits



Source: SW/PMT data, WB staff estimates

¹³ The analysis of share of benefits received assumes that those who were listed as program beneficiaries in the administrative data were indeed receiving the full benefit amounts. For cash benefits, the amounts were annualized according to program design (benefit amounts and payment frequency). For reimbursements, it is assumed that all beneficiaries received their full amount in the year of the analysis (for programs that are provided less frequently than once a year), and the average reimbursement amounts were estimated using the 2012 expenditure figures obtained from GOSWS.

Figure 77. Pro-Poor and Non-Pro-Poor Programs: Percentage of Benefits Received by Individuals, According to Household PMT Score Quintiles by Program



Source: SW/PMT data, World Bank staff estimates.

II. Program Participation by Beneficiary Type

The elderly: Around 70 percent of pension-aged individuals benefited from at least one social welfare program, not including social insurance pensions which are not part of this analysis. About 76 percent of total social welfare benefits received by the elderly went to those who benefited from multiple programs, which may be a strong indication of the fragmented nature of programs addressing the needs of the elderly.

The disabled: Around 66 percent of the disabled received benefits from at least one social welfare program. Around 63 percent of the disabled over 16 years old benefited from at least one program, while 87 percent of the disabled under 16 years old benefited from at least one program. Among the disabled above 16 years of age, Social Welfare Pensions comprised the largest proportion (76 percent) of benefits that went to the disabled. Around 43 percent of the benefits were received by those benefiting from only one program (predominantly Social Welfare Pensions), while those benefiting from multiple programs received a larger share of their benefits from Social Welfare Transfers and the Allowance for the Disabled.

The disabled under 16 years of age are not eligible for Social Welfare Pensions, and 81 percent of all benefits to this group were provided by the CMP. Although only about one in five disabled children under age 16 received benefits from three or more programs, when they did, they received a combination of the CMP, Social Welfare Transfers, and the Allowance for the Disabled.

The poor: Around 62 percent of individuals from households in the poorest quintile (according to PMT scores) were direct beneficiaries of at least one social welfare program, but the figure dropped to 29 percent when excluding the CMP. The majority of the poor received only one program—about 64 percent of total benefits going to the poorest quintile went to beneficiaries who received only one program, including the CMP. The largest share of benefits for the poor came mainly from the CMP. The Food Stamp Program was the only program targeted at the poor: All 15,118 household beneficiaries were among the poorest 2.7 percent (according to PMT scores). Among the bottom 2.7 percent, 85.6 percent of households were beneficiaries of the Food Stamp Program.

III. Policy Recommendations

A. Consolidating Fragmented Programs

Three strategies are recommended in consolidating the existing social welfare programs:

- **Consolidate small programs** by prioritizing program design based on the need to provide comprehensive support to the targeted population so beneficiaries do not need to access multiple programs, while taking into account the different needs of male and female beneficiaries, in addition to the specific needs of the target group.
- **Strengthen programs that are needs-based** and gradually phase out entitlement-based programs.
- In the future, consider **transferring health-related benefits to be covered by Health Insurance**.

B. Making Social Welfare Programs Poverty-Targeted

To contain costs of social welfare programs while making them more effective, programs could be made poverty-targeted. For example, benefit amounts for the richer quintiles could be reduced or eliminated, using the readily available PMT database.

The CMP is expected to have a considerable poverty impact, but the level of program expenditures may be difficult to sustain. As discussed above, the program has wide coverage and a large benefit amount. At the same time, the total budget for transfers of this program alone was MNT 240 billion (approximately US\$ 130 million) in 2013, accounting for 51 percent of total transfers made through social welfare programs in Mongolia. Considering the fiscal deficit faced by the government, this level of expenditures on the CMP may be difficult to sustain.

Taking these facts into account, possible options going forward include:

- **Continue the CMP as is** as the program is effectively reaching the poor, if the fiscal environment allows for the program to continue;
- **Introduce program design features to the CMP such that the poor receive larger amounts, while maintaining universal coverage of the program.** This could be achieved by using the PMT to identify children in poor households or through categorical means of providing larger amounts for children in households with many (three or more, for example) children. Reallocation of benefits could be done in a cost-neutral way or in a way that reduces total program cost:
 - To maintain cost neutrality, the grant amounts reallocated to the poor would be equal to the reduction in grant amounts for the better-off.
 - To reduce program cost, the sum of the grant amounts reallocated to poorer children would be lower than the sum of grant amounts reduced for better-off children.
- **Terminate the CMP and replace it with a new poverty-targeted cash transfer program.** Termination of the CMP would give the government fiscal space to design a poverty-targeted welfare program, with clear poverty alleviation objectives. Two design options could be:
 - Implement the **Poverty Benefit program** stipulated in the Social Welfare Law (2012).¹⁴ The new program would need to provide significant levels of coverage and benefits to compensate for the loss of benefits experienced by poor households due to termination of the CMP. The advantages are that the program would have a clear poverty alleviation objective, and, depending on coverage

¹⁴ The direct translation of the program title in the Social Welfare Law from Mongolian is: “Benefit for members of HHs in need for social assistance” (Poverty benefit).

and benefit amounts, it could lead to considerable budget savings. The disadvantages are that this would be a new program, and as with any new program, considerable operational preparation would be required.

- Add a **child benefit component** to the new Poverty Benefit Program described above to maintain the focus on providing support to the next generation (as in the CMP). Adding a child benefit component to the Poverty Benefit Program would increase the complexity of program design as the transfer amounts per household would differ according to the number of children.

Introduction of design changes must be accompanied by strengthening of certain features of program operations, particularly if poverty targeting will be introduced:

- Strong communication campaigns would be critical.
- Introducing targeting, whether through PMT or other categorical means, is bound to introduce exclusion error (eligible beneficiaries being excluded). Therefore, an effective grievance redress mechanism would be essential.
- Further simulation analysis is recommended to identify the most effective scenario for poverty impact.
- If targeting will be conducted through application of the PMT, continued efforts would be needed to ensure that the PMT database is up-to-date and complete and addresses grievances from individuals regarding their registered level of welfare according to the PMT scores.

C. Increasing the Generosity and Coverage of Poverty-Targeted Program(s)

Currently, total estimated transfer amounts from all programs going to poor households are small. The average household transfer amount is approximately 12 percent of household consumption at the poverty line for a household of five members. Most countries provide social welfare benefits that represent 20-35 percent of the poorest households' post-transfer consumption, although there is considerable variation worldwide. The most generous countries in the Europe and Central Asia region provide benefits that represent between 40-55 percent of the poorest households' post-transfer consumption (World Bank, 2013).

There is an urgent need to focus the attention of social welfare programs in Mongolia on ensuring that the poor are better protected from economic shocks. Increasing the generosity and coverage of programs to protect the poor could involve implementing the Poverty Benefit Program as described above or (in the short term) revamping the Food Stamp Program.

D. Strengthening Active Labor Market Programs that Serve as a Safety Net for the Vulnerable

To provide an effective safety net for vulnerable workers, it would be important to have effective and robust Active Labor Market Programs. The current social welfare system provides no safety net support for those who are poor (but not as poor as the bottom 5 percent) or near-poor who do not meet the eligibility criteria for existing social welfare programs. Laborers with temporary jobs or seasonal jobs do not qualify for unemployment benefits due to program design, yet they are the ones who may be most affected by an economic adjustment or other external shocks.

Similarly, for social welfare beneficiaries who are currently unemployed or under-employed, social welfare programs could be linked with co-responsibilities for able-bodied beneficiaries to engage in work/skills accumulation activities. Welfare program beneficiaries are entitled to benefits as long as they remain within the categorical eligibility criteria. While the government needs to increase the generosity and coverage of poverty-targeted programs, such programs should not create dependency but encourage beneficiaries to engage in labor. New generation work activation programs could be introduced for welfare

beneficiaries who are unemployed, seasonally unemployed, or underemployed, applying the principles of “welfare-to-work” transition approaches proven to be effective in many middle-income countries.

E. Strengthen Monitoring and Evaluation of Social Welfare Programs

Stronger program monitoring and evaluation will enable the government to make more informed policy decisions. To date, no impact assessment of programs has been conducted, and the government has little understanding of program impact and how the programs can be improved. To help inform future decisions, the government could:

- Request the addition of a specific module focused on social protection to the HSES questionnaire, or at a minimum request revision of the HSES questionnaire “other income” section to distinguish social welfare and social insurance benefits.
- Fully utilize the social welfare management information system currently under development for monitoring purpose.
- Conduct periodic reviews of programs by analyzing administrative data to inform decision-making.

