Mongolia Quarterly Economic Update
The World Bank

The World Bank’s Mongolia Quarterly Economic Update assesses recent economic and social developments and policies in Mongolia. It also presents findings of ongoing World Bank activities in Mongolia. The Update is prepared by a team from the World Bank’s Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Region Vice-Presidency, consisting of Munkhnasan Narmandakh, Tehmina Khan and Altantsetseg Shilegmaa under the guidance of Rogier van den Brink. This Update also received contributions from Zahid Hasnain, Gailius Draugelis and Jostein Nygard. Copies can be downloaded from http://www.worldbank.org.mn. For further information, comments and questions, please contact Munkhnasan Narmandakh (mnarmandakh@worldbank.org).
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Abbreviations and acronyms

bn Billion
BoM Bank of Mongolia
CPI Consumer Price Index
FX Foreign currency
GDP Gross Domestic Product
HDF Human Development Fund
LC Local currency
LHS Left hand side
MFA Mongolian Financial Association
mn Million
MNT Mongolian togrog
MoF Ministry of Finance
mom Month-on-month
mt Metric ton
NPL Non-performing loan
NSO National Statistics Office
OT Oyu Tolgoi
RHS Right hand side
US$ United States Dollar
WPT Windfall Profit Tax
yoy Year-on-year
Ytd Year-to-date
Executive Summary

GDP growth accelerated to an unprecedented 17.3 percent in 2011 from 6.4 percent in 2010 and the unemployment rate fell from 13 percent in 2010 to 9 percent in 2011. However, real wages for unskilled workers in the urban informal sector are starting to fall as the inflation rate reached 11.1 percent yoy in December. Sharply rising government spending is the root cause of overheating: government spending rose by 56 percent in 2011 and is budgeted to rise by a further 32 percent this year, fueled by sharply rising resource revenues. This pro-cyclical fiscal policy could result in another “boom-and-bust” cycle Mongolia experienced before, particularly as the global economy could face a substantial slowdown in growth due to the continuing European sovereign debt crisis, and which could result in a sharp drop in mineral prices and subsequently government revenues.

Government spending in 2011 was almost double that in 2009 in real terms, and mainly reflects pre-election year pressures, efforts to make good on earlier political promises for large cash transfers and large increases in capital expenditures. Because of high revenues, the government budget deficit is still modest: the 2011 deficit amounted to 3.6 percent. However, the structural deficit (based on long run commodity prices as defined under the Fiscal Stability Law) is much higher at 5.8 percent.

On the monetary front, the Bank of Mongolia (BoM) took significant action to curb inflation and lending growth in 2011. But with inflation still high, the real policy interest rate negative and bank lending expanding at a staggering pace (73 percent yoy), more tightening is needed. Liquidity risks are also rising and a large amount of NPLs remains on the loan books. Given the easy convertibility between dollar and local currency accounts the banking system remains vulnerable to capital flight, if macro-prudential action is not taken to strengthen it. Such action could include, in addition to the recently introduced additional capital buffers for systematically important banks, the use of additional provisioning requirements for highly volatile sectors such as construction, mortgage and consumer loans.

The Togrog depreciated by 11 percent during 2011 reflecting high domestic inflation and declining commodity prices towards the end of last year, factors that similarly impacted the currencies of other emerging mineral-rich economies. Going forward, exchange rate flexibility remains crucial. It will reduce the risk of one-way speculative bets on the currency and allow the economy to better absorb external shocks such as commodity price shocks without transmitting these directly to budgetary and export revenues as in the previous bust in 2008. More significantly, it will help the economy adjust through movements in the nominal exchange rate rather than through sharp cuts in domestic wages, employment and prices that hurt the real incomes and profits of workers and businesses. Finally, exchange rate flexibility is desirable in that it will reduce incentives for the private sector or banks for taking on unhedged risk.

The trade deficit reached record levels (US$ 1.7 bn in December 2011) as imports of mining-related equipment and fuel imports have surged. But exports also grew strongly, reaching US$ 4.8 bn in December from US$ 2.9 bn a year ago supported almost entirely by coal shipments to China. The current account deficit widened to 35 percent of GDP from 14 percent in 2010, but was fully funded by record FDI inflows of US$ 5.3 bn or almost 62 percent of GDP on a four-quarter rolling sum basis.

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

2 This is UB inflation. The nationwide inflation in Ulaanbaatar is slightly lower at 10.2 percent yoy in December.
There have been major legislative developments in 2011 and early 2012 aimed at strengthening policy institutions and frameworks. The Integrated Budget Law (IBL) was passed in December 2011: this organic budget law contains measures to support fiscal sustainability and the successful implementation of the Fiscal Stability Law. It also strengthens the public investment framework by requiring feasibility studies and alignment with national priorities for projects to be included in the Public Investment Program and the budget. This will help permanently lock in prudent fiscal policies and mechanisms in the future alongside the FSL.

The Social Welfare Law was passed in early January. This mandates the provision of a targeted poverty benefit replacing the existing system of universal cash transfers. This represents a major step towards setting up a fiscally sustainable social protection system while supporting Mongolia’s poor - it is expected to reach about 130,000 poorest households, or one-fifth of all households in Mongolia.

To ensure macroeconomic stability and to prevent a hard landing for the economy in case of an adverse external shock, Mongolia needs to adhere strictly to prudent fiscal policies as set out in the FSL and IBL and tightening both fiscal and monetary policy to reduce inflation, take macro-prudential action to reduce systemic risks in the banking sector and maintain a flexible exchange rate that will act as the first buffer in any external shock materializes.

These are uncertain times for Mongolia. The economy faces growing headwinds from the global economic environment, while the looming elections increase domestic uncertainty. Until a substantial amount of savings has accumulated in the stabilization fund, Mongolia remains strongly exposed to volatility in commodity prices. With global economic prospects diminishing, and with any potential stimulus package from China unlikely to be focused on infrastructure as during the last global financial crisis in 2008-09, extra caution is warranted.

“Be prepared” sums up the appropriate policy advice at this point in time. Mongolia’s policy-makers realized the importance of “being prepared” when they passed the landmark FSL in June 2010. It is now critical to adhere to the principles contained in this law, in order to ensure that the country’s vast coal and copper resources are converted into sustainable growth that improves the welfare of all current and future Mongolian citizens.
Real sector developments

GDP growth accelerated sharply to 17.3 percent in 2011...

The economy grew at a furious pace in 2011, with preliminary data showing GDP growth of 17.3 percent year-on-year (yoy). This is more than double the GDP growth in 2010 of 6.4 percent, and well above the average 9 percent outturns seen during the previous mining boom in 2004-08. The astronomical growth rate makes Mongolia one of the fastest growing countries in the world.

... but the growing contribution of the wholesale and retail trade sectors indicates that growth is increasingly being driven by consumption and expansionary fiscal policy

The fastest growing sector was wholesale and retail trade, which expanded by 43 percent during 2011. And during the final quarter of 2011, it grew by a massive 70.5 percent. The sector contributed 4 percentage points (pp) to overall growth in 2011, and 6.7 percentage points to quarterly growth of 18.7 percent in Q4 (Fig 1 and Fig 2). This is much larger than the growth contribution of any other sector and reflects increased consumption fueled by the huge increase in government spending over the past year: government spending rose by 56 percent during 2011, with a large portion directed towards large cash handouts to every citizen.

The mining and manufacturing sectors meanwhile expanded by 8.7 and 16 percent during 2011, contributing 1.5 and 1.0 pp to growth. The transport and construction sectors also performed well during 2011, with positive contributions of around 1.6 and 0.2 pp respectively. However, fourth quarter figures reveal that despite a strong showing for 2011 as a whole, both sectors contracted sharply in Q4. Growth in construction fell to minus 20.5 yoy percent in Q4, following an outturn of 66.9 percent in Q3. The transport and storage sector contracted by 29 percent, after growing by 35 percent in Q3. This sharp contraction cannot be explained by seasonality alone. Given concerns that the economy has been overheating for a while now, and in particular that a bubble has been brewing in the construction sector, the fall in output in Q4 is therefore of concern, particularly given that a significant share of bank lending is directed towards this sector.

Agricultural output, which had contracted sharply during 2010 because of the “dzud” (severe weather conditions), was flat in 2011 overall, with a decline of 9.2 percent in Q4. Labor force surveys show that the sector accounts for more than a third of total employment, and continuing difficulties are undoubtedly taking a toll on poor households which derive their livelihood from the sector.

Industrial output growth has slowed, but remains at a healthy pace

Industrial output growth slowed on a 3-month moving average basis, but activity in manufacturing and mining and quarrying operations is still growing at a healthy rate (Fig 3). Within manufacturing, which accounts for about a third of total industrial output, the textiles sector (mostly cashmere related items) contracted in Q4, but growth in the manufacturing of base metals remains strong (Fig 4).

Labor Markets and Poverty

Labor force surveys show that unemployment, although still high, is falling

Formal unemployment figures which include only those who are registered with the Labor and Social Welfare Service Center show an increase in the unemployment rate to 5 percent in December up
from 3.3 percent in December 2010. The overall number of registered unemployed increased to around 57 thousand persons from 38 thousand since 2010.

However these numbers have tended to underestimate the true extent of unemployment, which is better gauged through labor force surveys\(^3\). These show that unemployment, although still high, is starting to fall. The latest Q4 2011 survey from the NSO estimates the unemployment rate at 9 percent, down from 13 percent in Q4 2010, with some 103 thousand people unemployed from the total labor force\(^3\) of 1,147 thousand.

**Real wages in informal markets are being eroded by high inflation**

The latest World Bank survey conducted in informal labor markets in December 2011 revealed that, compared to the same period from 2010, the total number of workers and real wages has almost doubled on average, especially in wholesale and retail markets and construction, due to increased work opportunities offered by strong economic growth in these sectors. However, most recently, there was a reduction in number of casual workers of about 6 percent compared to October due to the seasonal closure of construction labor markets and reduced outdoor sales activities due to cold weather. Workers’ real informal market wages on average were about 7 percent lower in December compared to October 2011 (Fig 5).

Reduced job opportunities during the winter months, combined with rising inflation, explain the decline in real wages of the most vulnerable in society relative to the last survey in Q3 2011. Nearly 40 percent of those surveyed indicated that their earnings did not meet their basic needs, while the wages earned in these markets were sufficient to meet only food and shelter needs for the rest (Fig 6). The latest survey also indicated a continued influx of unskilled workers from rural regions into these informal markets reflecting continuing hardship in the countryside, with such workers accounting for 30 percent of survey participants.

**Inflation**

**Inflation pressures have continued to build ...**

Consumer prices remained in double digits during 2011 except for spring when government policy successfully kept food price\(^5\) inflation under control by the managed sale of existing meat reserves\(^6\) at below-market prices. However, headline inflation in Ulaanbaatar reached 11.1 percent yoy in December, up from 2.8 percent in May 2011 (Fig 7). Core inflation (which excludes food and energy, because they are typically more volatile) has also kept increasing throughout the year (Fig 8) reaching 12.4 percent yoy (3mma) in December.

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\(^3\) These also take into account those who are not officially registered as unemployed with the Labor and Social Welfare Service Centers.

\(^4\) The active population comprises all persons above 15 years of age whose activity status, as determined in terms of the total number of weeks or days during a long specified period or the preceding 12 months or the preceding calendar year, was either employed or unemployed.

\(^5\) Food consumption patterns from the 2007/8 household survey show that the median household below the poverty line allocates more than 80 percent of its food expenditure to meat and dairy products (46 percent), and to flour and bread (36 percent).

\(^6\) The government had subsidized more than 2,000 herders and meat vendors in 2011 and prepared higher than normal meat reserves (16,000 tonnes in 2011 vs. 2,800 tonnes in 2010)
Economic growth accelerated sharply to 17.3 percent in 2011.

Fast growing wholesale and retail trade sectors reflect high consumption and expansionary fiscal policy.

Industrial output growth is slowing but remains at a healthy pace.

And the manufacturing of base metals is also growing strongly.

Real wages fell in the second half of last year in informal labor markets as inflation has picked up.

Nearly 40 percent of those surveyed reported that wages were inadequate for meeting basic needs.

Sources: NSO, WB staff estimates. * Preliminary GDP estimates.
Because Mongolia imports the bulk of its non-meat food from China, its food inflation typically follows China’s with a lag of three months or so (Fig 10). With food prices in China rising by 9.1 percent yoy in December, pressures on food prices in Mongolia will likely remain strong for some time. The government is planning to reintroduce the meat subsidy program in 2012 to help keep a lid on meat prices which rose by more than 20 percent yoy in Q4.

... reflecting expansionary fiscal policy

Growing inflation pressures reflect the effects of an expansionary fiscal policy stance in an already booming economy, as the Oyu Tolgoi mine comes closer to completion. Government spending in 2011 was a staggering 56 percent higher than the previous year, while the 2012 budget seeks to ramp up spending even more. This is a substantial injection of demand into the economy at a time when there is limited room for slack. Unless spending is restrained, inflation pressures will continue to build.

High inflation significantly erodes the real income and purchasing power of all citizens, but in particular the poor, as they find it difficult to hedge against inflation, for instance by investing in long-term assets which are unaffected by inflation, e.g. real estate.

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**Fig 7** Headline inflation remained high in 2011 reflecting overheating pressures

% yoy, UB

**Fig 8** While core prices have kept rising during the year as well

% yoy 3mma, UB

**Fig 9** With Mongolian food prices lagging those in China by 3 months, food inflation pressures should stay strong

%

**Fig 10** With real interest rates negative, there is scope to raise the base rate futher

%
Moreover, the effects of higher inflation are also being seen in exchange rate movements: the currency depreciated by some 11 percent in 2011, particularly in the second half. This reflects in part the much higher domestic inflation in Mongolia compared to its trading partners.

**To control inflation, monetary and fiscal policies need to work in tandem**

The BoM took significant policy action last year. It raised the benchmark rate three times, by a total of 125 basis points to 12.25 percent in October (Fig 10) and the banking sector reserve requirement ratio to 11 percent. However, with headline inflation rising to 13.5 percent, the real policy rate is currently negative, indicating the need for more tightening in order to anchor both inflation and inflation expectations. But that will prove hard to achieve if monetary policy and fiscal policy are working in opposite directions, as is currently the case.

Accordingly, in order to contain inflation, it is important to rein in government spending. The huge increases in government expenditures have added to the inflation pressures and increase the risk of a wage-price spiral if higher inflation expectations become entrenched. High domestic inflation also causes the currency to appreciate in real terms, hurting both agricultural exports, on which the rural population depends, and an already small manufacturing sector. It is therefore important that actual 2012 expenditures are lower than budgeted both to prevent further overheating and to allow for the necessary fiscal consolidation once the Fiscal Stability Law’s structural balance rule (keeping the structural fiscal deficit to 2 percent of GDP) goes into effect on January 2013.

**Fiscal developments**

**The 2011 budget set the record in spending, - double the level in 2009**

Spending during 2011 rose to record levels, increasing by 56 percent compared to the previous year. (Fig 11 and Fig 12). Overall, the size of government has doubled in two years, i.e. relative to 2009 levels. The increased spending reflected pre-election year pressures and efforts to make good on earlier political promises for large cash handouts and increases in infrastructure spending. The original 2011 budget (passed at the end of 2010) had aimed to raise spending by 33 percent on 2010 outturns, mostly on social transfers, and current and capital expenditures. But with receipts boosted by high commodity prices and accelerating growth, the budget was amended in November with the intention of spending the extra cash: in the final budget, planned spending was some 60 percent higher than 2010 outturns.

**One-fifth of 2011 spending occurred in December alone, representing a significant injection of demand into an already overheating economy.**

Significantly, one-fifth of 2011 spending occurred in December alone (Fig 13). A third of this was on transfers and one-fifth on capital expenditures, which represents a substantial increase in domestic demand at a time when there is limited slack in the economy. In particular, MNT 286.3 bn was transferred to the Ministry of Agriculture for agricultural subsidies and subsidized credit lines. Another MNT 122.6 bn was used to fully fund a number of large projects which had been underfunded in the original budget due to lack of budget financing. Also, MNT 34 bn was added in order to implement the Air Pollution Law approved by parliament, which included the subsidization of improved stoves for ger

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1 MNT 50 bn was used to finance sheep and camel wool production, MNT 100 bn for subsidized credit lines to cashmere production, and MNT 150 bn for subsidized credit line to SMEs. To finance these schemes, the government has so far issued MNT 286.3 bn in domestic bonds out of MNT 300 bn planned in 2011.
households. These considerable increases in the capital budget have not been matched by improved
capacity in the Ministry of Finance and the National Development and Innovation Committee for project
appraisal and budgeting, calling into question the quality of public spending. In addition, artificial
pressures to disburse funds in December compromise public financial management.

December spending patterns were similar to spending patterns for 2011 as a whole. The largest
expenditure item in 2011 was social transfers, followed by capital expenditures. Cash transfers
distributed from the Human Development Fund amounted to MNT 21,000 per month per person,
contributing significantly to the consumption power of the poor. However, the transfers were universal,
benefitting the non-poor too, adding to spending pressures in the overheating economy, fuelling
inflation, and hence undermining the poverty-reduction effect of the cash transfers. Another quarter of
the increase was accounted for by spending on wages and salaries and goods and services (Fig 14).

The overall deficit was contained at 3.6 percent due to buoyant revenues, but the structural
deficit is much higher at 5.8 percent

Compared to 2010, revenues were 43 percent higher, boosted by growing receipts from royalties
and dividends. Although the withdrawal of the Windfall Profits Tax (WPT)8 at the start of the year
resulted in a substantial loss to government revenues (the WPT contributed 13.7 percent of total
revenues in 2010), this has been more than compensated for by VAT receipts on mining related
equipment imports. With the economy booming, corporate and personal income tax receipts are also
buoyant, as are VAT receipts on domestic goods and services. Unfortunately, instead of saving this extra
revenue, the government not only spent it all but closed the year with a deficit of MNT 391 billion.

As a result, the overall deficit amounted to only 3.6 percent, albeit a deterioration from the
balanced budget achieved in 2010. A positive development is that since 2011 the budget has been based
on estimates of structural (i.e. long-term) mineral revenues as required by the FSL, with the difference
between actual revenues and structural revenues (MNT 241 in December or around 2 percent of GDP)
saved in a Fiscal Stability Fund. But by this measure, the structural deficit (structural revenues less actual
expenditures) is of course higher at 5.8 percent of GDP than the overall deficit of 3.6 percent.

Spending will be raised further under the 2012 budget, mostly on current expenditures and
large public work projects

The 2012 Budget approved in December plans to raise spending to MNT 6,309 bn, a 32 percent
increase from 2011 outturns. In absolute terms, this comes close to total GDP in 2009. An increase in
revenues of 32 percent on 2011 levels is also projected, and nominal GDP at MNT 16 trillion. The
structural deficit under these spending plans and revenue and GDP forecasts amounts to 3 percent in
2012 (Table 1).

The increase in spending is largely directed towards wages and salaries (up 36 percent) first by MNT
80,000 in April and by 28 percent in October 2012, and subsidies and current transfers (up 33 percent).
Together these items constitute more than 50 percent of the total expenditures in the budget. In
addition, capital expenditures under the proposed 2012 budget are 88 percent higher than 2011
outturns. These are to be directed towards infrastructure development—notably on upgrading road and
rail networks to the tune of UD$ 1 bn, necessary for getting Mongolia’s mineral wealth out of the
ground and to market. The budget for capital repairs has been roughly maintained at 2011 levels,
although this is still double the level in 2010 (Table 2).

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8 A 68 percent tax applied to revenues from prices exceeding base prices of $2600/tonne for copper and $850/ounce for gold until
December 31, 2010.
The country’s construction sector is facing capacity constraints, particularly a shortage of skilled labor, construction materials in addition to bottlenecks in transportation. These issues, along with regulatory constraints on construction companies, are discussed in Box 1. Therefore, it is uncertain to what extent ambitious infrastructure plans can be planned and implemented in such a short span of time without compromising project quality, appraisal and implementation.

Table 1 Selected Fiscal indicators (in percent of GDP unless specified)

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<td>% of GDP</td>
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<tr>
<td>Total government revenue</td>
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<td>35.4 (floor)</td>
<td>40.6</td>
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<td>33.6</td>
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<td>7.4</td>
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<td>6.3 (floor)</td>
<td>9.9</td>
<td>12.4</td>
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<td>5.0 (ceiling)</td>
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<td>-5.8</td>
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<td>Non-mining balance (% GDP)*</td>
<td>-12.4</td>
<td>-10.5</td>
<td>-19.8*</td>
<td>-16.0*</td>
<td>-11.9*</td>
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<td>GDP actual/ estimate (Togrog T)</td>
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<td>8414</td>
<td>10,157</td>
<td>10,829</td>
<td>16,13</td>
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Memo items (% annual change)

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<td>113.4</td>
<td>89.0</td>
<td>88.0</td>
<td></td>
</tr>
</tbody>
</table>

1/ As percent of GDP assumptions in national budget. 2/ As defined in the FSL with revenues based on long run mineral prices.* Mining revenue for 2011 and 2012 assumes that 75 percent of revenues from VAT on imports is for mining imports, which is non-refundable to importers

Table 2 Capital expenditure composition, MNT mn

<table>
<thead>
<tr>
<th></th>
<th>2009 Actual</th>
<th>2010 Actual</th>
<th>2011 Actual</th>
<th>2012 Approved</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total capital expenditures</td>
<td>460,564</td>
<td>564,711</td>
<td>1,067,168</td>
<td>2,000,998</td>
</tr>
<tr>
<td>% annual increase</td>
<td>-26.2</td>
<td>22.6</td>
<td>89.0</td>
<td>87.5</td>
</tr>
<tr>
<td>Domestic Investment</td>
<td>396,581</td>
<td>502,373</td>
<td>925,054</td>
<td>1,693,324</td>
</tr>
<tr>
<td>% annual increase</td>
<td>-17.8</td>
<td>26.7</td>
<td>84.1</td>
<td>83.1</td>
</tr>
<tr>
<td>Capital Repairs</td>
<td>11,784</td>
<td>24,417</td>
<td>51,209</td>
<td>52,624</td>
</tr>
<tr>
<td>% annual increase</td>
<td>-57.2</td>
<td>107.2</td>
<td>109.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Other capital expenditures</td>
<td>25,543</td>
<td>28,970</td>
<td>90,905</td>
<td>72,211</td>
</tr>
<tr>
<td>% annual increase</td>
<td>-72.8</td>
<td>13.4</td>
<td>213.8</td>
<td>-20.6</td>
</tr>
<tr>
<td>Road fund financed by project loan</td>
<td>26,657</td>
<td>8,951</td>
<td>-</td>
<td>182,839</td>
</tr>
<tr>
<td>% annual increase</td>
<td>32.1</td>
<td>-66.4</td>
<td>-100.0</td>
<td>-</td>
</tr>
</tbody>
</table>

Fig 11  Fiscal balances deteriorated in the last quarter of 2011

% of GDP*  % of GDP*

- Revenue & grants (LHS)
- Total expenditure and net lending (LHS)
- Total expenditure (LHS)
- Fiscal balance (RHS)
- Adjusted fiscal balance (RHS)

Fig 12  ... as government spending was ramped up

% increase in expenditures 2011 vs 2010

Fig 13  ... particularly in the final quarter of 2011

% share of total expenditure for the year, by month

Fig 14  Spending on transfers and other current spending accounted for the bulk of total spending in 2011

% of total expenditures in 2011

Fig 15  The loss in Windfall Profits Tax revenues in 2011 has been offset by rising VAT receipts...

% change in revenues in Dec 2011 vs Dec 2010

Fig 16  ... which accounted for one-sixth of total revenues in 2011

% contribution to revenues, 2011

Sources: MoF, NSO, WB staff estimates.*GDP interpolated using actual 2008, 2009, 2010 and 2011 GDP data ** Adjusted fiscal balance excludes net lending from expenditure, leaving current and capital expenditure only.
Box 1 Key Challenges in the Construction Sector in Mongolia

The development of Mongolia’s construction sector is vital to its future, particularly for transport infrastructure necessary for getting its mineral wealth out of the ground and to market. The economy is already experiencing a boom as one major mining project is coming on-stream, and several other large mining projects are also planned. These will yield huge benefits in terms of rising incomes and exports revenues, and jobs in mining and related transport and infrastructure sectors. But they also carry the risk of Dutch Disease, whereby mineral sector inflows cause the currency to appreciate and rising wages erode the competitiveness of the non-mineral traded sectors. This can only be compensated by sharp increases in productivity of the non-mineral sectors of the economy. In this context, improving the planning and execution of infrastructure investments is key.

Such improvements are urgently needed, because the government plans to launch a massive infrastructure development project designed to boost broad-based economic growth. If successfully implemented, 95 percent of the Mongolian road network will be paved by 2016. The total investment planned for the project is estimated at MNT 6.27 billion. The capital expenditures under the proposed 2012 budget are almost double the amount in 2011. Financing is to be obtained from various sources, including PPPs and the newly created Development Bank.

As it stands, the project is behind schedule as only 26 percent of the engineering scope of work and drawings has been completed, even though construction was scheduled to have begun in 2011. Industry observers estimate that currently only 5 percent of licensed domestic road construction companies are capable of large construction projects. To fill the production gaps, Mongolia has accepted bids from foreign construction companies. But output by both domestic and foreign companies would have to triple to meet current plans.

The government would need to urgently address the following areas in order to expand road sector capacity successfully: company capabilities and capacity, business and government policy, funding and performance, labor force, and construction materials.

First, the existing domestic road construction companies are too small for the planned large-scale operations. Second, some infrastructure priorities have been influenced by political and other non-economic considerations. Third, the present level of road maintenance funding covers only 20 percent of the estimated needs.

Fourth, skilled workers comprise only about 20 percent of Mongolia’s 1.1 million laborers and most of these are being drawn into the mining sector. Hence, the construction sector faces a growing shortage of capable and trained personnel. While the technology used in the construction sector has improved significantly, training to provide the workers the necessary skills to keep pace has faltered. At the same time, highly trained engineers are aging, while the young are struggling to find quality training to become competitive. Due to labor force shortages, it is essential for companies to obtain laborers and specialists from abroad. However, in addition to numerous steps and long approval process involved in obtaining permits from the government, the current regulation requires companies to pay substantial amount of monthly fee per foreign worker on top having to provide competitive salaries.

Fifth, foreign companies are required to remove imported equipment within one year. Because road construction projects typically require three years to complete, foreign companies face significant time constraints if they want to bring their equipment from overseas.

Sixth, transparency and fair competition in the construction sector are a concern as fiscal spending for capital investments is skyrocketing. A review of sample projects showed that all of the directly awarded (non-competitive) contracts incurred significant time overruns.

Finally, projects need to have a minimum level of preparation before being submitted to budget, so as to encourage both contractors and lawmakers to obtain additional experience through training and partnerships, discipline the government to improve the tender process, avoid neglecting maintenance of existing infrastructure
and create monitoring and consulting companies to assist and oversee the road construction projects.

Source: World Bank Staff

**Mongolia's universal cash transfers will be replaced by a system of proxy means tested benefits targeted to the poorest households**

The government approved the HDF Law alongside the 2012 budget with MNT 787.1 bn for HDF expenditure. This is 13 percent of the planned expenditure and 5 percent of the projected GDP. Resources from the HDF are projected to be mainly used for cash benefits (MNT 692.6 bn) and tuition grants for 170,000 students in graduate schools (MNT 83.6 bn).

The government intends to distribute the majority of the increase as the remainder of the cash transfer program, amounting to MNT 128,000 per citizen in the first half of 2012. In addition, MNT 1 mn for every elderly person, MNT 1 mn for every disabled person plus MNT 1 mn worth of “Erdenes-Tavan Tolgoi” LLC shares that are to be distributed to every citizen by February 1, 2012. The Oyu Tolgoi and Tavan Tolgoi mining projects remain the principal sources for financing of the HDF in 2012. The HDF is counting on receiving a total of MNT 312.5 bn as prepayment, MNT 365 bn as royalty fees from mining licenses, and MNT 110 bn as dividends and capital gains from selling shares of strategic deposits.

There is a growing recognition that the HDF universal cash transfers have been costly, not only fiscally, but also macro-economically (contributing to inflation) and socially (creating welfare dependency). This program is supposed to be terminated in June 2012, and the government plans to roll out a targeted poverty benefit to replace, as mandated by the SWL. The introduction of the targeted social assistance during 2012 will help provide a basic safety net, as the program is likely to be targeted to the bottom 20 to 30 percent of income distribution of the population and is expected to reach about 130,000 households, over one-fifth of total households in Mongolia. Households should receive a monthly payment equal to MNT 5,000 per each adult in the household, and a further MNT 10,000 per child. The 2012 budget has allocated 2 percent of GDP for this purpose.

**The 2011 budget outturns and 2012 plans undermine the Medium-Term Budget Framework (MTBF)**

2011 spending outturns, amounting to 44.2 percent of GDP, far exceed the ceiling set out in the 2011 Medium Term Budget Framework. If revenues had not outperformed, the overall balance for 2011 too would have far higher than allowed by the 2011 MTBF\(^9\) (Table 3).

Furthermore, the 2012 Budget passed at the end of December plans to increase expenditures by another 32 percent on top of 2011 outturns. Admittedly, the 2 percent of GDP structural deficit ceiling of the FSL only becomes binding in 2013 and no transition path to this has been specified, so that neither the 2011 nor the 2012 budgets violate the letter of the FSL. But the highly pro-cyclical nature of the 2011 and 2012 budgets contradict the FSL *in spirit* and the 2011 budget outturn is clear contradiction with the 2011 MTBF. This undermines the usefulness of the MTBF concept: namely to allow for sustainable multi-year budgeting within the limits of a sound macroeconomic framework.

\(^9\) The MTBF lays out binding multi-year ceilings on expenditure and the deficit.
Table 3 Aggregate indicators for the Budget Framework under the MTBF in comparison to 2011 approved and outturn numbers (% of the projected GDP)

<table>
<thead>
<tr>
<th></th>
<th>MTBF 2011</th>
<th>2011 Approved*</th>
<th>2011 Outturn</th>
<th>2012 planned*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2011</td>
<td>2012</td>
<td>2013</td>
<td></td>
</tr>
<tr>
<td>Floor on total budget revenue</td>
<td>35.4</td>
<td>35.4</td>
<td>30.3</td>
<td>41.0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2012</td>
<td>40.6</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2013</td>
<td>38.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ceiling on total budget expenditure</td>
<td>40.4</td>
<td>39.4</td>
<td>32.3</td>
<td>48.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2012</td>
<td>44.2</td>
<td>39.1</td>
</tr>
<tr>
<td>Ceiling on total budget deficit**</td>
<td>-5.0</td>
<td>-4.0</td>
<td>-2.0</td>
<td>-7.6</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-3.6</td>
<td>-1.0</td>
</tr>
<tr>
<td>Floor on capital expenditure</td>
<td>6.3</td>
<td>6.0</td>
<td>4.7</td>
<td>11.8</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>9.9</td>
<td>12.4</td>
</tr>
</tbody>
</table>


External sector

The trade and current account deficit hit new highs, but were funded by record FDI inflows of US$ 5.3bn in 2011

The trade deficit has repeatedly hit new highs over the past year as imports have surged (Fig 17). The latest data show a deficit of US$ 1.7 bn for 2011, up from US$ 0.37 bn in 2010. Imports—mostly mining transport equipment, fuel and machinery imports (Fig 18)—reached US$ 6.5 bn in December nearly double the level in 2010.

Exports also grew strongly, reaching US$ 4.8 bn at close of year, up from US$ 2.9 bn a year ago supported almost entirely by large coal shipments to China—the world’s largest thermal coal consumer—from coal mines in Southern Mongolia (Fig 19). Coal is the largest export earner for Mongolia currently, constituting almost half of the value of total exports (Fig 20). In 2011 coal exports amounted to US$ 2.2 bn or more than double their total export value in 2010 (US$ 0.9 bn). Earnings from copper exports rose by 25 percent during 2011 in dollar terms, although volumes were mostly unchanged. Despite gold prices benefiting from flight to safety flows into the metal, the volume of gold exports fell, so that overall export earnings fell 36.6 percent. Exports of greasy cashmere and combed goat down performed badly as well, declining 45 percent and 16 percent in 2011.

Global commodity prices have fallen considerably since September last year. Copper prices for instance were some 16 percent lower in January than their average values in September (Fig 21). With global economic prospects looking dim as the euro area crisis drags on, the momentum of global trade is slowing, and with China trying to engineer a soft landing for its housing market and its economy, the risks only lie to the downside (Fig 22). Renewed volatility in global financial markets or any shift in risk appetite, in both domestic and overseas investors, remains an important concern going forward.

The current account deficit widened to 35 percent of GDP in December 2011 from 14 percent the previous year, but was financed by the record levels of FDI inflows of US$ 5.3 bn or 62 percent of GDP (Fig 23 and Fig 24). Net borrowing from abroad continued to rise, due to the donor disbursement and loans to the commercial banks. Net remittances rose to US$ 417.1 million in 2011 from US$ 129.4 million in 2010.
Fig 17 The trade deficit has repeatedly hit new highs

$ mn, 12-month rolling sum

Fig 18 driven mostly by transport equipment and machinery imports

Percentage point contributions to year-on-year growth

Fig 19 Exports are growing strongly as well ...

Exports, percentage point contributions to year-on-year growth

Fig 20 ...driven by large coal exports to China

Exports, percentage point contributions to year-on-year growth

Fig 21 Commodity prices have fallen sharply since peaking in Q4 of last year

Jan 2007=100

Fig 22 and Chinese imports of metals and coal are growing at a much slower pace than in 2009-10

% yoy 3mma
The current account deficit widened due to growing trade and service deficits (Fig 23). But was fully funded by huge FDI inflows (Fig 24).

Sources: BoM, MoF, NSO and WB staff estimates.

The Exchange Rate and Balance of Payments

The Mongolian togrog depreciated by 11.4 percent in 2011 against the US$ (Fig 25). The real exchange rate has stayed mostly stable during 2011 although it depreciated in December by 4.6 percent yoy. The trends for the year suggest that high domestic inflation has been mirrored in the weakening of the currency. Rising global risk aversion and declining commodity prices are additional factors contributing to the depreciation as has also occurred in other emerging mineral rich economies (Fig 26). Mongolia’s flexible exchange rate regime, which was adopted in the aftermath of the 2009 bust when the de-facto peg to the US dollar came under pressure, functioned well in 2011. In 2011, the country also entered a 3-year currency swap agreement with China, Mongolia’s largest trading partner, which will help to smooth out temporary fluctuations.

During 2011, reserves reached a record level of US$ 2,460 mn in August, up from US$ 2.09 billion in 2010 (Fig 28). However, with the currency coming under pressure in the final months of 2011, the central bank sold reserves to stem excessive exchange rate volatility, so that by close of year net international reserves had declined to US$ 2.27 billion (nearly 25 percent of GDP). The central bank has been sterilizing the monetary impact of capital inflows over the past year into Mongolia with the issuance of central bank paper. The pace had slowed somewhat in the final quarter, but picked up again in December (Fig 28).

Going forward, continued exchange rate flexibility will reduce the risks of speculative bets on the currency, provide a cushion in case of an adverse external shock, and...

Continued flexibility in response to external conditions is critical for a number of reasons. First, it would reduce the likelihood of any speculative one-way bets as could happen under a de-facto peg, an open capital account and unsustainable fiscal policy. As Box 2 explains, currency crises are closely linked to overall fiscal policies, such that even the expectation of increasing that at government’s deficits will increase uncertainty and could result in a loss of confidence in a pegged currency. Continued flexibility in the exchange rate is also helpful for another reason, namely it can help reduce the tendency for...
currency mismatches i.e. borrowers taking advantage of fixed rates (or implicit government guarantees of fixed rates) to borrow in foreign currency without hedging

Second, a flexible exchange rate could be used to cushion the impact on the economy of any adverse event e.g. a fall in export prices. In the first instance, allowing the currency to depreciate when the dollar price of exports is falling, helps to preserve export earnings in local currency terms, shielding both domestic producers and government budgets.

... allow the economy to regain competitiveness through the nominal exchange rate movements rather than painful domestic price, wage and employment cuts.

Importantly, the depreciating currency helps to boost demand for the country’s products and hence functions as an automatic stimulus and adjustment to trade shocks. Essentially, the economy regains competitiveness through a nominal depreciation. With a “fixed” nominal exchange rate, the adjustment – as is currently happening in the troubled Southern European economies that are tied to the euro – has to occur through the real exchange rate, namely through sharp and painful domestic wage and price cuts expenditure restraint and productivity increases, all of which can take a long time and can be extremely painful, both economically and in terms of the social costs.

Other advantages of maintaining a flexible currency include that ability of monetary authorities to act as lender-of-last-resort in case of financial distress and to provide liquidity when the banking system comes under strain. Crucial for the central bank to be able to perform this function is the knowledge that it can print the necessary money needed to provide liquidity – this is lost under a fixed exchange rate when it commits to buying and selling domestic currency at a fixed rate against another currency. 10

In Mongolia’s case, the experience of early 2009 provides ample evidence of the end-results of an unsustainable peg. By not letting its currency float in response to the sharp drop in commodity prices, both budgetary and export revenues in local currency terms were hammered. And in the process the central bank ended up losing one third of its reserves.

Fig 25 The nominal exchange rate has depreciated since mid-2011, but the real exchange rate has stayed stable

% yoy change

Oct -08: 24% real appr
Dec-10: 22% real appr
Dec-08
6.86
Dec-09
12.86
Dec-10
18.86
Dec-11
24.86

Jan-06 Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12

Reer % yoy
USD vs MNT % yoy
appreciation
real depr

Fig 26 in line with other emerging mineral rich economies

Index=100 in July 2008

Mongolian Tugrug
Average of developed mineral rich currencies
Average of emerging mineral rich currencies (excl. MNT)

Box 2 Three generations of currency crisis models: what do they say?

Recent history is replete with episodes of currency crises in both developing and developed countries. These have been frequently accompanied by financial and banking sector crises as well, with sharp losses in national output, and deep recessions and sometimes contagion to other countries. As a result, a substantial literature has emerged on the causes and consequences of a currency crisis with models categorized as first-, second- or third-generation.

First generation models highlight the inconsistency between fixed exchange rates and fiscal policies. With fixed exchange rates, monetary authorities agree to exchange the national currency against another at a fixed rate, so that money supply (or the supply of domestic currency) is no longer determined by the central bank. However, if the government is running persistent fiscal deficits at the same time, then eventually these will have to be financed in one of two ways: either through depleting assets such as foreign exchange reserves (which cannot continue indefinitely) or printing money which is inconsistent with the peg. This inevitably leads to a collapse of the peg.

Later models have emphasized that persistent and rising fiscal deficits and falling reserves do not have to precede a currency crisis. Instead, news, for example that the government is going to bail out a banking sector lead to the expectation that future deficits will be large and unsustainable, and trigger a currency crisis, even before the government has actually incurred the cost of the bailout.

Second generation models stress conflicting goals and objectives of the government. For example, governments may be inclined to defend the peg, because it helps to anchor inflation and inflation expectations. It may be inclined to abandon if a large portion of debt is denominated in domestic currency and the government is tempted to inflate the debt away, but cannot as long as monetary policy is anchored by the fixed exchange rate. Depending on the government’s tradeoffs and costs of maintaining a peg, and depending on expectations of how long a peg would last, currency attacks can ensue.*

Third generation models tie currency crises to financial sector crises and underscore the importance of currency mismatches on balance sheets, particularly in developing countries. Essentially, banks and firms borrow in foreign currency and lend in local currency. This creates credit risks: their income is derived from the production of non-traded goods and services, while their liabilities (the debts they have to repay) are denominated in foreign
currency, the value of which (in local currency terms) increases after a depreciation or devaluation. Other models highlight the role of financial liberalization or government guarantees in generating such crises. For example, implicit or explicit government guarantees may encourage banks to take on foreign debt, or deposit insurance and financial liberalization may create incentives for a lending boom that eventually leads to a banking and currency crisis. **


Banking sector

Continued vigilance on financial sector risks and macro-prudential policies are needed to put the banking sector on a surer footing

The volume of banking system deposits reached new highs during 2011. Local currency deposits climbed to MNT 2.9 trillion in December, up 31 percent from a year ago (Fig 29). Both local and foreign currency deposits continued their upward trend, while deposits in foreign currency peaked at MNT 1 trillion in November. Nominal interest rates on US dollar deposits are very high by international standards with some time deposits offering rates higher than 14 percent, reflecting high demand for these deposits by the banks. However with inflation picking up, the average real rates of return on local currency deposits turned negative in September (Fig 30).

Meanwhile, bank lending is growing at a furious pace (Fig 31). December data show an annual increase in the total stock of loans outstanding of 72 percent. Moreover, most of the credit is directed towards a small number of borrowers – the fifty largest borrowers in the banking system account for more than one-quarter of all loans (Fig 32). Loan portfolios are also heavily concentrated in the real estate and construction, which are particularly susceptible to a bust – indeed construction contracted sharply in Q4 of 2011 – and where loan losses were the highest in the previous financial crisis as well. A drop in the ratio of liquid assets to total assets from 44 percent at the end of 2010 to 32 percent at the end of 2011, and rising loan to deposit ratios also indicate growing liquidity risks (Fig 33). Although capital buffers are higher than in the run-up to the previous bust, continued vigilance on financial risks is required and macro prudential policies needed to put the banking sector on surer footing (Box 3).

Together with loans in arrears, the ratio of NPLs to total outstanding loans fell to 7.2 percent in December after peaking at 24.6 percent in November 2009. But this improvement is mainly due to the rapid growth of loan portfolios: the total stock of outstanding NPLs amounted to MNT 329 bn at the end of last year, only slightly lower than MNT 374 bn in December 2010 (Fig 34). The government has paid MNT 100 bn for one of the failed banks and has so far recovered about MNT 30 bn. The MoF expects that another MNT 50 - 60 bn could be recovered by 2013.

Box 3 Banking sector risks in Mongolia

Mongolia’s banking sector has recovered considerably since 2009 when it experienced a full-blown crisis and
flight out of local currency deposits into foreign currency, leading to the failure of two banks in 2009. Strong policy action by the government helped to restore financial stability, and central bank supervision was also strengthened, with tighter prudential regulations on asset classification and loan provisions applied. That said, the banking sector also benefitted from a faster than expected recovery.

However, there are once again growing concerns that the banking sector is overheating. Credit is expanding extremely fast and credit risk remains poorly monitored while lending is highly interconnected and directed to a small number of borrowers. Meanwhile the banking system is highly concentrated: the top three banks account for more than 70 percent of market share. Competition is relatively limited in the mostly privately owned banking system, as indicated by relatively high interest rate spreads of around 6 percent in 2011. There continue to be no reputable foreign banks operating with full license in Mongolia, although there is interest in entering the market. Deposits have grown rapidly in the aftermath of the crisis (up by 65 percent in 2010 and 29 percent in first three quarters of 2011), but the combination of a blanket guarantee with relatively weak supervision regime raises questions about the efficiency of resource mobilization.

Mongolia’s banking system is also highly dollarized, as about one third of system deposits are denominated in foreign currency. Combined with easy convertibility of local currency accounts into foreign currency accounts, this reduces the effectiveness of the central bank in providing liquidity to the system in period of financial distress and also increases the risk that the banking sector is exposed to currency mismatches, namely that it is funded by FX denominated deposits and lending in local currency to borrowers that are earning and repaying their loans in local currency.

Although prudential norms are in line with international Basel II and Basel III standards, enforcement has lagged. In particular, a number of banks are not adhering to exposure limits on lending to related parties and large borrowers. And while the system-wide capital adequacy ratio has improved from 5 percent at the peak of the crisis in 2009 to 15 percent as of December, 2012 (excluding two banks in receivership) compared to the existing regulatory threshold of 12 percent, this figure masks significant variations among the banks.

And compared to most other countries in the region, capital buffers are lower, while non-performing loan ratios are higher in Mongolia (Box Figure 1). Moreover, as highlighted in an IMF Financial Stability Assessment in mid-2011, the reported ratios do not fully reflect expected losses due to a relaxing of provisioning requirements (regulatory forbearance), because of inadequate classification and provisioning for some of the largest problem borrowers, and lack of proper risk-weighting for interbank exposures that reflect on-lending to large borrowers.

The three largest banks have been able to bring in additional capital from various sources. However, the BoM had to grant regulatory forbearance to three other banks (including one systemically important institution) that have been the subject of supervisory action plans since the beginning of 2011, requiring the banks to reach compliance with prudential norms over a period of time. Meanwhile, the loan to deposit ratio (excluding government deposits) rose to slightly above 100 percent in December, from 77 percent in 2010, indicating growing liquidity risks.

Accordingly, it is critical that the BOM closely monitors financial risks and enforces full compliance of Mongolian banks with current prudential norms, particularly with respect to having adequate capital buffers to...
Mongolia Quarterly Update 2012

Because the recently introduced additional capital buffers for systemically important banks, the BOM could consider the use of additional provisioning requirements to prevent the build up of risks stemming from rapid credit growth, especially in highly volatile sectors (construction, mortgage, consumer loans). And it could require banks to maintain higher reserves with the BOM for short term borrowing and large deposits. Finally, BOM’s capacity to monitor systemic risks and take early corrective action should be improved, and proper coordination with government and parliament should be ensured, for instance through the Financial Stability Council.


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**Fig 29 Both local and foreign currency deposits continued their upward trend**

<table>
<thead>
<tr>
<th>MNT bn, month-on-month change</th>
<th>MNT bn, stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>FX deposits, stock RHS</td>
<td>MNT deposits, stock RHS</td>
</tr>
<tr>
<td>MNT deposits, change</td>
<td>FX deposits, change</td>
</tr>
<tr>
<td>MNT deposits, change</td>
<td>MNT deposits, change</td>
</tr>
</tbody>
</table>

---

**Fig 30 But real economy-wide interest rates on time deposits have been negative since September**

<table>
<thead>
<tr>
<th>Percent (annual rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI inflation</td>
</tr>
<tr>
<td>Real maximum interest rate on LC time deposits</td>
</tr>
<tr>
<td>Real average interest rate on LC time deposits</td>
</tr>
<tr>
<td>Real interest rate on bank LC loans</td>
</tr>
</tbody>
</table>

---

**Fig 31 Credit is growing at record levels**

<table>
<thead>
<tr>
<th>MNT bn</th>
<th>% year-on-year change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total loans outstanding</td>
<td>Annual growth, RHS</td>
</tr>
</tbody>
</table>

---

**Fig 32 ... directed mostly to a small number of borrowers**

<table>
<thead>
<tr>
<th>MNT bn</th>
<th>lending to 50 largest borrowers as % of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>MNT billion</td>
<td>Share of total loans outstanding RHS</td>
</tr>
</tbody>
</table>

---

11 According to the bank loan classification regulation, loans with principal in arrears automatically become NPLs after 90 days.
Major Legislative Reforms

Mongolia has seen a flurry of reforms in recent years aimed at strengthening its public institutions and policy frameworks. These include the landmark Fiscal Stability Law which locks in prudent fiscal policies to shield the economy from mining sector related booms and busts and the withdrawal of the Windfall Profits Tax in January 2011, which acted as a major deterrent to investment in the mining sector and the signing of the Oyu Tolgoi investment agreement which serves as a model for future mining investment agreements in Mongolia. During 2011 and in January 2012, major legislative developments included the Integrated Budget Law (IBL), a revised Procurement Law, a Social Welfare Law (SWL) and a Law on Gender Equality.

The Integrated Budget Law (IBL) was passed in December 2011. This law defines the entire budget process, and hence is also referred to as an organic law. It benefited from technical assistance provided by the Fund and the Bank, which also included study tours for members of parliament and technocrats to other countries with sound budget laws and practices. It contains a range of measures to support fiscal sustainability, and, in particular, the successful implementation of the FSL. It also strengthens the public investment project (PIP) framework by requiring feasibility studies and alignment with national priorities for all PIPs. Finally, the law starts a process of fiscal decentralization, which includes increased citizen participation in the budget process. It constitutes a major step in helping to permanently lock in prudent fiscal policies and mechanisms in the future, including those contained in the FSL (Box 4).

A new Social Welfare Law was passed in January 2012. It mandates the introduction of a means tested poverty benefit in Mongolia which is expected to be rolled out in mid-2012. The provision of targeted benefit is necessary in order to ensure that the neediest would be shielded from the boom-and-bust cycles so common for mineral-dependent economies. The targeted program is expected to reach about 130,000 poorest households, or over one-fifth of total households in Mongolia.

Finally, a long overdue Law on Gender Equality was also passed earlier in the year in February 2011. The law explicitly prohibits any act of exclusion, restriction and discrimination against equal rights and equal opportunities of a man and a woman (gender based violence and sexual harassment) in all spheres. It obliges central and local governments, ministries, as well as employers and political parties
to install regulations and mechanisms that ensure gender equality in their operations as well as outcomes and to report to the public and the respective higher authorities. The Civil Service Council (CSC) as well as all employers are to introduce standards preventing gender discrimination. The law also rules that the employer shall be held liable if its employee commits an act of gender discrimination in a workplace. Significantly, the law establishes penalties for individuals, officials, public service agencies, political parties and media organizations for various breaches of gender equality legislation. Subsequent legislative amendments introduced 20 percent women’s quota of the candidates from each party for the national parliament and gender relevant provisions in the laws on government, labor, civil service and the NHRC. The government also set up a working group to draft a new Gender Equality Action Plan for the next 5 years.

Box 4: The Integrated Budget Law

On December 23, 2011 the State Great Khural passed the Integrated Budget Law of Mongolia (IBL), a comprehensive law that replaces the Public Sector Management and Finance Law (PSMFL) as the primary budget legislation for the country.

The main objectives of the IBL are to:

- Strengthen the medium term fiscal framework (MTFF) and ensure fiscal stability;
- improve the comprehensiveness of the budget;
- strengthen the public investment planning and capital budgeting process;
- ensure efficient financial management;
- significantly increase the authorities and financial resources of local governments; and
- strengthen accountability through participatory budgeting.

On fiscal stability, the IBL mandates that the entire budget, and not just parts of it, should follow the fiscal rules set in the FSL and the expenditure limits set in the MTFF. The law therefore explicitly states that the budget consists of the state (central government) budget, the Human Development Fund, and the Social Insurance Fund, that the budget should list projects to be executed through concessions contracts, and include information on government guarantees and contingent liabilities, thereby improving the budget’s comprehensiveness. The budget calendar is laid out in detail with the process commencing with the approval of the MTFF by the SGH by June 1, together with the Socio-economic Guidelines, and which forms the basis for the line ministries ceilings (for recurrent and capital expenditures). Line ministry proposals, and those of the National Development and Innovation Committee (NDIC) for large projects, as discussed below, are meant to comply within the limits imposed by these ceilings. This provision should significantly improve the credibility of the budget process.

The IBL significantly strengthens public investment planning and capital budgeting, thereby redressing a major weakness in the PSMFL. It mandates that only projects that have gone through a proper appraisal process will be considered for financing, and introduces the concept of a rolling four-year Public Investment Program (PIP) for large projects (greater than 30 billion MNT) as a stock of potentially financeable projects that have passed a pre-feasibility study. The NDIC has the responsibility to conduct these pre-feasibility studies on line ministry proposals and to determine which projects enter the PIP, with the approval of the PIP resting with the Cabinet. All financing decisions — whether to fund projects from the budget, loans, concessions, or the Development Bank of Mongolia — are then made by the Ministry of Finance (MoF), abiding by the good principle of the MoF as a single point of control on such matters. Importantly, the recurrent cost implications of the capital projects also need to be included in line ministry proposals and are an integral part of the capital budgeting process. The IBL also introduces the provision of carry-over funding — i.e. the authorization to spend unused funds in the subsequent fiscal year —
for multi-year capital projects thereby potentially improving project execution.

The authorities of local governments have been significantly enhanced, with the capital city and aimag governments responsible for basic education, primary healthcare, urban planning and construction, social welfare services, water supply and sewerage, public transport, urban roads and bridges, and municipal services such as street lighting and garbage removal; and soums and districts responsible for some municipal services, pasture management, and environmental protection. These functions will be financed through local taxes and fiscal transfers (an equalization grant) from shared taxes from the central government, with the transfer formula based on population, population density, remoteness and size of the local government, and level of local development. There is also a conditional performance element to the transfers that are linked to local tax effort. Only the capital city government is allowed, with the approval of the MoF, to borrow from capital markets to finance public investment projects, with the debt limited to the previous year’s revenue and debt service limited to 15 percent of the previous year’s revenue. The soum and district budgets would need to be informed by an annual citizen’s survey on local development needs and priorities.

Provisions in the IBL relating to the process for the preparation of the MTFF, Socio-economic Development Guidelines, and the budget go into effect as of February 1, 2012. Other provisions, particularly pertaining to fiscal decentralization, go into effect January 1, 2013.

Source: World Bank Staff

Air Quality Standards in Mongolia

Air pollution in Ulaanbaatar significantly exceeds international and domestic air quality standards, severely impacting residents’ health especially in the ger areas.

Air pollution has been a blight for the people living in the ger areas of Ulaanbaatar, affecting not only their daily lives, but most critically the health of everyone in the city. A study undertaken by the World Bank in cooperation with the Mongolian Ministry of Nature, Environment and Tourism (MNET) and other Mongolian government agencies and the scientific community estimated that daily exposures to particulate matters which includes the fine particles (PM$_{2.5}$) and the coarse particles (PM$_{10}$), are associated with an additional 1591 (range, 385-2721) deaths per year on average and an additional 4465 (range, 1828-8083) hospital admissions for lung and heart diseases. The total economic value of these health damages would be equal to close to a fifth of Ulaanbaatar’s GDP in 2008. Box 5 discusses the study’s key findings.

Box 5 UB Air Pollution

Ulaanbaatar is the coldest capital of the world and it is one of its most polluted. Even though other pollutants exceed international standards, particulate matter should be considered a priority mitigation target given its very high levels. The particulate matter (PM) concentrations at or below 10 micrograms per cubic meter – which have known health impacts – are between 10-25 greater than Mongolia’s own air quality standards (AQS) The World Bank’s recently released Air Quality Analysis of Ulaanbaatar: Improving Air Quality to Reduce Health Impacts study shows that in several locations at certain times in Ulaanbaatar the PM concentrations are so high that the study team is not aware of similarly high monitored PM values in any other city in the world. The PM concentrations are particularly high in the cold winter months in the peri-urban ger areas – where about 2/3rd of the population of Ulaanbaatar lives and where many inhabitants rely on stoves to heat their homes.

This pollution includes high concentrations of PM that is harmful to human health and has significant economic impacts. The current annual health damage estimates range from between $177 - $727 million (mean value $463
PM concentrations in the poor, peri-urban ger areas were captured systematically for the first time in the Bank’s study, revealing significantly higher concentrations.

The study concludes that a solution will require a wide range of pollution abatement measures – there is no one magic bullet. In order to bring PM concentrations in line with Mongolia’s air quality standards, PM emissions from key pollution sources will have to be reduced by about 94 percent. The most critical factors contributing to the high, ground level PM concentrations come from coal combustion in Ger stoves (incomplete combustion because the stove does not match the fuel well), followed by windblown dust, road dust, exhaust particles and dust from vehicles and heat only boiler (HOB). Although gross PM emissions from power plants are very large, they have a more limited impact on the exposure of the population because the pollution is dispersed in high stacks and usually blown away from population centers. However, it is important to continue to emphasize pollution reduction and energy efficiency improvements in the power plants not only due to dust but also due to its SO₂ and CO₂ emissions and their regional and global impacts.

**Box Figure 2 Comparison of UB PM$_{10}$ concentrations (2008–09) with Chinese cities (2008) and other world capitals (2004)**

The study’s cost benefit analysis of various mitigation options shows that benefits accrue over different periods of time and some measures may be more cost effective than others. In addition, some measures may be more affordable than others. The study demonstrates that the sheer magnitude of the air pollution-induced health damages calls for a strategy that implements well prepared short terms actions, while medium and long term solutions are developed in parallel. This includes accelerating the already established program on replacing traditional ger stoves with new, cleaner stoves in all the gers, reducing dust through greening and road paving, and boiler switching. The study also includes relocation to apartments connected to district heating as a vehicle to get cleaner air in the long term, but the outlined short and medium abatement options are strongly needed in order to quickly bring down the high health costs. This kind of analysis should continue so that it can measure progress of pollution reduction efforts, and identify improvements.

The study is a product of a four-year cooperation between the World Bank, the Ministry of Nature, Environment and Tourism (MNET), the UB Government, the Ministry of Health, the National University of Mongolia, the Public Health Institute, National Agency of Meteorology, Hydrology and Environmental Monitoring (NAMHEM) and
Central Laboratory for Environmental Monitoring (CLEM). Inputs were received from various sources including stove-fuel emissions testing from the ADB supported Stove Emissions and Efficiency Testing Laboratory of the Ministry of Mineral Resources and Energy.

**Box Table 1:** Indicated ranges for annual average PM concentrations in Ulaanbaatar, June 08–May 09

<table>
<thead>
<tr>
<th>Area</th>
<th>PM$_{10}$ $\mu g/m^3$</th>
<th>PM$_{2.5}$ $\mu g/m^3$</th>
<th>Exceedance: Ratio to AQSs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Central city areas</td>
<td></td>
<td>Mongolian:</td>
</tr>
<tr>
<td></td>
<td>150–250</td>
<td>75–150</td>
<td>3–6</td>
</tr>
<tr>
<td></td>
<td>Ger areas</td>
<td>350–700</td>
<td>7–14</td>
</tr>
<tr>
<td></td>
<td></td>
<td>200–350</td>
<td></td>
</tr>
</tbody>
</table>

Source: AMHIB data

Economic outlook

Mongolia’s growth prospects are very good, if the appropriate institutional framework is developed to ensure adequate management, investment and fair sharing of the proceeds from the country’s vast mineral resources. The passage of the Fiscal Stability Law, the Integrated Budget Law, the revised Procurement Law, and the Social Welfare Law, all demonstrate parliament’s and senior leadership’s commitment to such institutional strengthening. However, actual implementation has fallen short of these commitments with regards to ensuring a stable macroeconomic environment which leaves the country vulnerable to an external shock, as was the case in 2008-09.

In order to minimize this risk it is important for the government to rein in government spending, in line with the rules set out in the FSL. The huge increases in government expenditures have added to the inflation pressures that hurt the poor the most, and increase the risk of a wage-price spiral if higher inflation expectations become entrenched. High domestic inflation also causes the currency to appreciate in real terms, hurting both agricultural exports, on which the rural population depends, and an already small manufacturing sector. It is therefore important that actual 2012 expenditures are lower than budgeted both to prevent further overheating and to allow for the necessary fiscal consolidation once the FSL goes into effect on January 2013.

This fiscal tightening has to be complemented by further monetary tightening. While the Bank of Mongolia has raised interest rates, these are currently negative territory on account of the high inflation. A further increase in the policy rate would help contain inflation by slowing credit growth, by making it more expensive for firms to borrow, and by helping ease the depreciation pressure on the togrog by making it more attractive to hold togrog deposits thereby reducing imported inflation. Excessive credit growth has also underlined the need for continued vigilance on financial sector risks and strengthening of macro-prudential policies.

The current depreciation of the togrog should not be used to abandon the flexible exchange rate. The flexible exchange rate is the single most important policy difference between today and the last crisis. Targeting or controlling the exchange rate, as was the case in 2008, would greatly increase the risk of a speculative attack as reserves are run down to defend the exchange rate. The Bank of Mongolia
should continue to intervene to smooth excessive volatility; however this is different from explicitly targeting a specific level of the exchange rate.

To reiterate, this is a vulnerable time for Mongolia. Until the Oyu Tolgoi mine becomes operational, a structural increase in mineral output and revenues takes place, and a substantial amount of savings has accumulated in the stabilization fund, Mongolia remains strongly exposed to volatility in commodity prices. Indeed, among East Asian commodity producers, it has the highest ratio of commodity exports to total exports. With the global economic outlook negative, and with any potential stimulus package from China unlikely to be focused on infrastructure as during the last global financial crisis in 2008-09, extra caution needs to be exercised: “be prepared” sums up the appropriate policy advice at this point in time. Mongolia’s policy-makers realized the importance of “being prepared” when they passed the landmark FSL in June 2010. It is now critical that this law be implemented to help ensure that the country’s vast coal and copper resources are converted into sustainable growth that improves the welfare of all current and future Mongolian citizens.
**Table 4 Mongolia: Key Indicators**

<table>
<thead>
<tr>
<th>Output, Employment and Prices</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (% yoy change)</td>
<td>8.9</td>
<td>-1.3</td>
<td>6.4</td>
<td>17.3</td>
<td>15.2</td>
</tr>
<tr>
<td>Industrial production (2006=100)</td>
<td>113</td>
<td>109.6</td>
<td>120.5</td>
<td>132.2</td>
<td>145.4</td>
</tr>
<tr>
<td>% yoy change</td>
<td>2.7</td>
<td>-3.3</td>
<td>10</td>
<td>9.7</td>
<td>10</td>
</tr>
<tr>
<td>CPI Ulaanbaatar (% yoy change, eop)</td>
<td>23.2</td>
<td>1.9</td>
<td>14.3</td>
<td>11.1</td>
<td>12</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Public Sector</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Government expenditures (as % of GDP)*</td>
<td>37.6</td>
<td>35.2</td>
<td>36.6</td>
<td>44.2</td>
<td>39.1*</td>
</tr>
<tr>
<td>Government revenues (as % of GDP)*</td>
<td>33.1</td>
<td>30.2</td>
<td>36.6</td>
<td>40.6</td>
<td>38.1*</td>
</tr>
<tr>
<td>Government balance (% of GDP)*</td>
<td>-4.5</td>
<td>-5</td>
<td>0</td>
<td>-3.6</td>
<td>-1.0*</td>
</tr>
<tr>
<td>Non-mineral govt balance</td>
<td>-14.1</td>
<td>-12.4</td>
<td>-10.5</td>
<td>-16.0</td>
<td>-11.9</td>
</tr>
<tr>
<td>Public Sector Debt (% of GDP) (1)*</td>
<td>31</td>
<td>49.4</td>
<td>42.2</td>
<td>38.6</td>
<td>37.1</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Foreign Trade, BOP and External</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade balance ($ mn)</td>
<td>-613</td>
<td>-229</td>
<td>-379</td>
<td>-1747</td>
<td>-400.0</td>
</tr>
<tr>
<td>Exports of goods ($ mn)</td>
<td>2534.5</td>
<td>1903</td>
<td>2899</td>
<td>4780</td>
<td>5000.0</td>
</tr>
<tr>
<td>(% yoy change)</td>
<td>30</td>
<td>-25</td>
<td>52</td>
<td>65</td>
<td>4.6</td>
</tr>
<tr>
<td>Imports of goods ($ mn)</td>
<td>3147</td>
<td>2131</td>
<td>3278</td>
<td>4874</td>
<td>5400.0</td>
</tr>
<tr>
<td>(% yoy change)</td>
<td>57.1</td>
<td>-32.3</td>
<td>53.8</td>
<td>48.7</td>
<td>10.8</td>
</tr>
<tr>
<td>Current account balance ($ mn)</td>
<td>-690.1</td>
<td>-592.0</td>
<td>-886.7</td>
<td>-2993.1</td>
<td>-1438.0</td>
</tr>
<tr>
<td>(% of GDP)*</td>
<td>-12.3</td>
<td>-12.9</td>
<td>-14.3</td>
<td>-35.0</td>
<td>-13.6</td>
</tr>
<tr>
<td>Foreign direct investment ($ mn)</td>
<td>838.5</td>
<td>1037.6</td>
<td>1629.7</td>
<td>5309.5</td>
<td>1500.0</td>
</tr>
<tr>
<td>External debt (% of GDP) (2)*</td>
<td>31</td>
<td>43.3</td>
<td>30.3</td>
<td>22.8</td>
<td>19.8</td>
</tr>
<tr>
<td>Foreign exchange reserves, net ($ mn)</td>
<td>637</td>
<td>1145</td>
<td>2091</td>
<td>2274</td>
<td>-</td>
</tr>
<tr>
<td>In month of next years imports of g&amp;s</td>
<td>3.6</td>
<td>4.2</td>
<td>5.1</td>
<td>5.1</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Markets</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic credit (% yoy change)</td>
<td>59.11</td>
<td>-9.33</td>
<td>26.69</td>
<td>75.76</td>
<td>...</td>
</tr>
<tr>
<td>Base policy rate (eop)</td>
<td>9.75</td>
<td>10.0</td>
<td>11.0</td>
<td>12.25(Dec)</td>
<td>...</td>
</tr>
<tr>
<td>Exchange rate (MNT/USD, avg)</td>
<td>1267</td>
<td>1443</td>
<td>1257</td>
<td>1,264.79</td>
<td>...</td>
</tr>
<tr>
<td>REER (real effective exch rate) (% yoy eop, +app)</td>
<td>13.7</td>
<td>-15.5</td>
<td>26.9</td>
<td>-4.6</td>
<td>...</td>
</tr>
<tr>
<td>Stock Market Top 20 index (2000=100, eop)(5)</td>
<td>1182</td>
<td>1229</td>
<td>2931</td>
<td>3984 (Jun)</td>
<td>...</td>
</tr>
</tbody>
</table>

**Memo:**

| Nominal GDP (MNT bn)             | 6556 | 6591 | 8414 | 10830 | 13989 |
| Nominal GDP ($ mn)               | 5174 | 4567 | 6694 | 8562  | ...   |
| GDP per capita ($)               | 1946 | 1685 | 2434 | 3067  | ...   |

*Notes: 1) Total public sector debt. 2) On public and publicly guaranteed debt. * 2012 Budget projections. Sources: NSO, BoM, World Bank, IMF*