

World Bank: East Asia Update, April 2008

MONGOLIA

Mongolia's real GDP growth rate was 9.9 percent in 2007.

Growth was driven by agriculture (which contributed 3.4 percentage points), and services (4.3 percentage points). In the agriculture sector, the December 2007 annual livestock census reported an increase of 15 percent from 34.8 to 40.3 million livestock, with the number of goats, sheep and cattle increasing by 18, 15 and 14 percent respectively. While most of the foreign direct investment (FDI) coming into Mongolia continues to go to mining, the value-added of the sector grew by only 1.7 percent this year (mainly from coal extraction). The services sector continues to show strong growth, driven in particular by transport and trade (2.1 and 1.3 points of economic growth respectively). At the end of February 2008, the number of registered unemployed had declined by 5.1 percent.

Despite a planned budget deficit of 3.9 percent of GDP, the government's fiscal balance recorded a surplus again, for the third consecutive year.

Preliminary outturns suggest a 2.2 percent fiscal surplus in 2007, with revenues reaching 40.6 percent of GDP and expenditures 39.4 percent of GDP. This was the result of higher-than-expected revenues and lower-than-planned expenditures. The key reasons for strong revenue performance were: (i) higher than anticipated commodity prices and the imposition of the windfall tax on gold and copper; (ii) robust economic growth; and (iii) improved revenue administration. Expenditures were below budgeted levels because the execution rate for capital expenditures fell below expectations. The resulting fiscal surplus enabled the Government to build additional reserves at the Bank of Mongolia of about \$169 million (4.4 percent of GDP). At end 2007, government deposits at the central bank were equal to \$531 million (14 percent of GDP)

Inflation accelerated to reach 15.1 percent in 2007, the highest level in a decade.

The price index climbed 4.6 percent in the first two months of 2008 alone. This marked rise was due to rapid monetary growth, public sector wage increases, and increases in the price of key imports, especially food. At the end of February 2008, money supply (M2) increased by 48.5 percent. Total loans outstanding increased by 67.2% of which loans to private sector increased by 78.9%.

Declining (officially recorded) gold exports and robust import growth led to a trade deficit in 2007.

Compared to a year ago, exports grew by 22.5 percent (reaching \$1.9 billion) and imports rose by 42.5 percent (reaching \$2.1 billion). Since the imposition of the windfall tax on gold and copper exports, officially recorded gold exports have started to decline as more and more gold is now allegedly being smuggled out of the country to avoid the tax. For the first year, the (positive) price impact of high international prices for copper and gold on export earnings has been outweighed by the (negative) impact of the windfall tax on recorded gold exports. Meanwhile, import growth has remained robust in 2007, led by strong economic growth which translated in sustained demand for consumption and investment goods.

The fixed nominal exchange rate has led to real appreciation of the currency vis-à-vis the dollar and a sharp increase in foreign exchange reserves.

At end 2007, the nominal exchange rate against the US dollar was stable at 1,169.97 togrogs/dollar (1171.8 at end February 2008), leading to significant real appreciation against the US dollar. Given that the currency is allowed to fluctuate within a margin of ± 1 percent against the US dollar, the IMF re-classified Mongolia's exchange rate arrangement from floating to a conventional peg. There is no commitment to keep the parity irrevocably. At end-2007, the Mongolia's net international reserves (NIR) climbed 41.5 percent to reach \$972.4 million, equivalent to over 5 months of imports. Difficulty in sterilizing this reserve accumulation has led to the sharp increase in money supply and the consequent acceleration in inflation.

Mongolia should maintain rapid growth in 2008 and beyond in part because of construction activity associated with large FDI inflows that begins in 2008 and the world class Oyu Tolgoi

copper mine starts operations in 2010. In addition, continued high (albeit declining) gold and copper prices will allow the authorities to maintain their expansionary fiscal stance and this is expected to be supported by sustained growth in agriculture (livestock sector), and continued expansion in services (led by trade and transport). Mongolia's principal challenge is to husband its windfall gains from the current commodity price boom in international markets and translate these assets into a reliable revenue stream that will serve future expenditure needs and help reduce poverty over the long term. In this regard, it could usefully emulate other East Asian countries that are exploring ways to maximize long-term returns on their fiscal and foreign exchange surplus.

http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/5501921207007015255/MN_update_apr08.pdf