

# MONGOLIA ECONOMIC UPDATE

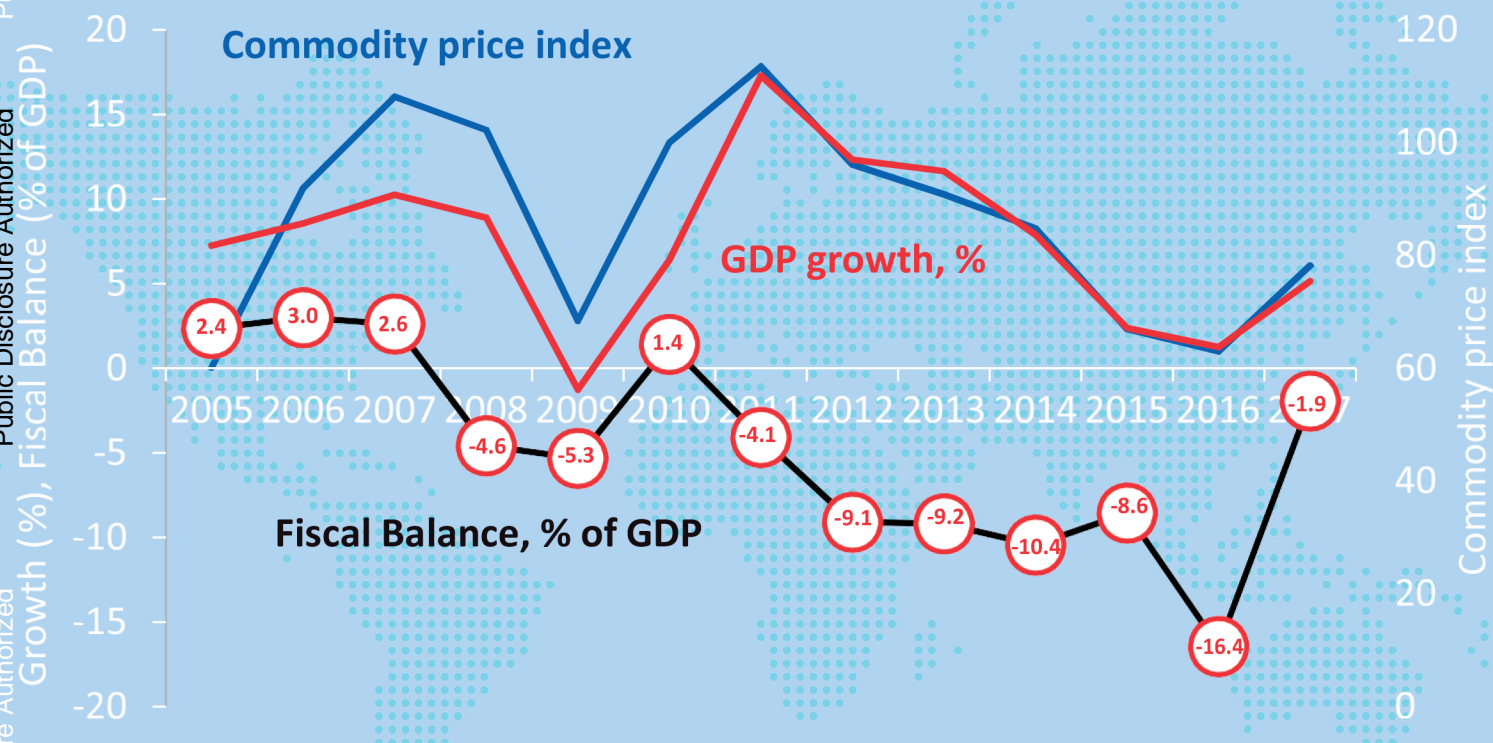
## Fiscal Space for Growth: The Role of Public Investment Spending Efficiency

Public Disclosure Authorized

Public Disclosure Authorized

Public Disclosure Authorized

Public Disclosure Authorized



July 2018



THE WORLD BANK  
IBRD • IDA | WORLD BANK GROUP

# MONGOLIA ECONOMIC UPDATE

---

## Fiscal Space for Growth – The Role of Public Investment Spending Efficiency

---

**JULY 2018**

This report is a product of the staff of the International Bank for Reconstruction and Development/The World Bank with external contributions. The findings, interpretations, and conclusions expressed in this report do not necessarily reflect the views of the World Bank, the Executive Directors of The World Bank or the governments they represent. The World Bank does not guarantee the accuracy of the data included in this report.

### **Rights and Permissions**

The material in this publication is copyrighted. Copying and/or transmitting portions or all of this work without permission may be a violation of applicable law. The International Bank for Reconstruction and Development/The World Bank encourages dissemination of its work and will normally grant permission to reproduce portions of the work promptly.

For permission to photocopy or reprint any part of this work, please send a request with complete information to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, USA, telephone 978-750-8400, fax 978-750-4470, <http://www.copyright.com/>.

All other queries on rights and licenses, including subsidiary rights, should be addressed to the Office of the Publisher, The World Bank, 1818 H Street NW, Washington, DC 20433, USA, fax 202-522-2422, e-mail [pubrights@worldbank.org](mailto:pubrights@worldbank.org).

## CONTENTS

<b>Abbreviations and Acronyms</b> .....	iv
<b>Acknowledgements</b> .....	vi
<b>List of figures</b> .....	vii
<b>Executive Summary</b> .....	x
<b>I. PERFORMANCE AND PROSPECTS</b> .....	1
A. Recent Economic Developments .....	1
B. Outlook and Risks .....	30
C. Closing the Productivity Gap – The Role of Public Investment Efficiency .....	32
<b>II. THE ROLE OF PUBLIC INVESTMENT EFFICIENCY FOR GROWTH –     A ROAD MAP FOR REFORM</b> .....	35
A. The Rise and Fall of Capital Expenditures Since 2010 .....	35
B. Efficiency of Mongolia’s Public Investment Program.....	36
C. PIM – Legal and Institutional Issues .....	39
D. A Road Map for PIM Reforms .....	41
<b>References</b> .....	47
<b>Annex: Growth Accounting Modelling</b> .....	48



# MONGOLIA ECONOMIC UPDATE

## MONGOLIA - GOVERNMENT FISCAL YEAR

January 1 – December 31

## CURRENCY EQUIVALENTS

(Exchange Rate Effective as of June 1, 2018)

Currency Unit	=	Tugrik (MNT)
US\$ 1.00	=	MNT 2450.65

## ABBREVIATIONS AND ACRONYMS

AQR	Asset Quality Review
BoM	Bank of Mongolia
BOT	Build-Operate-Transfer
BT	Build-and-Transfer
CBB	Central Bank Bill
CIT	Corporate Income Tax
DBM	Development Bank of Mongolia
DIB	Department of Investment Budget
DICOM	Deposit Insurance Corporation of Mongolia (under the Ministry of Finance)
EAP	East Asia and Pacific
FDI	foreign direct investment
GAAR	General Anti-Avoidance Rule
GDP	Gross Domestic Product
GNI	Gross National Income
GoM	Government of Mongolia
GTL	General Taxation Law
H1	First half
H2	Second half
IADI	International Association of Deposit Insurers
LICs	Low Income Countries
LMICs	Lower Middle Income Countries
LTD	Loan-to-Deposit
MDA	Ministries, Departments, and Agencies
MNT	Mongolian Tugrik
MoF	Ministry of Finance
MTBF	Medium-Term Budget Framework
MTFF	Medium-Term Fiscal Framework
NDA	National Development Agency
NEER	Nominal Effective Exchange Rate
NPLs	Non-performing Loans

## MONGOLIA ECONOMIC UPDATE

NSO	National Statistics Office
PBOC	People's Bank of China
PIF	Pension Insurance Fund
PIM	Public Investment Management
PIMA	Public Investment Management Assessment
PIP	Public Investment Program
PIT	Personal Income Tax
PPP	Public Private Partnership
Q1	First quarter
Q4	Fourth quarter
REER	Real Effective Exchange Rate
RMBS	Residential Mortgage-backed Securities
SDV 2030	Sustainable Development Vision 2030
SGK	State Great Khural (the Mongolian parliament)
TFP	Total Factor Productivity
TOT	Terms of Trade
UB	Ulaanbaatar
UPN	Unique Project Number
VAT	Value Added Tax
y/y	Year-on-Year

<b>Vice-President:</b>	Victoria Kwakwa
<b>Country Director:</b>	Bert Hofman
<b>Country Manager:</b>	James Anderson
<b>Global Practice Director</b>	John Panzer
<b>Practice Manager:</b>	Deepak K. Mishra
<b>Task Team Leader:</b>	Jean-Pascal Nganou

## ACKNOWLEDGEMENTS

This paper was prepared by a core team led by Jean-Pascal Nganou (Senior Economist, TTL) and comprised of Davaadalai Batsuuri (Economist, MTI), Sulaiman Nyanzi (Consultant), and Altantsetseg Shiilegmaa (Economist, MTI). The team is grateful for comments and guidance received from Bert Hofman (Country Director), Deepak K. Mishra (Practice Manager), and James Anderson (Country Manager).

We also wish to thank the peer reviewers Sudhir Shetty (Chief Economist, East Asia and Pacific Region) and Ekaterine T. Vashakmadze (Sr. Country Economist, DECPG).

Sincere appreciation goes to Diane Stamm (Consultant) and Xavier De la Renaudiere (Consultant) for an excellent editing of the report. The team is grateful to Indra Baatarkhuu (Communications Associate, AEAPEC) for her advice on the dissemination of the report. Angar (Program Assistant, MFM) provided outstanding operational support of the report.

## LIST OF FIGURES

Figure (ES).1	Net FDI inflows versus Real GDP growth (US\$ billion; y/y, %), 2006-17	xii
Figure (ES).2	Budget revenue, expenditures and deficit (% of GDP), 2003–17	xii
Figure (ES).3	A proposal of a road map for PIM reforms	xiv
Figure I.1	Contribution to economic growth — Demand-side factors (in %)	2
Figure I.2	FDI and gross fixed capital formation (% of GDP), 2005–17	2
Figure I.3	Private consumption recovered significantly, while government consumption remained sluggish in real terms	2
Figure I.4	Strong recovery in real household income boosted private consumption	2
Figure I.5	Real GDP growth by activity, 2011 Q1–2018 Q1	3
Figure I.6	Production growth of key commodities (3-month rolling sum; y/y, %)	3
Figure I.7	Inflation significantly rebounded in 2017 driven mainly by a surge in non-food, non-oil inflation reflecting demand shocks; meanwhile, food inflation seems to be stabilizing at near the target as the one-off factors dissipated	4
Figure I.8	The disinflationary cycle during 2014–16 is consistent with declining aggregate demand during the period, reflected in a contracting output gap; similarly, the rebound in inflation is consistent with a change in output gap	4
Figure I.9	After a downward trend, unemployment rate slightly increased in 2018 Q1 reflecting seasonal effects	6
Figure I.10	Industrial sector has been driving labor market while shifting away from agriculture	6
Figure I.11	Workers in mining sector are paid relatively higher wages...	7
Figure I.12	Improved market conditions also raised household income while growing inflation has been eroding real wage growth	7
Figure I.13	Adjustment in the unsustainable current account was done between 2014 and mid-2017	8
Figure I.14	Despite strong export performance, the current account deficit has slightly worsened since mid-2017, mainly due to a rising profit repatriation by mining companies	8
Figure I.15	Imports have been growing fast with escalation of investment, while exports performance has been robust	8
Figure I.16	Terms of trade significantly improved in 2017 due to higher commodity prices	8
Figure I.17	Surge in coal exports significantly boosted exports since late 2016...	9
Figure I.18	... supported by rising export prices of key commodities	9
Figure I.19	Imports of capital goods and fuel have been rising strongly since late 2016 amid large FDI and investment	10
Figure I.20	Imports of consumption goods have also been rising since late 2016	10
Figure I.21	Strong recovery in FDI has helped ease pressure on the balance of payments, covering current account financing needs	11
Figure I.22	More than US\$ 1.4 billion was mobilized in 2017 to reduce the BoP pressure through debt financing	11
Figure I.23	Large FDI inflows in mineral sector and official sector support improved the balance of payments...	11

# MONGOLIA ECONOMIC UPDATE

Figure I.24	...and resulted in a US\$ 1.7 billion rise in international reserves (15 percent of GDP) in 2017 despite strong import growth	11
Figure I.25	The Nominal exchange rate has stabilized since early 2017 after years of depreciation...	13
Figure I.26	...while the currencies of most resource-rich countries have broadly strengthened against the U.S. dollar	13
Figure I.27	Expenditure, revenue, fiscal balance, 2011–17	15
Figure I.28	Public debt and components, 2012–17	15
Figure I.29	Spending consolidation performance (% of GDP), 2016 and 2017	16
Figure I.30	MTFF: Growth Profile	17
Figure I.31	MTFF: Debt Profile	17
Figure I.32	Interbank rates have been on the decline since November 2016, in tandem with lower policy rates	18
Figure I.33	Average lending rates and deposit rates have also marginally declined in recent months amid improving funding conditions	18
Figure I.34	M2 growth has been strong, with rising net foreign assets and credit to the private sector	19
Figure I.35	Strong money supply growth has mainly been driven by a rise in local currency deposits	19
Figure I.36	Expanded BoM's balance sheet has been slowing since October 2017, mainly due to the limited subsidy to the housing mortgage program	20
Figure I.37	BoM's policy credit has been declining with the phase-out of Price Stabilization Program and mortgage loans, but remains high	20
Figure I.38	Reserve accumulation and phase-out of policy loans have contributed significantly to strengthening of reserve money supply since the beginning of 2017	21
Figure I.39	Fast-rising net foreign assets have been contributing to reserve money growth since mid-2017 despite fiscal tightening and phase-out of policy loans by the BoM	21
Figure I.40	BoM projection on inflation	22
Figure I.41	BoM projection on economic growth	22
Figure I.42	Bank loans had steeply declined in 2014–15 with weak loan demand and phasing out of policy loans by the BoM	23
Figure I.43	Bank loans growth has been accelerating since late 2016 mainly driven by individual loans	23
Figure I.44	Funding conditions for banks are relaxing with accelerating local currency deposit growth despite declining BoM funding	24
Figure I.45	Accelerating deposit growth is mostly driven by a surge in local currency deposits	24
Figure I.46	The loan-to-deposit ratio has been declining since late 2016, with fast-growing deposit	25
Figure I.47	Excess liquidity conditions are reflected in a surge in Central Bank Bill (CBB) holdings by banks	25
Figure I.48	Credit conditions are still tighter in most sectors except the mining sector, which posted a strong recovery in loans	24
Figure I.49	Individual credit growth has been a key driver of total credit growth	26
Figure I.50	Household debt ratios to GDP and income have increased substantially	26
Figure I.51	Individual credit growth has been a key driver of total credit growth, while corporate loans have seen moderate growth	27

# MONGOLIA ECONOMIC UPDATE

Figure I.52	Mortgage loan growth has slowed, driven by the limited subsidy of the BoM to the housing mortgage program	27
Figure I.53	The loan quality ratio has stabilized with the strong economic recovery and speedy credit growth ...	28
Figure I.54	... while deterioration of loan quality has mainly been driven by loans to the private sector	28
Figure I.55	Global growth is projected to continue to moderate in the coming years...	32
Figure I.56	Growth in EAP region will gradually moderate in 2019-20	32
Figure I.57	Potential output growth decomposition	34
Figure I.58	Real government consumption gap and output gap	34
Figure I.59	Relationship between fiscal impulse and output gap	34
Figure II.1	Co-movement between public investment and growth	37
Figure II.2	Correlation between public investment and economic growth	37
Figure II.3	Mongolia's total investment is among the highest in EAP	37
Figure II.4	Evolution of public and private investment, EAP 2017	37
Figure II.5	Efficiency of public spending ranking	38
Figure II.6	Measure of public investment efficiency in Mongolia (Ratio of GDP growth to government capital spending, % of GDP)	38
Figure II.7	PIM Institutional Arrangements: Roles and Responsibilities of Key Institutions	41
Figure (A).1	Results of Growth Accounting by Dutu (2017)	49
Figure (A).2	Results of Growth Accounting by Bank of Mongolia (2013)	49
Figure (A).3	A comparison of trends of the capital output ratio using various assumptions	50

## LIST OF TABLES

Table (ES).1	Key Economic Indicators (2014-20)	xiii
Table (ES).2	Capital expenditures and main sources of funding (in percent of GDP)	xv
Table I.1	Mongolia: Average results of growth accounting	33
Table II.1	Capital expenditures and main sources of funding (in percent of GDP)	36
Table II.2	Debt incurred through off-budget investment funding in 2016 (MNT billion)	36
Table II.3	Key Institutions involved in management of public investment	40

## LIST OF BOXES

Box I.1	Slow progress toward achieving Sustainable Development Vision 2030 amid strong economic recovery	5
Box I.2	Key fiscal adjustment reforms adopted by the Government of Mongolia in 2017	14
Box I.3	The Medium-Term Fiscal Framework for 2019–21	17
Box I.4	Monetary Policy and Financial Sector Guideline for 2018–20	21
Box I.5	Goals of the amendment to the central bank law	22
Box I.6	Household loans and debt	26
Box I.7	Mongolian banks Asset Quality Review and results	28
Box I.8	Benefits resulting from the Banking Law and Deposit Insurance Law amendment	30
Box I.9	Global and Regional Outlook and Risks – Key Highlights	32
Box II.1	Current legal documents regulating public investment management	39
Box II.2	Purpose of prescreening	42
Box II.3	Example of rationalization criteria	44





## EXECUTIVE SUMMARY

### This Report and this Summary:

- (i) Review the recent economic and fiscal performance of Mongolia;
- (ii) Outline current medium-term prospects of Mongolia's economy;
- (iii) Discuss short-term risks and structural vulnerabilities; and
- (iv) Comment on the efficiency of past public investment programs and practices.

### I. A STRONG ECONOMIC RECOVERY IN 2017 AND 2018

**2017 was a good year for Mongolia. A strong economic recovery, accompanied by moderate inflationary pressures, led to lower fiscal and Balance of Payment (BoP) deficits and triggered a slight decline of the country's public debt.** Mongolia's economic performance is likely to further improve in 2018 and current prospects for the next couple of years assume continued or accelerated growth, and continued improvements in the country's public finance and balance of payments position, provided the government continues to implement its ongoing adjustment program with the support of its development partners.

**Mongolia's economic performance improved dramatically in 2017 and at the beginning of 2018** with the GDP growth rate increasing from 1.2 percent in 2016 to 5.1 percent in 2017 and 6.1 percent during

the first quarter of 2018. Strong growth was accomplished without excessive inflationary pressures. Indeed, the consumer price index (CPI) increased from 1.3 percent in 2016 to 6.4 percent in 2017 (6.1 percent in May 2018), but remained below the central bank target of 8 percent.

**The economic recovery was not due – at least initially – to strong growth in the mining sector.** Despite a rebound of coal production, the mining sector contracted in 2017 because of the decline of the more important copper sub-sector still affected by unfavorable global commodity prices and geologically lower gold content in Oyu Tolgoi (OT)’s production. In 2018, copper production and exports increased significantly and, despite the mediocre performance of coal, there was a general rebound of the mining sector. The main factor behind the strong economic growth of the past eighteen months was large inflows of foreign direct investments, attracted by promising mega-projects in the mining sector in an increasingly positive external environment.

**The country’s good economic performance had a positive impact on public finances.** The primary fiscal deficit, which had reached 12.5 percent of GDP in 2016, turned into a small surplus (2.1 percent of GDP) in 2017. The overall fiscal deficit including all DBM spending declined from 16.4 percent of GDP in 2016 to a low 1.9 percent in 2017. Improvements in the fiscal performance were due to a dramatic increase in government revenue and effective control of public spending, both recurrent and capital expenditures.

**On the revenue side, a gain of close to 5 percent of GDP was achieved,** as government revenue increased from 24.4 percent of GDP in 2016 to 29.2 percent in 2017. This was not the result of significant tax policy adjustments, as most of the tax changes passed by Parliament in 2017 would not take effect until 2018, and some were then reversed. Consequently, the growth of revenue was entirely due to the economic recovery and substantial increases in mining-related revenue.

**On the public spending side, the gain was more than 9 percent of GDP** (from 40.5 percent of GDP to 31 percent in 2017). The reduction of recurrent expenditures was equivalent to less than 2 points of GDP (from 27.2 percent of GDP in 2016 to 26.6 percent in 2017). More radical were the cuts in capital expenditures (from 10.9 percent of GDP in 2016 to 4.3 percent in 2017), a welcome development since public capital spending in Mongolia, compared with similar countries, was extremely high, as well as poorly managed and largely responsible for large and growing fiscal deficits from 4.1 percent in 2011 to 16.4 2016.

**Improvements in Mongolia’s economic performance also had a positive impact on external accounts.** Exports increased by 26.1 percent in 2017 (mainly coal) and by 14.6 percent during the first five months of 2018 (mainly copper). Imports increased by 29.1 percent in 2017, due to a combination of imports of capital goods (linked with FDI-financed investments) and consumer goods (linked with the general economic recovery). Despite the strong rebound of imports, the trade balance slightly improved, but the deficit of the income balance increased due notably to large and growing payments on the public debt and the repatriation of profits by mining investors.

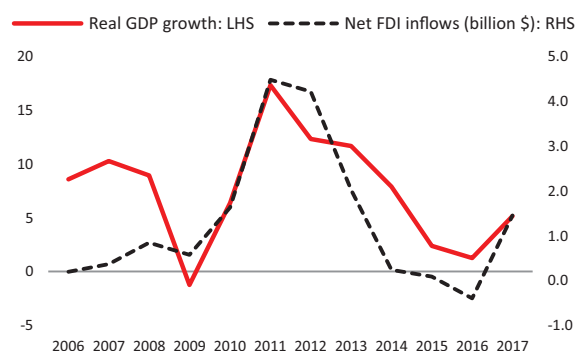
**Nevertheless, the balance of payments improved and a \$1.4 billion surplus in 2017 replaced a \$18.2 million deficit of 2016.** Improvement in the BoP was mainly due to massive inflows of FDI, strong donor support and the successful refinancing (on better terms) of government guaranteed bonds maturing in 2017 and 2018.



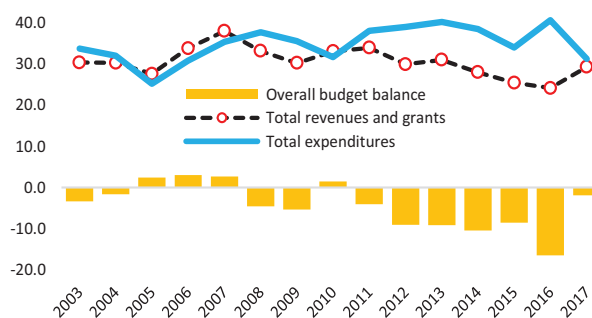
# MONGOLIA ECONOMIC UPDATE

Improvements in the balance of payments ended a long period of depreciation of the Tugrik. A slight appreciation of the Mongolian currency was observed in 2017. This led to a moderate appreciation of the real effective exchange rate which had no significant impact on the country's competitiveness.

**Figure (ES).1 Net FDI inflows versus Real GDP growth (US\$ billion; y/y, %), 2006-17**



**Figure (ES).2 Budget revenue, expenditures and deficit (% of GDP), 2003-17**



Sources: NSO; World Bank staff estimates.

## II. A POSITIVE OUTLOOK

**By and large, the country's short- and medium-term prospects remain positive.** The recovery should continue, perhaps accelerate (a GDP growth rate of over 6 percent in 2019-20). As in 2017-18, economic growth should be driven by large FDI-financed investments in mining. However, almost all the sectors would benefit, notably industry (including mining) and trade, transport and other services. Agriculture (mainly livestock) – which was severely affected by harsh weather conditions during the winter – should grow more slowly. Inflation will likely rise although modestly – putting at risk the BOM medium term target of 8 percent as food and petrol prices are expected to continue to increase. Private consumption is also projected to further improve over the medium term. Accordingly, BOM is likely to gradually tighten monetary policy to contain inflation. Poverty should decline, at least in urban areas. As the poverty rate is higher in rural areas, a better performance of agriculture and a more significant decrease of rural poverty are essential to support the fight against poverty.

**Economic growth, higher exports and higher commodity prices should continue to have a strong positive impact on government revenue.** Fiscal deficits should therefore continue to decline, provided the government implements effectively most of the measures included in its Economic Reform Program, which form part of the adjustment programs supported by the country's development partners, including the IMF and the World Bank. The debt-to-GDP ratio should therefore continue to decline.

**Despite higher investment-related imports, economic growth supported by stronger exports and higher commodity prices, should also have a strong positive impact on the external sector.** Despite large public debt payments and repatriation of profits, the balance of payments should continue to improve, owing to large FDI inflows and donor assistance.

The following Table summarizes current economic projections for 2018-20, as envisaged in ongoing Bank-IMF supported adjustment programs.

# MONGOLIA ECONOMIC UPDATE

**Table (ES).1 Key Economic Indicators (2014-20)**

	2014	2015	2016	2017e	2018f	2019f	2020f
<b>Real GDP growth, at constant market prices</b>	<b>8.1</b>	<b>2.5</b>	<b>1.5</b>	<b>5.1</b>	<b>5.5</b>	<b>6.6</b>	<b>6.2</b>
Private Consumption	6.3	7.2	-8.2	4.3	5.1	6.3	6.7
Government Consumption	12.2	-4.7	11.0	-3.2	-1.8	0.5	4.2
Gross Fixed Capital Formation	-21.7	-34.4	7.8	32.8	11.8	34.7	9.4
Exports, Goods and Services	53.2	1.2	12.6	13.4	7.9	3.9	2.2
Imports, Goods and Services	6.8	-11.5	12.4	25.0	8.4	12.3	4.0
<b>Real GDP growth, at constant factor prices</b>	<b>7.9</b>	<b>2.4</b>	<b>1.2</b>	<b>5.1</b>	<b>5.5</b>	<b>6.6</b>	<b>6.2</b>
Agriculture	13.7	10.7	6.2	2.3	3.5	3.6	3.8
Industry (incl mining)	12.7	9.9	-0.6	-1.4	5.5	7.3	7.7
Services	7.8	0.6	1.5	8.8	6.1	7.1	5.8
<b>Inflation (Private Consumption deflator)</b>	<b>11.0</b>	<b>1.1</b>	<b>0.9</b>	<b>6.4</b>	<b>8.1</b>	<b>8.2</b>	<b>7.1</b>
<b>Current account balance (% of GDP)</b>	<b>-11.5</b>	<b>-4.8</b>	<b>-6.3</b>	<b>-10.5</b>	<b>-8.2</b>	<b>-8.1</b>	<b>-6.9</b>
<b>Financial and Capital account (% of GDP)</b>	<b>8.7</b>	<b>3.6</b>	<b>7.9</b>	<b>31.3</b>	<b>9.5</b>	<b>16.6</b>	<b>10.5</b>
Net Foreign Direct Investment (% of GDP)*	2.3	1.6	1.1	13.1	13.2	15.2	12.6
<b>Fiscal Balance (% of GDP)**</b>	<b>-10.4</b>	<b>-8.6</b>	<b>-16.4</b>	<b>-1.9</b>	<b>-4.7</b>	<b>-4.6</b>	<b>-2.8</b>
<b>Primary Balance (% of GDP)</b>	<b>-8.5</b>	<b>-5.4</b>	<b>-12.5</b>	<b>2.1</b>	<b>-1.0</b>	<b>-1.5</b>	<b>-0.1</b>
<b>Debt (% of GDP)***</b>	<b>57.9</b>	<b>60.1</b>	<b>87.2</b>	<b>84.4</b>	<b>79.3</b>	<b>76.3</b>	<b>72.4</b>
Memo items:							
Nominal GDP (millions US\$)	12196	11728	11056	11021	12560	14219	15800
Nominal GDP (billions MNT)	22227	23150	23936	27161	30978	35295	40073

\* In 2016, Net FDI number excluded the transactions of OT-2 project financing in May-June, 2016.

\*\*On-budget plus DBM spending

\*\*\*General government debt data excludes SOE's debt and central bank's liability from PBOC swap line.

## III. SHORT-TERM RISKS AND STRUCTURAL VULNERABILITIES

The list of possible short- and medium-term risks is long. It includes political risks, regional instability, climate shocks, natural disasters, and sudden changes in the overall external environment and global commodity prices. However, the most critical risk is a sudden relaxation of the government's commitment to full implementation of its adjustment program. This is what happened in 2010, when, encouraged by booming exports, high commodity prices, and growing government revenue, the government stopped implementing its own program and increased public spending, planting the seeds for the next public finance crisis.

**This, however, is not the most probable scenario.** It is true that some measures aimed at increasing revenue (a progressive personal income tax) and reducing the cost of the pension system (increasing the retirement age), which were expected to be effective in 2018, were approved by the Parliament only to be rescinded. So far, however, the government has been implementing all the most important components of its adjustment program, including drastic cuts in both recurrent expenditures (e.g., a hiring freeze) and capital expenditures.

**Perhaps more critical is the analysis of Mongolia's long-term structural vulnerabilities.** The first is the extreme vulnerability of Mongolia's economic performance to the fluctuations of global commodity prices. The second is the fact that most of the country's economic growth seems to come from physical capital accumulation, not from factor productivity.

**All the reviews of Mongolia's past and recent economic developments demonstrate the extreme vulnerability of the country's economic performance to frequent changes in global commodity prices.** The mining sector, whose performance depends on the performance and prospects of the world economy, accounts for only 20 percent of GDP, but produces 90 percent of the country's exports and in good years 20 percent of total government revenue. Minimizing this vulnerability to the external environment is intellectually easy but politically difficult. Substantial savings during the good years can create effective buffers against some of the worse effects of depressed commodity prices. This was well understood by the authors of Mongolia's Fiscal Stability Law of 2010, which limited fiscal deficits to 2 percent of GDP, calculated based on average commodity prices over 16 years. The rules of the Fiscal Stability Law, however, were not implemented. Political pressures were strong, and the governments did not resist the temptation to increase public spending when the economy was booming and government revenue increasing.

**Another critical long-term vulnerability of the Mongolian economy is what reveals a growth accounting model.** Apparently, most of the past economic growth came from physical accumulation of capital, not from improvements in factor productivity. The two structural vulnerabilities of the Mongolian economy are in fact closely related. Most of the accumulation of capital is financed by large inflows of FDI, which, of course, are based on the judgment of external investors on the medium- and long-term prospects of the country's mining production and exports.

**Clearly the best long-term protections against these two vulnerabilities would be the diversification of the Mongolian economy.** Consequently, government and donor policies should give a high priority to an economic diversification agenda that helps counter the ups and downs of the mining sector. Investment in human resources and developing the country's technical and technological capacity are probably the best way to support diversification, together with sound investments in the most appropriate infrastructure and systematic development of the country's economic institutions.

#### IV. EFFICIENCY OF CAPITAL SPENDING

The analysis of Mongolia's public investment performance shows that most of the recent public investment programs were overambitious and unrealistic and were largely responsible for the fiscal crisis of the past few years. It also indicates that the mediocre quality of the programs created inefficiencies that must be addressed in the future years.

**The surge in capital expenditures until 2015 was the key factor behind the large increase of public finance deficits and the public debt.** In 2013, Mongolia's capital expenditures accounted for about 16 percent of the GDP, much higher than the 6.1 percent average of East Asian countries. This was not due to an increase of capital spending in the state budget. As the rules of the Fiscal Stability Law limited structural budget deficits, the increase in capital spending was entirely financed by off-budget funds, including DBM financing, promissory notes authorized by the Parliament since 2014, and more recently Build-Transfer (BT) operations.<sup>1</sup>

---

<sup>1</sup> A cash budget does not show the cost of promissory notes or BT operations until the government makes a payment.

## MONGOLIA ECONOMIC UPDATE

**Table (ES).2 Capital expenditures and main sources of funding (in percent of GDP)**

	2010	2011	2012	2013	2014	2015	2016	2017
<b>Total Capital Expenditures</b>	<b>6</b>	<b>9.7</b>	<b>12.1</b>	<b>16.3</b>	<b>14.9</b>	<b>9.1</b>	<b>10.4</b>	<b>4.3</b>
<b>- On-Budget</b>	<b>6</b>	<b>9.7</b>	<b>9.1</b>	<b>7.8</b>	<b>8.4</b>	<b>6</b>	<b>9.3</b>	<b>6.1</b>
- Investment	5.4	8	8.2	6	6.5	2.6	3.1	3.3
- Maintenance	0.3	0.4	0.3	0.5	0.4	0.5	0.2	0.3
- Foreign-Funded	0.3	1.3	0.6	1.3	1.1	1.1	2.3	2.4
<b>- Off-Budget (DBM)</b>	<b>0</b>	<b>0</b>	<b>3</b>	<b>8.5</b>	<b>6.5</b>	<b>3.1</b>	<b>1.1</b>	<b>-1.8</b>

Source: MoF data; World Bank staff estimates

**In 2015, the government took several measures aimed at improving fiscal management.** Reducing capital spending was a major component of the country's adjustment program. In effect, capital spending decreased from 14.9 percent of GDP in 2014 to 9.1 percent in 2015, rose to 10.4 percent in 2016 (as the government repaid outstanding promissory notes authorized since 2014), but declined again to 4.3 percent in 2017. At the same time, DBM-financing of non-commercial projects was included in the state budget and the use of promissory notes was stopped in 2016.<sup>2</sup>

**The large public investment program implemented over the past five years did not produce the expected benefits.** It did not prevent a sharp decline of GDP growth rates since 2011. In fact, the main legacy of the program was a major increase in public finance deficits and public debt, which will have a lasting impact on the country's economic and fiscal performance.

**Cross-country benchmarks highlight the inefficiency of Mongolia's public investment.** The country ranks 124th on efficiency of public spending in the Global Competitiveness Index. Similarly, according to the 2016 IMF Public Investment Management Assessment (PIMA), Mongolia's scores are much lower than for other emerging market comparators.

**Three main factors explain the mediocre quality of Mongolia's past public investment programs.** The first one is a policy bias. Too many Mongolian governments encouraged line ministries, government agencies and local governments to identify, finance and implement many new projects, large or small, without adequate consideration for the sustainability of the policy and the quality of the proposed operations. The second factor was an excessive decentralization and fragmentation of the decision-making process. The Ministry of Finance is only responsible for projects financed by the state budget. The use of off-budget financing techniques (DBM and promissory notes) enabled a wide variety of ministries and agencies to launch a large number of new projects outside any national strategic vision about the country's development priorities. Third, very few efforts were made to develop and disseminate adequate guidance on effective project appraisal techniques.

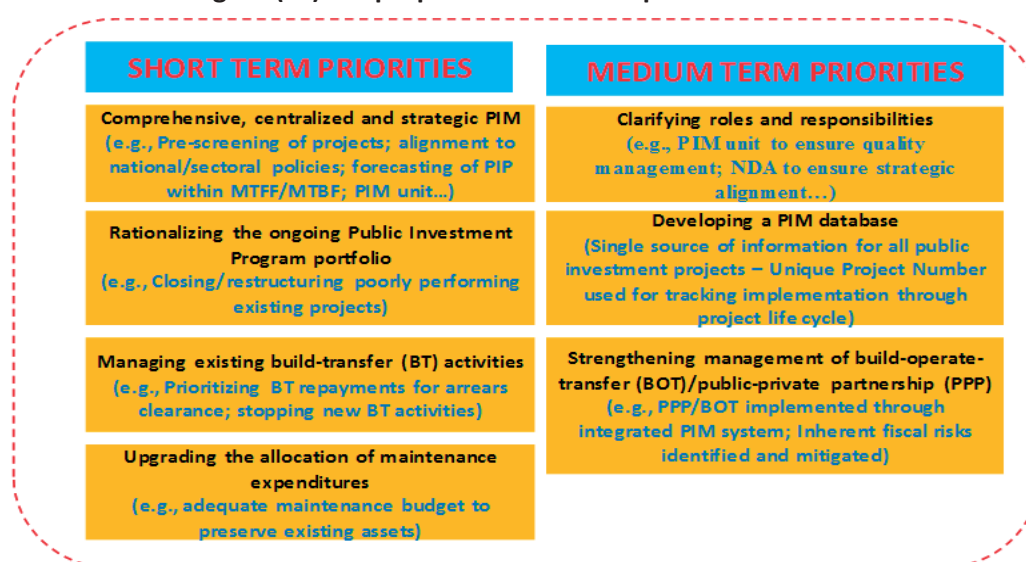
**Poor investment planning and project selection led to ineffective implementation of approved operations.** Actual public spending is only a fraction of amounts planned in the budgets and disbursement rates for capital expenditures are particularly low. Another efficiency issue is the lack of adequate funding for maintenance. Despite the recent increase in public investment, the capital maintenance budget did not increase substantially over the past ten years. The GDP ratio of maintenance spending increased from 0.3 percent of GDP in 2003-09 to an average of 0.4 percent in 2014-15 before declining to less than 0.2 percent in 2016. More importantly, the ratio of maintenance

<sup>2</sup> But BT financing continues.

to total capital expenditures sharply declined from 5.1 percent in 2010 to 1.9 percent in 2016. The shortage of maintenance expenditures reduces the benefits and shortens the economic life of ongoing and new investments in infrastructure and other sectors.

**To conclude, Mongolia needs to review and reshape its public investment policies and decision-making processes.** The pre-screening of projects should be based on well-conceived national and sector strategies. The approval of investment programs should be based on realistic revenue forecasts and sound medium-term economic and fiscal frameworks. The roles and responsibilities of the various stakeholders should be clarified. A central public investment management unit should be able to review project proposals for quality assurance purposes. A project data base should be developed and become the main source of information for all public investment projects. Finally, the ongoing investment program should also be rationalized, including restructuring or eliminating non-performing ongoing projects. A proposal of a road map to improve public investment management is presented below (Figure (ES).3).

**Figure (ES).3 A proposal of a road map for PIM reforms**



Source: World Bank (2018c).





## I. PERFORMANCE AND PROSPECTS

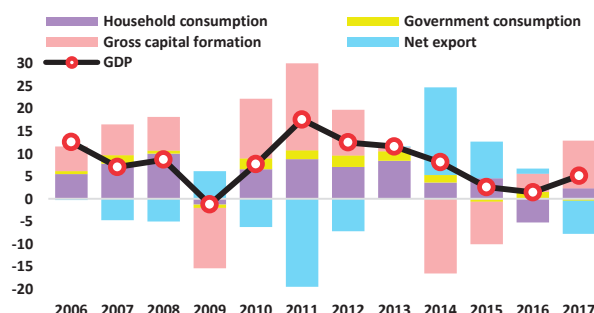
### A. Recent Economic Developments

*Following a period of considerable economic and financial turbulence, Mongolia's economy recovered strongly in 2017, supported by a surge in foreign direct investment, high global commodity prices, and restoration of macroeconomic stability.*

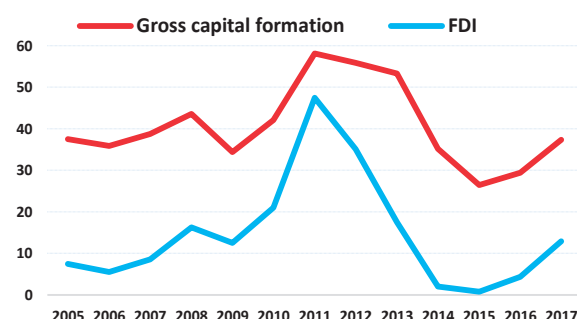
Economic recovery in 2017 was stronger than anticipated, as real gross domestic product (GDP) increased by 5.1 percent from 1.2 percent in 2016, following a prolonged period of a slowdown in growth. The growth momentum of 2017 continued into 2018 Q1, as the economy grew at 6.1 percent following a robust recovery of the mining sector and strong private consumption. Despite bottlenecks at the border with China and a harsh winter, the mining sector expanded in 2018 Q1 from a contraction in 2017 and barely any growth in 2016.

On the demand side, investment and private consumption are the two main factors explaining the recent growth acceleration of Mongolia (Figure I.1 ). Investment demand continued to grow during 2017 buoyed by new inflows of foreign direct investment (FDI) as market expectations improved. In fact, there is a strong correlation between FDI and gross fixed capital formation. Both FDI and gross fixed capital formation peaked in 2011, and when FDI almost dried, investment plummeted by almost a half (Figure I.2 ). Gross fixed capital formation grew by 36.2 percent in 2017, almost double the growth in 2016 after two consecutive years of contraction. On average, net FDI inflows finance about 60 percent of private investments.

**Figure I.1 Contribution to economic growth — Demand-side factors (in %)**



**Figure I.2 FDI and gross fixed capital formation (% of GDP), 2005–17**

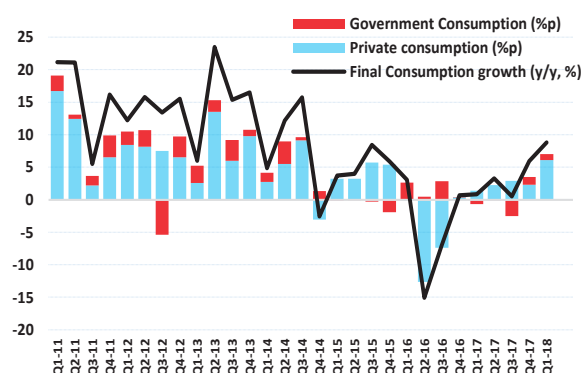


Sources: NSO; World Bank staff estimates.

**Private consumption recovery was supported by positive developments in the labor markets and stronger credit growth performance in 2017.** Private consumption, which had significantly contracted in 2016, grew by 4.3 percent in 2017, and 9.6 percent in the first quarter of 2018. The recovery in consumer optimism reflects a strong rebound in individual credit and real income growth, following positive developments in the labor market (Figure I.4 ).

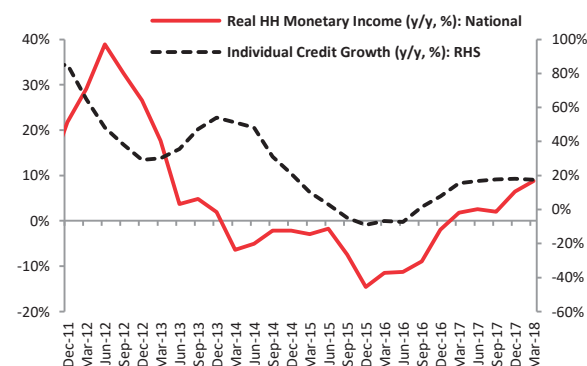
**Figure I.3 Private consumption recovered significantly, while government consumption remained sluggish in real terms**

Growth contributions of private and government consumption (% point)



**Figure I.4 Strong recovery in real household income boosted private consumption**

Real average household income growth (y/y, %)



Sources: NSO; World Bank staff estimates.

**In contrast to the four previous years, net exports were not a source of growth in 2017;** in fact, net exports dragged down GDP growth by 7.3 percentage points. As private absorption strongly recovered, imports growth outpaced exports growth.

**On the supply side, growth recovery in 2017 was driven mainly by the non-mining sectors (services, manufacturing, and agriculture), and by net taxes on products.** Their expansion continued through 2018 Q1 (Figure I.5). The growth of the services sector, manufacturing, and taxes was mainly due to the strong link to domestic demand. Services expansion was mainly driven by higher growth in the transport, wholesale and retail trade, and communications subsectors. The manufacturing sector also

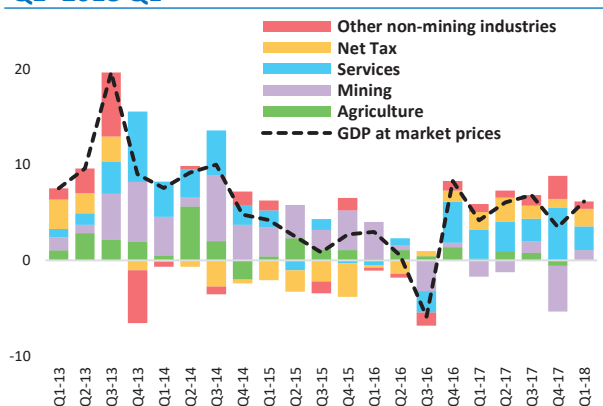
grew strongly, with quarterly growth rates exceeding 20 percent in 2017. This trend continued in 2018 Q1 following positive developments in electricity generation activities.

**The construction sector showed some signs of recovery in 2018 Q1 after a prolonged period of contraction.** The construction sector shrank during most of 2017 but signs of recovery appeared at the end of 2017 and in 2018, with strong growth rates of 18 percent and 15 percent for two consecutive quarters (2017 Q4 and 2018 Q1).

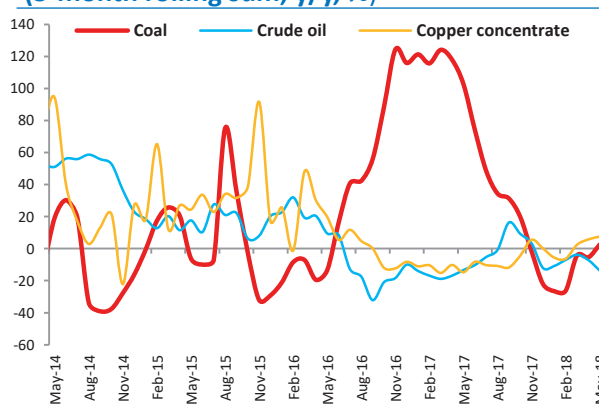
**The performance of the agriculture sector has been severely affected mainly by exogenous factors including weather conditions.** The contribution of agriculture to growth was positive during 2017. However, because of a severe winter, the sector contracted by 6 percent year-on-year (y/y) in 2017 Q4 and posted only a minuscule growth rate in 2018 Q1.

**The mining sector recovered modestly in 2018 Q1 following a contraction episode that began in 2014.** The mining sector was a major drag on economic activity in 2017 (but rebounded in 2018, growing at 4.2 percent in 2018 Q1). The activity of the sector declined in 2017, despite a spectacular performance of the coal subsector due to favorable global commodity prices and weathering of bottlenecks at the border with China. Although coal production reached a historical peak, growing by 33 percent in 2017 (Figure I.6 ), the entire mining sector declined by 6.9 percent in 2017, as copper, which accounts for 40 percent of the production of the mining sector and 15 percent of GDP, contracted by 9 percent. During 2018 Q1, the negative growth of coal production was more than offset by a recovery in copper production, which is likely to continue and stimulate growth in 2018.

**Figure I.5 Real GDP growth by activity, 2011 Q1–2018 Q1**



**Figure I.6 Production growth of key commodities (3-month rolling sum; y/y, %)**



Sources: NSO; World Bank staff estimates.

*Inflationary pressures rebounded in 2017 after a protracted disinflationary period, as spare capacity in the economy continued to decline, and adverse supply-side shocks including international oil prices and bad weather affected growth and higher taxes. Nonetheless, inflation remained below the Central Bank target.*

**Inflation steadily increased in 2017, reaching an average of 6.4 percent.** This was a reversal of the disinflationary trajectory that saw inflation collapse from 15 percent in 2012 to 0.9 percent in 2016 (Figure I.7 ). The rebound in inflation can be attributed to a recovery in aggregate demand, increases

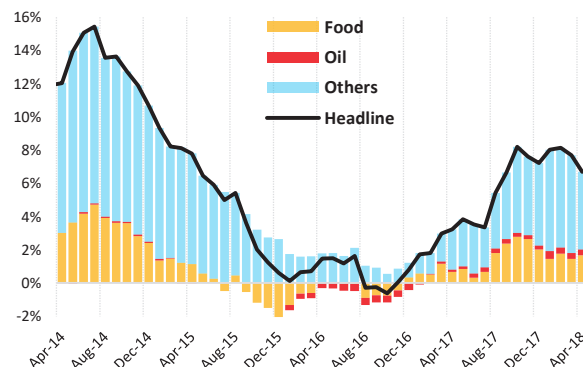


in international oil prices, exchange rate passthrough to prices, and tax increases implemented during 2017 in the context of the ongoing economic adjustment program. Figure I.8 plots the business cycle measured by the Hodrick–Prescott (HP) filter<sup>3</sup> and the production function approach. It shows that there was a reduction in aggregate demand since 2014, which can explain the disinflation trajectory. According to the production function approach, demand rebounded in 2017, and is thus consistent with the recovery in inflation. But the recovery in demand cannot fully explain the big jump in inflation.

**The other factors that explain inflationary trends are tax increases, increases in the international oil prices, and a revision of the consumer basket by the National Statistics Office (NSO).** Drought conditions during the summer of 2017 explain the food price inflation in Ulaanbaatar (UB), which reached 11 percent (y/y) in October 2017, as does the harsh winter, which caused increases in prices for some food components such as meat. However, as the impact of short-lived shocks such as drought conditions and the effects of taxes on prices faded away, inflation stabilized at around 6.4 percent in the first quarter of 2018. Going forward, inflation is likely to accelerate and stabilize around the central bank target due to increases in demand and central bank actions.

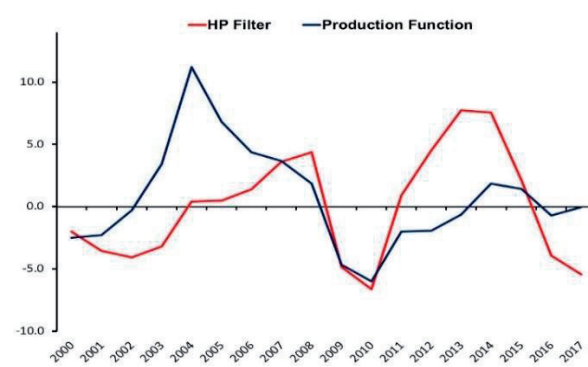
**Figure I.7 Inflation significantly rebounded in 2017 driven mainly by a surge in non-food, non-oil inflation reflecting demand shocks; meanwhile, food inflation seems to be stabilizing at near the target as the one-off factors dissipated**

Consumer price inflation (y/y, %): Ulaanbaatar



**Figure I.8 The disinflationary cycle during 2014–16 is consistent with declining aggregate demand during the period, reflected in a contracting output gap; similarly, the rebound in inflation is consistent with a change in output gap**

Food price compared to non-food price inflation (y/y, %): Ulaanbaatar



Sources: NSO Bulletin; World Bank staff estimates.

**The unemployment rate was on the downward trend in most of 2017 with the solid economic recovery, despite slow progress to achieve Mongolia's Sustainable Development Vision 2030.**

Despite a rapid decline - although partly reversed - during 2010-16 in the incidence of poverty supported mainly by higher wages and transfers, Mongolia's progress toward achieving its Sustainable Development Vision 2030 (SDV 2030) has been slow (Box I.1). The official poverty statistics indicate that the poverty rate in Mongolia declined from 38.7 percent in 2010 to 21.6 percent in 2014, but rose again to 29.6 percent in 2016, reflecting deteriorating economic conditions during 2014-16.

<sup>3</sup> The Hodrick–Prescott filter is a tool used mainly in real business cycle macroeconomic theory, to remove from data the cyclical component of a time series.

Rural poverty rates have been regularly higher than urban rates, but the gap has narrowed over the years. Box I.1 indicates that progress towards achieving SDV 2030 has been slow in terms of the selected socioeconomic indicators. For example, real GDP growth and GNI per capita, and human capital index all remain below their 2014 baseline values. However, the recent economic recovery has also impacted the labor market.

## Box I.1 Slow progress toward achieving Sustainable Development Vision 2030 amid strong economic recovery

The Sustainable Development Vision 2030 (SDV 2030) was adopted through Resolution No. 19 of the State Great Khural of Mongolia (the parliament) on February 5, 2016. The main objective is to make Mongolia an upper-middle income country within a decade. To achieve this objective, SDV 2030 would have to rely on sound macroeconomic and fiscal policies and a gradual diversification of the country's economy, lessening its dependence on the production and export of minerals. The 10 goals of SDV 2030 are to:

1. Increase Mongolia's GNI per capita to US\$ 17,500 and become an upper middle-income country based on its income per capita
2. Ensure average annual economic growth of not less than 6.6 percent during 2016–30
3. End poverty in all its forms

Reduce income inequality and have 80 percent of the population in the middle- and upper-middle-income classes

4. Increase the enrolment rate in primary and vocational education to 100 percent and establish a lifelong learning system
5. Improve the living environment of the Mongolian people to lead a healthy and long life, and increase life expectancy at birth to 78 years
6. Rank among the first 70 countries on the human development index
7. Preserve the ecological balance and rank among the top 30 countries on the Green Economy Index
8. Rank among the top 40 countries on the Doing Business Index and the top 70 countries on the Global Competitiveness Index
9. Build professional, stable, and participative governance, free of corruption, that is adept at implementing development policies at all levels.

**Table B8.1. Progress on 8 selected key results indicators (out of 20 Indicators) on the performance and implementation of Mongolia SDV 2030**

Indicator	Unit	Baseline (2014)	Progress to date (2017)	Target (2030)
Annual average economic growth	%	7.8	5.1	6.6
Gross National Income per capita	US\$	4166	3196.8	17500
Human Development Index	rank	90	92*	70
Life expectancy	years	69.57	69.1**	78
Global Competitiveness Index	rank	104	101***	70
Doing Business Index	rank	56	62	40
Share of the population with social insurance coverage in the total economically active population	%	84.4	82.9**	99
Number of foreign tourists traveling in Mongolia	million persons	0.392	0.469	2.0

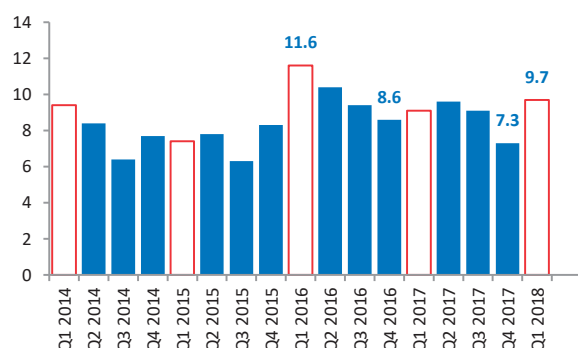
Note: \* = recent data available in 2015; \*\* = recent data available in 2016; \*\*\* = recent data available in 2017-18.

**Labor market conditions improved following a strong economic recovery as suggested by key labor market indicators.** The unemployment rate declined to 7.3 percent in the last quarter of 2017 compared to 8.6 percent a year ago (Figure I.9 ), reflecting a strong economic performance. Total labor force was estimated at 1.3 million persons in the end-2017 and the labor force participation rate reached 62.4 percent in the same period (Figure I.10 ). However, in 2018 Q1 the unemployment rate increased to 9.7 percent, reflecting Mongolia's highly seasonal patterns due to difficult work conditions in the winter, especially in construction, agriculture and mining sectors.

**There is evidence of a sectoral shift of labor force from traditional agriculture sector into non-agriculture reflecting mainly the developments in the mining sector.** Agriculture employed 25.1 percent of total number of jobs in 2018 Q1, lower than its employment share (36 percent) in 2012 Q1 reflecting a structural transformation driven by mining; the share of industrial sector including mining, manufacturing and construction rose to about 20 percent in end-March 2018 from 13.2 percent in the same period of 2012. Service sectors also absorbed a large proportion of the labor force that migrated from agriculture (54.4 percent from 50.7 percent). Despite the capital-intensive nature of mining, its employment share rose from about 4 percent of total employment since 2010 Q1 to 6.3 percent in the same quarter last year, reflecting a sharp recovery of the mining industry especially in coal (Figure I.10 ).

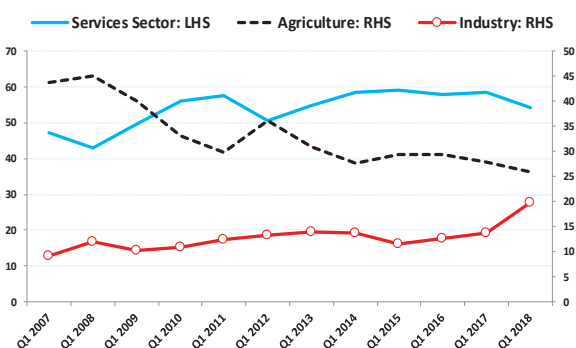
**Figure I.9 After a downward trend, unemployment rate slightly increased in 2018 Q1 reflecting seasonal effects**

Unemployment rate (%)



**Figure I.10 Industrial sector has been driving labor market while shifting away from agriculture**

Percentage share of employment by sectors (%)

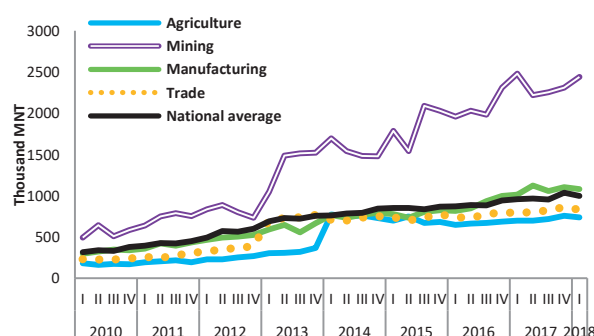


Source: NSO, WB staff estimates

**While the national level of wages has trended upward over the last few years, the average wages in mining activities exceeded significantly that of other sectors.** Following the positive developments in the mining sector in the past few years, this sector is attracting more labor offering higher wages. The average wage growth increased to 10.2 percent in 2017 Q4 from 2.9 percent in 2015 Q4. In 2018 Q1, average wage continued to grow at 4.1 percent (y/y). As discussed above, private consumption recovered strongly in 2017 while inflation pressures continued to build due to a combination of demand and supply-side factors.

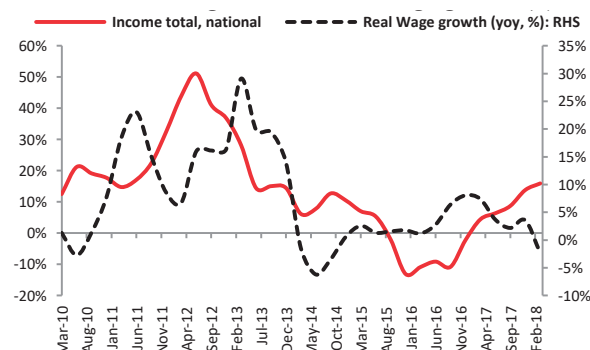
**Figure I.11 Workers in mining sector are paid relatively higher wages...**

Wage level by sector



**Figure I.12 Improved market conditions also raised household income while growing inflation has been eroding real wage growth**

Household income growth and Real wage growth (%)



Source: NSO, WB staff estimates

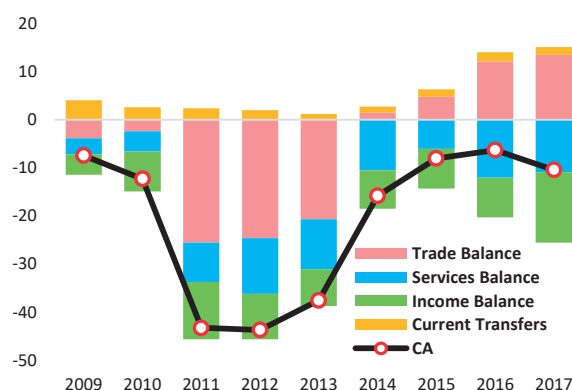
**External sector: After years of declining current account deficits caused by real exchange rate depreciation and slower domestic demand, the current account position started to deteriorate again as profit repatriation from mining companies increased.**

Despite a significant surplus in goods trade, the current account deficit continued to worsen in 2017 as import demand for services escalated, interest payments on external debt increased, and mining companies repatriated profits. The current account deficit, which declined from 43.6 percent of GDP in 2012 to 6 percent in 2016, increased again to 10 percent in 2017 (Figure I.13 ). In fact, the deficit on the services account worsened from 12 percent in 2016 to 16 percent in 2017, overwhelming the goods trade surplus, which marginally improved from 11.5 percent to 12.2 percent. In addition, the primary income deficit worsened by 0.7 percentage points of GDP to 7.5 percent, widening the current account deficit.

**The sharp adjustment of trade in goods since 2012 was mainly due to declining imports of goods caused by weakening FDI inflows and rapid exchange rate adjustments.** Goods imports posted an average decline of 12 percent between 2012 and 2016, while exports grew on average by 5 percent during the same period (Figure I.14 ). The return of FDI in 2017 brought about a recovery in imports, which grew by 26 percent in 2017, while exports grew by 22 percent. The trade surplus (Free-On-Board terms) rose to US\$ 1,490 million in 2017 from US\$ 1,337 million in 2016 and US\$ 562 million in 2015. The income account deficit also significantly increased to US\$ 1,613 million in the same period from US\$ 911 million the previous year, with growing investment income payments on external debt and large profit repatriation of mining companies. The deficit in transportation services also increased compared with a year ago, reflecting the strong external trade and recovering domestic demand.

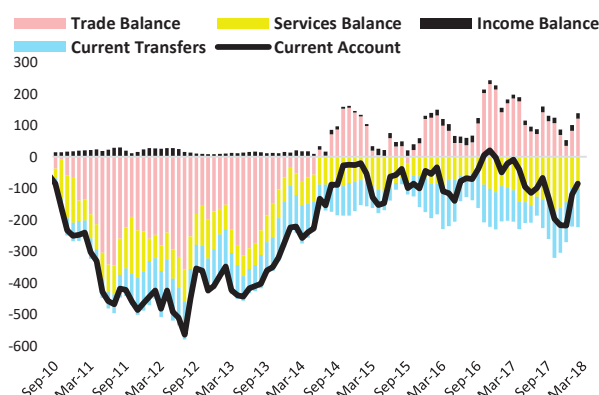
**Figure I.13 Adjustment in the unsustainable current account was done between 2014 and mid-2017**

Current account balance (% of GDP), 2005–17



**Figure I.14 Despite strong export performance, the current account deficit has slightly worsened since mid-2017, mainly due to a rising profit repatriation by mining companies**

Monthly current account balance (US\$ million, 3-month rolling sum)

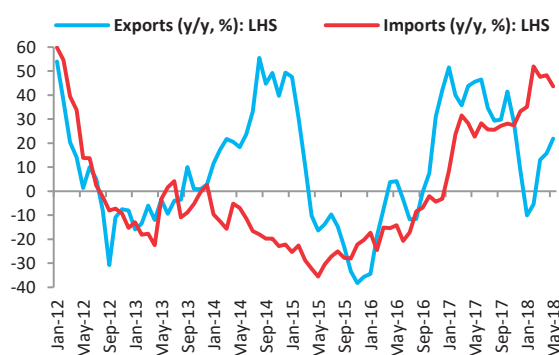


Sources: BoM; World Bank staff estimates.

**A robust growth in exports drove improvements in trade despite a significant imports surge explained by growing oil prices and investment.** Imports increased by 45.5 percent in the first five months of 2018, following a 29.1 percent increase in 2017, amid a continued inflow of FDI and growing real income growth of households. Exports performed very well since late 2016, with higher commodity prices and increased external demand, particularly from China. Total exports grew by 14.6 percent in the first five months of 2018, following a 26.1 percent increase in 2017 on the back of historically high coal exports. Exports slightly weakened in January and February. Terms of trade<sup>4</sup> substantially improved throughout 2017, with sharp rises in commodity prices.

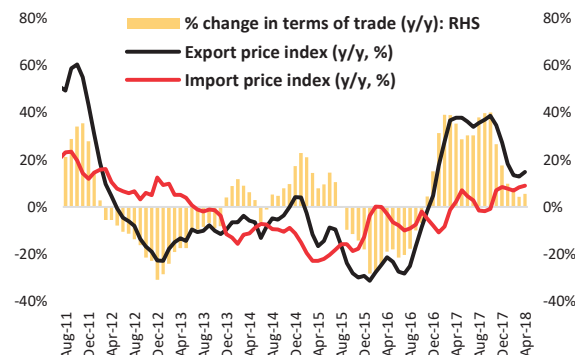
**Figure I.15 Imports have been growing fast with escalation of investment, while exports performance has been robust**

Imports and exports (% y/y)



**Figure I.16 Terms of trade significantly improved in 2017 due to higher commodity prices**

Terms of trade change



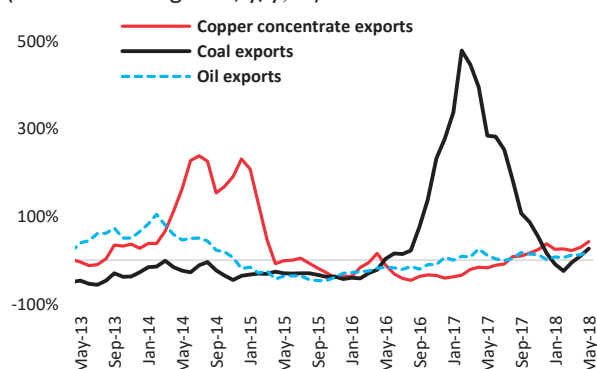
Sources: NSO; BoM; World Bank staff estimates.

<sup>4</sup> 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 fewer imported goods, which would be used for domestic consumption or investment.

**The continued strong performance of coal exports and the recovery of copper exports boosted Mongolia's mineral exports during January–May 2018.** The strong performance of the coal sector (133 percent growth in 2017), which stimulated trade and transport activities, was a key driver of the solid economic recovery in 2017. The volume of coal production and exports rose by about 30 percent (y/y) in 2017. During January–May 2018, the value of coal exports grew more moderately, by 9.8 percent (y/y), from US\$ 1 billion during the same period the previous year. Positive price developments offset a decline (16 percent) in the volume of exports during January–May 2018. In addition to some base effects, the driving factors behind the slowdown in coal exports include ongoing bottlenecks at the border with China and seasonal effects (for example, a harsh winter slightly affected coal production volume, which fell by less than 5.1 percent). After contraction in mid-2016 and late 2017, the growth of exports of copper concentrates rebounded and accelerated to 30.2 percent in May 2018 following a cyclical recovery in gold content in Oyu Tolgoi's copper production. Owing to higher oil prices, crude oil exports grew by 15 percent (y/y) in the first five months of 2018. The export volume of crude oil increased by 15 percent, with a 28.5 percent growth in price, but volume plunged by 10.5 percent compared with the same period the previous year (see Figure I.17 and Figure I.18 ).

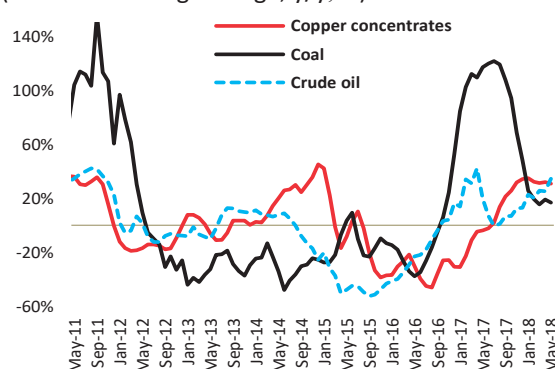
**Figure I.17 Surge in coal exports significantly boosted exports since late 2016...**

Growth in export of key commodities  
(3-month rolling sum; y/y, %)



**Figure I.18 ... supported by rising export prices of key commodities**

Exports price changes  
(3-month moving average; y/y, %)



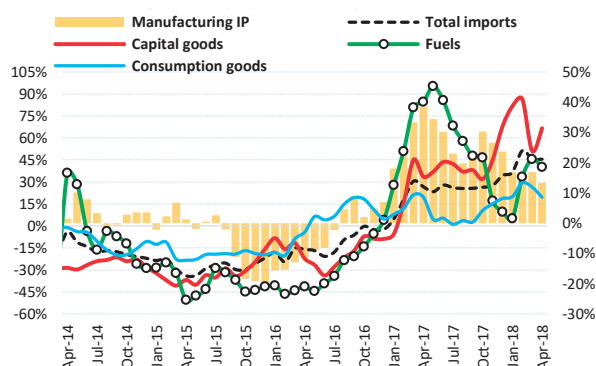
Sources: NSO; World Bank staff estimates.

**Imports of capital and consumer goods increased substantially due to escalation of investment and a solid economic recovery.** After years of adjustment with cooling economic activity, total imports reached US\$ 2.1 billion during January–May 2018, up by 45.5 percent (y/y), led by a large increase in imports of investment goods and oil products, mainly reflecting the ongoing construction phase of the Oyu Tolgoi underground mine. Imports of capital goods have been rising significantly since early 2017 as sharp rises in FDI led to a recovery in investment demand. During January–May 2018, imports of machinery and equipment increased by 42.6 percent, following a 140 percent increase in 2017. At the same time, imports of consumer goods grew by 19.5 percent (y/y), following a 19 percent decline at end-2017. Oil product imports continued to increase sharply (by 40 percent), reflecting higher oil prices.



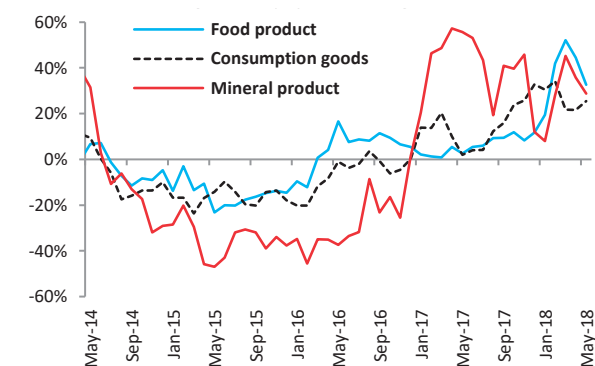
**Figure I.19 Imports of capital goods and fuel have been rising strongly since late 2016 amid large FDI and investment**

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



**Figure I.20 Imports of consumption goods have also been rising since late 2016**

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

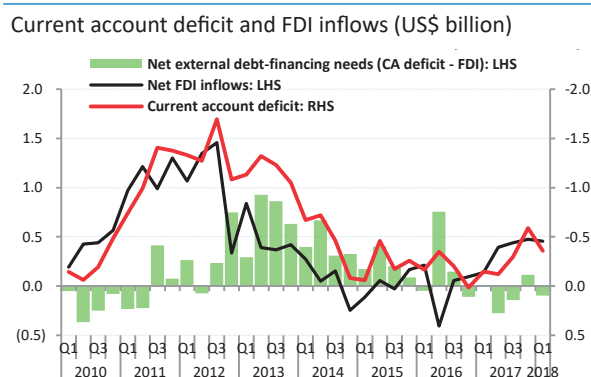


Sources: NSO; World Bank staff estimates.

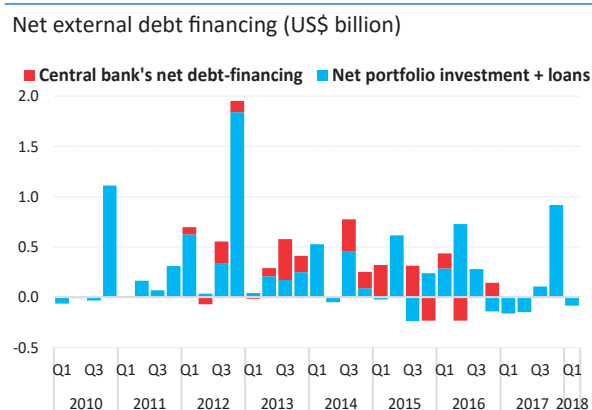
**Balance-of-payment (BoP) pressures were eased thanks to large FDI inflows.** After years of substantial pressures, the overall BoP balance improved in 2017, posting a US\$ 1.4 billion surplus instead of a deficit of US\$ 18.2 million in 2016. This was the result of strong coal exports, a significant increase in net FDI inflows (about US\$ 1.3 billion), and significant donor assistance. Market confidence also improved due to policy changes supported by the country's development partners including the World Bank, IMF, the Asian Development Bank, Japan, China, and the Republic of Korea. Owing to an improved external position, gross international reserves increased from US\$ 1 billion in February 2017 (its lowest level since August 2008) to US\$ 3 billion (about five months of imports) for 2017. For the first four months of 2018, despite an increase in the deficit of investment-related services and income, BoP pressures remained moderate following continued FDI inflows.

**To make large external payments, the government was able to mobilize considerable amounts of external financing.** For many years, the government had implemented expansionary economic policies, which led to high fiscal deficits and rising debt. These policies included a major increase in public investment, supported by large international borrowings. A US\$ 580 million government-guaranteed bond of the Development Bank of Mongolia (DBM) became due in March 2017. Two other large repayments were also due in 2018. Thanks to improved investor confidence, buoyed by the announcement of donor support in February 2017, the US\$ 580 million DBM bond was successfully refinanced through a bond exchange, with new investment of US\$ 600 million with a seven-year maturity at a rate lower than the prevailing market rates. In October 2017, to pay the bonds maturing in 2018, the government issued a new sovereign bond (named the "Gerege" bond) of US\$ 800 million with a 5.5-year maturity and a 5.625 percent rate, which was also lower than the rate that the government was paying on the bonds being rolled over. The US\$ 500 million sovereign bond due in 2018 was successfully repaid on January 5, 2018. With the easing of financing needs, the central bank has not drawn down from the bilateral currency swap facility with the People's Bank of China (PBoC) since late 2016, and the outstanding amount remained at US\$ 1.8 billion (Figure I.21 and Figure I.22 ).

**Figure I.21 Strong recovery in FDI has helped ease pressure on the balance of payments, covering current account financing needs**



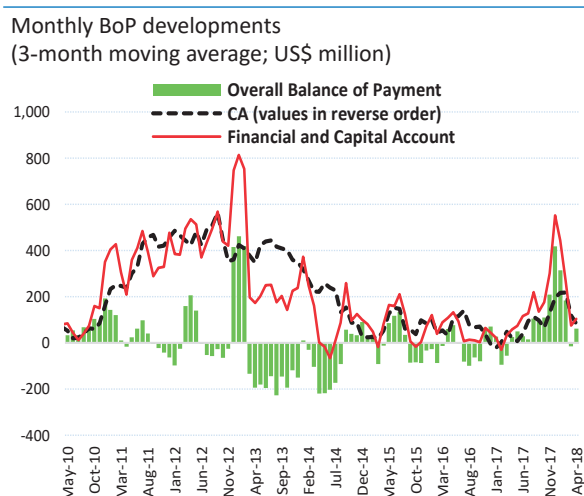
**Figure I.22 More than US\$ 1.4 billion was mobilized in 2017 to reduce the BoP pressure through debt financing**



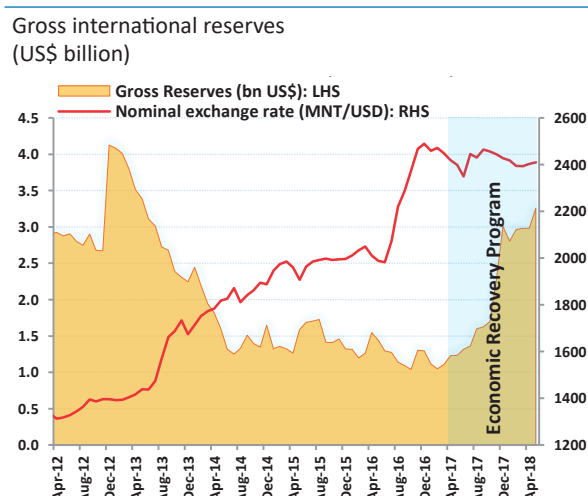
Sources: BoP/External debt statistics (BoM); World Bank staff estimates.

**International reserves improved significantly to reach US\$ 3 billion in 2017.** Foreign exchange reserves had fallen from a peak at US\$ 4.1 billion in December 2012 to a low US\$ 1 billion in February 2017. Since then reserves have increased gradually, supported by a strong recovery of coal exports and FDI inflows. The issuance in October 2017 of the US\$ 800 million Gerge sovereign bond and the purchase of gold by the BoM from individuals and companies (US\$ 700 million in 2017) were also important contributing factors. The overall balance-of-payments deficit was moderate during the first four months (US\$ 47 million) thanks mainly to FDI inflows in the mineral sector (Figure I.23 ). Gross international reserves stood at US\$ 2,963 million (about five months of imports of goods and services; Figure I.24 ) by the end of February 2018.

**Figure I.23 Large FDI inflows in mineral sector and official sector support improved the balance of payments...**



**Figure I.24 ...and resulted in a US\$ 1.7 billion rise in international reserves (15 percent of GDP) in 2017 despite strong import growth**



Sources: BoM (BoP); World Bank staff estimates.



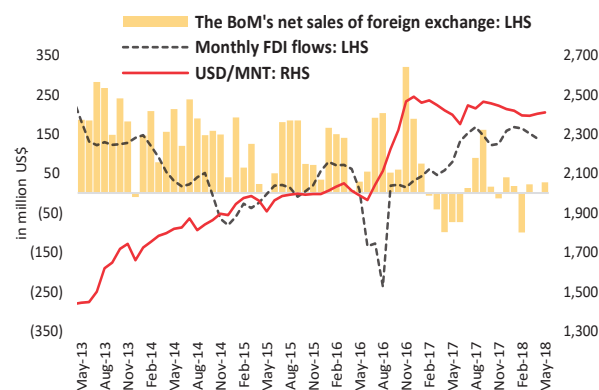
*The country's improved external position and effective policy adjustment eased exchange rate pressures.*

**The Tugrik depreciated against the U.S. dollar by almost 80 percent in nominal terms between March 2013 and January 2017, trading at MNT 2,490:US\$ 1 compared to MNT 1,392:US\$ 1 in 2013.** The depreciation was caused by the deterioration of the external balance following a substantial decline in exports and a sharp fall in FDI. In early 2017, the balance of payments improved, thus easing depreciation pressures on the Tugrik (however, a sharp depreciation of the currency was observed in June and July 2017, during the presidential electoral season). The adjustment of the exchange rate started in February 2017, buoyed by strong coal exports and the February 2017 announcement of the government's economic recovery plan supported by major donors including the IMF and the World Bank. In addition, sovereign bonds maturing in 2018 were refinanced at relatively lower interest rates. In 2017, as the balance of payments recorded a surplus of US\$ 1.4 billion due to strong mineral exports and large FDI inflows, the nominal exchange rate appreciated by 2.5 percent (y/y) against the U.S. dollar. Fearing growing appreciation pressures, the central bank appropriately used the country's improved external position to accumulate reserves rather than encouraging an appreciation of the local currency. Accordingly, the central bank interventions on the foreign exchange market were significantly reduced, with the net sales of foreign exchange dropping to only US\$ 86 million in 2017 from US\$ 1.6 billion on average during 2013–17. Gross international reserves substantially increased to US\$ 3 billion (five months of imports) from US\$ 1 billion (two months of imports).

**The rate of currency depreciation slowed in recent months despite the strengthening of the currencies (against the U.S. dollar) of neighboring and commodity-dependent countries.** The persistent depreciation trend was reversed shortly in April and May 2016, before the parliamentary election, with strong intervention by the BoM. After the two-month appreciation, the Tugrik sharply depreciated by 30 percent to its peak of MNT 2,570 per US\$ 1 in November 2016 from MNT 1,962 per US\$ 1 in late June 2016. This sharp weakening was mainly attributed to early signs of slower intervention by a new administration at the BoM and reduced business confidence triggered among others by an announcement by the new government of a worsened state of the economy. With strong coal exports and early signs of approval of the government's economic recovery plan supported by development partners, the Tugrik has been moderately appreciating since early 2017. Generally, despite a moderate strengthening since early 2017, the Tugrik depreciated by 22.6 percent over the last two years (June 2016 to May 2018). In contrast, most of the currencies in other commodity-dependent countries have appreciated at a moderate rate in recent months (Figure I.25 and Figure I.26 ).

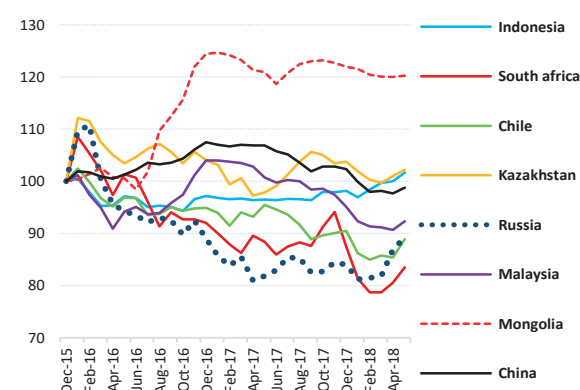
**Figure I.25 The Nominal exchange rate has stabilized since early 2017 after years of depreciation...**

MNT per US\$: May 2016–May 2018  
BoM's net foreign exchange sales in spot foreign exchange auctions (US\$ million)



**Figure I.26 ...while the currencies of most resource-rich countries have broadly strengthened against the U.S. dollar**

Foreign exchange rate per US\$ in resource-rich countries (2015 Dec = 100)



Sources: BoM.

The real effective exchange rate (REER) saw a moderate appreciation with higher inflation. The REER has been on a slower appreciation since the end 2016, with rising inflation. In contrast, the nominal effective exchange rate (NEER)<sup>5</sup> has been moderately weakening, reflecting the weaker performance of the Tugrik relative to other currencies.

**Fiscal policy and debt sustainability: Fiscal performance was strong in 2017 and consolidation has remained on track in 2018 Q1.**

Following the economic slowdown of 2014-16, decisive measures were taken by the government, which began its term in July 2016, to reduce the budget deficit and restore macroeconomic stability. The parliament approved the Economic Recovery Program in November 2016, which combined short-term measures aimed at restoring fiscal sustainability and long-term actions aimed not only at consolidating fiscal reforms but also at diversifying the economy, improving the business environment, and attracting foreign investment for stable growth (Box I.2 ).

<sup>5</sup> The NEER is a weighted average of exchange rates with major trading partners. The REER further adjusts the NEER by accounting for Mongolia's price level relative to those of its trading partners. The NEER and REER are measured as an index and are regarded as a measurement of the external sector's competitiveness compared to the country's trading partners.

## MONGOLIA ECONOMIC UPDATE

### Box I.2 Key fiscal adjustment reforms adopted by the Government of Mongolia in 2017

Table B1.1 presents the key fiscal adjustment measures contained in the supplementary budget for 2017 adopted by the Government of Mongolia.

**Table B1.1 Key fiscal adjustment measures**

Key measures	Importance	Progress to date
Pay-as-you-go (PAYGO)	To restrict Parliament's power to increase the expenditure envelope reflected in the budget presented by the MoF (effective 2018 onward).	Approved under 2017 budget amendment and is currently effective.
Fiscal Council	To improve fiscal discipline in compliance with the FSL through preparing independent budget forecasts and costings of policy proposals from members of parliament, prevent off-budget expenditures.	Established in November 2017 under the parliamentary budget standing committee. Being a body under this parliamentary committee may affect its independence.
Tax reforms	<p><b>Corporate Income Tax (CIT):</b> Tax simplification. Entities with up to MNT 50 million annual sales income to pay 1 percent tax rate out of its taxable income and to submit simplified financial statement once a year. Entities with annual sales income less than MNT 1.5 billion to get 90 percent of their paid taxes refunded.</p> <p><b>Personal Income Tax (PIT):</b></p> <ul style="list-style-type: none"> <li>To introduce a progressive tax rate and yield additional revenues.</li> <li>Mongolia's current flat PIT rate is among the lowest in the world.</li> </ul> <p>Introduce international taxation rules such as General Anti-Avoidance Rule (GAAR), transfer pricing. Mongolia's General Taxation Law (GTL) is currently missing a GAAR provision that is now standard in most countries' tax legislation.</p>	<p>Revised CIT law submitted to Parliament in May 2018, but rejected as concerns were raised on apparent additional benefits to multinational companies operating in Mongolia on top of their existing tax breaks.</p> <p>Progressive PIT became effective January 1, 2018, but was reversed by the government on January 29, 2018, due to political pressure mainly due to abrupt decrease in take-home incomes for high-income earners.</p> <p>Transfer pricing rule, which is defined broadly under the existing GTL, has been spelled out in the revised GTL requiring related business entities to charge one another the same price as unrelated entities on the sale of comparable goods and services.</p>
Pension reforms	Fiscal transfers to the Pension Insurance Fund (PIF) reached 2.2 percent of 2017 GDP and are projected to substantially increase to about 6 percent in 2030, raising concerns over fiscal sustainability of the PIF. This requires a package of pension reforms including raising the retirement age and private contributions.	Parliament raised the pension age in November 2017, but reversed the decision on January 29, 2018, due to social pressure claiming that retirement age extension was unrealistic at best.
Public investment efficiency reforms	Prevent new concessions: no new build-transfer (BT) operations, and transfer payments for ongoing BTs based on audit opinions. Select Public Investment Programs based on Rationalization Guidelines approved by Cabinet.	Approved in November 2017 with annual budget. The preparation of guidelines is underway.

So far, Mongolia's fiscal performance under the Economic Recovery Program has been significant. The primary fiscal accounts markedly improved in 2017, posting a surplus of 2.2 percent of GDP, an enormous improvement compared to a primary deficit of 13.1 percent of GDP in 2016. The strength of

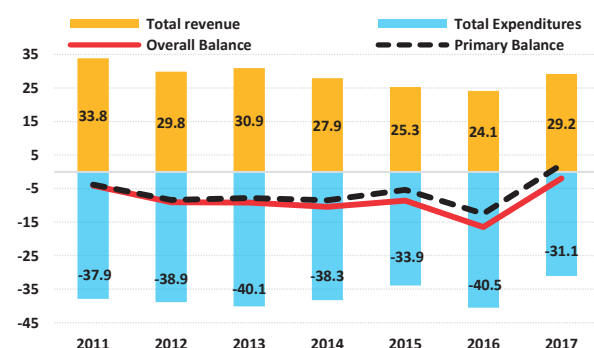
## MONGOLIA ECONOMIC UPDATE

the fiscal accounts is due to the combined effects of fiscal measures implemented under the Economic Recovery Program, a strong domestic economic performance, a strong mining sector, and improved global commodity prices, which generated stronger than planned revenues.

**The overall fiscal deficit declined to 1.9 percent of GDP in 2017, a dramatic improvement over the 17 percent deficit of 2016** (Figure I.27 ). The 2016 deficit resulted from high off-budget spending during the election season channeled through the DBM to bypass the ceiling on structural deficit set by the Fiscal Stability Law. Because of debt accumulation, interest payments more than tripled in the last five years to 4.1 percent of GDP in 2017.

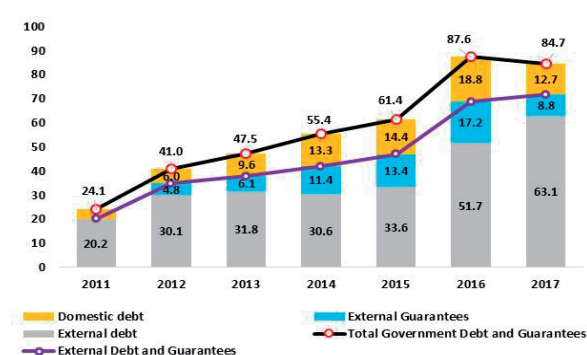
**Figure I.27 Expenditure, revenue, fiscal balance, 2011–17**

(in % of GDP)



**Figure I.28 Public debt and components, 2012–17**

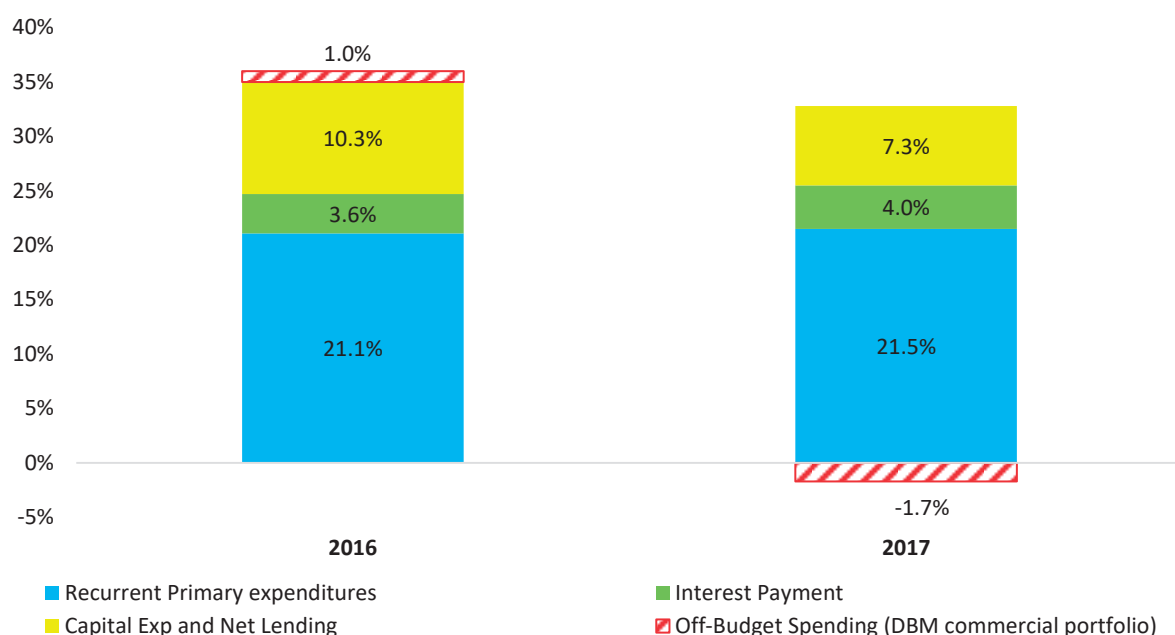
(in % of GDP)



Sources: BoM; International Monetary Fund (2018).

**Improvements in public spending have been considerable (Figure I.29 ).** Total public spending, which reached 40.5 percent of GDP in 2016, contracted to 31 percent in 2017. The bulk of the adjustment came from reduced capital expenditures, contracting from 6.6 percent of GDP to 4.3 percent in 2017. Actual recurrent spending also declined, relative to planned, following the reduction in interest payments and the impact of hiring freeze on the wage bill. The decline in current expenditures came from the reduction of all spending components except interest payments. However, Mongolia's total public spending remains higher than the average of commodity-dependent countries (29.5 percent of GDP).

**Figure I.29 Spending consolidation performance (% of GDP), 2016 and 2017**



Sources: MoF data; World Bank staff estimates.

**Higher than expected revenue was buoyed by royalties from coal exports and related revenue and strong economic activity that lifted import-related taxes.** Total revenue increased from 23.5 percent of GDP in 2016 to 29.2 percent in 2017, higher than initial projections. Mining-related revenue increased from 15 percent of total revenue and 3.3 percent of GDP to 21 percent of revenue and over 6 percent of GDP in 2017. This shows Mongolia's strong dependence on global commodity prices and mineral exports and its vulnerability to global economic conditions. Non-mineral revenue also increased by 24 percent in 2017, mostly due to improved value-added tax (VAT) collection following implementation of a new VAT law, which became effective in 2015, and increased customs duties.

**Increased capital spending, financed by off-budget resources and high domestic and foreign borrowing, led to a sharp increase in public debt, up to 88 percent of GDP in 2016.** The fiscal adjustments approved by the government in 2016 to improve its fiscal credibility are beginning to bear fruit and the public debt decreased slightly to 84.5 percent of GDP in 2017 (Figure I.29 ).

**External government debt and guarantees jumped to US\$ 6.6 billion (69 percent of GDP) in 2016, accounting for over 76 percent of the increase in total government debt.** Total external guarantees reached US\$ 1.6 billion in 2016, due to government guarantees of bonds and loans issued or contracted by public and private entities. The direct external debt of the government amounted to US\$ 4.9 billion in 2016, including US\$ 2.2 billion in sovereign bonds and a US\$ 0.3 billion syndicated loan. Total government direct and guaranteed debt reached US\$ 9.4 billion in 2017, approximately 84 percent of GDP. In net present value terms, total government debt accounted for 74.4 percent of GDP (at current prices) in 2017.

**Planning forward, Mongolia's new Medium-Term Fiscal Framework (MTFF) for 2019–21, recently discussed in the Parliament, projects a stronger growth outlook and a relatively lower public debt.** The government's new MTFF for 2019–21 submitted to the parliament on April 30, 2018, along with the socioeconomic guideline for 2019, indicates that real GDP is projected to grow at 8 percent in

2019 before settling at about 6 percent, on average, in 2020–21. The government argues that this optimistic growth outlook is predicated on an accelerated implementation of mega-projects including those articulated in its recently launched “Three Pillars Development Policy,” as well as the expected positive impact of its tax reforms. Managing key risks, including delays at the border with China, as well as the risk of potential decline in FDI following various disputes with Oyu Tolgoi, will be instrumental in achieving this ambitious objective (Box I.3 ).

## Box I.3 The Medium-Term Fiscal Framework for 2019–21

The Medium-Term Fiscal Framework (MTFF) for 2019–21 (Ministry of Finance, 2018) was approved by the parliament in May 2018 together with the Socio-Economic Guidelines for 2019. The MTFF for the next three years aims at implementing the Government Action Plan for 2016–2020, and to strengthen fiscal stability through further accelerating economic growth, reducing the fiscal deficit and government debt, and tightening fiscal discipline.

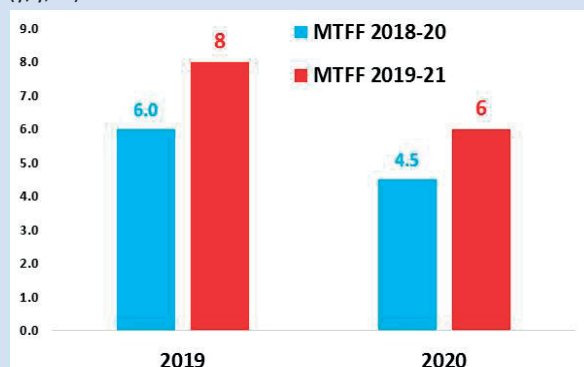
Mongolia’s MTFF for 2019–21 projects a stronger growth outlook and a relatively lower public debt. Real GDP is projected to grow at 8 percent in 2019 before settling at about 6 percent on average in 2020–21. The government argues that this optimistic growth outlook is justified by the successful implementation of its recently launched “Three Pillars Development Policy,” as well as a positive outcome from its proposed tax reform. Despite a stronger growth outlook, the new MTFF assumes that the fiscal deficit for 2019–20 will remain almost unchanged (at 6.2 percent of GDP) compared to the previous MTFF (6.1 percent) resulting from higher spending.

Public debt is also expected to decline faster than initially envisaged in the previous MTFF, as the government’s medium-term debt strategy will focus on rolling out build-and-transfer (BT) projects and other state guarantees, while relying only on long-term, low-cost, concessional borrowing to ease the debt burden. As a result, the net present value of public debt is projected to decline from 74.4 percent in 2017 to 55.3 percent in 2019 before further dropping gradually to about 48 percent in 2020 and 41 percent of GDP in 2021, below the regulatory threshold of 75 percent for 2019, 70 percent for 2020, and 60 percent for 2021.

The economic outlook projected by the government, which seems optimistic, could only materialize if some of the key downside risks are successfully mitigated. These include the delayed implementation of major projects, and the risk of decline in FDI flows if the ongoing probe in the mining sector is mishandled, as well as the bottleneck issues at the border with China.

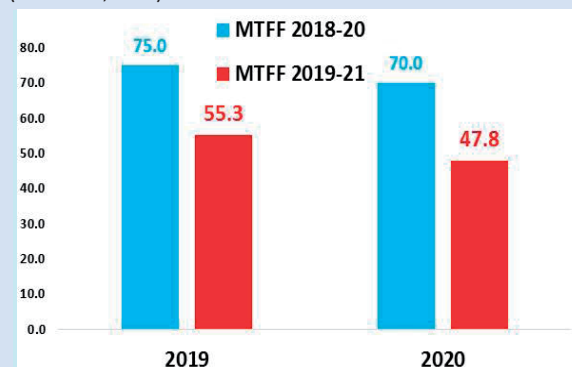
**Figure I.30 MTFF: Growth Profile**

(y/y, %)



**Figure I.31 MTFF: Debt Profile**

(% of GDP, NPV)



Source: Ministry of Finance (2018).

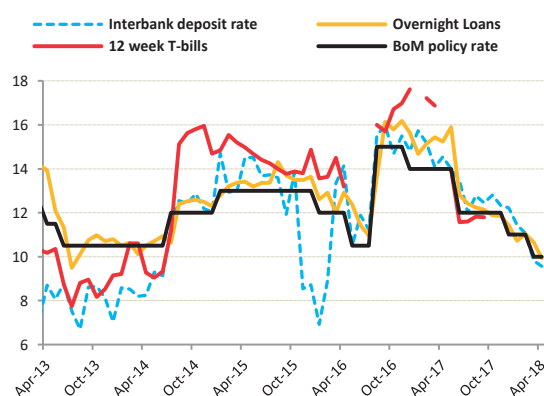
## MONGOLIA ECONOMIC UPDATE

*Monetary and exchange rate policies: Monetary conditions improved owing to the strong performance of the external sector, leading to a rebound of private sector credit growth.*

Although monetary policy has been easing in the last few years, mainly reflecting reduced inflation pressures, it has only slowly translated into lower interest rates. After persistent high interest levels between mid-2014 and late 2016, the interbank market rates have been on the decline, with four cuts in the central bank policy rate from 15 percent in November 2016 to 10 percent in April 2018. During the same period, overnight loan rates declined to less than 10 percent from 16.2 percent (Figure I.32). The government limited its issuance of domestic security, and the one-year government bond yield also sharply fell to 12 percent in October 2017 from 18 percent at its peak in January 2017, largely reflecting increased excess reserves. Bank deposit rates have been posting a gradual reduction since October 2017, amid improving funding conditions and lowered policy rates as well as increased excess reserves. Domestic currency deposit rates—which were stable at around 13 percent on average during most of 2017—slightly declined to 12.8 percent in April 2018. Almost flat deposit rates reflect a strong competition among banks for deposits. Meanwhile, bank lending rates have also been gradually declining since September 2017, as a result of growing excess reserves and lowered policy rates. Weighted average lending rates of new domestic currency loans fell to 19.3 percent in April 2018 from 20.4 percent a year ago (Figure I.33). However, interest channel to lending rates through the interbank market remained limited, possibly due to the fact that (a) substantial loans were issued at fixed subsidized rates under the Price Stabilization Program and the housing mortgage program, and (b) the lending rates of commercial loans seem to have been more affected by deposit rates (a high concentration of depositors in the banking system).

**Figure I.32 Interbank rates have been on the decline since November 2016, in tandem with lower policy rates**

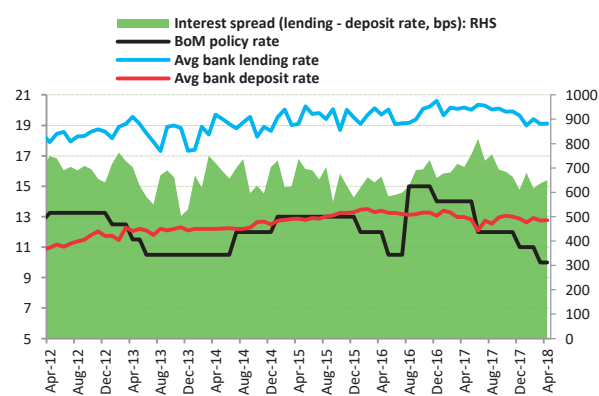
Interbank market rates and BoM policy rate (%)



Source: BoM.

**Figure I.33 Average lending rates and deposit rates have also marginally declined in recent months amid improving funding conditions**

Weighted average lending and deposit rates (domestic currency, %)



Money supply (M2) recovered in 2017, following a slump in 2016 and a protracted period of slowdown since 2014. The recovery gains continued in 2018, with credit growth increasing to 31 percent in April 2018 (compared to minus 6 percent in December 2016). On the asset side, credit to the public sector and net foreign assets switched roles in terms of driving money growth. The main driver during the first quarter of 2018 was the accumulation of net foreign assets posting growth in excess of



20 percent, which reflected limited central bank interventions in the foreign exchange market, strong export revenue, and strong donor support coupled with improved market sentiment (Figure I.34 ).

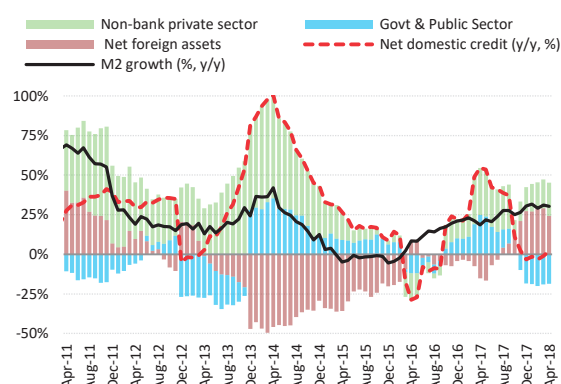
**The growth of net domestic assets was stimulated by the recovery of credit to the private sector, which grew by over 10 percent during the first quarter of 2018, as monetary policy eased and loan demand rebounded.** Private sector credit growth had declined since 2014, reaching negative growth of 2 and 8.4 percent in 2016 before the beginning of a recovery in 2016 H2.

**The growth of credit to the public sector averaged 16 percent in 2017 but declined substantially in the first quarter of 2018.** By April 2018, its growth was - 19 percent, reflecting fiscal consolidation measures that stopped the issuance of new treasury bonds and off-budget spending through BOM and DBM credit to the government and the public sector.

**On the liability side, money was mainly driven by strong growth in local currency deposits, which averaged over 40 percent in the last quarter of 2017 and the first quarter of 2018.** The growth of local currency deposits was strong in 2017, averaging 28 percent, compared to only 6.6 percent in 2016. Growth in foreign currency deposits, although on a recovery path, remained weak (Figure I.35 ).

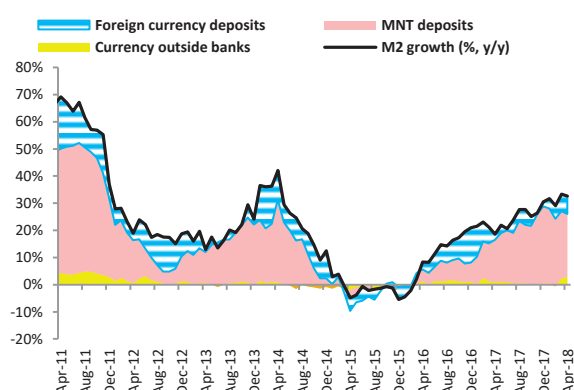
**Figure I.34 M2 growth has been strong, with rising net foreign assets and credit to the private sector**

M2 growth decomposition by assets (y/y, %), April 2011–April 2018



**Figure I.35 Strong money supply growth has mainly been driven by a rise in local currency deposits**

M2 growth decomposition by liabilities (y/y, %), April 2011–April 2018



Sources: BoM; World Bank staff estimates.

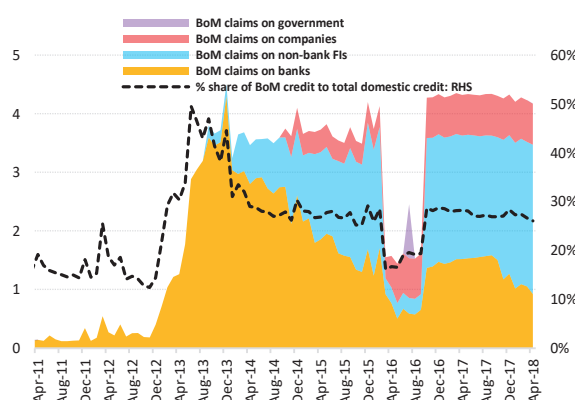
**The phasing out of the Price Stabilization Program and the reduction of subsidies to the housing mortgage program have slowed the expansion of the central bank's balance sheet, though its domestic assets remain substantial.** The domestic assets of the central bank declined moderately to MNT 4.6 trillion in April 2018, from MNT 5 trillion peak at end-2016 (Figure I.36). The central bank gradually tapered off some of its quasi-fiscal activities under the Economic Recovery Program. Injection of liquidity through the Price Stabilization Program has been almost fully phased out, with the outstanding amount declining to MNT 1.6 billion in April 2018 compared to MNT 2.8 trillion by end-2013. The Economic Recovery Program also limited BoM and government financing of the subsidized housing mortgage program. BoM's claims on the housing mortgage program, which peaked at MNT 3.7 trillion in October 2017, declined to MNT 3.1 trillion in April 2018, of which MNT 2.6 billion in securitized



mortgage loans (residential mortgage-backed securities) transferred from commercial banks to BoM's balance sheet. The BoM, which also provided MNT 700 billion in liquidity support via banks to the corporate sector since the end of 2014, expects to be repaid starting in 2019. Despite the slow growth of housing mortgage loans, the outstanding amount of policy loans provided by the BoM remains substantial, with the one-off corporate sector financial support reaching over MNT 4.6 trillion in April 2018, or 26 percent of total domestic credit of the economy (Figure I.37 ).

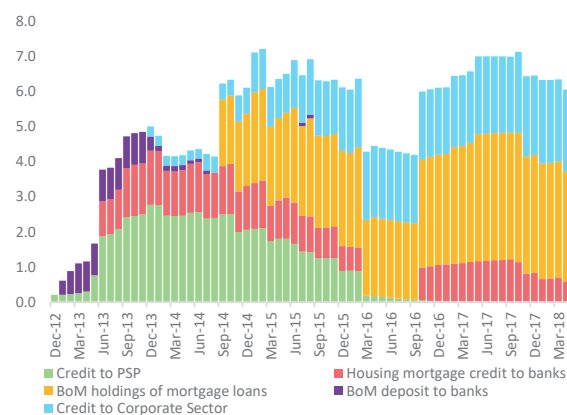
**Figure I.36 Expanded BoM's balance sheet has been slowing since October 2017, mainly due to the limited subsidy to the housing mortgage program**

BoM domestic asset (MNT trillion)



**Figure I.37 BoM's policy credit has been declining with the phase-out of Price Stabilization Program and mortgage loans, but remains high**

Outstanding BoM credit to policy loans (MNT trillion)

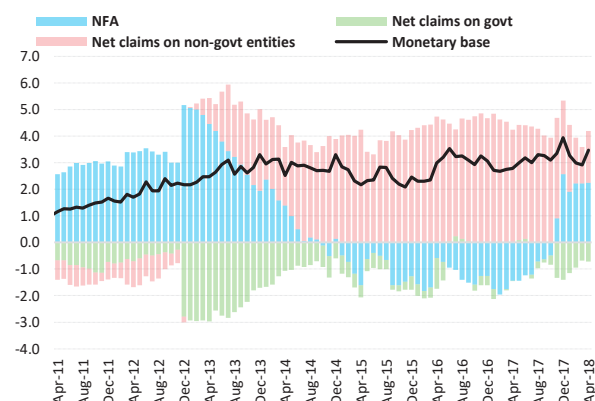


Sources: BoM; World Bank staff estimates.

**The changing composition of reserve money (or monetary base) illustrates the effects of monetary and fiscal policies since the end of 2016.** After years of persistent decline, BoM's net foreign assets recovered remarkably since November 2017, boosting official international reserves to US\$ 3 billion due to BoM's increased gold purchases, donor support, and stronger capital inflows. Limited foreign exchange market interventions by the central bank supported the expansion of the monetary base by absorbing less local currency liquidity from the banking system. The central bank claims on nongovernment entities (the financial and the corporate sectors) reflect the impact on reserve money supply of phasing out BoM's quasi-fiscal activities. After a rapid rise in 2013–14, the monetary base impact of quasi-fiscal activities steadily declined and was eventually phased out. Another important factor behind changes in the reserve money supply since early 2017 was the reduction of DBM's off-budget expenditures. In November 2017, US\$ 400 million from the "Gerege" bond and financial support from donors were placed (as Tugrik deposits) at the central bank. This led to a large increase in BoM's net foreign assets and government deposits (that is, a sharp drop in net claims on the government in November 2017). The drop in net claims on the government is also partly explained by the government's new policy on treasury single account since October 2017. The combination of reducing the central bank's quasi-fiscal programs and tight control on public spending decelerated reserve money growth in 2017 (Figure I.38 and Figure I.39 ).

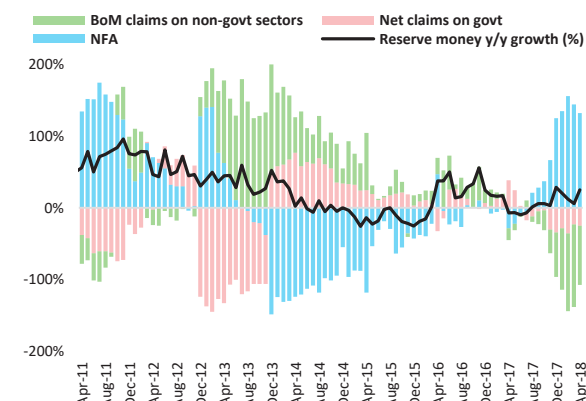
**Figure I.38 Reserve accumulation and phase-out of policy loans have contributed significantly to strengthening of reserve money supply since the beginning of 2017**

Money decomposition – assets side (MNT trillion)



**Figure I.39 Fast-rising net foreign assets have been contributing to reserve money growth since mid-2017 despite fiscal tightening and phase-out of policy loans by the BoM**

Money growth decomposition – assets (y/y, %)



Sources: BoM; World Bank staff estimates.

## Box I.4 Monetary Policy and Financial Sector Guideline for 2018–20

The new Monetary Policy and Financial Sector Guideline for 2018 (Bank of Mongolia (2017)) was approved by the Parliament on November 16, 2017, and includes the following measures.

### Monetary policy

- To limit inflation to 8 percent during 2018–20
- To implement macroprudential policies consistent with monetary policies to avoid accumulation of risks in the financial sector
- To strengthen communication channels on monetary policies to improve implementation and effectiveness of monetary policies and enhance transparency
- To maintain a flexible exchange rate in line with macroeconomic fundamentals to support domestic production, exports, and overall competitiveness of the economy.

#### a. Banking supervision

- To implement bank recapitalization and other measures aimed at improving the financial capability and risk absorption capacity of the banks, promoting financial inclusion and strengthening financial stability
- To develop a better risk-based supervision framework.

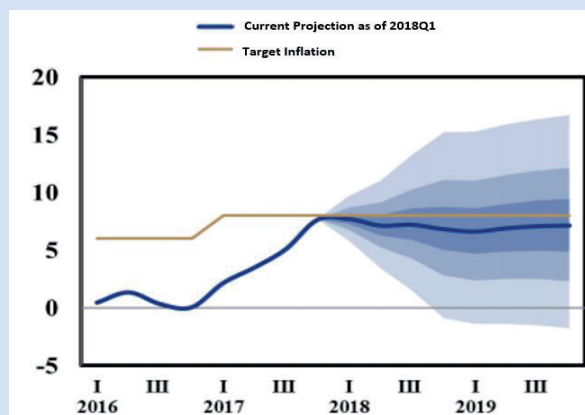
#### b. Development of financial infrastructure and institutions

- To efficiently implement newly approved and amended laws and regulations
- To improve the payment and settlement system and create a consolidated management of payment instruments
- To prepare the legal framework of an asset management institution for the management of growing non-performing loans
- To improve the financial literacy of the public in support of international financial institutions and the private sector.

The recent BoM inflation report (Bank of Mongolia (2018)) stated that despite a solid economic recovery, inflation will remain under the agreed target in 2018–19, with waning high base effects due to increased taxes in 2017 and some one-off factors including changes in the Consumer Price Index basket. It also noted that 2018 growth will exceed 5.1 percent in 2017, with large FDI inflows and strong credit growth and cyclical recovery in Oyu Tolgoi's copper production.

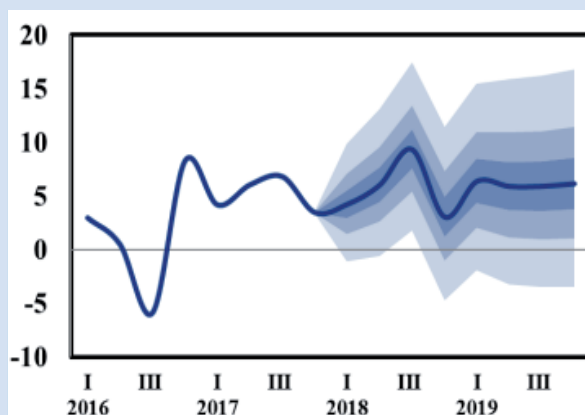
**Figure I.40 BoM projection on inflation**

Annual headline inflation (y/y, %)



**Figure I.41 BoM projection on economic growth**

Quarterly real GDP growth (y/y, %)



Sources: Summarized by World Bank staff based on Bank of Mongolia (2017; 2018).

## Box I.5 Goals of the amendment to the central bank law

The amendment to the central bank law was approved on January 12, 2018, by the parliament with 69.1 percent of the vote. The goal of the amendment is to improve the legal status of the central bank (Bank of Mongolia), strengthen its independence, improve its decision-making process in line with international best practices and principles of central banks of other countries, and stop its quasi-fiscal activities. The amendment to the central bank law and other related laws became effective on April 1, 2018. It is in line with the economic recovery plan (Parliament Decree № 71 in 2017), the recommendations of the economic standing committee's assessment of central bank operations (Parliament Decree № 43 in 2017), and the ongoing IMF Extended Fund Facility program. The key features of the amendment:

- Limit budgetary operations (mainly quasi-fiscal operations implemented during 2013–16), which are not related to the monetary policy objectives
- Clarify financial transactions and other relations between the central bank and the government
- Improve the decision-making process through legalizing the following committees:
  - o The monetary policy committee, which is composed of seven members—the governor, the two deputy governors, and four external members appointed by the parliament for six years
  - o The supervision committee, with a view to increasing transparency and accountability in decisions related to supervision policy
- Authorize the central bank to implement macroprudential policy
- Strengthen the supervision framework for bank operations
- Improve the legal framework for central bank loans to banks.

The law is expected to contribute to sustainable economic growth and to price and financial stability by strengthening the legal framework, the independence of the central bank, and sound implementation of monetary policy.

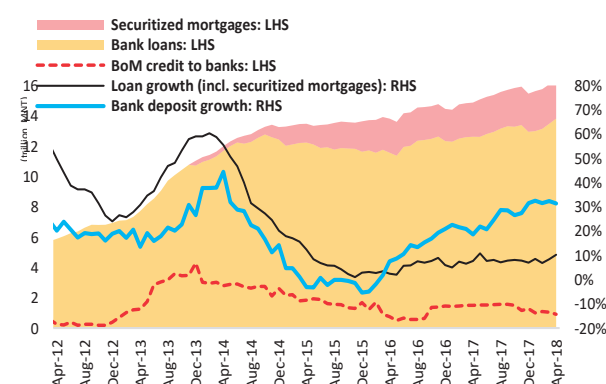
Sources: BoM; legalinfo

*The banking sector funding conditions have been easing, but deterioration of asset quality has remained substantial.*

The growth of outstanding bank loans (y/y) accelerated to 16.5 percent<sup>6</sup> in April 2018 from 5.8 percent in 2016 despite a context characterized by high lending rates and uncertainty surrounding the findings of the Asset Quality Review. Bank loan growth has rapidly recovered since mid-2016 and accelerated further throughout 2017, mainly driven by individual loans (non-mortgage individual loans), reaching 20 percent (y/y) in April 2018. Corporate loans saw a strong recovery in the second half of 2016, but growth moderated in 2017. In 2012–13, bank loans almost doubled, largely driven by a substantial BoM credit to banks (Figure I.42 ). After years of sharp increases, loan growth has significantly declined with the deterioration of economic activity and an inevitable gradual tapering of quasi-fiscal activities by the BoM (Figure I.43 ). As the funding conditions of banks began to improve since the beginning of 2016, bank loan growth started to rise steeply, but mainly in individual loans amid high levels of non-performing loans in the corporate sector.

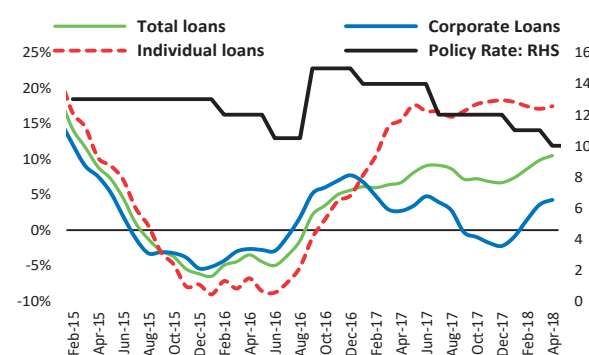
**Figure I.42 Bank loans had steeply declined in 2014–15 with weak loan demand and phasing out of policy loans by the BoM**

Growth of outstanding loans (y/y, %), April 2012–April 2018



**Figure I.43 Bank loans growth has been accelerating since late 2016 mainly driven by individual loans**

Growth of outstanding loans (y/y, %), 2015–18



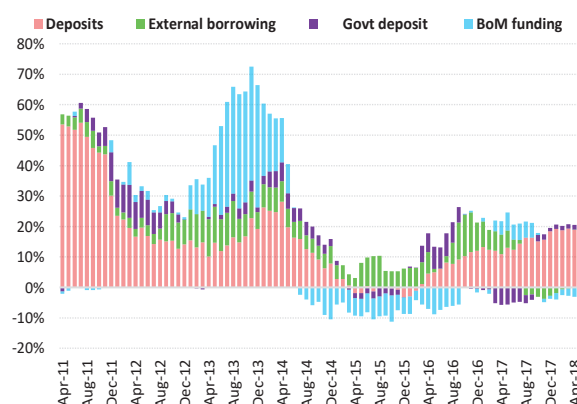
Sources: BoM; World Bank staff estimates

**Funding conditions of banks have been improving.** After a rapid increase in funding in 2013 and early 2014, with massive central bank funding and strong deposit growth, it substantially weakened in 2014 and early 2016, particularly in local currency deposits, straining banking system liquidity. This sharp weakening in funding conditions was mainly attributed to a deterioration of economic activity and a fast increase in non-performing loans (NPLs) and tapering of policy loans by the BoM. At the same time, the growth of foreign currency deposits—which account for 30 percent of total deposits—had been robust both in U.S. dollar and local currency values. However, domestic currency deposits have been increasing considerably since early 2017, with a high deposit rate and growing loan demands amid a sharp recovery of economic activity. This increased liquidity has so far been mostly absorbed by increasing excess reserves, with only limited impacts on bank loan growth in the corporate sector due to high level of NPLs.

<sup>6</sup> Our definition of outstanding loans includes mortgage loans that have been securitized by the Mongolia Mortgage Corporation since 2013. Ninety percent of the securitized mortgage loans (residential mortgage-backed securities) were transferred to BoM's balance sheet from commercial banks and are now excluded from commercial banks' balance sheets.

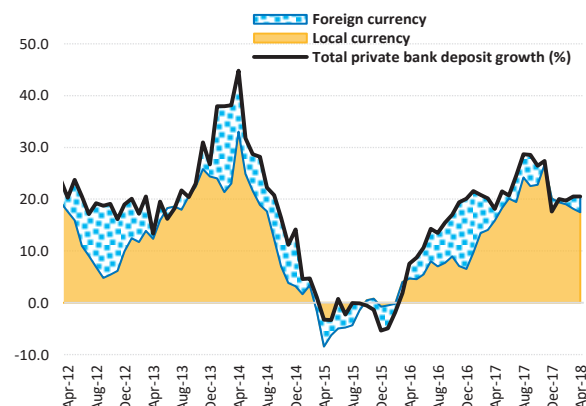
**Figure I.44 Funding conditions for banks are relaxing with accelerating local currency deposit growth despite declining BoM funding**

Growth components of commercial bank funding sources (y/y, %)



**Figure I.45 Accelerating deposit growth is mostly driven by a surge in local currency deposits**

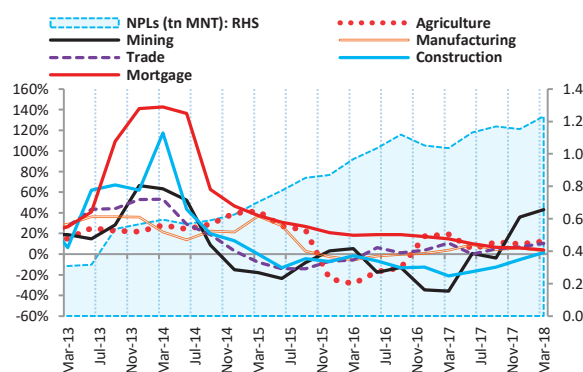
Growth of outstanding loans by currencies (y/y, %)



Sources: BoM; World Bank staff estimates.

**Figure I.48 Credit conditions are still tighter in most sectors except the mining sector, which posted a strong recovery in loans**

Bank loan growth by sectors (y/y, %)



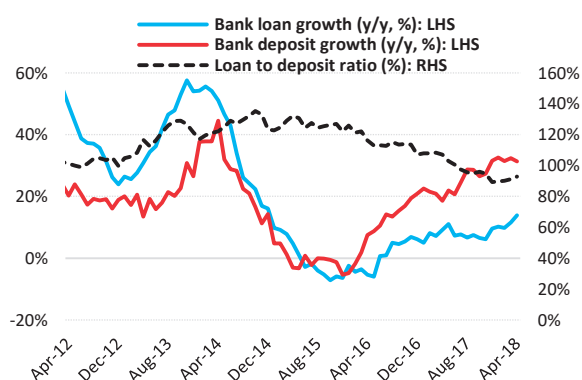
Sources: BoM; World Bank staff estimates.

The loan-to-deposit (LTD) ratio has been declining since mid-2015, with deposit growth exceeding loan growth. The 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 in late 2014 due to large increases in policy loans funded by the central bank. The LTD ratio has been gradually declining with the withdrawal of policy loans and slower loan growth, reaching 95 percent in April 2018 amidst higher deposit growth. Total deposits of banks excluding government deposits reached MNT 15.6 trillion in April 2018, while the total outstanding loans of banks (except for residential mortgage-backed securities) was MNT 15.1 trillion.

**Reserve buffers of the banking system have increased significantly mainly with no issuance of T-bills since October 2017.** Bank reserves excluding central bank bills stood at 16.6 percent of total deposits in April 2018, well above the 12 percent reserve requirement ratio. However, bank excess reserves have been on a sharply rising trend since October 2017, leading to higher demand of government bonds with the interest rates of one-year government bonds declining to 11.6 percent, down from 17.6 percent at end-2016. To reduce interest payments, the government has stopped issuing domestic T-bills in favor of concessional financial support from development partners, including the IMF and World Bank. As of April 2018, outstanding T-bill amounts declined to MNT 1.9 trillion from MNT 3.6 trillion at its peak in July 2017. In the meantime, bank holdings of central bills reached its peak of MNT 4.4 trillion compared to MNT 1.5 trillion in July 2017. Substantial excess reserve was also partly reflected in high level of NPLs.

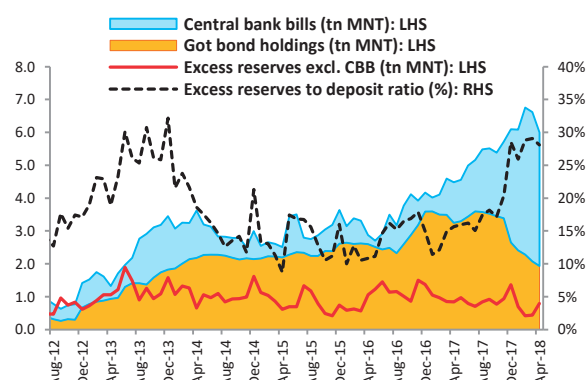
**Figure I.46 The loan-to-deposit ratio has been declining since late 2016, with fast-growing deposit**

Loan to deposit ratio (%) excluding government deposits



**Figure I.47 Excess liquidity conditions are reflected in a surge in Central Bank Bill (CBB) holdings by banks**

Bank liquid asset composition (MNT trillion): 2010–15



Sources: BoM; World Bank staff estimates.

**Despite the strong economic recovery, credit growth remains moderate in most sectors except mining due to high level of NPLs.** Following an economic contraction during 2014–16, credit conditions substantially deteriorated in riskier sectors (for example, mining, construction, and wholesale and retail). Credit growth, however, has recovered moderately since mid-2017, largely driven by the mining sector. Credit growth in the mining sector has significantly improved since March 2017, reflecting recent strong developments in the mining industry. Meanwhile, trade and services sectors loan growth has been recovering quickly. However, credit growth in the construction industry has still been affected by a large inventory in the real estate sector, and weak and cooling mortgage lending. In contrast, loans to the agriculture (mainly to herders) and manufacturing sectors has increased.

**Banks have increasingly shifted their loan portfolio away from the private sector, undermining growth prospects.** After a large correction in 2015–16, outstanding bank loans increased by 17.8 percent in May 2018 from 5.3 percent in December 2016, largely due to a substantial increase in credit to households (20 percent in April 2018 from a 12 percent contraction at end-2015). Household loans represent almost 50 percent of total loans in Mongolia, and its stock has risen to nearly 27 percent of the 2017 GDP from 21 percent in 2015. Initially, household loans were largely driven by the expansionary housing mortgage program managed by the central bank in 2013–14, which was substantially scaled down in 2015–16 because of economic difficulties Mongolia faced after 2014. This loan category has recently picked up substantially, largely driven by salary and consumer loans. Following the rise in the average loan to households, the average household debt-to-income ratio (including residential mortgage-backed securities) reached 80 percent in the first quarter of 2017, up from 40 percent in 2012. Meanwhile, corporate loan growth has been recovering but remained weak, posting a 4.5 percent increase in March 2018 from 9.2 percent in November 2016, despite a stronger than expected economic recovery. To support private sector activity, the central bank has reduced its policy rate by 500 basis points since November 2016, and the government has limited its issuance of domestic T-bills since November 2017. On June 15, 2018, the Bank of Mongolia set a debt-to-income limit at 70 percent in response to fast-growing individual loans (see Box I.6).



## Box I.6 Household loans and debt

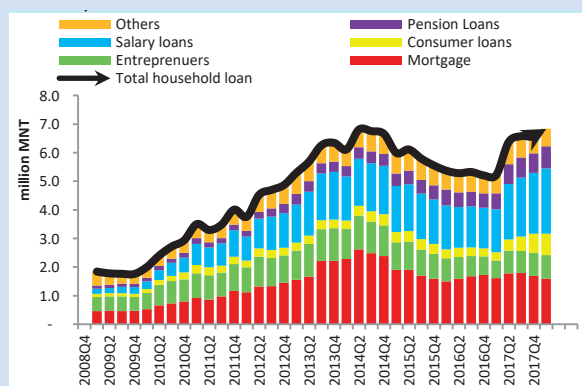
To improve banks' quality of assets, the Bank of Mongolia (BoM), Mongolia's central bank, introduced an important macroprudential policy by setting a limit on the debt-to-income ratio. Following the meeting of the Monetary Policy Committee on June 15, 2018, the BoM decided to keep its policy rate unchanged at 10 percent. Moreover, the BoM introduced a ceiling on the debt-to-income ratio for consumer loans at 70 percent to curb individual loans, which have grown substantially over the last few months. The BoM indicated that the nationwide inflation rate remained moderate at 6.1 percent (y/y) in May 2018 and expected to remain under its 8 percent target in the medium term, despite continued demand-side pressures from a stronger economic recovery.

Moreover, they argued that household debt gradually increased in earlier years but has been rising quickly in recent months. Average household debt at end-2018 Q1 is estimated at MNT 10.7 million. Total bank loans to individuals including residential mortgage-backed securities have significantly increased, especially driven by the subsidized housing mortgage program of the BoM and large increases in overdraft (salary) and consumer pension loans. Using individual loans as an indicative measure for household financial liability, recent data indicated that individual loans grew more than three-fold over the last six years from MNT 3 trillion in 2012. During the same period, mortgage loans quintupled mainly due to the subsidized housing mortgage program. In May 2018, outstanding mortgage loans accounted for 50 percent of total loans to individuals, a significant increase from 30 percent in 2012. Meanwhile, overdraft (salary) and pension loans represented over 40 percent of total individual loans, at MNT 3.1 trillion in 2018 Q1 compared to MNT 968 billion at end-2012.

Following the rise in the average loan to households, the average household debt-to-income ratio reached around 80 percent in 2018 Q1, up from 39 percent in 2012. The household debt-to-GDP ratio also rose to 35 percent from 18.4 percent over the same period (Figure I.49 and Figure I.50 ). The BoM decision on the policy rate and Debt to Income Ratio is welcome amid a continued economic recovery and rising debt burden. The sharp increase in household loans seems to reflect Mongolia's economic difficulties in 2014 and beyond, which increased the poverty headcount ratio by 9 percentage points between 2014 and 2016. The gradual rise in household income, especially non-mineral income, in recent quarters has been eroded by a sharp increase in household debt, and therefore could weaken household consumption and accumulate risk in the financial sector and hurt growth. Data on the debt-service-to-income ratio are not available but are likely to be increasing, as well.

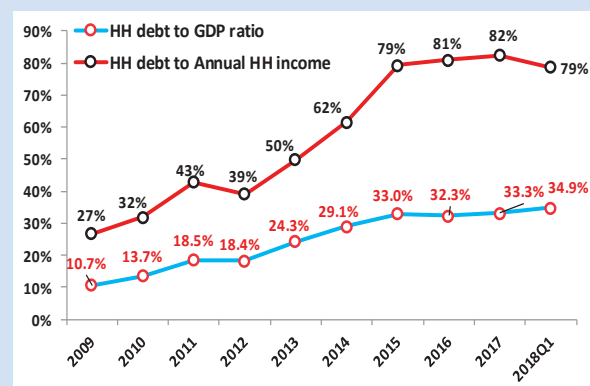
**Figure I.49 Individual credit growth has been a key driver of total credit growth**

Average individual bank loan per borrower (MNT million)



**Figure I.50 Household debt ratios to GDP and income have increased substantially**

Household debt (in % of GDP, % of annual household income)



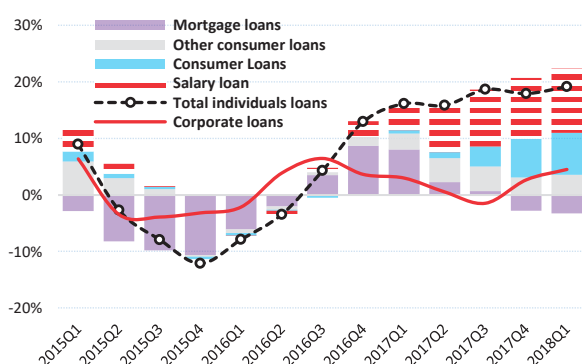
Sources: BoM; World Bank staff estimates.

**Mortgage loan growth has been cooling with limited state (BoM and government) funding to the subsidized housing mortgage program.** Total outstanding mortgage loans slowed to 3.5 percent in April 2018 compared to 13.3 percent a year ago and 5.8 percent at end-2017. This deceleration was mainly caused by a substantial decline in state funding to the subsidized housing mortgage program as part of the economic recovery program. The housing mortgage program has been run as a revolving fund since early 2017, using only principal repayments and interest inflows for additional loans. However, the subsidized housing mortgage program remained a key driver for total mortgage credit growth since mid-2013. Mortgage loans that were originated under the housing mortgage program reached MNT 3.2 trillion in April 2018, accounting for 77 percent of total mortgage loans. Meanwhile, MNT 2,580 billion of housing mortgage loans were securitized into residential mortgage-backed securities via the Mongolia Ipotek Corporation, and the BoM purchased 90 percent of the residential mortgage-backed securities (Figure I.52 ).

**Authorities are restructuring the design of the housing mortgage program, which will be transferred from the BoM to the government.** The current program design involves features that make it unsustainable, distortive, and fiscally inefficient, including the loose criteria for eligible borrowers and properties to be mortgaged, and unduly complicated mechanisms using underdeveloped asset-backed instruments. In this regard, the government and the BoM are currently improving the design of the housing mortgage program and plan to transfer the mortgage asset of the BoM to the government, which is expected to be completed by September 2018.

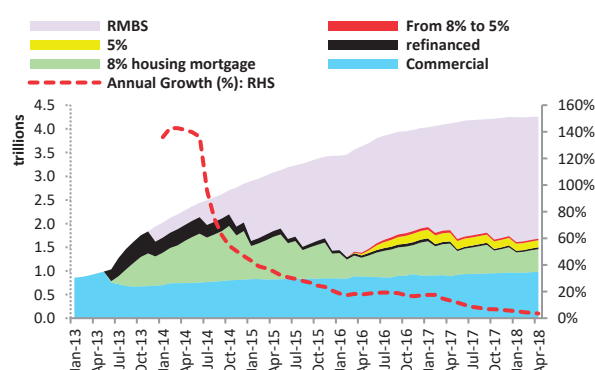
**Figure I.51 Individual credit growth has been a key driver of total credit growth, while corporate loans have seen moderate growth**

Individual bank loan growth (y/y, %)



**Figure I.52 Mortgage loan growth has slowed, driven by the limited subsidy of the BoM to the housing mortgage program**

Outstanding mortgage loans (MNT trillion)

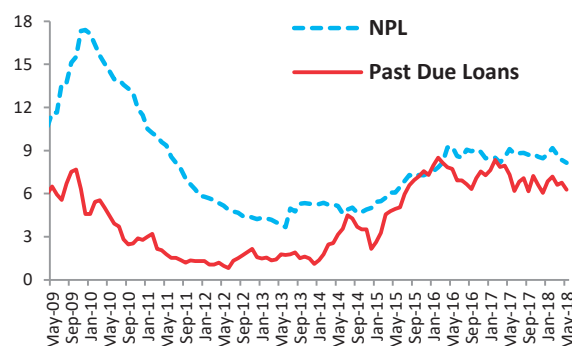


Sources: BoM; World Bank staff estimates.

**Deterioration of bank asset quality has slowed somewhat.** After years of deterioration, the fast-rising non-performing loans (NPLs) of banks have stabilized since early 2017, with the strong economic recovery. The NPL ratio was 5 percent at the end of 2014 and jumped to 8.5 percent at end-2017 (Figure I.53). Private sector problematic loans were a key driver of substantial deterioration of total loan quality. NPLs rose by 4.7 percent in the first four months of 2018, reaching MNT 1.2 trillion in April. The ratio of NPLs to total outstanding loans was relatively flat in 2017, averaging around 8.6 percent, with rising credit growth. Past-due loans—which are overdue for less than 90 days—more than doubled in the first nine months, reaching MNT 978 billion in April 2018 from MNT 823 billion at the end of 2017. The loan share of past-due loans reached 6.8 percent in April, slightly up from 6.2 percent at end-2017.

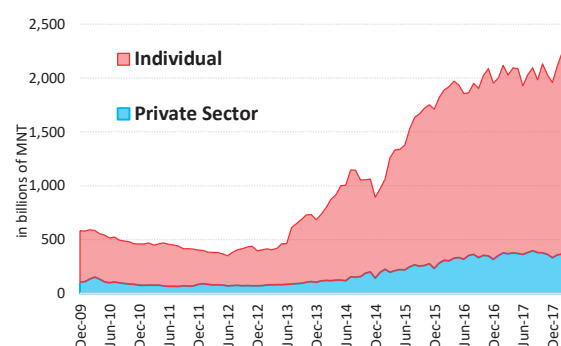
**Figure I.53 The loan quality ratio has stabilized with the strong economic recovery and speedy credit growth ...**

NPLs and past-due loans as percent of outstanding loans (%)



**Figure I.54 ... while deterioration of loan quality has mainly been driven by loans to the private sector**

Problematic loans = NPLs + past-due loans (MNT billion)



Sources: BoM Bulletin; World Bank staff estimates.

Note: NPLs and past-due loans include liquidated banks.

**In response to deteriorating asset quality, several measures were taken to improve the resilience of the banking system.** Since 2014, the central bank has introduced several measures to strengthen prudential regulations. Some of these measures include (a) imposing higher risk weights (120 percent) on foreign currency loans to unhedged borrowers, and (b) raising the general provisioning ratio of normal loans to 1 percent from zero. In April 2015, the BoM raised the minimum paid-in capital requirement for banks from MNT 16 billion to MNT 50 billion, which went into effect from 2016 for systemically important banks and from 2018 for small banks. As the government and the central bank has started to implement the economic reform plan since May 2017 with the support of donors, Asset Quality Review has been done by an independent consultancy firm (PricewaterhouseCoopers), which covered 91 percent of corporate loans of the banking system and identified a capital shortfall of 2 percent of GDP (MNT 543 billion). A deadline of nine months was granted by the BoM to ailing banks to recapitalize, and this exercise is expected to conclude by end-2018 (see Box I.7). The authorities are currently working on improving the legal and regulatory framework for NPL resolution.

## Box I.7 Mongolian banks Asset Quality Review and results

**In February 2018, the Bank of Mongolia, the country's central bank, published the results of the Asset Quality Review (AQR) in the context of the country's economic recovery program supported by many development partners.** This exercise, performed by PricewaterhouseCoopers in cooperation with national supervisors, reviewed the balance sheets of 14 commercial banks, of which one was state owned. Over six months, 230 professionals worked on the AQR using a methodology based on the European Central Bank's AQR manual adapted to the Mongolian context. This assessment included a review of the quality of banking sector assets and a forward-looking stress test to determine, among other things, eventual recapitalization needs of the individual banks. A key feature of this AQR compared to other AQRs is the risk management assessment of banks, particularly banks that use mining licenses as loan collateral.

**The AQR covered banks' loans, receivables, guarantees, other credit-equivalent guarantees, letters of credit, other off-balance-sheet assets, and third-level assets.** The consulting company executed the following evaluation steps:

1. Processes, policies, and accounting review
2. Review of credit risk management framework
3. Loan data integrity validation
4. Sampling
5. Credit review
6. Collateral and real estate valuation
7. Distribution of sampling results
8. Collective provision analysis
9. Level 3 fair value exposure review
10. Configuration on required capital.

**The AQR assessment of the soundness of bank balance sheets reveals that the Mongolian banking sector is in relatively good shape.** As mentioned, the AQR, which covered 91 percent of corporate loans of the banking system, identified a capital shortfall of 2 percent of GDP (MNT 543 billion), which represents about 6.9 percent of budget revenue and 3.5 percent of total deposits in the banking system. The BoM gave ailing banks 9 months to recapitalize, and this exercise is expected to conclude by end-2018. The banking system remains resilient and capable of recapitalizing, as evidenced by bank capital adequacy and liquidity ratios, estimated at 17.1 percent and 44.6 percent, respectively, in March 2018.

In the meantime, the Bank Recapitalization Law was approved by the parliament in June 2018. The approved law aims at improving the legal and regulatory framework for bank resolution mechanisms and, ultimately, for strengthening financial stability. It would do that by improving the legal framework for how government bailouts can be implemented to support systemic banks in the event of a capital shortfall. The recapitalization law addresses issues such as financial stability, governance of the public recapitalization process, burden sharing, restructuring, strict oversight, and exit scenarios.

The AQR results were less alarming than anticipated. However, banks have increasingly shifted their loans portfolio away from the private sector, which is concerning as it could undermine the financial sector stability. Thus, recent macroprudential measures undertaken by the monetary authorities including raising the debt service to income ratio on consumer loans are expected to limit excessive growth of household loans and its associated risk. In addition, the effective implementation of recommendations of the AQR including recapitalization of some banks will be crucial for financial stability.

*Source:* BoM

## Box I.8 Benefits resulting from the Banking Law and Deposit Insurance Law amendment

The Mongolian parliament passed the amendment to the central bank law on January 18, 2018. The amendment aimed to ensure financial stability and reduce operational risks of banks by strengthening their governance and supervision framework. The amendment and related laws went into the effect April 1, 2018. Key features of the amendment:

- Improve requirements for shareholders, executive management, and board members
- Upgrade rules on related party loan exposure and final beneficial owners
- Improve risk management and internal controls at banks, including limiting concentration risks in loan portfolios
- Introduce a “Risk based supervision framework” for the central bank supervision policy from “Compliance based,” in line with international standards and elements of Basel II and Basel III standards
- Improving the early intervention framework
- Strengthen bank resolution legislation, funding, and the cooperation framework to meet best international standards in cooperation with the Ministry of Finance and the Deposit Insurance Corporation of Mongolia (DICOM)
- Grant the BoM power to apply levies on banks to cover the cost of supervision, including AQRs.

The Bank Deposit Insurance Law was also amended by the parliament on February 18, 2018, to bring it in line with International Association of Deposit Insurers (IADI) Core Principles for Effective Deposit Insurance Systems. The law also improved data sharing between DICOM and the BoM to ensure faster payout of deposits where appropriate.

Sources: International Monetary Fund (2018); Legalinfo.mn.

## B. Outlook and Risks

**Despite some base effects, the signs of strong economic performance in 2018 Q1 are expected to continue for the rest of the year.** Economic growth would improve modestly from 5.1 percent in 2017 to 5.5 percent in 2018, and then would accelerate to over 6 percent in 2019–20. Private investment will remain a key driver of growth in the medium term, especially in mining, trade, and transport services. Despite reduced depreciation pressures on the exchange rate, inflation is likely to rise (modestly), with risks tilted to the upside to the extent of overshooting the BoM medium-term target of 8 percent, as food and oil prices are expected to continue to increase. Private consumption is projected to further improve over the medium term. Consequently, the BoM is likely to tighten monetary policy to contain inflation.

**Agriculture is projected to grow modestly in 2018** (below its 2014–15 performance because of the adverse effects of a harsh winter, which resulted in the death of more than 700,000 animals) and to strengthen to about 4 percent over the medium term. Industry is projected to grow around 7 percent in 2018–20, as substantial developments are expected in mining. The growth of the services sector would be supported by strong links between mining and transport. Moreover, trade and transport may also gain from the intensification of relations with Russia.

**The fiscal deficit would further decline in 2018, buoyed by strong revenue performance supported by higher commodity prices,** provided the government remains committed to implementing the fiscal consolidation program agreed with its development partners, despite recent policy reversals. Declining

deficits will lead to continued debt reduction over the medium term.

**The balance of payments will continue to face structural vulnerabilities exacerbated by the debt situation.** Despite robust export growth, investment-related construction imports over the next two years will rise and put pressure on the current account balance. Exchange rate depreciation would continue to subside following the disbursement of donor support and new FDI inflows, unless rising current account deficit put downward pressure on the currency. Moreover, gross international reserves would significantly improve to 6.8 months of imports in 2019 from 4.9 months in 2017.

Given the positive macro outlook, poverty rates are expected to start declining in 2018. However, unless economic activity improves in rural areas (where nearly half the poor live), gains in terms of reduction of urban poverty may be partly offset by protracted rural poverty.

### Risks to the outlook

While growth was stronger in 2017, Mongolia's underlying structural issues have not disappeared and there are substantial domestic and external exogenous risks to the outlook. These risks include persistent political and policy uncertainty, which could affect FDI and delay implementation of mega projects in the mining sector; commodity market volatility; bottlenecks at the border; and regional instability.

Recent policy reversals, including returning to a flat PIT rate and reversing the increase in the retirement age, have undermined the government's credibility and its commitment to the fiscal consolidation program supported by donors. Relatedly, if mishandled, the ongoing investigations attempting to establish the responsibilities of former prime ministers, ministers of finance, and other executives, in the signing of the investment agreement with Oyu Tolgoi could deter FDI inflows and affect market sentiments and FDI. In contrast, if the government maintains fiscal discipline and promotes policies aimed at attracting FDI, Mongolia's prospects for growth and poverty reduction are more positive. Weather-related shocks will remain an important challenge. Livestock is the main source of income in rural areas, and further growth is key to raising living conditions in the countryside. Adaptation to climate change should be prioritized to mitigate food and livestock production shocks.

Sluggish regional demand (mainly from China) and commodity market volatility are likely to affect Mongolia's growth prospects (Box I.9). Improving government management of mining revenue is therefore critical. Recent efforts to promote export diversification through improved trade cooperation is a positive step.

Worsening of non-trade barriers at the southern border and resumption of coal imports by China from the Democratic People's Republic of Korea could affect Mongolia's coal exports. The recent visit of the Prime Minister of Mongolia to China helped relieve some of these pressures. However, an unsuccessful implementation of the recommendations of the Asian Pacific Group (APG) to address the deficiencies of Mongolia's Anti-Money Laundering/Counter-Financing of Terrorism (AML/CFT) regime is an additional risk for the macro outlook as it could potentially impact on FDI and the financial sector.



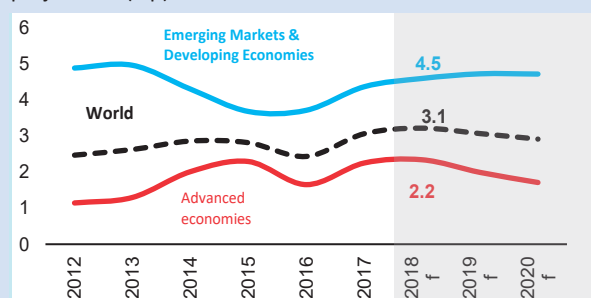
## Box I.9 Global and Regional Outlook and Risks – Key Highlights

**Global growth has eased, but remains robust, and is projected to reach 3.1 percent in 2018 (World Bank, 2018a).** It will then slightly moderate to an average of 3 percent in 2019–20, reflecting a gradual slowdown in advanced economies (Figure I.55).

**Growth in the East Asia and Pacific region is expected to gradually moderate from 6.3 percent in 2018 to 6.1 percent on average in 2019–20 (Figure I.55).** The modest slowdown in regional growth is largely due to the gradual and planned structural slowdown in China. Activity in the rest of the region is expected to peak at 5.4 percent in 2018 and remain steady, around its potential rate in 2019. The outlook is predicated on broadly stable commodity prices in the next two years, strong but gradually moderating global demand, and a gradual tightening of global financing conditions.

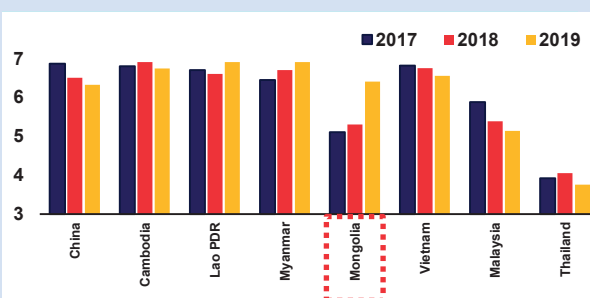
**Figure I.55 Global growth is projected to continue to moderate in the coming years...**

Global real GDP growth contribution projections (%p)



**Figure I.56 Growth in EAP region will gradually moderate in 2019–20**

Real GDP growth (y/y, %)



Source: World Bank (2018a; 2018b).

**The growth of China, the main trade partner to Mongolia, is itself subject to uncertainty.** The GEP of the World Bank (June 2018) assumes that China's growth is projected to edge down to 6.5 percent in 2018 and slow further to 6.3 percent on average in 2019–20, as export growth moderates and deleveraging takes hold. In addition, policy accommodation is expected to further diminish as authorities continue to tighten macroprudential regulation and gradually remove their supportive fiscal stance. Downside risks to the outlook stem from financial sector vulnerabilities and an intensification of trade tensions amid increased protectionism in key trading partners.

**Oil prices are substantially higher than previously expected, and other commodity prices have also risen.** While near-term projections for commodity prices have been revised up, they are expected to level off later in the forecast horizon. Oil prices are expected to average US\$ 70 per barrel in 2018 and US\$ 69 in 2019, up from an average of \$53 per barrel in 2017. Metals prices rose modestly in the first quarter of 2018; however, prices posted gains in April, after the imposition of sanctions on a large aluminum producer. Metal prices are expected to rise 9 percent this year, reflecting strong demand, but then moderate in 2019.

Source: Vashakmadze (2018).

## C. Closing the Productivity Gap – The Role of Public Investment Efficiency

**A productivity gap characterizes Mongolia's current growth model.** The growth accounting exercise reveals that during the last decade, almost all the growth came from physical capital accumulation, with a limited role for total factor productivity (TFP).<sup>7</sup> This is not unexpected in low-income countries

<sup>7</sup> See details in Annex 1.

(LICs) and lower middle-income countries (LMICs). However, with the transition to higher income, the role of TFP should gradually increase and sustain growth. Potential growth accelerated from an average of 1 percent in the 1990s to about 7 percent since 2008, with capital accumulation contributing over 92 percent of this growth up from 68 percent in the first half of the 2000s (Table I.1 and Figure I.57 ). This reflects the high gross investment rate, which more than doubled to an average 40 percent of GDP between the 1990s and the 2010s.

**Table I.1 Mongolia: Average results of growth accounting**

	1981–2010	1981–90	1991–2000	2001–07	2008–10	2011–17
Output per Worker	1.7	1.3	-1.0	3.8	6.0	5.1
Capital per Worker	2.3	2.9	0.1	2.6	6.0	5.2
Average Potential Growth	3.9	3.7	0.8	6.2	7.7	7.1
Total Factor Productivity	-0.6	-1.6	-1.2	1.1	-0.1	-0.1
Capital	3.7	4.4	1.3	4.2	7.2	6.5
Employment	0.8	0.9	0.7	0.9	0.7	0.7
Working-age Population			0.8	1.0	1.6	0.9
Labor Force Participation			-0.9	0.1	-0.5	0.0
Employment Rate			0.1	0.1	-0.9	0.1
Gross Investment Rate	21.4	17.0	17.4	22.2	39.4	40.9

Source: World Bank staff estimates.

Note: The analysis assumes: initial capital = 2.1, share of capital in income = 63 percent, and depreciation rate = 5 percent.

**Actual and potential growth in Mongolia has been fluctuating.** As Figure I.57 indicates, actual and potential growth rates in Mongolia have been fluctuating due to a number shocks. Actual and potential growth exceeded 10 percent during 2008–12, declined during 2012–16, but returned to an upward path in 2017. This can be explained by negative TFP growth due to institutional weaknesses and an unfavorable external environment that may have triggered a decline in FDI. During 2012–13, the terms of trade declined by 12 percent, and again by 18 percent (y/y) between the second half of 2015 and the first half of 2016. On the institutional front, the poor fiscal management that led to skyrocketing debt levels (from 58 percent of GDP in 2014 to the unsustainable level of 87 percent in 2016) could have triggered fears among investors with respect to the quality and safety of their funds. This would mean a structural upward shift in the country’s risk premium and inefficient capacity utilization in such an uncertain and unsustainable environment. The lack of credibility and flexibility of macroeconomic policies adds to this uncertainty, creating a lack of confidence. It also affects the economic policy space necessary to respond to exogenous shocks which magnify or prolong the negative impact of exogenous shocks with deleterious effects on long-term growth.

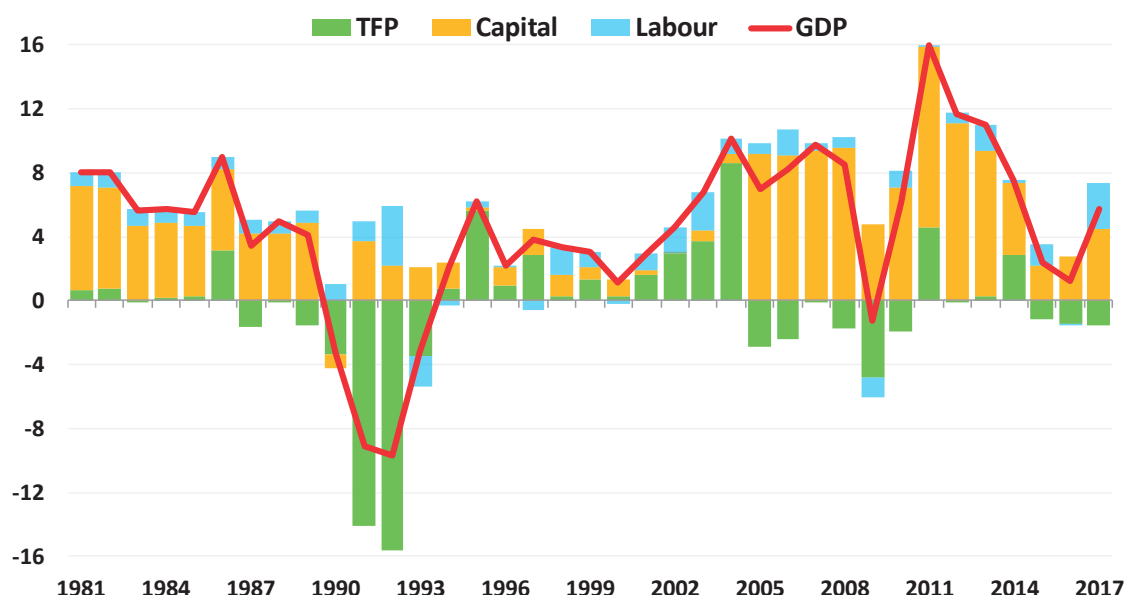
**A major institutional weakness has been the procyclicality of Mongolia’s fiscal policy.** Historically, the fiscal impulse<sup>8</sup> is positively related to the output gap in Mongolia (Figure I.58): the fiscal policy is expansionary during boom years and contractionary during recessions, thus magnifying and/or prolonging the impact of shocks. This is further confirmed by the strongly positive correlation between government consumption and the business cycle (Figure I.58). Consistent with the general view that the efficiency of fiscal policy and thus the size of its multiplier depend on the cyclical position of the

<sup>8</sup> The fiscal impulse is referred to as the negative change in structural fiscal balance.

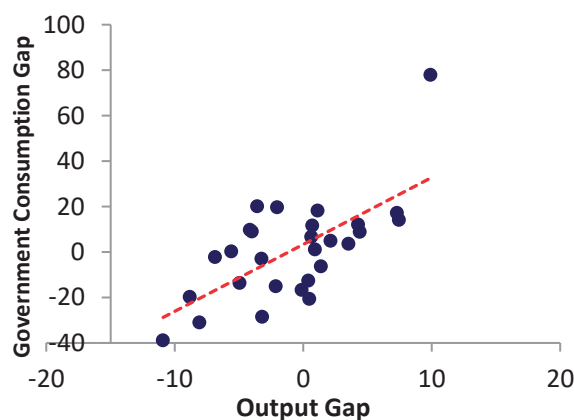
## MONGOLIA ECONOMIC UPDATE

economy so that it is mostly productive during recessions compared to booms, procyclical fiscal policy in Mongolia would diminish productivity.

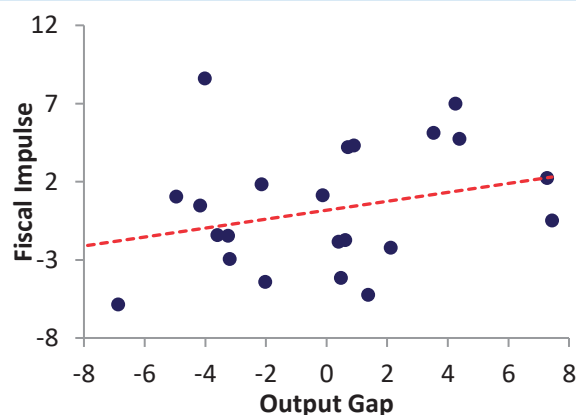
**Figure I.57 Potential output growth decomposition**



**Figure I.58 Real government consumption gap and output gap<sup>9</sup>**



**Figure I.59 Relationship between fiscal impulse and output gap<sup>10</sup>**



Sources: NSO; MoF; World Bank staff estimates.

The muted role of TFP (Figure I.57), which is unexpectedly negative, is linked to institutional weaknesses and probably the limited role of knowledge and technological spillovers from the mining sector—the largest sector and the main recipient of foreign direct investment—to other productive sectors. This should be a signal to the authorities that they need to consider a number of institutional and other structural reforms to boost TFP and economic diversification. In this area, the fiscal and institutional reforms started in 2016 are a positive development. These reforms should be implemented effectively and efficiently.

<sup>9</sup> The real government consumption gap is the difference between the actual value of real government consumption and the trend real govt consumption estimated using the H-P filter.

<sup>10</sup> The output gap is the difference between the actual real GDP and the trend real GDP estimated using the H-P filter.



## II. THE ROLE OF PUBLIC INVESTMENT EFFICIENCY FOR GROWTH – A ROAD MAP FOR REFORM

### A. The Rise and Fall of Capital Expenditures Since 2010

Mongolia has been hooked on projects. The Government of Mongolia (GoM) has recently been dealing with unconventional practices such as quasi-fiscal expenditures (see paragraphs below) and unsustainable volumes of loans for new projects that have arisen since the economic slowdown in the mid-2010s. For at least the last five years, it seems the driving motivation behind public investment management activity has been the need to start as many projects as possible in the shortest period while at the same time deferring the fiscal consequences for as long as possible.

The surge of capital expenditures until 2014 was the key factor behind the dramatic increase in consolidated public finance deficits and the public debt. Capital expenditures rose from 4.2 percent of GDP in 2000–06 to 7.2 percent in 2007–10 as strong revenue linked with growing mineral exports helped finance a huge infrastructure development program. The increase in capital expenditures continued after 2010 financed first by high revenue until the end of the commodity boom, and then by external borrowing when a sharp decline in mineral exports slowed economic growth and drastically reduced government revenue. As a result, capital spending averaged 11.5 percent of GDP during 2012–14, a level that far exceeded the 6.1 percent average of East Asian countries in 2014.



## Off-budget spending was the main driver of the growth of capital expenditures from 2012 to 2014.

The combination of sluggish government revenue and the deficit control rules of the Fiscal Stability Law prohibited the use of regular budget spending to finance the large public investment program that the government launched to stimulate economic growth. In fact, on-budget funding of capital expenditures declined from 9.7 percent of GDP in 2011 to an average of 8.5 percent during 2012–14. The increase in capital spending was therefore entirely financed through off-budget funding, notably through transferring the proceeds of foreign loans to the government (or government-guaranteed loans) to the Development Bank of Mongolia (DBM) for the financing of non-commercial (public) projects. In 2014 the parliament authorized the issuance of promissory notes to finance a variety of projects initiated by ministries, agencies, and local governments, which also used a new funding technique (called build-transfer, or BT, financing). Cash budgets do not show the cost of ongoing projects financed by promissory notes or BT operations, which are not accounted for until the government makes a payment.

**Table II.1 Capital expenditures and main sources of funding (in percent of GDP)**

	2010	2011	2012	2013	2014	2015	2016	2017
<b>Total Capital Expenditures</b>	<b>6</b>	<b>9.7</b>	<b>12.1</b>	<b>16.3</b>	<b>14.9</b>	<b>9.1</b>	<b>10.4</b>	<b>4.3</b>
<b>- On-Budget</b>	<b>6</b>	<b>9.7</b>	<b>9.1</b>	<b>7.8</b>	<b>8.4</b>	<b>6</b>	<b>9.3</b>	<b>6.1</b>
- Investment	5.4	8	8.2	6	6.5	2.6	3.1	3.3
- Maintenance	0.3	0.4	0.3	0.5	0.4	0.5	0.2	0.3
- Foreign-Funded	0.3	1.3	0.6	1.3	1.1	1.1	2.3	2.4
<b>- Off-Budget (DBM)</b>	<b>0</b>	<b>0</b>	<b>3</b>	<b>8.5</b>	<b>6.5</b>	<b>3.1</b>	<b>1.1</b>	<b>-1.8</b>

Sources: MoF data; World Bank staff estimates

**Reducing capital expenditures was a major component of the government's economic recovery program.** Indeed, capital expenditures declined from 11.1 percent of GDP in 2014 to 6.0 percent in 2015; rose to 9.3 percent in 2016, when the government repaid outstanding promissory notes; and declined again to 6.1 percent of GDP in 2017. At the same time, the DBM financing of non-commercial projects was included in the budget since 2015, and the use of promissory notes was stopped in 2016, but BT financing continues. Table II.2 shows the lasting impact of past off-budget financing on the public debt.

**Table II.2 Debt incurred through off-budget investment funding in 2016 (MNT billion)**

	Debt Incurred	Repaid	Outstanding
<b>Promissory Notes</b>	672	672	0
<b>DBM (non-commercial projects)</b>	2,528	20	2,508
<b>Build-Transfer</b>	2,300	72	2,128
<b>Total</b>	<b>5,400</b>	<b>764</b>	<b>4,636</b>

Sources: MoF and DBM data

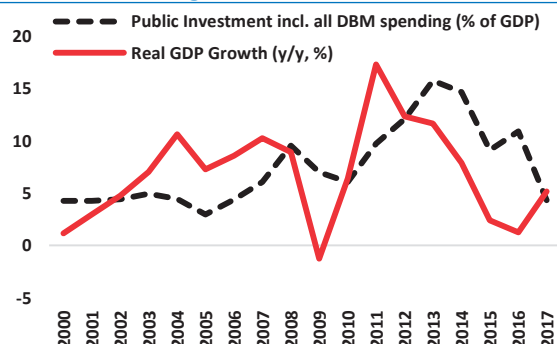
## B. Efficiency of Mongolia's Public Investment Program

**The large public investment program implemented in recent years in Mongolia has not produced the expected benefits.** It did not prevent a sharp decrease of GDP growth rates after 2011 and, in fact, its main legacy is a major increase in public finance deficits and public debt, which will have a lasting impact on the country's economic and fiscal performance. While public investment correlates positively with

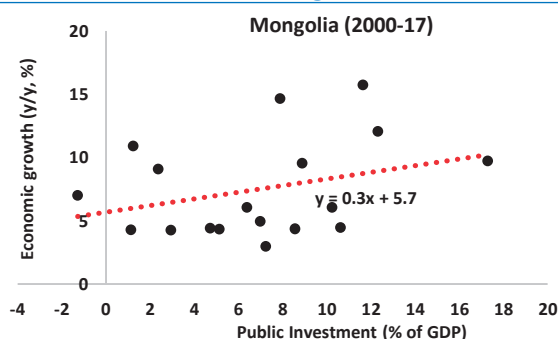
# MONGOLIA ECONOMIC UPDATE

economic growth in Mongolia, a cross-country comparison shows that in 2017, Mongolia spent more on public capital spending than its East Asia and Pacific (EAP) comparators. China tops the list of EAP countries characterized by their level of public investment relative to their level of income per capita. Mongolia is ranked second.

**Figure II.1 Co-movement between public investment and growth**



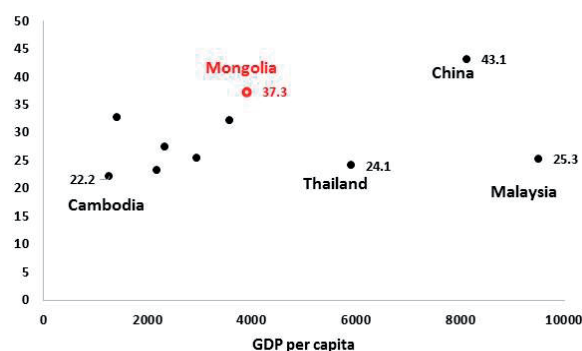
**Figure II.2 Correlation between public investment and economic growth**



Sources: NSO data; World Bank staff estimates.

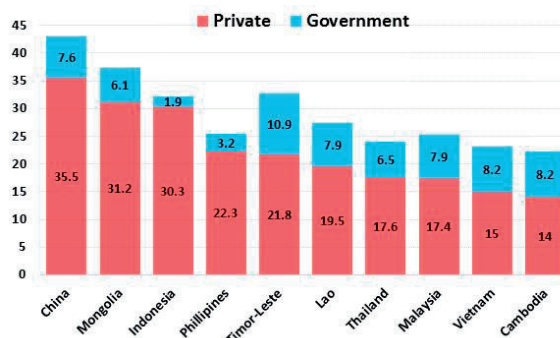
**Figure II.3 Mongolia's total investment is among the highest in EAP**

Gross investment in 2017 in EAP countries (% of GDP)



**Figure II.4 Evolution of public and private investment, EAP 2017**

Gross investment by public and private, 2017 (% of GDP)



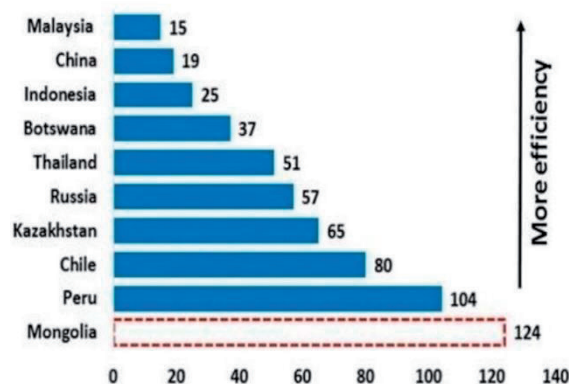
Sources: NSO data; World Bank staff estimates.

Moreover, public expenditure efficiency in Mongolia is low; the country ranks 124th on efficiency of public spending on the Global Competitiveness Index (World Economic Forum, 2016, Figure II.5 ), and has been on a declining trend (Figure II.6 ). The 2016 IMF Public Investment Management Assessment (PIMA) for Mongolia revealed the poor performance in terms of public investment management (PIM) practices. Mongolia's scores are much lower than those for other world and emerging market comparators, some of which invest far less than Mongolia. Weak PIM led to poor project selection, long project implementation delays, high cost overruns, and a rapid deterioration of existing assets (see above), thereby contributing to low spending efficiency. This report argues that successful implementation of a road map aimed at improving public investment efficiency is the highest priority. The proposal includes actions organized around six themes: (a) developing a comprehensive and consolidated approach to PIM, (b) clarifying roles and responsibilities, (c) developing a PIM database, (d) rationalizing the ongoing Public Investment Program portfolio, (e) managing the existing build-

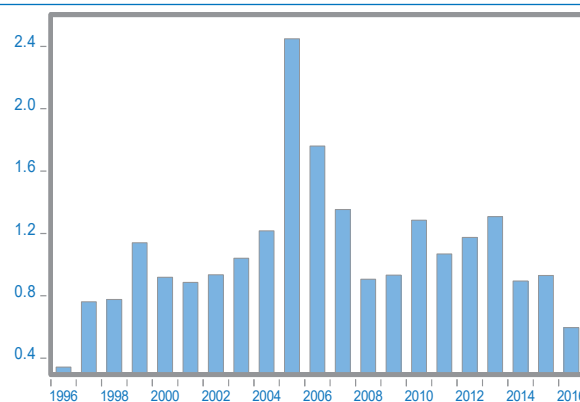


transfer (BT) activities and strengthening build-operate-transfer (BOT)/public-private partnership (PPP) management, and (f) upgrading the allocation of maintenance expenditures.

**Figure II.5 Efficiency of public spending ranking**



**Figure II.6 Measure of public investment efficiency in Mongolia (Ratio of GDP growth to government capital spending, % of GDP)**



Sources: World Economic Forum (2016).

The fragmentation of the decision-making process; the absence of a coordinated approach based on sound national and sector development strategies; generally poor project preparation, appraisal, and selection procedures; and the low priority given to maintenance have a strong negative impact on the quality, effectiveness, and efficiency of the program. The Ministry of Finance is only responsible for the selection of programs and projects financed by the state budget. Direct lending by ministries, departments, agencies, and local governments through promissory notes and BT financing enable them to short-circuit whatever controls are in place to moderate the size and growth of the program and improve the quality of individual projects.

**The National Development Agency (NDA) is expected to play a strategic coordinating role in the PIM system.** For a long time, however, the main objective of most government ministries, departments, and agencies was to prepare, finance, and implement the largest possible number of projects, rather than adopting a strategic approach integrating public investment planning and project selection into broad, well-conceived, and realistic economic and sector development strategies. The National Development Plan includes major infrastructure projects that seem to lack a basic analysis of prospective demand. The NDA is also responsible for checking the quality of projects developed under the concession law, which regulates concession and PPP contracts, including BT operations, which can be large. However, there is a critical lack of capacity in NDA, and its role in that area is likely to be transferred to the Ministry of Finance, which also does not have the staff and capacity to play a major role in project appraisal, and monitoring.

**Poor investment planning and project selection lead to ineffective implementation of approved projects.** Low execution rates, weak management structures and performance, and other administrative capacity constraints limit absorptive capacity. This institutional capacity issue cuts across all levels of government.

**Modest and falling budget allocations for operation and maintenance are a major drawback.** Despite the recent increase in public investment, the capital maintenance budget has not increased substantially over the last 10 years. The GDP ratio of maintenance spending increased from 0.3 percent of GDP during 2003–09 to an average of 0.4 percent during 2014–15 before declining to less than 0.2 percent in 2016. More importantly, the ratio of maintenance to total capital expenditures sharply declined from 5.1 percent in 2010 to 1.9 percent in 2016. The average in comparator countries is about 6.2 percent. The short- and long-term efficiency of Mongolia’s public investment program is seriously affected by the shortage of maintenance expenditures, which reduces the benefits and shortens the economic life of new infrastructure and other projects.

### C. PIM – Legal and Institutional Issues

#### Legal Issues

**The legal framework for the management of capital expenditures is a set of budget and investment laws regulating a variety of public finance management procedures.** Box II.1 summarizes several of the principal pieces of legislation regulating public investment management and other budget expenditures.

#### Box II.1 Current legal documents regulating public investment management

**The Integrated Budget Law, which is the organic budget law, also is the most important legal document for the public investment management (PIM) system.** It provides clear legal mandates and specifies requirements for public investment programming and budgeting. Chapter 5 clarifies the roles and responsibilities of key stakeholders. It describes in detail the PIM planning process, including submission of project proposals, prioritization mechanisms for integration of specific proposals in the public investment program, and approval of the program by the State Great Khural (the Mongolian parliament).

**The Fiscal Stability Law controls total public spending, including capital expenditures,** through rules limiting public finance deficits based on actual government revenue over several years.

**The Law on the Development Bank of Mongolia** created new types of PIM projects that are not affected by the public finance deficit rules of the Fiscal Stability Law. As a result, most of the increase in capital expenditures during 2012–15 was financed by the DBM. DBM non-commercial projects are now integrated into the state budget and subject to the same rules and regulations as investments financed by that budget.

**The Law on Concessions deals with concessions and PPP contracts.** This is the law that regulates the fairly large number of build-transfer projects that have been implemented in recent years.

**The Public Procurement Law establishes procurement rules for both recurrent and capital expenditures.** The selection of procurement procedures depends on threshold values assigned by the Cabinet.

*Source: World Bank (2018c).*

**The main issue, however, is less the legal framework itself, than its implementation.** No specific technical, practical, and operational guidance has been developed regarding feasibility studies and project implementation, including financing and execution of the DBM’s non-commercial projects and the structure of BT projects. In fact, actual project planning, appraisal, and budgeting processes are managed through internal negotiations and informal agreements among key stakeholders, including the Ministry of Finance and the line ministries concerned.

The lack of clear guidelines has had a negative impact on some of the programs approved by the government. For instance, most BT projects do not require private partners to assume real risks and responsibilities with respect to the financing and implementation of the projects, but the government is legally obligated to repay private contractors upon the transfer of the assets to the government. This means that BT projects have become another form of promissory note.

## Institutional Issues

The PIM institutional landscape includes many stakeholders (Table II.3). The State Great Khural is the highest body, which approves capital investment policies, plans, and projects. The National Development Agency and the Ministry of Finance have similar responsibilities for the preparation of investment programs and budgets. It is not clear how the two institutions coordinate their activity. In practice, line ministries tend to deal directly with MOF's Department of Investment Budget (DIB). Line ministries separately manage investment and recurrent expenditures with a dual budget system. Maintenance and other recurrent costs of capital projects are incorporated in the State Budget when the investment project concerned is completed. According to DIB and external observers, the funds available for operations and maintenance are clearly insufficient.

Line ministries submit procurement plans for projects financed by the State Budget before receiving the funds for approved projects. DIB is responsible for budget execution and procurement but delegates the function to line ministries and other spending agencies.

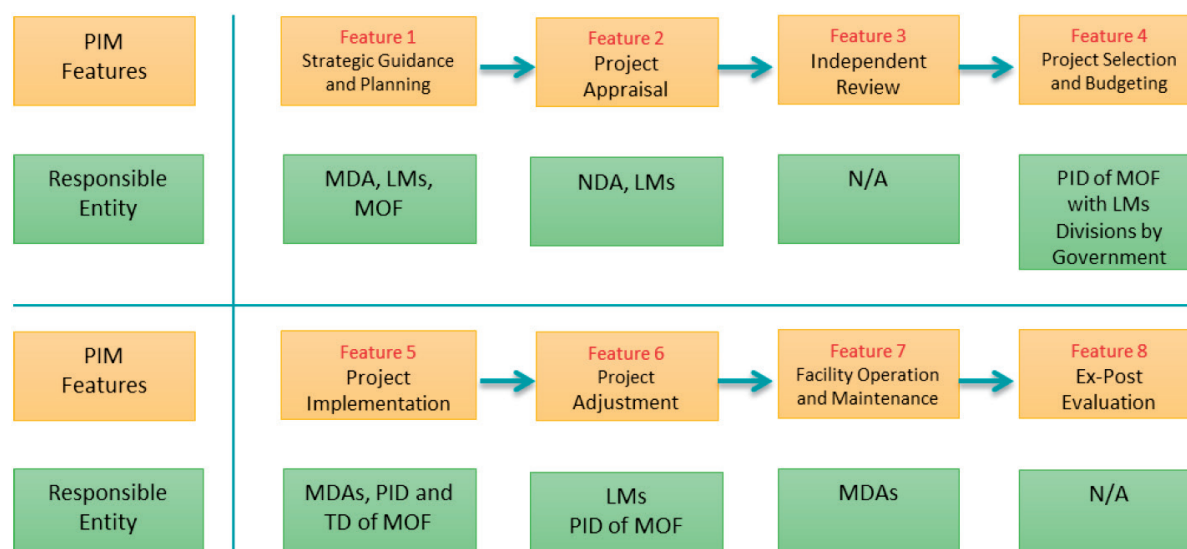
**Table II.3 Key Institutions involved in management of public investment**

Institution	Role in public investment management
State Great Khural (SGK)	Approves State Budget, including decisions concerning public investment policies, plans, and projects
The Cabinet	Reviews and adopts public investment policies and projects and submits the State Budget to the Great Khural
National Development Agency (NDA)	Prepares and manages the public investment program, which provides the basis for the selection of projects in the State Budget
Ministry of Finance (MoF)	Prepares the State Budget and manages budget execution; estimates resources available for funding
Department of Investment Budget (MoF)	Manages budget execution (including procurement) for domestically financed projects
Department of the Treasury (MoF)	Manages single Treasury account
Line Ministries and Agencies	Prepare budget and project requests; provide financial and progress reports to MOF; implement – and report on – public investment projects

Source: World Bank (2018c).

A review of the roles and responsibilities of key institutions reveals gaps in PIM practices (Figure II.7). There is no independent review and no ex-post evaluation of investment projects. The gatekeeping oversight role of the MoF (in the upstream decision process and the downstream implementation process) is generally limited, and almost nonexistent in the case of BT and BOT projects. These weaknesses allow fiscal risks to go unmanaged until it is too late.

**Figure II.7 PIM Institutional Arrangements: Roles and Responsibilities of Key Institutions**



Source: World Bank (2018c).

Note: National Development Agency (NDA), Line Ministries (LMs), Ministry of Finance (MOF), Not Available (N/A), Public Investment Department (PID), Treasury Department of MoF (TD), Ministries, Departments, and Agencies (MDAs).

## D. A Road Map for PIM Reforms

**The current practice of preparing and executing public investment projects in Mongolia does not exhibit good practice for a PIM system.** The arrangements are completely fragmented and there is no way to identify the efficiency and effectiveness of development activity. A road map for improving public investment management in Mongolia includes 17 actions organized around six themes, including (a) developing a comprehensive and consolidated approach to PIM, (b) clarifying roles and responsibilities, (c) developing a PIM database, (d) rationalizing the ongoing PIP portfolio, (e) managing existing BT activity and strengthening BOT/PPP management, and (f) upgrading the allocation of a maintenance budget.

### Developing a Comprehensive and Cohesive Approach to a PIM System

**All development activity should be framed by the expected results of the investment project rather than through the source of funding.** The source of funding should become the secondary consideration after projects have been identified as being of value to the nation. To that extent, all (regardless of funding source or type) initial project proposals in Ministries, Departments, and Agencies (MDAs) should be assessed through a standard prescreening template that should be completed by project proposers. The template would become the single point of entry to the PIM system in Mongolia. Implementing this would remove the “funding bias” that favors projects that have identified non-budget external funding regardless of whether the project is a priority and regardless of the direct and contingent liabilities that may be incurred as a result.

**In a successful PIM system, the project proposal should be driven by either national or sectoral policies.** This would provide the authorities with a useful tool that could be used, when necessary, to contain expansionary pressures on the public investment program.

## Box II.2 Purpose of prescreening

Prescreening represents a common point of entry into a formal PIM system. It prevents financial and human resources from being wasted on feasibility studies for projects that would never be funded and assists in reducing pressures on the budget by keeping the project pipeline at a manageable level. If implemented properly, it is also an effective tool in reducing the possibility of unsustainable extrabudgetary finances being sourced without consideration of the wider fiscal consequences.

Prescreening is also an important first quality step that allows the proposing authorities to test the robustness of a project concept in terms of logic, risk, and sustainability. It is also in the interests of the proposing authorities that their projects provide real solutions to real problems and that they are planned and implemented effectively to avoid constant problems throughout the operational life of the project.

In good practice countries, all projects, large or small, are expected to follow the same formal prescreening process. A positive decision at this first stage of entry into the PIM system requires that the strategic policy relevance, rationale, and realism of the project proposal is demonstrated to the satisfaction of the decision makers and a convincing case has been made to justify expenditure, whether it is to consider funding to directly implement a small project or on further planning and appraisal for larger ones.

*Source:* World Bank (2018c).

**As a public investment planning tool, the GoM should consider the development of a rolling forecast for annual public investment expenditure within an MTFF or Medium-Term Budget Framework (MTBF).** This would not only provide guidance to line ministries as they plan future projects, but it will help the MoF's Investment Budget Department to withstand unrealistic demands during the budget round each year. Given the unpredictability of government revenues due to commodity price fluctuations, the forecast should predict a range of scenarios (loosely "Base Case," "Best Case," and "Worst Case") that might be called upon closer to the actual budgeting period when revenues are more likely to have a greater prospect of accuracy. The forecast should also identify and estimate the associated recurrent costs of projects and indicate the impact of the year in which they are completed. For this reason, also, the forecast should cover commitments for other forms of finance such as BOT and foreign-financed projects, which, when they are completed, often incur significant recurrent costs.

**The GoM should gradually move quickly toward a rules-based PIM system, with new regulations and templates that are also backed with guidance.** This is to ensure consistency in the system and even-handed treatment in the way that projects are identified, prepared, appraised, and selected. To achieve consistency in project appraisal, project proposers should follow a standard template system that covers all the required steps of appraising a project.

**A project proposal should only enter the PIM system formally with a Unique Project Number (UPN), which is assigned when it has been successful in the initial prescreening.** This allows tracking of the project as it moves through the various stages of appraisal and, if ultimately selected, implementation. The UPN would be a foundation of the proposed project database and would allow all contracts and related expenditures to be tracked against the original proposal. This would make project monitoring and (eventually) project completion reports and ex-post evaluations easier to undertake, yielding valuable lessons to the GoM, which could be used to improve the formulation of future projects.

**When projects have been successfully prescreened and allocated a UPN, they should be formally appraised to a degree that is commensurate with the scale of the project.** Project appraisal should

become a default position for all projects. Unlike on large projects, which require full feasibility studies and cost-benefit analysis, appraisal need not be a complex and time-consuming exercise for small projects, but the necessary time and effort should be dedicated to proving the need for the project and that it is a worthwhile and efficient use of public funds. The type and scale of appraisal should be proportional to the nature of the project, and the government should regulate appropriate thresholds at which they apply.

### Clarifying Roles and Responsibilities

**As the entity responsible for managing the public finances, it is essential that the MoF is fully aware of and able to manage the commitments that MDAs are making on behalf of the Government of Mongolia.** The present unsatisfactory situation regarding unmanaged PIM activity and debts accumulated through extrabudgetary funding has happened while the role of the MoF has been restricted to somewhat limited direct budget-funded activities. The MoF should be made aware of all financial commitments related to projects before they approved. This should be made mandatory through an appropriate regulation.

**The role of some institutions engaged in PIM appears to be in flux and quickly needs to be clarified.** The amended Concession Act implies a reduced role for the NDA with a rebalancing of authority back to the MoF. Clarification of these amended roles needs to be accompanied by adequate resources to fulfil them. Furthermore, the powers of line ministries to enter into extrabudgetary funding arrangements needs to be curtailed.

**The GoM should identify and empower a single entity (for convenience, hereafter, the “PIM Unit”) to develop and manage the PIM system and the Public Investment Program within in a single cohesive framework.** Although MDAs and local governments should retain responsibility for identifying, preparing, and executing public investment projects, all this activity should come under the overview and supervision of a PIM Unit regardless of the form of procurement, the form of contract, or source of funding. In addition, the MDAs should prepare their projects within the PIM framework, which would be strengthened and monitored by the PIM Unit. The PIM Unit would also be responsible for reviewing and checking project proposals for quality assurance purposes (see below). PIM Units are often found in ministries of finance, but not exclusively. If a PIM Unit is not located within the MoF, it is still essential that the highest level of cooperation is undertaken with the Department of Investment Budget in the MoF. Alternatively, this department could be converted into the PIM Unit.

**A quality management system should be developed to check the quality of project proposals through identification, preparation, appraisal, and readiness for implementation stages.** This should start with the prescreening step, which would check whether projects have been correctly identified and whether they are appropriate. Further checks should then be developed after the appraisal stage prior to the procurement procedure and again following implementation prior to the project becoming operational. The proposed PIM Unit would be responsible for the development of the quality management system, its implementation, and its subsequent operation. The overall objective of the quality management system would be to ensure that only correctly identified, fully prepared project proposals with credible implementation plans are selected for funding (regardless of the source of that funding).



## Developing a PIM Database

**A project database that is a single source of information for all public investment projects should be developed.** To create a cohesive picture of all development activity in Mongolia, all projects regardless of the source of funding would be assigned a UPN on condition that a proposal passes through the first quality check at the prescreening stage. This UPN would stay with the project throughout its useful life into the operational phase or until activity ceases in the case of rejected or abandoned projects. This will allow all capital estimates to be updated and expenditure to be tracked against individual projects across multiyear implementation and across all contracts that are related to the realization of the project. It should also include for the first time a tracking item that includes and updates projected operational and maintenance costs related specifically to the project throughout its development phase. This will help the Investment Budget Department at the MoF to forward plan budgets based on future as well as existing commitments and planned expenditures on an aggregate basis, thus helping them identify an available envelope for possible new projects with more confidence. This can be taken forward after the rationalization of the Public Investment Program.

## Rationalizing the ongoing Public Investment Program Portfolio

**Rationalize the Public Investment Program (PIP) to restructure and/or remove non-performing ongoing projects from the portfolio so that the financing demands of the portfolio can be prioritized and more effectively aligned with available fiscal resources.** Similar rationalization efforts have already been made in the governments of Romania (World Bank, 2016a) in 2015 and Ukraine (World Bank, 2016b) in 2016–17. Portfolio rationalization is an urgent issue in Mongolia, because many public investment projects, including more than 480 state budget projects (including 119 projects transferred from the DBM non-commercial investment projects), around 55 BT or BOT projects with contracts signed, and many other projects under preparation and/or appraisal to be adopted, are already in the PIM pipeline seeking their own funding. A major part of the portfolio has been seriously underfunded, which has led to a huge and unaffordable overhang of partially implemented projects.

### Box II.3 Example of rationalization criteria

**Rationalization guidelines could be established through a resolution of the Cabinet, providing clear guidance and criteria for how underperforming ongoing projects can be effectively screened, identified, prioritized, resolved, and managed.** The objective of portfolio rationalization guidelines is to improve the effectiveness and efficiency of public investment expenditure under deteriorated fiscal space conditions by prioritizing well-performing ongoing projects or restructuring underperforming ones from the PIP. For the scope and coverage of the rationalization guidelines, the guidelines would cover the portfolio of all ongoing/uncompleted state-level, public capital investment projects, whether funded by the State Budget (former DBM included), BT, BOT, or foreign-financed.

The proposed rationalization procedure will focus on (a) identifying underperforming projects from within the overall PIP; and (b) removing or suspending these projects from the PIP and subjecting them to a rationalization procedure to resolve their status. This would involve re-costing, restructuring, postponing, closure, and liquidation, or curtailed completion and handover. In the absence of a comprehensive PIP database, it will be necessary to carry out a detailed survey or review of uncompleted projects led by the MoF and Line Ministries (LMs).

Possible examples of the rationalization criteria include checking the strategic relevance or importance, project implementation progress, and project feasibility. The “strategic relevance/importance” criterion is to ensure the relevance/importance of the project in medium-term and long-term national and sectoral plans. The “implementation progress” criterion checks whether the physical construction is over 50 percent or another percentage, and whether the remaining funding requirement is less than the percentage of total estimated cost. The “project feasibility” criterion is to assess the socioeconomic feasibility with information on demand estimates.

This analysis, however, cannot include economic feasibility in the assessment criteria, due to the lack of sufficient cost and time to collect and assess individual feasibility studies (feasibility studies shall be done again for some selected ones only if necessary). As an auxiliary criterion, contractual obligation is also checked. Projects financed by foreign loans or grants often have contractual obligations, and these projects should be additionally prioritized. Similarly, projects that already signed concessions also receive additional consideration.

*Source: World Bank (2018c).*

### Managing BT Activity

**The system of BT financing for projects should be closed permanently by removing loopholes created by the amendment to Resolution 37.** BT represents a form of borrowing that deliberately aims to defer the cost of payment for projects to future years. It is an expensive form of finance and represents a huge distortion to the present PIM system. The PIP therefore needs to account for the future repayment schedule of the BT projects that are currently under implementation. There is a risk that these repayments will eventually crowd out budgetary investment projects under tight revenue conditions. Its continuing presence is also a major constraint to any reform program aimed at moving PIM practices in Mongolia to what might be considered good international practice.

**BT repayments should be prioritized to clear the arrears as soon as possible, with the contracts incurring the most punitive penalties and interest charges being cleared first.** BT schemes represent an expensive form of finance that is already accruing interest and penalty charges for late payment—making it more expensive still. The current slow rate of repayment adds significantly to the arrears and runs the risk that some of the investments made under BT will no longer be in operation or will be obsolete before they are paid for.

### Strengthening BOT/PPP Management

**The increasing scale and volume of BOT/PPP projects in Mongolia demands that urgent action be taken to strengthen implementing and monitoring capacity.** Unlike BT procurement, BOT is a more credible form of public-private partnership (PPP) as it usually involves some genuine risk taking by the private partner. Already the value of investments through BOT have reached more than MNT 3.7 billion and appear set to increase further as project proposers see other non-budget funding options being closed. If done correctly, BOT/PPP projects can bring efficiencies into public investment projects and deliver effective outcomes. Furthermore, maintenance provision is the responsibility of the private provider. However, if they are done incorrectly, the fiscal consequences could last decades. Given the stark contrast between success and failure, it is imperative to dedicate sufficient capacity to the subject area and to ensure that the regulatory and institutional arrangements are appropriate.

**All further activity related to PPP should be focused on identifying and preparing opportunities for implementing projects with BOT/PPP within a single cohesive PIM system.** PPP projects should not be generated through separate and parallel legal and institutional arrangements, but as a part of the integrated PIM system that recognizes projects of value to the nation regardless of the form of financing and implementation. Therefore, PPP should not be used as a creative accounting technique; instead it should be employed when it is more efficient and effective to do so and it can be assessed qualitatively that a PPP implementation is likely to deliver a better outcome than more conventional procurement. The GoM will need to focus on the following additional areas in addition to other normal considerations in preparing an investment project: (a) the feasibility of the project or its interest to investors as a PPP—soft market test results are required to make this assessment and judgement; (b) a value-for-money assessment compared with conventional implementation; and (c) fiscal risks, which require analysis.

**Fiscal risks that come with all BOT/PPP contracts should be understood, quantified, recorded in accordance with the Debt Management Law (DML), and monitored.** The current stock of BOT/PPP projects, estimated at MNT 3,767 billion, contains unknown contingent liabilities, and there is an existing legal requirement to report them. An urgent exercise should be undertaken to evaluate existing BOT/PPP contracts and assess the contingent liabilities contained within. These should then be reported to the Debt Management Division of MoF.

**New BOT/PPP projects should not be signed until the fiscal consequences have been identified and quantified with MoF.** This includes an assessment of both explicit and contingent liabilities within the final draft contract prior to signature. An assessment of the cumulative effects of new liabilities on top of existing ones should also be undertaken. The GoM may also wish to consider capping the total amount of PPP liabilities it incurs.

### Upgrading the Allocation of Maintenance Budget – Investing in Existing Assets

**Maintenance costs and all other operational costs should be estimated at an early stage of project preparation.** Projects should not be selected without sight of these costs. Without adequate maintenance, assets resulting from investments quickly deteriorate, leading to underperformance, increasingly disappointing outcomes and, ultimately, increased pressure to replace them earlier than expected. It is also impossible to adequately appraise an investment project without an appraisal of the operating costs. There is no “golden rule” for the provision of maintenance budget levels, which in any case are usually provided for in the operational recurrent budgets of MDAs.

In the case of BOT/PPP projects, the provision, and therefore the cost, of maintenance is almost always the responsibility of the private company.<sup>11</sup> This means that the future maintenance costs are estimated by the private company in its business plan prior to submitting its tender for the project. Similar behavior is therefore required of public entities in preparing their project proposals for appraisal. The costs of future maintenance should therefore be estimated as a matter of course along with all other future operational costs associated with the project. For instance, in a school building proposal, the operational costs should include annual teacher and other staff costs, the heating and other utility costs, as well as the costs of the provision of other goods and services that needed in a school. This comprehensive approach of estimation of operational costs will enable the MoF to better plan its future recurrent budget provisions for completed projects.

<sup>11</sup> This is not the case in BT projects where the maintenance cost falls to the responsible public entity—another example of why BTs are not PPP projects.

## REFERENCES

- Bank of Mongolia, 2013. “Growth Accounting.” Internal Note. Ulaanbaatar, Mongolia.
- Bank of Mongolia, 2017. Monetary Policy Guideline for 2018. Government Document. Ulaanbaatar, Mongolia.
- Bank of Mongolia, 2018. Inflation report (2018 Q1). Government Document. Ulaanbaatar, Mongolia.
- Dutu, R., 2012. Long-Term Growth and Macroeconomic Stability in Mongolia. Technical assistance report on macroeconomic modelling and risk analysis. Multi-Sectoral Technical Assistance Project (MSTAP). Ulaanbaatar, Mongolia.
- Cheng, K., 2003. “Growth and Recovery in Mongolia During Transition.” IMF Working Paper No. 03/217. Washington, DC. USA.
- International Monetary Fund, 2018. Mongolia: Third review of the Extended Fund Facility Program. Staff report. Washington, DC. USA.
- [www.legalinfo.mn](http://www.legalinfo.mn)
- Ministry of Finance, 2018. Medium Term Fiscal Framework for 2019-21. Government Document. Ulaanbaatar, Mongolia.
- Piketty, T., 2014. Capital in the Twenty-First Century. The Belknap Press of Harvard University Press. Cambridge, Massachusetts. USA.
- World Economic Forum, 2016. Global Competitiveness Index 2016–17, Insight Report.
- Vashakmadze, E., 2018. Global and Regional Outlook and Risks – Key Highlights. Box prepared for the Global Economic Prospects report (2018), World Bank, Washington, DC. USA.
- World Bank, 2016a. Romania: Rationalizing the Existing Public Investment Portfolio. Technical assistance reports. Washington, DC. USA.
- World Bank, 2016b. Ukraine: Development and Introduction of a Methodology for Public Investment Portfolio Cleaning. Technical assistance reports. Washington, DC. USA.
- World Bank, 2018a. *Global Economic Prospects*. Washington, DC. USA (June).
- World Bank, 2018b. *The Commodity Markets Outlook*. Washington, DC. USA (June).
- World Bank, 2018c. *Mongolia: Public Expenditure Review*. Washington, DC. USA (forthcoming).

## ANNEX: GROWTH ACCOUNTING MODELLING

The growth accounting methodology aims to explain the growth rate of aggregate output in terms of the growth contributions from the various factors of inputs including capital, and labor, as well as the growth of Total Factor Productivity (TFP). The analysis normally assumes a standard neo-classical production function of type Cobb Douglas:  $Y = AL^{1-\alpha}K^\alpha$ . Where;  $K$  is capital stock,  $L$  is employment (Labor),  $\alpha$  represents the capital share in output, and  $A$  is the TFP, also referred as the Solow residual. At the macroeconomic level, the TFP captures the efficiency of capacity utilization and the rate of capacity utilization. The TFP can change due to efficiency — a desired long-term phenomenon such as technological or institutional changes or due to short term phenomenon of increasing or fall in the rate of capacity utilization from boom or bursts cycles.

Due to lack of data on capital stock in most countries including Mongolia, the growth accounting normally begins by assuming an initial capital output ratio  $(K/Y)_0$  in a certain period; in our case in this report, 1980. This is used to determine the initial capital stock,  $K_0 = Y_0 * (K/Y)_0$ . The perpetual inventory method is used to generate a series of capital stock using the gross fixed capital formation ( $I_t$ ) data and the rate of depreciation ( $\delta$ ) following the equation of motion of capital —  $K_t = (1 - \delta)K_{t-1} + I_t$ .

The assumption about  $(K/Y)_0$  is of paramount importance because if it is set too high, the incremental contribution of capital would be less and thus would be assigning a higher role to productivity. This is why rich countries can hardly increase their growth by accumulating more capital, yet low-income countries, which are capital deficient and thus with low capital-output ratio, command higher return on the scarce capital which may attract new capital to achieve higher growth.

In this analysis, we assume a capital output ratio of 1.5 (150 percent) in 1980. This assumption is reasonable in our view for two reasons. First, at the time the country was under the influence of Soviet Union and under the socialist system poor countries could hardly accumulate capital due to lack of private incentive. Secondly, this would yield a capital output ratio of 3.3 (330 percent) in 2017 which is quite reasonable compared to ratios ranging between 5-6 for wealthy nations (Piketty, 2014). Dutu (2012), a study financed under the World Bank's Multi-Sectoral Technical Assistance Project (MSTAP), assumes that the  $K/Y$  ratio in 2005 is 200 percent, far below the 560 percent by Bank of Mongolia for the same period.

In addition to the assumption about capital-output ratio, the Mongolia Economic Update assumes as it is common in the literature that  $\delta$  is 5 percent. The Bank of Mongolia study uses 6.8 percent, but this should not yield substantial differences in the results. With the assumptions on initial capital and depreciation, capital stock series are generated.

The last assumption made in the growth accounting analysis concerns the capital share in output,  $\alpha$ . This report uses the input output table for 2011-2015 and estimates an average  $\alpha$  of 63 percent, compared with 74 percent in Dutu (2012) and 51.6 percent in the Bank of Mongolia study of 2013 (Bank of Mongolia, 2013).

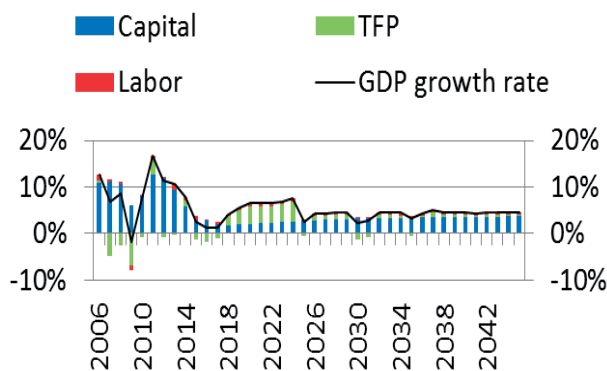
We apply HP-filter on employment and the estimated TFP to generate potential GDP implied by these assumptions and decompose its growth to establish the potential growth in Mongolia.

## MONGOLIA ECONOMIC UPDATE

Our results are similar to those obtained by Dutu (2012) (Figure (A).1) indicating that capital accumulation is the main driver of potential growth in the recent decade. The results in Bank of Mongolia (2013), informed by the Penn World Tables, seem less plausible as the capital output ratio implied in their analysis dramatically rises in the early -1990s and then rapidly falls from 7.6 in mid-1990s to 5.9 in 2005 to 3.6 in 2013, yet this was a period of rapid investments in physical capital in the country (Figure (A).2). The Bank of Mongolia results assigns a higher role to TFP in explaining growth as a falling ratio implies that real GDP is growing much faster than the stock of capital or the latter is falling. While a K/Y ratio of 7.5 surpasses that for many other high-income countries, its trend does not seem to capture the emergence of the capital stock fueled by FDI that Mongolia experienced in the recent decade, making Mongolia one of the EAP countries, after China, with the highest total investment (as a share of GDP) in 2017. In contrast, the estimates implied by the assumptions in this Update, appear to capture more adequately the recent decade of rapid investments and thus capital accumulation seen in Mongolia (Figure (A).3).

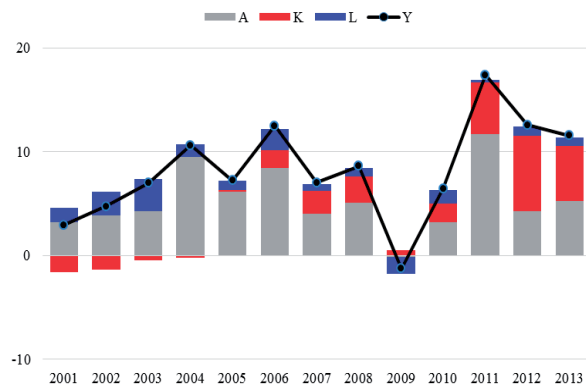
The growth accounting results in this report are also broadly in agreement with those of an earlier IMF working paper (Cheng, 2003), which covered a period up to early 2000. This paper also assumed an initial capital of zero in 1959, a capital share in output of 69 percent, and a depreciation rate of 6 percent. This IMF working paper concluded that capital accumulation was the main engine of growth before the 1990s, but TFP became positive only from the late 1990s up to 2000.

**Figure (A).1 Results of Growth Accounting by Dutu (2017)**



Source: Dutu (2012).

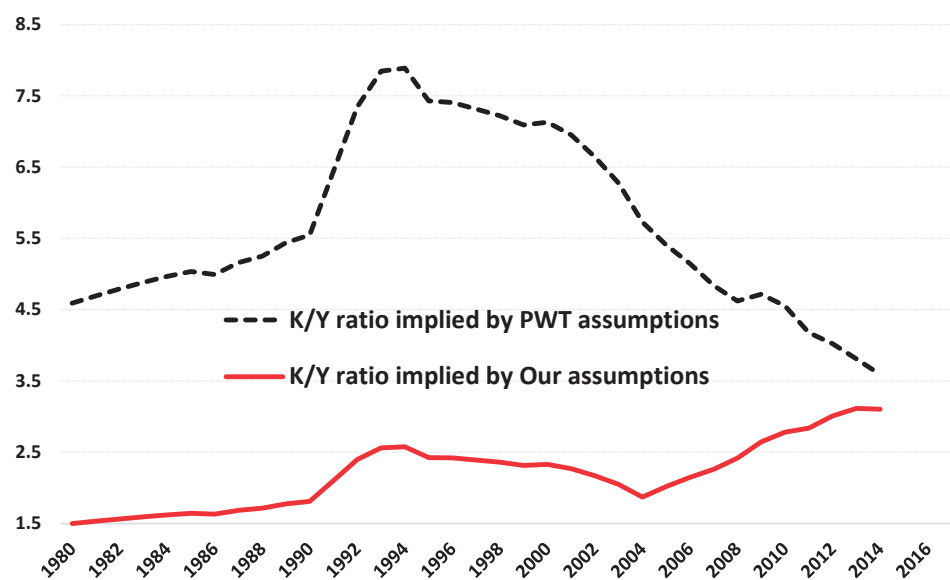
**Figure (A).2 Results of Growth Accounting by Bank of Mongolia (2013)**



Source: Bank of Mongolia (2013).



**Figure (A).3 A comparison of trends of the capital output ratio using various assumptions**



Source: Penn World Tables (PWT); World Bank staff estimates.







**THE WORLD BANK**  
IBRD • IDA | WORLD BANK GROUP

5<sup>th</sup> Floor, MCS Plaza Building, 4 Seoul  
Street, 14250 Ulaanbaatar, Mongolia  
Tel: +(976)70078200  
Web: [www.worldbank.org/mongolia](http://www.worldbank.org/mongolia)  
Twitter: WorldBankMgl

## **1 Mongolia Economic Update**