Country report **MONGOLIA**

Summary

Mongolia's economy is growing strongly on the back of strong investments in the mining sector and highly expansionary fiscal policies. As a result, real GDP growth is in double digits at an estimated 15% this year. The economy is overheating as a result, reflected by inflation, which will increase to an estimated 17% this year. The budget balance remains in the black, supported by large mining related revenues. Both public and external debt are decreasing rapidly. Mongolia's export structure is vulnerable, as it exports only a few commodities, nearly all to China. Moreover, Mongolia's FDI inflows are needed to cover large trade and current account deficits. With resource nationalistic parties now in the ruling coalition, there is a risk that FDI inflows will decline in the future.

Things to watch:

- Political developments and development policies
- Commodity/mineral prices
- Foreign investor interest in mining sector

Author: **Erwin Blaauw**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-62648
E.R.Blaauw@rn.rabobank.nl

Mongolia

National facts	
Type of government	Parliamentary
Capital	Ulaanbaatar
Surface area (thousand sq km)	1,564
Population (millions)	3.2
Main languages	Khalka Mongol (90%)
	Turkic, Russian
Main religions	Buddhist Lamaist (50%)
	Shamanist and Christian
	Muslim
Chief of State (president)	Tsakhia Elbegdorj
Head of Government (prime-minister)	Norov Altnkhuyag
Monetary unit	Tugrik (MNT)

Social and governance indicators	rank / total
Human Development Index (rank)	110 / 187
Ease of doing business (rank)	86 / 183
Economic freedom index (rank)	81 / 179
Corruption perceptions index (rank)	120 / 183
Press freedom index (rank)	100 / 178
Gini index (income distribution)	33.03
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
China	92	China	31
Russia	2	Russia	25
Canada	2	US	8
		Japan	7

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	9	0.01
Nominal GDP at PPP	13	0.02
IMF quotum (in mln SDR)	51	0.02
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2673	25
Nominal GDP per head at PPP	4223	34

Economic structure	*2011*
Real GDP growth (%)	17.3
Agriculture (% of GDP)	16
Industry (% of GDP)	33
Services (% of GDP)	51

Source: CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Due to limited data availability, the figures presented in this report should be treated as indicative.

Economic structure and growth

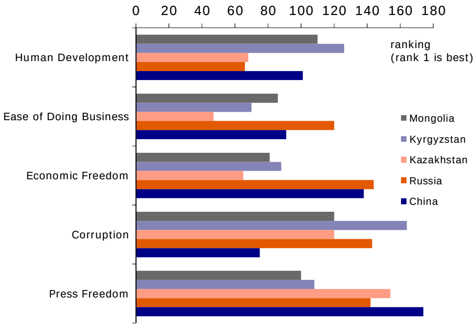
Traditionally, Mongolia's economy was dominated by herding and agriculture. However, mining Mongolia's large reserves of a wide range of mineral resources has become the main driver of economic development in the past decade. After a short-lived contraction in 2009, the economy returned to positive growth in 2010 on the back of export growth. Growth accelerated into double digit territory in 2011 on the back of strong investment in the mining sector, increased mining output and highly expansionary fiscal policies. With real GDP growth at 16.5% in 2011 and an estimated 15% in 2012, the Mongolian economy is overheating. In the years thereafter, growth will remain very strong on the back of increased mining output, as the Oyu Tolgoi mine is expected to come under steam in 2013.

The Oyu Tolgoi mine, one of the world's largest untapped copper reserves, is estimated to produce 500,000 tonnes of copper and 500,000 ounces of gold a year for the next 35 years. In addition, Mongolia is planning to step up the production of coal as well with the development of the Tavan Tolgoi coal mine, the World's largest untapped reserve of its kind. As a result, if managed correctly, Mongolia's economic medium-to-long term outlook should be bright.

In spite of these sound growth forecasts, Mongolia's economic structure remains vulnerable. The Mongolian economy is highly dependent on the production and export of commodities and thus at the mercy of international commodity price fluctuations. Moreover, Mongolia is landlocked between Russia and China and is highly dependent on trade with these countries. Russia supplies nearly all of its fuel and energy needs, while China buys more than 90% of the country's total exports. Mongolia is thus particularly vulnerable to adverse developments in the Chinese economy.

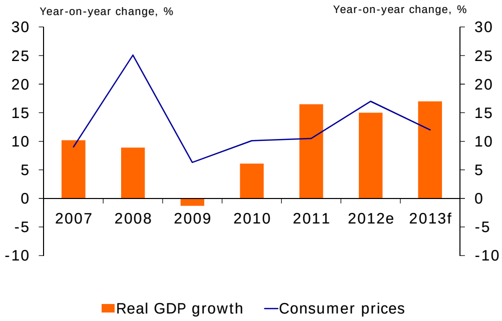
Furthermore, Mongolia sound economic outlook could be adversely affected by an adverse change in investor sentiment, as the country will need substantial amounts of foreign direct investment (FDI) to further develop its mining sector and reap the benefits of its massive natural resource endowments. After the June elections, the Democratic Party opted to form a coalition with two smaller parties, the Mongolian People's Revolutionary Party (MPRP) and the Mongolian National Democratic Party (MNDP). This is seen as a risk, as these parties are associated with resource nationalism, seeking to gain more control over, and an increased share of income from Mongolia's mining sector. Laws that were perceived as favoring foreign mining companies were overturned under pressure from these parties. As a result, the newly formed coalition is causing concerns among (potential) foreign investors.

Figure 1: Social indicators



Source: See factsheet

Figure 2: Growth and inflation



Source: EIU

Political and social situation

Mongolia's democracy is still young and, as a result, democratically accountable institutions are immature. Corruption, also among high-ranking officials, remains a problem and large protests followed the 2008 elections victory of the Mongolian People's Party (MMP), allegedly the result of election fraud. Following the 2008 elections, the MMP formed a coalition with the Democratic Party (DP) and the subsequent presidential elections (perceived as fair) were won by the Democratic Party candidate Elbegdorj. The next presidential elections are scheduled in May 2013. The DP won the recent parliamentary elections in June 2012, but opted not to renew the coalition with the MMP and instead chose to form a coalition with two smaller parties, the MPRP and the MNDP. To maintain the interest of foreign investors and to maintain political stability, consistent mineral resource wealth policies are vital, as the government has to balance the demands of the Mongolian people, many of whom have yet to reap the benefits of the developments in the mining sector, and the interests of foreign mining companies. With the MPRP and the MNDP now part of the ruling coalition, there is a risk that the balance will tip too far away from the interest of foreign investors and scare them off.

Although GDP per capita (in real terms) nearly doubled in the past decade, Mongolians remain relatively poor with average GDP per capita being around 25% of the world average and income growth that has been very uneven. To address this, the government is actively developing the mining sector to spur economic development. However, this policy is leading to increased public unrest, especially by cattle herders and environmentalists, the main supporters of the MPRP and the MNDP, who claim international mining companies destroy grasslands and receive overly generous terms.

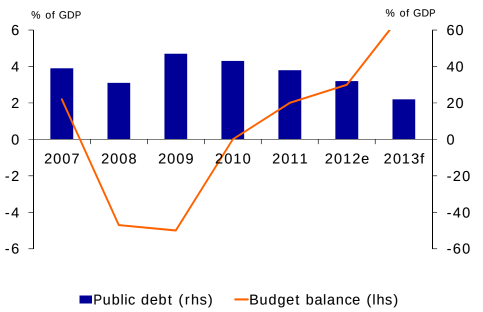
Mongolia's government's foreign policy is pragmatic, primarily aimed at maintaining good relations with its most important trade partners Russia and China. In addition, Mongolia is seeking closer relations with other countries that support its democracy, such as the US and Japan who are substantial aid donors, and with other Asian democracies in order to somewhat reduce Mongolia's dependence on its two large neighbors.

Economic policy

After Soviet support evaporated following the demise of the Soviet Union in 1991, Mongolia's economy fell in dire straits and the government was forced to embark on an extensive reform program geared towards a free market economy, including the privatization of the previously state-run economy.

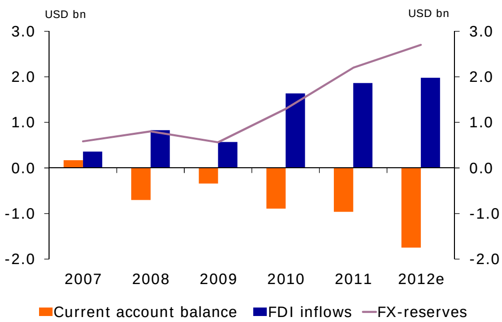
The government's current expansionary fiscal policies represent a return to the pro-cyclical fiscal policies of before 2009. On the one hand, the expenditure increase is understandable given the country's social and structural problems that need to be addressed. On the other hand, inflationary pressures will rise as a result, which will negatively impact people's purchasing power. A fiscal responsibility framework was introduced in 2010, but the targets will only take effect from 2013 onwards. For 2012, however, expenditures are expected to increase by 74% compared to 2011. Still, the government budget is expected to be in surplus this year, as it was in 2011, supported by large mining and export related revenues.. For 2012, a surplus of 3% of GDP is estimated, followed by a surplus of 7% and 4% of GDP in 2013 and 2014 respectively. Public debt, meanwhile, is a bit too high for comfort at 38% of GDP in 2011, but is declining and will expectedly amount to around 22% of GDP by 2014. If international commodity prices or mining output projections would disappoint, this would have a strong adverse effect on the health of Mongolia's public finances, as some 40% of total revenues are related to the mining sector.

Figure 3: Government finances



Source: EIU

Figure 4: Current account, FDI inflows and FX-reserves



Source: EIU

With the growth rate in double-digit territory, partly due to the expansionary policies, overheating is an important concern. Inflation was high at around 10% in 2010 and 2011, and is expected to increase further this year to 17%. When the fiscal responsibility framework becomes effective from 2013 onwards, inflation is expected to decrease to around 12% a year.

Monetary policies are inadequate to counter inflation, partly as the activities of Mongolia's central bank, the Mongol Bank, are subject to approval by a pro-growth oriented parliament. The

Mongolian tugrik floats freely, although the central bank does intervene from time to time to smoothen out volatility.

Balance of Payments and external position

Mongolia's trade account is one of the country's weaknesses. The trade balance usually shows a large deficit and is structurally weak, as Mongolia exports mainly commodities while having to import nearly all consumer goods and fuel. In addition, the trade balance is weakened by the substantial imports of capital goods related to the development of the mining sector. Furthermore, the services and income accounts are in deficit due to the involvement of foreign companies in the country's mining sector. Substantial remittances from Mongolians living and working abroad are insufficient to keep the current account in the black and the current account generally shows a wide deficit. In 2011, the current account deficit amounted to about 12% of GDP, and is expected to increase to nearly 17% of GDP in 2012. On the back of increased commodity exports, the current account deficit is expected to narrow from 2013 onwards.

The balance of payments is supported by strong FDI inflows, amounting to 23% of GDP in 2011 and estimated at around 17% of GDP this year. If foreign investors would be scared off by political developments, this would thus not only hurt the development of the economy, but also lead to a deterioration of the balance of payments. This would increase the vulnerability of Mongolia to poor economic performance of China and international commodity price fluctuations. Given Mongolia's large current account deficit and weak export structure in combination with its dependence on FDI inflows and donor aid to support the balance of payments, external liquidity risk is high.

For the time being, the trend is positive though, with foreign exchange (FX) reserves increasing from a low USD 561mln end-2009 to an estimated USD 2.7bn by the end of this year. The import cover provided by these reserves remains barely sufficient at around 3 months. Mongolia's foreign debt has increased steadily to nearly USD 4bn in 2012, but decreased as a percentage of GDP from a high 78% in 2007 to an estimated 33% this year. However, on the bright side, most of this external debt is on concessional terms.

Mongolia

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	10.2	8.9	-1.3	6.1	16.5	15.0	17.0
Consumer prices (average % change pa)	9.0	25.1	6.3	10.1	10.5	17.0	12.0
Current account balance (% of GDP)	4.4	-12.6	-7.5	-14.6	-11.9	-16.8	-14.7
Total foreign exchange reserves (mln USD)	583	802	561	1294	2197	2700	n.a.
Economic policy							
Budget balance (% of GDP)	2	-5	-5	0	2	3	7
Public debt (% of GDP)	39	31	47	43	38	32	22
Consumer prices (average % change pa)	9.0	25.1	6.3	10.1	10.5	17.0	12.0
Exchange rate LCU to USD (average)	1170	1267	1442	1256	1396	1290	1304
Recorded unemployment (%)	3.2	3.2	3.0	2.8	2.5	2.5	2.5
Balance of payments (mln USD)							
Current account balance	172	-706	-345	-891	-964	-1747	-206
Trade balance	-51	-627	-189	-183	-178	-333	-80
Foreign direct investment inflows	359	829	570	1635	1863	1976	196
External position (mln USD)							
Total foreign debt	3042	3360	3910	3782	3159	3432	3920
Total foreign exchange reserves	583	802	561	1294	2197	2700	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Current account balance (% of GDP)	4.4	-12.6	-7.5	-14.6	-11.9	-16.8	-14.7
FDI (% of GDP)	9.2	14.8	12.4	26.8	23.0	19.0	14.0
Foreign debt (% of GDP)	78	60	85	62	39	33	28
FX-reserves import cover (months)	4.1	2.9	2.1	2.8	3.4	2.7	n.a.

Source: S&P