Country report **MONGOLIA**

Summary

Mongolia's economy is recovering on the back of strong international demand for its commodity exports. Growth recovered to 6.1% in 2010 and will remain strong in the coming years. Structurally, Mongolia's economy is weak. The mining sector dominates the economy, which makes the country's economic performance dependent on international commodity price fluctuations. Moreover, Mongolia is landlocked between Russia en China, also the country's main trade partners, making the country dependent on good relations with its neighbours and susceptible to adverse economic developments in these countries. Inflation is rising on the back of the economic recovery and expansionary fiscal policies. This is forcing the central bank to tighten monetary policies, resulting in an inefficient policy mix. The government has to balance the demands of economically disadvantaged Mongolians and those of international mining companies to successfully develop its mineral resources. Mongolia's current account is structurally weak and usually in deficit, which is financed by donor aid, FDI inflows and debt flows. As a result, external liquidity risks are present in spite of the 8 months of import cover provided by the country's stock of FX-reserves.

Things to watch:

- Progress regarding further development of mining sector
- Negative international commodity prices fluctuations
- Rising inflationary pressures

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Mongolia

National facts	
Type of government	Parliamentary
Capital	Ulaanbaatar
Surface area (thousand sq km)	1,564
Population (millions)	3.1
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)	Sukhbaatar Batbold
Monetary unit	Tugrik (MNT)

Social and governance indicators	rank / tota
Human Development Index (rank)	100 / 169
Ease of doing business (rank)	73 / 183
Economic freedom index (rank)	94 / 179
Corruption perceptions index (rank)	116 / 178
Press freedom index (rank)	76 / 178
Gini index (income distribution)	36.57
Population below $1.25 per day (PPP)	2%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
China	85	Russia	33
Canada	4	China	31
Russia	3	Japan	6
		South Korea	6

Economy

Economic size	*bn USD*	*% world total*
Nominal GDP	6	0.01
Nominal GDP at PPP	11	0.01
IMF quotum (in mln SDR)	51	0.02
Standards of living	*USD*	*% world av.*
Nominal GDP per head	1935	20
Nominal GDP per head at PPP	3548	30

Economic structure	*2010*
Real GDP growth (%)	6.1
Agriculture (% of GDP)	15
Industry (% of GDP)	31
Services (% of GDP)	54

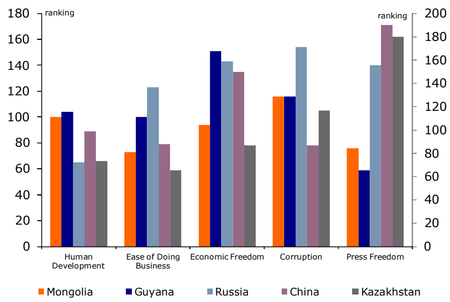
Source: Reuters EcoWin, IHS Global Insight, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

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

Economic structure and growth

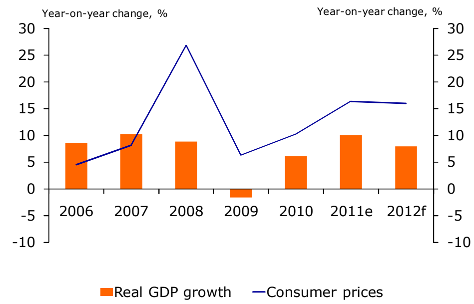
Traditionally, Mongolia's economy was been dominated by herding and agriculture. However, mining Mongolia's large reserves of a wide range of mineral resources, among which copper, gold, coal, uranium, tin and some more exotic minerals such as molybdenum and fluorspar, has become the main driver of economic development in the past decade. The global commodity boom therefore benefitted the Mongolian economy, with real GDP growth averaging 8.8% a year between 2003 and 2008. In 2009, the economy contracted by 1.6% before positive growth returned in 2010 (6.1%) driven by exports. In fact, all sectors performed well with the exception of the agricultural sector due to poor weather and the appreciation of the tugrik. Mongolia's economic medium-to-long term outlook is bright. The Oyu Tolgoi mine, one of the world's largest untapped copper reserves, will expectedly come under steam in 2013, which is estimated to produce, annually, 500,000 tonnes of copper and 500,000 ounces of gold for the next 35 years. In addition, with China's energy demand increasing (at the moment, some 40% of China's coal imports originate in Mongolia) and with the development of the Tavan Tolgoi coal mine, the World's largest untapped reserve of its kind, the importance of coal mining is expected to increase in the coming years. In all, the development of the mining sector is forecasted to propel GDP growth from 10% in 2011 and 8% in 2012 to an estimated 27% and 19% in 2013 and 2014 respectively. However, 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. As a result, the country is dependent on trade with these countries. Russia supplies nearly all of its fuel and energy needs while China buys around 85% of the country's exports. Finally, weather conditions, which are harsh with droughts in the summer and cold winters, can strongly and negatively affect economic performance.

Chart 1: Social indicators



Ranking; a higher ranking implies a worse score. Source: see factsheet

Chart 2: Growth performance



Source: IHS Global Insight

After the Mongolian banking sector was hit hard by the global economic crisis, substantial government support, among which capital support and a blanket deposit guarantee, was needed to keep the sector afloat. Since, the government has made progress in restructuring the sector and improving financial regulation and, although the banking sector is now recovering, it remains in a weak state.

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, formerly known as the Mongolian People's Revolutionary Party), allegedly the result of election fraud. In spite of the MMP's victory, a coalition government was formed with the Democratic Party. The subsequent presidential elections (perceived as fair) were won by the Democratic Party candidate Elbegdorj. Although the balance of power is tense, the country is ruled effectively. The next parliamentary election is scheduled in June 2012.

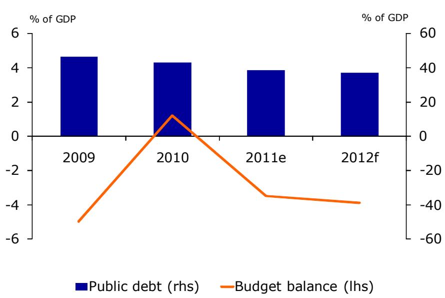
Although GDP per capita (in real terms) nearly doubled in the past decade, Mongolians remain relatively poor with average GDP per capita being around 20% of the World average and income growth that has been very uneven. To address this, the government is actively developing the mining sector to spur economic development. However, this policy is leading to increased public unrest, especially by cattle herders and environmentalists, who claim international mining companies destroy grasslands and receive overly generous terms. The harsh winter, which has forced many herders to relocate to the capital's slums, has aggravated the situation 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. After growth accelerated strongly during the global commodity boom, the economy

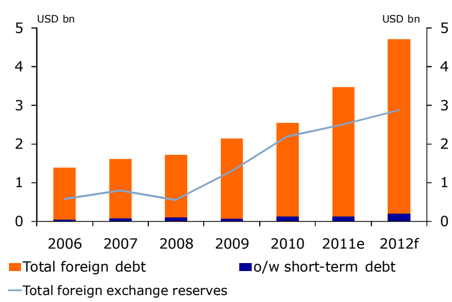
started to overheat, with inflation reaching nearly 30% in 2008. The global economic downturn relieved inflationary pressures, but a USD 236mln stand-by arrangement from the IMF was required to help the country move out of the crisis. The government's current expansionary fiscal policies have received strong criticism from the IMF, as the 7% expenditure increase planned for 2011 represents a return to the pro-cyclical fiscal policies adopted before the 2008/2009 crisis. On the one hand, the expenditure increase is understandable given the countries 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. What's more, a sudden fall of international commodity prices could make the current fiscal policy unsustainable. Strong broad money growth further increased inflationary pressures, prompting the Bank of Mongolia to start to tighten monetary policies. The resulting mix of expansionary fiscal policies and tightening monetary policies is inefficient, leading to increased macroeconomic instability and higher inflation. Indeed, inflation has been rising again from an average of 6.3% in 2009 to 10.2% in 2010, while a further increase to 16% in 2011 and 2012 is anticipated.
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. In January 2011, the 68% windfall profits tax on copper and gold was abolished. Although this opened the way for further mining developments, it will negatively affect government revenues. Still, the government's budget is currently not in a very poor shape. Supported by the mining sector and currently high commodity prices, the government was able to achieve a 2.5% of GDP surplus in the twelve months up to March 2011. However, in 2009, the budget registered a 5% of GDP deficit and the IMF projects budget deficits for 2011 and 2012 of 3.5% and 3.9% of GDP, respectively. Reflecting the importance of the mining sector, which accounts for some 40% of government revenues, the budget shows a wide deficit, estimated at 13% of GDP in 2011, when mineral related revenues are excluded. At 43% of GDP, public debt is a bit too high for comfort, given the country's level of development and its structural vulnerabilities, but manageable and expected to decline to 37% of GDP by 2012 in spite of a planned USD 700mln sovereign bond issue.

Chart 3: Public finances



Source:

Chart 4: Foreign debt and FX--reserves



Source:

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. Substantial remittances from Mongolians living and working abroad are insufficient to keep the current account in the black and Mongolia's current account deficit is rather sizeable at around 15% of GDP in 2010 and 2011. Increased mining output will boost exports in the coming years and the current account is expected to show a positive balance from 2013 onwards. Nonetheless, FX-reserves are expected to continue to increase from USD 2.2bn in December 2010 to USD 2.9bn by end-2012 as increased debt flows and foreign direct investment should cover the current account shortfall in the coming years. As imports increase, the import cover ratio will decline from 8.2 months in 2010 to 6.4 months in 2012. Mongolia's foreign debt has been increasing gradually from USD 1.4bn in 2006 (45% of GDP) to USD 2.7bn in 2010 (53% of GDP). In the coming years, further sharp increases to USD 3.6bn in 2011 and USD 4.5bn in 2012 are anticipated as the country borrows abroad to finance its development. However, as foreign debt is mostly on concessional terms (short-term debt is low at around USD 130mln), Mongolia's external position is less problematic than it seems. Nevertheless, as a result of the large current account deficit, external liquidity remains a concern, especially given the vulnerable current account structure.

Mongolia

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	8.6	10.2	8.9	-1.6	6.1	10.0	8.0
Consumer prices (average % change pa)	4.5	8.2	26.8	6.3	10.2	16.4	16.0
Current account balance (% of GDP)	6.5	6.3	-12.9	-9.0	-15.2	-13.3	-14.0
Total foreign exchange reserves (mln USD)	583	802	561	1294	2197	2510	2871
Economic policy							
Budget balance (% of GDP)	n.a.	n.a.	n.a.	-5.0	1.2	-3.5	-3.9
Public debt (% of GDP)	n.a.	n.a.	n.a.	47	43	39	37
M2 growth (% change pa)	n.a.	n.a.	n.a.	27	62	45	24
Consumer prices (average % change pa)	4.5	8.2	26.8	6.3	10.2	16.4	16.0
Exchange rate LCU to USD (average)	1165	1170	1268	1443	1256	1150	1127
Recorded unemployment (%)	3.2	2.8	2.8	3.3	3.3	3.0	3.0
Balance of payments (mln USD)							
Current account balance	n.a.	n.a.	n.a.	-410	-931	-1302	-1438
Trade balance	n.a.	n.a.	n.a.	-194	-278	-1049	-1107
Foreign direct investment inflows	n.a.	n.a.	n.a.	496	1574	1130	580
External position (mln USD)							
Total foreign debt	1440	1682	1833	2212	2682	3600	4910
Short-term debt	46	75	108	72	134	130	200
Total foreign exchange reserves	583	802	561	1294	2197	2510	2871
Key ratios for balance of payments, external solvency and external liquidity							
Current account balance (% of GDP)	n.a.	n.a.	-12.9	-9.0	-15.2	-15.1	-13.6
Foreign debt (% of GDP)	45	41	39	57	53	52	56
FX-reserves import cover (months)	3.7	3.9	1.8	5.9	8.2	6.7	6.4

Source: IMF, IHS Global Insight