MONGOLIA QUARTERLY BRIEF – OCTOBER 2011

(The full report can be downloaded at http://www.worldbank.org.mn)

The economic rebound in recent quarters has been stronger than expected and the economy is showing signs of overheating. These signs are show up in rising inflation, especially of those goods and services which are in strong demand, but cannot easily be imported or whose local supply cannot readily be increased to meet the growing demand. GDP growth reached 20.8 percent year-on-year (yoy) in Q3, following an outturn of 17.3 percent in Q2. Growth for the year as a whole will likely hit 15 percent, if not more, up from 6.4 percent in 2010, and is being pushed by infrastructure spending as Mongolia develops its vast mineral wealth.

Mining and manufacturing output are both rising at a healthy rate but there are growing fears of another construction bubble similar to the previous boom in 2004-08. Unemployment is trending down, but overall levels remain high at around 9 percent and October survey results from selected informal labor markets indicate that, on average, real wages have fallen (due to inflation) since the July survey. Almost half of those surveyed indicated that their earnings did not meet their basic needs, which confirms the negative impact of inflation on the poor.

Inflation continues its upward trend. Headline inflation in Ulaanbaatar accelerated to 11.9 percent yoy in September from 9.9 percent in August. Note that core inflation, which excludes all food and energy, has now continuously kept rising throughout the year, reflecting generalized wage and price pressures from a booming economy and large government cash handouts. With food prices rising and the government expected to ramp up spending sharply, inflation will likely rise further.

The trade deficit is close to record levels (US$ 1.4 bn in September using 12-month rolling sums) driven by a surge in mining-related equipment and fuel imports. Exports are growing strongly too, driven by large coal shipments to China. Nevertheless, copper exports are barely growing in volume terms, and cashmere exports are doing even worse. The Togrog has depreciated against the US$ since August in line with other currencies in the region due to rising global risk aversion, but this has been relatively small (about 4.8 percent), as FDI inflows to develop the OT mine have remained strong.

Although bank capital buffers are in much better shape compared to 2009 when two banks failed, nevertheless, continued vigilance on financial risks is necessary on a number of counts. High lending growth in the banking sector is focusing attention on asset quality in the banking system. Credit growth of 52 percent yoy in real terms in September is higher than the underlying real growth in the economy and is also highly concentrated, while the volume of non-performing loans remains high. And although deposits in the banking system are hitting new peaks, the loan to deposit ratio (excluding government deposits) has risen to about a 100 percent, implying growing liquidity risks. Ensuring financial stability will require close monitoring and pro-active implementation of macro-prudential norms and regulations such as higher capital ratios and limits on loan to value ratios.

The Bank of Mongolia raised its interest rate by 0.5 percentage points to 12.25 percent in October. This is the third rate increase this year, complemented by two increases in the reserve requirement ratio, in response to the rising trend in core inflation. Given long policy lags, and with inflation continuing to rise, more action will be needed. However, monetary policy's effectiveness in fighting inflation is undermined by expansionary fiscal policy, as is currently the case.

With government revenues boosted by mining sector receipts and a booming economy, public sector finances are in relatively good shape. On a 12-month rolling basis, the fiscal balance amounts to 2.5 percent of GDP in September.

In September, the government submitted to Parliament an amended 2011 Budget Law for consideration alongside the 2012 budget. Recall that the original 2011 budget already raised expenditures by 32 percent over 2010 outturns. While excess mineral revenues are saved in a stabilization fund as required by the Fiscal Stability Law (FSL), this is not required for above-trend non-mineral revenues. It is these that the government is proposing to spend under the 2011 budget amendment. This would raise expenditures by another 20 percent on top of 2011 plans, with a deficit target of 9.8 percent of GDP.

The 2012 Budget continues this fiscal expansion and targets a 74 percent increase in expenditures (mostly on wages and social transfers). In absolute terms, the proposed fiscal expenditure in the 2012 budget is double total expenditures in 2010 and is only slightly lower than total GDP in 2010. At the same time, based on optimistic revenue and GDP projections, the 2012 budget deficit is estimated at 4.1 percent of GDP.

Increased spending on wages and transfers creates the risk of setting in motion a wage price spiral, if higher inflation expectations become entrenched. Aside from the negative impact on the poor, this will undermine the competitiveness of exporting (agriculture) and import-competing businesses (mostly small and medium sized enterprises). Fortunately, the draft 2012 budget plans for the introduction of proxy means tested benefits targeted to the poorest in the second half of next year, replacing the current universal cash transfers. Twelve percent of the budget is allocated for this purpose.

Revenue, expenditure and GDP forecasts underlying the 2012 budget proposal are optimistic. High GDP forecasts are based on (i) continued strong flows of foreign direct investment, which has more than doubled between 2010 and 2011; (ii) continued rapid expansion of the mining sector, including coal; (iii) public investment being raised by a multiple, with second-round effects on economic growth due to multiplier effects; and (iv) an upsurge consumer demand due to the final disbursements of cash to the citizenry ahead of the 2012 elections, in order to fulfill the political promises made during the 2008 elections.

There are risks that these optimistic forecasts would not materialize. For instance, revenues could discontinue or reverse their current trends if the global economy deteriorates, coal exports could run into transport capacity constraints, large public investment projects could be delayed due to capacity constraints in preparation, contracting and execution, and OT production could be affected by delays in obtaining power from China.

Risks in the global environment have increased with heightened uncertainty in international financial and debt markets, and a slowdown of growth in developed countries. Indeed, commodity prices have already started falling. Accordingly, pro-active, prudent and risk-averse economic management is now needed, as the economy shows signs of overheating against a backdrop of rising global risks.