MONGOLIA

Highlights

- **The economy is recovering well.** Growth reached 5.3 per cent in the first half of 2017, significantly up from 1.0 per cent in 2016, largely reflecting the base effect, high fixed investment in the mining sector and a recovery in household consumption.
- **A new IMF programme is in place.** This is part of a broader US$ 5.5 billion package supported by China, Japan, Korea, the Asian Development Bank (ADB) and the World Bank. Disbursements are conditional on fiscal consolidation, monetary policy and banking sector reforms as set out in the new programme.
- **Significant fiscal reforms have been passed.** Progress has been made on legislation that strengthens tax administration, tax policy and budgetary controls, including through the establishment of a fiscal council.

Key priorities for 2018

- **Reforms under the IMF programme need to be implemented effectively.** Critical pillars of the programme are fiscal consolidation, strengthening the banking system, financial market reform, restoring debt sustainability and rebuilding international reserves.
- **Banking sector reforms need to advance.** A forthcoming Asset Quality Review should be followed by recapitalisation and restructuring of banks as needed. It will be key to improve the supervisory and regulatory framework, and strengthen the governance and independence of the Bank of Mongolia.
- **An environment conducive to large mining sector projects needs to be secured.** The natural resources sector requires further reform, including the promotion of transparency of the licensing process, further improving the effectiveness of the implementation of existing legislation, and strengthening the independence and technical capacity of the regulatory bodies.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	11.6	7.9	2.4	1.0	2.6
Inflation (average)	8.6	12.9	5.9	0.6	4.5
Government balance/GDP	-6.8	-1.2	-5.0	-15.4	-10.4
Current account balance/GDP	-25.4	-11.5	-4.8	-6.3	-4.9
Net FDI/GDP [neg. sign = inflows]	-16.7	-2.3	-0.9	37.8	-8.8
External debt/GDP	151.2	171.7	184.4	248.3	247.4
Gross reserves/GDP	17.8	13.5	11.3	11.8	n.a.
Credit to private sector/GDP	56.2	56.2	50.5	52.0	n.a.

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Macroeconomic performance

Mongolia's economy is recovering. Economic growth slowed to just 1.0 per cent in 2016, as domestic demand declined and investment struggled to recover from the downturn in previous years. However, a strong recovery has taken hold since late 2016 thanks to growing investment in the mining sector and higher coal prices and exports. Real GDP growth reached 5.3 per cent year-on-year in the first half of 2017, following a 9.8 per cent rise in the fourth quarter of 2016. Household consumption also improved. External trade turnover increased by 33.4 per cent year-on-year in the first nine months of 2017. Exports rose by 37.5 per cent year-on-year in US dollar terms, led by coal exports, while imports rose by 27.9 per cent in the same period.

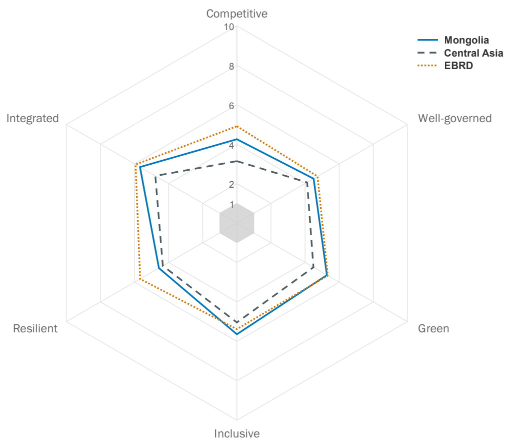
Currency pressures eased in 2017. This reflects the effect of the new IMF programme, the accompanying fiscal reforms, and higher exports. The tugrik modestly appreciated against the US dollar in the first 10 months of 2017, following a 20 per cent depreciation over 2016. This allowed the central bank of Mongolia (BOM) to lower its policy rate to 12.0 per cent in June 2017 from the 14.0 per cent rate established earlier. Upward pressure on inflation has been gradually building from low levels in 2016. Inflation reached 5.8 per cent in September 2017 year-on-year, after averaging 0.6 per cent in 2016.

Public finances have remained a challenge, although liquidity pressures have been overcome. The budget deficit widened to 15.4 per cent of GDP in 2016, versus an initially budgeted 4.0 per cent, partly as a result of including into the budget spending programmes previously undertaken by the central bank. For 2017, the budget deficit is expected to narrow to a still-significant 10.4 per cent of GDP, reflecting substantial reductions in the spending on state-funded programmes. Short-term liquidity pressures have abated since the government refinanced an external bond due in March 2017 by issuing a new seven-year maturity bond. This demonstrated solid market access in light of the new programme with the IMF, which unlocks a US$ 5.5 billion financial package from multilateral and bilateral lenders over the next three years to maintain the economic stability of the country.

In October 2017 the government of Mongolia issued US$ 800 million in a 5.5-year bond with a 5.625 per cent coupon. Proceeds from the bond will be used to repay debts from the government's previous bonds, including the Chinggis and Dim Sum bonds. Major public debt repayments will thus not be due before 2021.

The economy is projected to grow by 2.6 per cent in 2017, rising to 3.0 per cent in 2018, as mining investment and exports accelerate driven by the expansion of the second phase of the Oyu Tolgoi mine. Public spending will by contrast remain subdued in 2017-18, given the government has remained committed to the significant fiscal tightening envisaged under the IMF programme.

Assessment of transition qualities (1-10)



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Major structural reform developments

Mongolia is quite advanced towards its transition to a market economy. The country has the highest average transition quality score compared with other Central Asian countries and ranks 23rd among the 37 EBRD countries. Mongolia ranked 62nd out of 190 countries in terms of ease of doing business according to the World Bank *Doing Business 2018* report, with large gaps remaining in the areas such as getting electricity and trading across borders. In the mining sector, issues surrounding the share of state ownership, the rules governing the allocation of risks and rewards between the state and private investors, and the tax regime have all been subject to change and uncertainty.

Structural reforms are anchored within the new IMF programme. The programme – a three year US$ 434 million extended fund facility signed in May 2017 – focuses on economic reforms to: (i) tighten fiscal policy; (ii) improve the central bank's independence, governance and focus on core responsibilities; (iii) strengthen the financial sector; (iv) foster economic diversification and inclusive growth; and (v) protect the most vulnerable in society. The approval of the programme unlocked an additional US$ 5.2 billion financial support package, with the ADB, the World Bank, Japan and Korea, providing around US$ 3 billion budgetary and project support, and China extending an around US$ 2.2 billion swap line to BOM for the next three years.

The structural reform agenda has advanced. Staff-level agreement on the first and second review of the IMF programme was reached in October 2017. The rehabilitation and strengthening of the banking system is under way: the results of the comprehensive Asset Quality Review are expected in mid-December; important legal reforms are being drafted to strengthen the financial system; and improvements to the regulatory and supervisory framework are under way. On the fiscal side, progress has been made in strengthening the tax administration, tax policy and budgetary controls including through the establishment of a fiscal council and a high-level working group on tax policy.

Significant fiscal reforms have been passed. Legislation passed in April 2017 focused heavily on revenue-side reforms. Changes include a progressive personal income schedule that replaces the flat rate of 10 per cent applied previously and the taxation of interest on personal savings. Under the new progressive schedule, individuals with earnings exceeding tugrik 1.5 million (US$ 70,000) will be liable to additional marginal tax rates of 15 to 25 per cent. Other important amendments include the raising of retirement ages, which will be increased by six months every year from 2018 to reach the target pension-drawing ages of 65 years for men and women by 2028 and 2038, respectively. A 10 per cent tax will be levied on all savings accounts, effective from May 2017. Also, increases were adopted on fuel taxes, a vehicle tax schedule targeting larger vehicle engine capacities. Tariffs on imported cigarettes were also increased from 5 to 30 per cent, and higher excise taxes were imposed on alcoholic beverages and cigarettes, to be phased in during 2018-20. Mandatory social insurance fund contributions will also be increased gradually from 2018.

The strategic Oyu Tolgoi II mining project is gathering pace. Rio Tinto, the operator of Mongolia's biggest mine, Oyu Tolgoi (OT), is making progress on the second phase of the project, which was launched in 2016. A sum of US$ 6 billion has been invested so far in OT, and another US$ 5 billion could be invested under the new phase. Significant structural changes were made earlier to support mining activities in the country, which included the amendments to the Foreign Investment Law that clarified applicable tax regimes and permitted most foreign private investors to invest in a range of strategic sectors without seeking government approval. The amendments also stipulated that foreign-invested projects are governed by the rules in place when the contracts were signed. However, restrictions remain on foreign state-owned enterprises acquiring control of key mining assets.