MONGOLIA

Highlights

- **The economy continues to grow dynamically.** Growth accelerated to 6.3 per cent in the first half of 2018 after reaching 5.1 per cent in 2017. Copper exports and mining-related investment are major growth drivers, with domestic consumption also picking up.
- **Reform implementation has been largely on track, although with delays in some areas.** The quantitative benchmarks for foreign exchange reserves and fiscal balance under the IMF programme have been met, but some fiscal accounts and financial sector reform measures have been delayed.
- **The results of the Asset Quality Reviews (AQRs) in the banking sector were better than expected.** The AQRs revealed an aggregate capital need in the sector of 2 per cent of GDP, well below earlier projections. Banks need to meet the targeted capital levels by the end of 2018.

Key priorities for 2019

- **Fiscal consolidation needs to continue in line with the IMF programme.** Given the high level of public debt, equal to 84.6 per cent of GDP in 2017, government spending should be restrained and the efficiency of public spending enhanced. The management of public finances needs further improvement, especially the granting of concessions and public investment.
- **The banking sector should be strengthened.** Among the main short-term priorities in order to improve financial resilience and reduce borrowing costs are the recapitalisation of the banking sector and the adoption and enforcement of the non-performing loan (NPL) resolution framework.
- **The investment climate in the mining sector needs to improve.** To increase investor confidence, greater transparency, predictability and certainty in administration and enforcement of existing legislation in the mining sector are key.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	7.9	2.4	1.2	5.1	6.1
Inflation (average)	12.9	5.9	0.5	4.6	7.0
Government balance/GDP	-11.3	-8.5	-17.0	-1.9	-3.5
Current account balance/GDP	-11.3	-4	-6.3	-10.4	-9.0
Net FDI/GDP [neg. sign = inflows]	-2.8	-0.8	37.2	-13.1	-14.0
External debt/GDP	178.7	193.3	220.7	246.9	n.a.
Gross reserves/GDP	13.5	25.6	11.6	27	n.a.
Credit to private sector/GDP	59.3	53.9	56.9	52.9	n.a.

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Macroeconomic performance

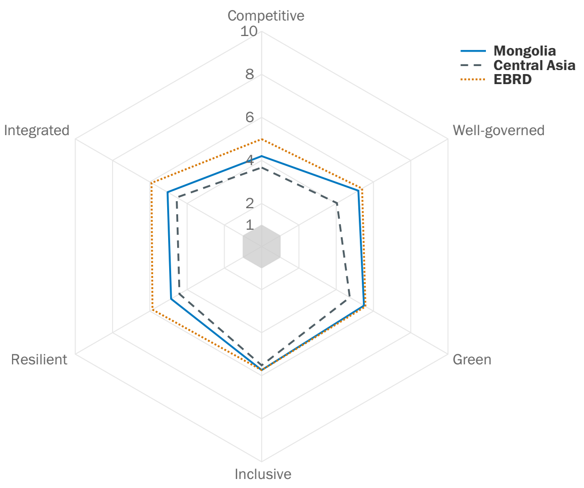
Economic growth has strongly accelerated. Real GDP grew by 5.1 per cent in 2017 after only 1.2 per cent in 2016, and continued growing by 6.3 per cent year-on-year in the first half of 2018. GDP growth was supported by rising commodity exports and foreign direct investment (FDI) in the mining sector. Domestic consumption has also begun to pick up. Stronger domestic demand induced inflation to accelerate from an average of 0.6 per cent in 2016 to 5.7 per cent year-on-year in September 2018. This is, however, still below the central bank's 8.0 per cent target.

External buffers are being rebuilt. Exports rose by 27.2 per cent year-on-year in US dollar terms in the first nine months of 2018, driven by copper exports, while imports rose by 45.8 per cent in the same period. A surge in FDI-related imports and repatriated profits led to a widening of the current account deficit from 6.3 per cent of GDP in 2016 to 10.4 per cent of GDP in 2017. However, this was more than compensated by FDI inflows, incoming donor funds and proceeds from bond issues in 2017, and resulted in a build-up of foreign exchange reserves from US$ 1.1 billion in January 2017 to US$ 2.9 billion in August 2018, equivalent to eight months of imports of goods and services. As a consequence, exchange rate pressures were alleviated and the currency appreciated slightly during 2017 and the first six months of 2018. This allowed the Bank of Mongolia (BoM) to cut the policy rate stepwise from 14.0 per cent in January 2017 to 10.0 per cent in March 2018. The tugrik has weakened slightly since mid-year 2018, along with other emerging market currencies, but not sufficiently to prompt the central bank to change its policy rate.

Fiscal consolidation measures and strong economic growth markedly improved the fiscal balance. The general government deficit narrowed from 17.0 per cent of GDP in 2016 to 1.9 per cent of GDP in 2017, performing substantially better than targeted under the IMF programme. Public finances improved as a result of rising tax receipts as exports strengthened and corporate incomes grew. Substantial reductions in capital expenditures also contributed to the better fiscal performance. Public debt decreased from 87.6 per cent of GDP in 2016 to 84.6 per cent of GDP in 2017.

Real GDP growth is forecast to stay around 6.0 per cent in the short run. The economy is projected to grow by 6.1 per cent in 2018 and 6.0 per cent in 2019. Mining-related FDI and a continued recovery in domestic consumption are expected to be key drivers. However, a slow-down in the implementation of reforms would expose the economy to risks, as Mongolia still faces a high external debt burden of 247 per cent of GDP and remains vulnerable to Chinese import policies and fluctuations in copper and coal prices.

Assessment of transition qualities (1-10)



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Major structural reform developments

Business environment reforms have been mixed. Mongolia ranked 74th out of 190 countries in terms of ease of doing business according to the World Bank's *Doing Business 2019* report. It scored relatively highly in getting credit, protecting minority investors, dealing with construction permits, but poorly in such areas as getting electricity, resolving insolvency and trading across borders. In the past two years progress has been made in enforcing contract and strengthening access to credit by setting up a new collateral registry. However, the unstable legal environment continues to be a constraint to FDI flows. In addition, amendments to the corporate income tax law effective from January 2018 have introduced a payment of a 30 per cent tax rate on gross assessed value of transfer of licence for land use, including exploration and extraction licences for mining, which further increases the costs of doing business for investors. Under pressure from businesses, particularly in the mining sector, the rate was subsequently lowered to 10 per cent of the assessed net value of the transfer rights.

Important reforms have progressed, but with delays in some areas. The overall reform agenda is anchored by a three-year Extended Fund Facility (EFF) with the IMF, signed in May 2017. The fifth Review of the EFF was completed in October 2018 with all end of September 2018 quantitative targets achieved. International reserves have increased substantially and the primary fiscal balance showed a surplus, mostly driven by positive external demand which has boosted tax revenues. Total disbursements under the IMF programme have so far reached around US$ 217.33 million out of the approved US$ 434.3 million. Stable programme performance is also paving the way for unlocking further disbursement funds of external donors. At the same time, structural reform progress has been lagging in some respects, with slower-than-expected implementation of fiscal reform and financial sector benchmarks.

Asset Quality Reviews have been completed and banks are required to take action by the end of 2018. The reviews revealed a capital shortfall in the banking system of around 2.0 per cent of GDP at the end of 2017, well below earlier IMF projections of a shortfall of 7.0 per cent of GDP. Capital adequacy was estimated at 13.7 per cent and liquidity coverage at 45.0 per cent. Banks are now working with the BoM on their respective action plans. Those banks that fail to meet capital requirements will have to sell assets or attract new capital. If some systemic banks are unable to close the capital shortfall, they will receive public funds.

The institutional, supervisory and regulatory framework of the central bank is being strengthened. Important changes to the Central Bank Law and Banking Law were adopted in January 2018. The new Central Bank Law enhances the independence of the BoM by restricting budgetary operations unrelated to its purpose, reduces the governor's voting power in favour of collective decision-making, and subjects the bank's operations to annual external audits. It also provides the BoM with greater power to conduct macro-prudential policies. The Banking Law was revised to introduce requirements to disclose the ultimate owners of banks, adopt corporate governance rules and restrict banks from setting up subsidiaries or affiliates for the purpose of circumventing bank regulation.

Fiscal and tax reforms have advanced, but several earlier measures were not followed through. Budget expenditures calculation has been modified to include net lending to the Development Bank of Mongolia, which used to finance off-budget investment projects. The fiscal target set by the IMF will apply to the combined outlay. Furthermore, amendments to the general tax law have been submitted to parliament. The new law envisages tax refunds of 90 per cent of income tax paid by small and medium-sized enterprises with annual sales income of less than MNT 1.5 billion (US$ 600 million equivalent). Taxpayers who cannot pay taxes on time, but who prove they can pay fully later, will be allowed an extension period of up to two years. However, in response to increased government revenues and rising public discontent, measures to introduce a progressive income tax, increase fuel excise tax and increase the pension age have not been implemented in line with the legislation adopted in April 2017.

A platform for public-private dialogue was established to improve the investment climate and ensure better investor protection. A Public Private Consultative Committee was set up under the Investment Protection Council in December 2017. The main task of the committee is to facilitate information sharing and the dialogue between authorities and the private sector about investment policies and regulations.