MONGOLIA

Highlights

- **Mongolia's growth has declined.** Growth reached 2.4 per cent in 2015 and 2.9 per cent in the first half of 2016, compared with 7.9 per cent in 2014, reflecting lower commodity prices and slower exports to China. Growth is expected to slow down significantly in the second half of 2016.
- **Expansion of Phase II of OT (Oyu Tolgoi) is likely to start in the second half of 2016.** Rio Tinto approved the underground development of the mine in May 2016. The US$ 6 billion project is expected to materially improve Mongolia's economic prospects and investment attractiveness.
- **The government has revised the fiscal framework for 2016-18, significantly increasing the budget deficit.** Most of the increase arises from consolidation of the off-balance sheet expenditures, which will help improve the transparency of fiscal expenditure. The planned level of the budget deficit in 2016 (18.2 per cent of GDP) is in breach of the 4.0 per cent deficit ceiling set in the Fiscal Stability Law.

Key priorities for 2017

- **Transparency and effectiveness of implementation of large projects in the mining sector need to be enhanced.** The development and expansion of large exploration projects will be the key drivers of economic growth in the coming years, but the natural resources sector requires further reform – including promotion of transparency of the licensing process; further improving the effectiveness of implementation of existing legislation; and strengthening the independence and technical capacity of the regulatory bodies. Implementation of the Extractive Industries Transparency Initiative (EITI) needs to continue.
- **Transparency of public accounts should be boosted by new technology.** Today, around 20 per cent of government goods and services are purchased through e-procurement. There would be significant benefits in terms of fairness and competition from increasing this to 100 per cent for central and regional public procurement.
- **Mongolia's high infrastructure requirements need greater private sector involvement.** The establishment of a strong framework for concessions/public-private partnerships (PPPs) should be combined with further strengthening of the project assessment and implementation capacity of the Development Bank of Mongolia.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	12.3	11.6	8.1	2.4	1.7
Inflation (average)	15.0	8.6	12.9	6.6	3.8
Government balance/GDP	-8.3	-7.5	-8.9	-5.0	-18.2
Current account balance/GDP	-27.4	-25.4	-11.5	-4.0	-11.1
Net FDI/GDP [neg. sign = inflows]	-35.8	-16.7	-2.3	-0.9	-7.2
External debt/GDP	60.1	74.2	88.3	93.3	n.a.
Gross reserves/GDP	33.6	17.8	13.5	11.3	n.a.
Credit to private sector/GDP	49.6	60.9	56.8	50.6	n.a.

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Macroeconomic performance

Mongolia's economic growth has been decelerating over recent years. From a peak of 17.3 per cent in 2011, economic growth slowed to 8.1 per cent in 2014 and further to 2.4 per cent in 2015 as inward foreign direct investment (FDI) dropped and key mining projects stalled. FDI inflows dropped from an average of 35 per cent of GDP in 2011-13 to around 0.9 per cent of GDP in 2015, owing to the earlier suspension of Phase II of OT, a major copper and gold deposit. Growth was also negatively affected by lower commodity prices and slowing demand from China – the main trading partner which accounts for around 88 per cent of Mongolia's exports. Currency pressures intensified in 2016, with the tugrik depreciating by around 13 per cent in January to September 2016. Economic slow-down and currency weakening in 2014-16 contributed to a rise in non-performing loans (NPLs) to 9.1 per cent in August 2016 from 5.0 per cent in December 2014. The National Bank of Mongolia gradually cut the policy rate to 10.5 per cent in May 2016 from 13.0 per cent in 2015, but increased it again by 4.5 percentage points to 15.0 per cent in August 2016.

The external position remains weak. As investment activity slowed, the current account deficit has declined from around 26.0 per cent of GDP in 2011-13 to around 4.0 per cent of GDP in 2015. Trade turnover decreased by 23.1 per cent, mainly due to a decrease in imports of 27.5 per cent, while exports decreased by 19.1 per cent. The high external debt level remains the main risk to the country's external position, with total external debt reaching 200 per cent of GDP in June 2016 (142 per cent excluding intercompany lending). High repayment volumes of around US$ 1.1 billion (around 9.4 per cent of GDP) are planned for 2017-18 as sovereign external bonds mature. The positive investor sentiment towards government debt in the country has increased, however, following the signing of Phase II of the OT project and given the prospects of longer-term gains from the country's mining resources. The government issued a US$ 500 million five-year sovereign bond in April 2016 and mobilised US$ 250 million through a syndicated five-year loan in March 2016.

Public finances are deteriorating. The deficit reached around 5 per cent of GDP in 2015 and the budget revenue estimate for 2016 was revised down by 23.8 per cent to MNT 5,344.3 billion, while expenditure increased by 22.5 per cent to MNT 9,741.4 billion. The projected budget deficit is 18.2 per cent of GDP, which is in breach of the 4.0 per cent Fiscal Stability Law deficit ceiling for 2016. The majority of the increase can be explained by the consolidation of selected off-budget expenditures, which will help improve transparency of fiscal expenditure. To finance the budget deficit, the government debt is expected to increase from 56.9 per cent of GDP in July 2016 to 81.3 per cent of GDP (excluding central bank liabilities) by the end of 2016.

Economic growth in 2016 is expected to slow down to 1.7 per cent, compared with 2.4 per cent in 2015, reflecting lower prices of commodities and slower exports to China. A slow-down in the real estate sector and declining house prices are also putting negative pressure on growth. While the challenging external environment will continue to weigh on growth, the signing of Phase II of OT will increase FDI and should lead to an improvement in the investment climate and consumer confidence.

Major structural reform developments

Mongolia is relatively far advanced in terms of promoting private ownership, and market distortions are fairly limited. Mongolia ranked 64th out of 190 countries in terms of ease of doing business according to the World Bank *Doing Business 2017* report. However, institutional strength is low; the country ranks in the bottom quartile for government effectiveness, control of corruption and the rule of law in the World Bank's *Worldwide Governance Indicators*. Shortcomings remain in terms of standards of corporate governance and business conduct, and levels of carbon intensity are still high. 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.

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Mining policies have improved the investment attractiveness of the sector. In May 2015 the government and Rio Tinto signed an agreement to launch Phase II of OT worth US$ 6 billion, which had effectively been suspended since 2013. The agreement covered tax liabilities of OT following an earlier audit, the calculation of royalty payments and a number of other issues. In early May 2016 Rio Tinto announced the final and formal approval for the expansion of Phase II of OT. This can be regarded as a positive signal by other foreign investors that are considering investing in the extractives sector.

Mortgage assets were transferred to the government in March 2016. The Bank of Mongolia (BoM) transferred mortgage assets related to the Subsidised Housing Mortgage Programme to the government, namely to the Future Pension Reserve Fund (FPRF), which was established in February 2016. The transferred assets included the outstanding residential mortgage-backed securities and BoM loans to banks that were extended under the subsidised mortgage programme over the last three years. Cash flows generated from the FPRF mortgage assets will finance new subsidised mortgages originated by the banks and support future pension payments, starting from 2030.

Mongolia is diversifying external economic relations, which are currently weighted towards China and Russia. Mongolia signed a bilateral economic partnership agreement (EPA) with South Korea in July 2016, the fourth largest trading partner for Mongolia, to cooperate in public transport, green development, healthcare technology and the energy sector. The EPA will help bolster trade and investment flows between the two parties. In June 2016 Mongolia's EPA with Japan also came into effect after four years of negotiation, and is expected to promote liberalisation of trade and investment flows between the two countries. Mongolia has also agreed a US$ 1 billion bilateral credit facility with the Export-Import Bank of India in May 2016 to facilitate upgrades in the infrastructure and railway sectors.

Mongolia, China and Russia adopted a plan to build an economic corridor between the countries. The plan, adopted in June 2016, combines five projects with a total value of US$ 50 billion, including a 997 km road connecting China and Russia, a 1,100 km railway line and extensions of other railway lines and oil and gas pipelines. The three countries have also signed an agreement on the mutual recognition of customs inspections for certain goods categories.