

## Economic growth travels a bumpy road

Бичсэн Administrator

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GDP growth accelerated to an unprecedented 17.3 percent in 2011 from 6.4 percent in 2010 and the unemployment rate fell from 13 percent in 2010 to 9 percent in 2011. However, real wages for unskilled workers in the urban informal sector are starting to fall as the inflation rate reached 11.1 percent yoy in December. Sharply rising government spending is the root cause of overheating: government spending rose by 56 percent in 2011 and is budgeted to rise by a further 32 percent this year, fueled by sharply rising resource revenues. This pro-cyclical fiscal policy could result in another “boom-and-bust” cycle Mongolia experienced before, particularly as the global economy could face a substantial slowdown in growth due to the continuing European sovereign debt crisis, and which could result in a sharp drop in mineral prices and subsequently government revenues.

Government spending in 2011 was almost double that in 2009 in real terms, and mainly reflects pre-election year pressures, efforts to make good on earlier political promises for large cash transfers and large increases in capital expenditures. Because of high revenues, the government budget deficit is still modest: the 2011 deficit amounted to 3.6 percent. However, the structural deficit (based on long run commodity prices as defined under the Fiscal Stability Law) is much higher at 5.8 percent.

On the monetary front, the Bank of Mongolia (BoM) took significant action to curb inflation and lending growth in 2011. But with inflation still high, the real policy interest rate negative and bank lending expanding at a staggering pace (73 percent yoy), more tightening is needed. Liquidity risks are also rising and a large amount of NPLs remains on the loan books. Given the easy convertibility between dollar and local currency accounts the banking system remains vulnerable to capital flight, if macro-prudential action is not taken to strengthen it. Such action could include, in addition to the recently introduced additional capital buffers for systematically important banks, the use of additional provisioning requirements or highly volatile sectors such as construction, mortgage and consumer loans.

The Togrog depreciated by 11 percent during 2011 reflecting high domestic inflation and declining commodity prices towards the end of last year, factors that similarly impacted the currencies of other emerging mineral-rich economies. Going forward, exchange rate flexibility remains crucial. It will reduce the risk of one-way speculative bets on the currency and allow the economy to better absorb external shocks such as commodity price shocks without transmitting these directly to budgetary and export revenues as in the previous bust in 2008. More significantly, it will help the economy adjust through movements in the nominal exchange rate rather than through sharp cuts in domestic wages, employment and prices that hurt the real incomes and profits of workers and businesses. Finally, exchange rate flexibility is desirable in that it will reduce incentives for the private sector or banks for taking on unhedged risk.

The trade deficit reached record levels (US\$ 1.7 bn in December 2011) as imports of

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mining-related equipment and fuel imports have surged. But exports also grew strongly, reaching US\$ 4.8 bn in December from US\$ 2.9 bn a year ago supported almost entirely by coal shipments to China. The current account deficit widened to 35 percent of GDP from 14 percent in 2010, but was fully funded by record FDI inflows of US\$ 5.3 bn or almost 62 percent of GDP on a four-quarter rolling sum basis. There have been major legislative developments in 2011 and early 2012 aimed at strengthening policy institutions and frameworks. The Integrated Budget Law (IBL) was passed in December 2011: this organic budget law contains measures to support fiscal sustainability and the successful implementation of the Fiscal Stability Law. It also strengthens the public investment framework by requiring feasibility studies and alignment with national priorities for projects to be included in the Public Investment Program and the budget. This will help permanently lock in prudent fiscal policies and mechanisms in the future alongside the FSL. The Social Welfare Law was passed in early January. This mandates the provision of a targeted poverty benefit replacing the existing system of universal cash transfers.

This represents a major step towards setting up a fiscally sustainable social protection system while supporting Mongolia's poor- it is expected to reach about 130,000 poorest households, or one-fifth of all households in Mongolia. To ensure macroeconomic stability and to prevent a hard landing for the economy in case of an adverse external shock, Mongolia needs to adhere strictly to prudent fiscal policies as set out in the FSL and IBL and tightening both fiscal and monetary policy to reduce inflation, take macro-prudential action to reduce systemic risks in the banking sector and maintain a flexible exchange rate that will act as the first buffer in any external shock materializes. These are uncertain times for Mongolia. The economy faces growing headwinds from the global economic environment, while the looming elections increase domestic uncertainty. Until a substantial amount of savings has accumulated in the stabilization fund, Mongolia remains strongly exposed to volatility in commodity prices. With global economic prospects diminishing, and with any potential stimulus package from China unlikely to be focused on infrastructure as during the last global financial crisis in 2008-09, extra caution is warranted. "Be prepared" sums up the appropriate policy advice at this point in time. Mongolia's policymakers realized the importance of "being prepared" when they passed the landmark FSL in June 2010. It is now critical to adhere to the principles contained in this law, in order to ensure that the country's vast coal and copper resources are converted into sustainable growth that improves the welfare of all current and future Mongolian citizens.