Mongolia: Staff Concluding Statement of the 2022 Article IV Mission

October 25, 2022

> A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.
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> The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC: *Stronger policy adjustment is urgently needed to address Mongolia's rising internal and external imbalances. This entails ensuring much greater exchange rate flexibility, strengthening international reserves to facilitate large external debt rollovers in 2023, and further tightening monetary policy by promptly phasing out the Bank of Mongolia's quasi fiscal operations by allowing the Anti-Pandemic Law to expire by end-2022. Strong fiscal consolidation is urgently needed in 2023. Introducing substantial targeting of social assistance toward the vulnerable and progressivity in personal income taxation would signal a welcome and durable shift in the direction of fiscal policy toward prudence. Substantial cuts in public investment will also be needed, including through greater transparency, strong oversight, and reprioritization of SOE investment projects as a matter of utmost priority. Strong banking supervision will be necessary for the sound execution of banking reforms at a time of economic uncertainty. In sum, Mongolia's economic resilience depends critically on Parliamentary actions in the coming months, notably on the 2023 budget.*

Rising external and internal imbalances

The post-pandemic recovery is gathering steam . After 4 successive quarters of economic contraction, the sharp uptick in 2022Q2 GDP largely reflects an acceleration of the ongoing economic recovery in the non-mining sector, especially agriculture. The year-long contraction in mining GDP due to border disruptions slowed due to easing cross-border trade.

Nevertheless, Mongolia's external imbalances are widening . The deterioration was initially driven by higher global prices for imported food and fuel and an export contraction due to border closures prompted by China's zero-COVID policy. Global prices and export bottlenecks have eased recently, with the latter reflecting the government's determined efforts to ensure the safe passage of cross-border trade. Yet, external balances have continued to worsen because of rising imports related to infrastructure and construction projects and the release of pent-up demand for consumer durables and services financed by savings accumulated during the pandemic. In addition, reflecting off-take barter agreements, a large share of export revenues of Erdenes Tavan Tolgoi (ETT), a major Mongolian state-owned enterprise (SOE), is being used to finance large investment projects by Chinese construction companies in Mongolia, thereby restricting FX inflows and boosting import growth. Together, these factors, along with capital outflows, increasing deposit dollarization, and tighter global financial conditions have exacerbated exchange rate (ER) pressures, which depreciated by 17½ percent year-to-date by end-September. Gross international reserves continue to decline, standing at a precarious US$2.8billion at end-September, well below desirable levels.

Inflation continues to surge past the BOM's target band . Until recently, inflation was driven by supply-side and global factors, such as high international prices, decline in domestic meat production, and supply disruptions related to China's border restrictions and sanctions against Russia. High food and energy inflation and ER passthrough are leading to large second-round effects on inflation despite still-weak labor market conditions. This reflects a sharp recovery in pent-up domestic demand due to increases in household real incomes owing to the large untargeted government support since 2020, a large hike in minimum pensions in early 2022, and, recently, wage recovery.

Quasi-fiscal and fiscal policies remain too lax. Parliament's repeated extension of the Anti-Pandemic Law (APL) to end-2022 continues to undermine the BOM's monetary policy tightening by compelling it to inject significant liquidity via its quasi-fiscal operations, and by impeding the interest rate channel of monetary policy transmission. As forewarned, the full cash payment of the expanded child money support in the 2022 supplementary budget is also adding to inflationary and ER pressures by boosting import demand. Though budget execution is likely to be better-than-planned due to higher mineral revenues from stronger commodity prices, the non-mineral primary balance —a more appropriate measure of underlying fiscal policy—continues to record a significant deficit. Moreover, the acceleration of delayed capex execution by end-year is likely to boost imports, ER and inflationary pressures.

Outlook: Fragile Recovery, Major Risks

The recovery is expected to continue in 2022H2 and 2023 , assuming that the disruptions from border closures are largely resolved by end-2022. Coal export production is likely to resume following the depletion of accumulated inventories. The start of Oyu Tolgoi's underground mine production in 2023H1 should provide a significant economic boost. The continued release of pent-up domestic demand will likely support growth in the near term, though the net impact will be small given Mongolia's high import dependence. However, domestic private sector activity is likely to be increasingly constrained by persistently high inflation and decelerating credit growth due to increasing bank risk aversion amid high economic uncertainty and deteriorating liquidity resulting from the drawdown of pandemic savings. Real GDP growth is thus forecast to reach 2.5 percent in 2022 and rise to 4 percent in 2023, mainly on account of mining sector contributions. Medium-term forecasts continue to envisage above-potential growth due to the normalization of copper and coal exports.

Inflation is expected to remain well above the BOM's target band till end-2023 . Rising meat production, falling international food and energy prices and the agreement to purchase Russian oil at a discount will ease inflationary (and external) pressures. However, the impact of fiscal and quasi-fiscal support, the approved large minimum wage increase effective January 1, 2023, and the lagged impact of ER depreciation will continue to push up inflation.

External buffers are expected to remain challenging .The current account deficit is likely to remain wide in 2022 –23, reflecting a gradual normalization of export volumes, and strong imports. With a significant share of coal export proceeds diverted abroad, and large external debt repayments, GIR is expected to hover around US$2½ billion by end-2022 and fall to precarious levels in 2023–24. Large external maturities coming due in 2023–24 are raising rollover risks amid tighter global financial conditions, rising sovereign yields to distressed levels, and uncertainty related to the resolution of DBM's high NPLs, potentially leading to large additional drains of GIR.

Downside risks dominate . The outlook is vulnerable to tightening global financial conditions, extended Chinese border closures, a faster slowdown in China, and commodity price volatility. Despite strong support from the U.S. and the U.K., the possible disruption of correspondent banking relationships due to de-risking by major Western banks in response to sanctions against Russia poses significant downside risks as Mongolia relies heavily on Russian petroleum and there is limited scope for geographical diversification. Suboptimal domestic policies—e.g., expansionary policies ahead of the 2024 Parliamentary elections and sizable contingent liabilities from the financial and SOE sectors—also pose concerns.

Policy Priorities: Resolving External and Internal Imbalances

A long legacy of unresolved and persistent balance sheet weaknesses; delays in strengthening policy tools for sound economic management, and excessive untargeted policy support since 2020 has resulted in limited policy space and instruments to manage the emerging pressures. The policy choices for resolving external and internal imbalances in the near term are limited and not first-best options. The window of opportunity to implement strong reforms is narrow, not least because of the recent sharp spike in Mongolia's spreads to distressed levels on the one hand, and the approaching 2024 elections, on the other. **Mongolia's economic strength will depend critically on the policies approved by Parliament in the coming months, especially the 2023 budget.**

A. Preserving External Stability

Much greater ER flexibility is warranted . While greater ER flexibility will pass through to inflation and worsen debt dynamics, it will improve private sector incentives to better manage external liabilities and will help contain imports and speculation. However, ER depreciation alone cannot resolve external pressures given its limited impact on infrastructure-related imports; tighter fiscal and quasi-fiscal policies are needed (below). The BOM should limit FX interventions to disorderly market conditions and design an effective communication strategy.

International reserves should be bolstered , as they are likely to have a material impact on debt rollover prospects, external financing conditions and ratings. The BOM should accumulate reserves through opportunistic interventions and be fully cognizant of external liability management plans of all entities. In addition to consolidation, the government should sharply cut back and prioritize public investment (including SOE-financed investment), ensure that Mongolia's repatriation requirements are respected, improve coordination with the BOM on external payments, and roll back tax exemptions on imports which foster imports and undercut the impact of ER depreciation. The government should, however, continue to facilitate automated zero-contact exports at the border, open new trade portals, and facilitate new FDI inflows. It should continue work with key stakeholders to ensure Russian oil import payments can proceed smoothly.

Rollover risks should be managed well. The rollover of Eurobonds should be executed at the earliest opportunity given tightening financial conditions, and the large PBOC swap line should ideally be renewed on concessional terms. The current plans to recoup a large share of DBM's NPLs by urging SOEs to repay their debt are taking time to implement. Currently, a (p)repayment of DBM's Samurai bonds would be feasible using revenues from NPL recoveries, but this is expected to reduce already-low GIR. However, given weak SOE finances, it is unclear if DBM's balance sheet can be strengthened in time for it to rollover its Eurobond by 2023Q3. If the situation does not improve, and given low levels of GIR, the least bad option maybe for the government to repay DBM's external liabilities through new external borrowing.

B. Addressing Persistent Inflation

To reduce inflation, quasi-fiscal operations should be quickly phased out . The APL should expire at end-2022, or even earlier if legislatively feasible, and not be resuscitated in another form. This should help contain the growth in subsidized mortgage credit, an important contributor to inflation and external imbalances, help improve banking sector liquidity, and allow BOM to reduce its large capital losses, improve its operational independence and the credibility of its monetary policy operations. All outstanding balances of these operations should be transferred to the government at end-2022. The government should allow these operations to gradually wind down in line with repayment terms starting in 2023, while managing investor expectations for the resulting rise in budget liabilities, including by improving its fiscal framework.

The BOM's latest monetary policy action was warranted . High policy rates are needed to ensure that forward-looking real rates are positive, and to signal the BOM's commitment to fight inflation. The latter would also require quasi-fiscal measures to stop. Given weaknesses in monetary transmission due to the lack of a domestic debt market and bank risk aversion, the pace of tightening should be calibrated to incoming data and avoid destabilizing the banking sector. To anchor inflation expectations, the BOM should clearly explain the factors driving inflation and the rationale for its policy stance.

The government should support the BOM's efforts to contain inflation . It can do so by continuing to ease supply bottlenecks, reducing domestic demand through strong fiscal consolidation and by better targeting policy support (including utility subsidies) toward the most vulnerable, improving monetary policy transmission through domestic debt issuance, and delaying the introduction of a smaller minimum wage increase. However, despite the inflationary impact, energy prices should continue to reflect market forces to preserve fiscal resources and help conserve energy use.

C. Strengthening Public Sector Balance Sheets

Strong high-quality consolidation is urgently needed to address external pressures and rollover risks, tackle inflation, reverse difficult debt dynamics, and build buffers for long-term fiscal spending pressures and large contingent liabilities. The scope for high-quality fiscal consolidation in 2022 is limited, at this late stage, to restricting capex execution to the highest priority projects. The public sector debt level remains high relative to the appropriate debt limit for Mongolia (50 percent of GDP). Longer-term debt ratios have also worsened following recent hikes in minimum wages and pensions, which will increase the size of the state subsidy for pensions. Mongolia's debt sustainability risks remain high, and significantly vulnerable to a decline in growth and ER depreciation. Weak profitability, lower liquidity, and increased leverage of large SOEs also pose significant fiscal risk. If the underlying fiscal risks are not adequately managed, the realization of contingent liability shocks would have considerable impact on Mongolia's debt outlook. **The proposed ½ percent of GDP consolidation in the 2023 budget is therefore simply inadequate to address the economic challenges ahead** .

The 2023 budget should introduce significant and long-overdue shifts in the direction of fiscal policy . In particular, targeting the child money program (CMP) to vulnerable households and introducing substantial progressivity in personal income taxation (PIT) is needed. Together with strong commodity prices, higher trade volumes, and ER depreciation, these measures would help reduce the 2023 budget deficit significantly and help boost international reserves by reducing discretionary imports of consumer and luxury goods. Additional revenue measures should also be considered, namely, eliminating customs duty exemptions for non-food imports to help improve external balances, and applying non-resident capital gains tax to net gains instead of gross sales value to help support planned bank and SOE IPOs. Further progress on tax and customs administration reforms is also needed.

In addition, substantial cuts in public investment are needed . Despite plans to limit capex to ongoing projects, the planned public investment financed by the budget, together with the large capex projects of SOEs, is likely to continue to boost ER pressures given the large import component of capital spending. A substantial further reduction in public investment spending by the budget and SOEs is needed to boost GIR to more adequate levels by end-2023 and to reduce debt rollover risks. Alternatively, greater targeting of CMP and larger revenue gains from PIT maybe required to reduce imports of consumer durables by the wealthy. Reducing the impact of public investment on external balances will require further delaying ongoing budget-financed capex plans, with tighter allotments of funds only to projects with the highest priority, and securing new concessional foreign financing. SOEs' off-take contracts should be transparently disclosed and incorporated in an updated Development Plan for Parliamentary prioritization and ratification to better align with Mongolia's dire external financing constraints. Public investment management should be urgently strengthened though Parliamentary approval of the draft PPP law (drafted with IMF/World Bank assistance); enhanced transparency; better project selection and management; and by boosting the capacity of the Ministry of Economic Development expeditiously. Mineral wealth management through the Sovereign Wealth Fund and Development Fund framework should be properly integrated into the fiscal framework and underpinned by clear accountability.

Additional fiscal measures will be needed to improve medium-term debt dynamics . Beyond 2023, CMP targeting should move towards household incomes-based targeting to expand the coverage of vulnerable households. This would require the collection of better household income data and the introduction of proxy-means targeting. The income thresholds for progressive PIT should be gradually lowered to boost revenues, tax exemptions rationalized and the PIT tax structure simplified to improve compliance. Pension reforms are needed to reduce the state subsidy to the social insurance fund and ensure pension system viability. The authorities should refrain from using fiscal buffers in lieu of reforms to contain debt, and save revenue windfalls. To this end, the 2021 legislative changes to forgo future savings in the Future Heritage Fund to fund the expansion of CMP should be reversed so that the reduction in CMP lead to an increase in fiscal policy space. The incentives to adhere to fiscal discipline would be strengthened by a transition to a simplified fiscal framework based on a nominal debt anchor of 50 percent of GDP and a simple operational rule; greater fiscal transparency and reporting; and corrective actions.

SOE governance should be improved to reduce fiscal risks from contingent liabilities .

· Regarding DBM, an independent external advisor should be appointed to conduct a diagnostic review and draft a reform plan. The long-term viability of its business model needs to be clearly determined in the context of efforts to strengthen the government's public investment management before DBM's operational future is determined.

· A well-thought out and sequenced approach is needed to manage potentially large fiscal costs associated with the privatization of non-financial SOEs. Although the draft SOE law would be a step forward, there is significant room for further improvement with regard to improving governance. Privatization of non-financial SOEs should be preceded by a robust risk assessment, strengthened oversight of SOE debt and investments, a sound regulatory framework, transparent reporting, and legislations for installing stronger fiscal discipline on SOEs (for example through an adoption of a non-bailout clause). A stronger financial oversight of SOE debt should be installed by placing budgetary ceilings on lending or guarantees, subject to annual Parliamentary approval.

D. Strengthening Financial Stability

The financial system remains stable, but vulnerabilities remain elevated . System-wide bank capital, asset quality, and profitability have improved, but higher risk aversion and lending slowdown—due to the economic uncertainty, IPO preparations, and higher policy rates—could put pressure on banks' balance sheets. Though the banking system remains liquid, banks' liquidity positions have deteriorated since mid-2021 due to deposit drawdowns to fund spending. The further deterioration in mining sector exposures, growing household debt burden, especially for lower-income households, and brisk expansion in lending by non-bank financial institutions (NBFIs) pose vulnerabilities.

Greater supervisory vigilance is thus warranted . Parliament's one-year delay in the IPOs of the domestic systemically important banks (D-SIBs) to June 2023 has allowed the BOM to conduct its asset quality review (AQR) of these banks and, together with the FRC, initiate a gradual approval of their IPOs. Given that the AQR provides a snapshot assessment of D-SIB balance sheets, the BOM should continue to closely monitor banking sector conditions and take additional supervisory actions, if necessary. This is particularly important given the recent deterioration of macroeconomic conditions and ongoing monetary tightening. The upcoming IPOs should be supported by fit and proper assessments of potential investors, and steps to ensure that bank capital is of high quality. The BOM should carefully communicate the results of the AQR to ensure confidence in the IPO process. NBFI supervision should be intensified and lending standards tightened to halt the build-up of excessive risks related to NBFI lending.

The prospects for shareholder diversification by end-2023 remain challenging . This reflects the thin capitalization of the stock exchange and Mongolia's expected economic challenges in 2023. The legal implications for not adhering to the timeline should be reconsidered and thought through carefully to avoid triggering banking sector instability. The BOM should develop appropriate contingency plans.

Key structural and institutional reforms are needed. The insolvency reform—which is supported by IMF and World Bank advice—should be expeditiously approved by Parliament to help facilitate the resolution of unsustainable debts in the economy. The FRC, MOF, BOM, and the deposit insurer (DICOM) should develop an effective crisis management framework including effective information exchange arrangements to enhance their response to possible downturns. Designing a bank resolution framework would be helpful in this regard.

An IMF team visited Ulaanbaatar to conduct the 2022 Article IV discussions during September 15–28, 2022. The IMF mission would like to thank the Mongolian authorities for frank and constructive discussions and their kind hospitality.

Table 1. Mongolia: Selected Economic and Financial Indicators, 2019-25

	2019	2022	2021	2022	2023	2024	2025

			Actual				Projections
			(In percent of GDP, unless otherwise indicated)				
National Accounts							
Nominal GDP (in USD million)	14,206	13,313	15,286	15,530	15,976	16,688	17,784
Real GDP growth (percent change)	5.6	-4.6	1.6	2.5	4.0	5.5	6.0
Contributions to Real GDP (ppts)							
Domestic Demand	5.7	-12.8	17.6	9.1	-2.3	5.0	5.2
Exports of G&S	5.8	-2.7	-7.5	0.4	8.9	4.8	4.4
Imports of G&S	-5.9	10.9	-8.5	-7.1	-2.6	-4.3	-3.6
Prices							
Consumer Prices (Avg; percent change)	7.3	3.7	7.1	14.7	12.3	9.0	8.3
Consumer Prices (EoP; percent change)	5.2	2.3	13.5	13.9	10.1	8.6	8.0
Copper prices (US$ per ton)	6010	6175	9317	8815	7914	7897	7881
Coal prices (US$ per ton) 1/	84	74	129	160	163	165	167
Gold prices (US$ per ounce)	1392	1770	1800	1820	1816	1875	1930
Oil price (in U.S. dollars per barrel)	61.2	41.8	69.4	98.2	85.5	80.2	76.2
GDP deflator (percent change)	10.0	3.7	14.4	12.5	10.9	8.8	7.6
General government accounts							

Primary balance (IMF definition)	3.3	-6.7	-1.1	0.9	2.0	2.4	1.7
Total revenue and grants	31.8	27.9	32.8	33.9	35.5	35.0	34.7
Primary expenditure and net lending	28.5	34.6	34.0	33.0	33.5	32.6	33.0
Interest	2.3	2.5	1.9	1.8	2.2	2.1	1.8
Overall balance (IMF definition) 2/ 3/	1.0	-9.2	-3.0	-0.9	-0.3	0.2	-0.1
Gross Financing Needs	0.8	16.1	13.4	4.7	22.0	6.0	5.3
General government debt 4/	66.8	83.4	67.7	72.2	72.7	69.6	66.0
Domestic	6.7	5.6	3.2	2.9	3.1	3.1	3.3
External	60.2	77.8	64.6	69.3	69.6	66.5	62.7
Monetary sector							
Broad money growth (percent change)	8.2	16.2	13.8	0.1	11.6	12.4	12.3
Reserve money growth (percent change)	5.4	-12.7	6.5	-1.6	9.7	10.5	11.5
Credit growth (percent change)	4.4	-3.8	18.5	8.2	7.8	8.8	10.1
Balance of payments							
Current account balance	-15.2	-5.1	-12.8	-20.5	-14.9	-12.5	-8.6
Exports of goods	50.6	52.5	54.0	59.8	67.8	71.4	73.3
Imports of goods	42.4	39.3	45.4	56.3	56.0	55.3	54.1
Exchange rate							

Togrog per U.S. dollar (eop)	2734	2850	2849	...	...	...	...
Memorandum item							
Population in million (eop)	3.3	3.4	3.4	...	...	...	...

Sources: Mongolian authorities; and IMF staff projections.

1/ Historical data from China General Customs Administration.

2/ The deficit could be higher after state subsidy for the pension system is updated to reflect changes in minimum pensions and minimum wages.

3/ Based on the 2023 draft budget document submitted to the Parliament.

4/ General government debt data excludes central bank's liabilities due to the PBOC swap line and SOE debt.

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