

The Impact of the Global Financial Crisis on Mongolia's Economy

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I Introduction

Mongolia began the transition from a centrally-planned to a market-based system in 1990. With the collapse of COMECON, the Mongolian economy faced considerable obstacles, leading to a 20% decline in total output in 1990-1993, triple-digit inflation (325.5%) in 1992, and a negative GDP growth rate (-9.2% in 1991 and -9.5% in 1992) after a 4.2% growth rate in 1989 (before the transition). In less than 20 years Mongolia has made significant progress in undertaking fundamental economic reforms, which is reflected in the strong growth performance of the Mongolian economy. The economy has grown rapidly in real terms at an average annual rate of 8.4% during the period 2004-2006, reaching 10.2% in 2007, and per capita income has more than doubled since 2004, reaching US\$1,960 in 2008. Until very recently the inflation rate averaged 7%.

II Mining in Mongolia's economy

Mongolia is a mineral-rich country and has abundant deposits of gold, copper, uranium and coal. Mongolia's mineral wealth (the net present value of mineral revenues) is presumed to be almost twice the non-mineral GDP, although estimates of the proven and potential resources are still uncertain.

Mining is the most important economic sector in Mongolia, accounting for approximately half of gross industrial output (Table 1).

Industrial output is largely based on copper and gold (Table 2).

Mongolia's share of total international reserves in the form of gold is also large compared with other gold-producing countries, and amounted to approximately 25%

in 2006.

In 2008, mining accounted for 28.2% of GDP, 74% of Mongolia's exports (of which copper and gold accounted for 33% and 24%, respectively) and 28.7% of government revenue (Table 3). 67% of all foreign direct investment (FDI) to Mongolia in 2007 went to the mining sector.

The economy and the budget of Mongolia rely heavily on the mining sector, making them vulnerable to the fluctuations in commodity prices which have negatively affected the Mongolian economy.

III Mongolia faced sharp reductions in the price of copper starting in summer 2008

During 2007 and 2008 the prices of Mongolia's main export products, copper and gold, had risen significantly. Starting in mid-2008, however, the copper price fell 67% from its peak of US\$8,685 per tonne in April 2008 to the 2004-level in December 2008; likewise for the international prices of Mongolia's other mineral exports (Figure 1).

In addition Mongolia's main trading partners (China, the EU, the US and Canada), which have accounted for over 95% of export revenues, have also been facing a downturn, and as a result their demand for Mongolia's exports has also decreased.

IV The impact of the global economic downturn is felt throughout the economy

Although Mongolia has limited direct exposure to the world financial crisis, the fall in copper prices due to weak world demand has had a serious impact on Mongolia's economy, affecting the balance of payments, exchange rates, fiscal accounts and the real economy.

Balance of payments. Mongolia's balance of payments

Table 1 Mongolia: Gross Industrial Output, billion MNT, constant prices (1995 and 2005)

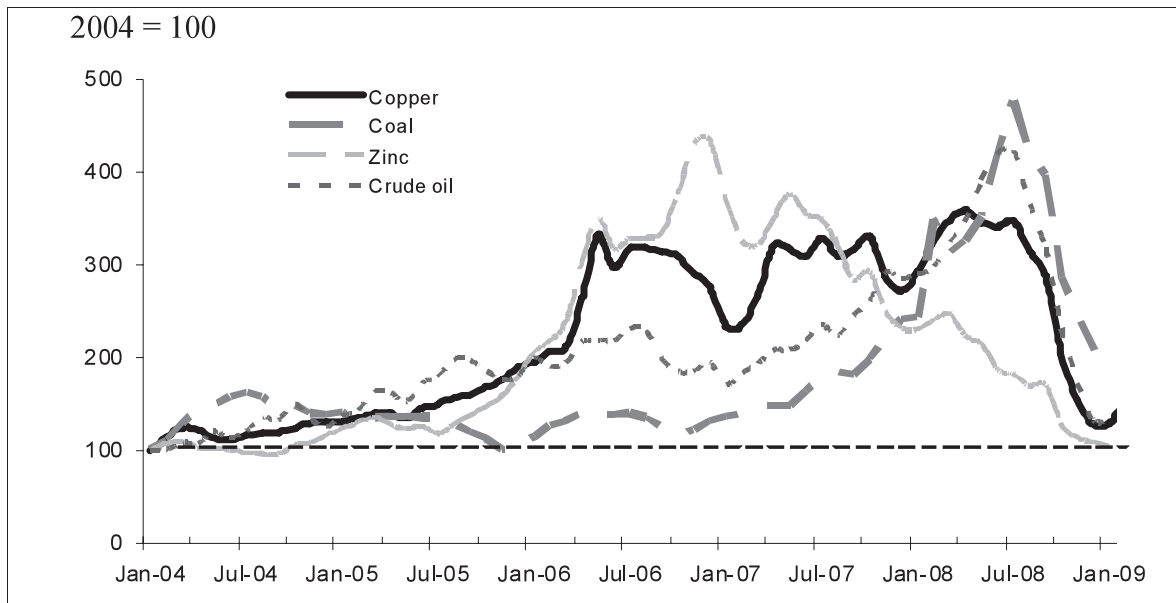
	1995	2000	2006	2007	2008
Total gross industrial output	222.9	243.6	1,555.8	1,716.9	1,764.6
<i>of which:</i> Mining & quarrying	92.5	132.6	977.6	973.7	975.7

Table 2 Mongolia: Production of Copper Concentrate and Gold

	1995	2000	2005	2006	2007	2008
Copper, 35% concentrate, thousand tonnes	346.4	357.8	361.6	537.7	543.1	525.3
Gold, kg	504	11,808	24,121	22,561	17,472	15,183

Table 3 Mining's Contribution to the Mongolian Economy

	2004	2005	2006	2007	2008
% of GDP	17.0	21.9	29.9	29.5	28.2
% of government revenue	11.2	13.3	28.6	35.0	28.7
% of exports	63.7	70.7	70.4	66.8	74.0

Figure 1 The Changes in the International Prices of Mongolia's Main Export Commodities

worsened during 2008, mainly due to a substantial increase in imports, while export earnings declined.

The declines in the value of copper, the main export product, and crude oil were primarily driven by price rather than volume. There was almost no change in export volumes from 2008 on, whereas the value of exports of copper has declined by 56% due to the drop in copper prices. Despite favorable prices gold production had fallen by approximately 50% by August 2009 compared to the same month of the previous year, mainly due to the lack of liquidity for financing gold extraction and to a windfall profit tax.

The increase in imports in 2008 was in part due to higher global food and fuel prices (due to the use of crops for bio-fuels, the record low inventories of food stocks, and high energy and fertilizer prices) as well as the significant growth in domestic demand over the last three years.

The falling copper prices in the second half of 2008 led to a trade deficit of 11.4% of GDP and a current account deficit of 13.7% of GDP in 2008, from a surplus of 6.7% of GDP in 2007, as the current account had been financed mainly by FDI.

The global economic recession led to a reduction of FDI inflow (8.3% of GDP in 2007), mainly in the mining sector, and fell from its peak in the third quarter of 2008 as a result of tight world credit conditions in addition to the falling prices of Mongolia's main exports. The adverse impact on the trade balance, however, was mitigated by sustained gold prices, despite the decrease in the mining of gold.

Exchange rates. The currencies of all mining-dependent countries in the world came under pressure due to the fall in mineral prices, and in response, many of these countries, starting in mid-2008, allowed their currencies to depreciate against the US dollar as an initial defense mechanism to absorb the shock.

Up until November 2008, however, the central bank (the Bank of Mongolia) pursued a policy to defend the national currency by selling US dollars to the banks. As

a result, the net international reserves (NIR) decreased dramatically (which had already been declining rapidly with the falling global copper prices). By the end of February 2009, NIR had declined by more than half, from their peak in mid-2008, when they amounted to more than US\$1 billion (Figure 2).

The exchange rate started to depreciate against the US dollar only from December 2008, reaching MNT 1,600 to the dollar at the beginning of March 2009. While the Bank of Mongolia lost US\$500 million in international reserves between July 2008 and February 2009, the currency depreciated by approximately 38% between the end of October 2008 and mid-March 2009.

Monetary tightening and the introduction of a transparent foreign exchange auctioning mechanism by the Bank of Mongolia has resulted in a relatively stable exchange rate over the last six months and the accumulation of international reserves. Net international reserves reached US\$684 million at the end of July 2009.

Fiscal accounts. The collapse in the price of copper has had a direct impact on government revenue, as its dependency on mining over the past few years has substantially increased.

The mining contribution to government revenue increased from 4.7% in 2002, to 28.6% in 2006 and 35% in 2007, and it was projected that mining would contribute 43% to the planned budget for 2008.

As a result of the fall in copper prices, fiscal revenues decreased by 10% of GDP from 2007 compared to their 2005 level (Table 4).

Despite falling mining revenues, spending remained high in 2008 due to large increases in civil service wages (129% over the last two years) and social welfare and universal social transfers (the Child Money Program) accounting for approximately 5.6% of budget expenditure in 2008. Capital spending and banking-system credit both spurred rapid growth in spending and led to an increase in the fiscal deficit.

The budget deficit in 2008 amounted to 5% of GDP,

Figure 2 Mongolia: Net International Reserves (NIR) to the End of 2008**Table 4 Mongolia: Fiscal Revenues, 2003-2009**

	2003	2004	2005	2006	2007	2008	2009
Government revenues, % of GDP	33.4	33.1	30.1	36.6	40.9	35.2	30.8
Mining's contribution to government revenues, %	7.5	11.2	13.3	28.6	35.0	28.7	8.1

after being in surplus for the previous three consecutive years. These budget surpluses during the boom years, however, were not sufficient to compensate for the external shock, as the non-mining fiscal balance deteriorated during the commodity boom, accounting for -15.3% of GDP in 2008.

In the first four months of 2009, compared to the same period in 2008, total revenue and grants have decreased by 31.4% due to reduced mining-related revenues: the windfall profit tax, royalties, and corporate income tax underwent the largest declines.

Although the sharp deterioration of the fiscal deficit had slowed down by August 2009—as a result of cutting expenditure on low-priority new investments, freezing the wages and hiring of civil servants, the limitation of non-concessional sovereign borrowings and the targeting of social transfers—the estimate for 2009 is 6.5% of GDP, exceeding the 5.8% of 2009 GDP envisaged in the June budget amendment and 5.4% in the March amendment. This is due to the 29% decrease in total revenues and grants in real terms in the first half of 2009, as against the first half of 2008.

Inflation. Rising wages in the public sector over the last two years acted as a benchmark for private-sector wages, and pushed up the overall wages in the economy, adding to the rise in inflation in 2007 and 2008. Inflation rose from 4.2% in January 2007, to 17.5% in January 2008, to 27.2% in April 2008, and reached 34% in August 2008.

In the first half of 2008 the main driver was food prices, accounting for 71% of inflation. As world food prices started to decline over the summer of 2008, inflation shifted from food to non-food items. For instance, bus and taxi fares increased by 50% and 39%, respectively, in August 2008, while tertiary education fees increased by an

Table 5 Mongolia: Domestic Price Increases of Selected Main Foodstuffs

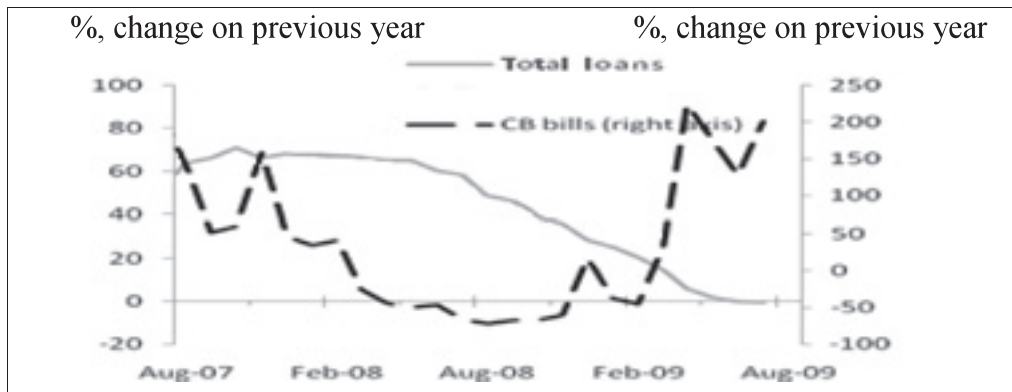
	2007/2008 Increase, %
Flour, high grade	19.9
Flour, lower grade	31.0
Bread	45.2
Milk and yogurt	44.2 and 51.4 respectively
Mutton and beef	8.7 and 7.5 respectively
Potatoes	58.6

average of 66%. Electricity and heating tariffs were raised by 28% and 39% on average, respectively, starting from July 2008.

Prices of imported food increased, following world market prices (wheat prices have increased nearly 200% since 2005 and overall food prices have increased by 75% since 2000), but the domestic prices of the exact same products, such as flour, rose even more (Table 5), partly due to reduced domestic wheat production in autumn 2007, resulting from drought in the main agricultural provinces—including Khentii, Selenge, and Tov aimags—and thereby contributing to the reduction of the aggregate supply and putting further pressure on prices.

As the poor in Mongolia spend 52-55% of their household budget on food, the increase in food prices also contributed to an increase of the incidence of poverty in the country: in 2007-2008 it increased to 35.2% of the total population, as against 32.2% in 2006.

Over the first half of 2009 the consumer price index (CPI) has been decreasing continuously, to 2.9% on the previous year, with core inflation in single digits as of the end of August 2009. The CPI at the end of 2009 is

Figure 3 Mongolia: Total Loan Growth and Purchase of Central Bank Bills (CBBs)

estimated at 8.5%.

Financial system. Until mid-2008 the financial system had also been growing strongly, in line with the economy as a whole. Real deposit rates turned to the negative, leading to a decrease of deposits and contributing to an outflow of deposits in domestic currency and their conversion into foreign currency deposits.

Domestic currency deposits decreased by 15.2% in 2008 compared to 2007, whereas foreign currency deposits increased by 20.4%.

After several months of outflows, domestic-currency time deposits increased by MNT 60 billion from February to March 2009, the largest increase since February 2007, and continued to increase to MNT 1,028 billion in August 2009—while foreign-currency time deposits decreased to MNT 580 billion, although they remain high overall compared to the pre-crisis level.

The non-performing-loan ratio in banks' loan portfolios increased—reaching 7.4% in February 2009, and 10.6% in April 2009, as against 2.9% in September 2008—affecting the banks' earnings and expenses.

The combination of all these factors led to liquidity problems in the banking sector, and therefore the banks were unwilling to extend new credits and started to build their liquidity.

The banks have further reduced lending and now are buying less risky central bank bills instead, which are more attractive relative to the higher risk of lending to the private sector (Figure 3).

Loan quality continues to deteriorate, as portfolios are exposed in the sectors that are experiencing a strong slowdown.

At the end of July 2009 the non-performing-loan ratio amounted to 20.4% of total outstanding loans, and reached 21.5% at the end of August 2009, showing a slowdown in the real sector and business growth, despite falling inflation and the easing of global food and fuel prices.

Growth. A larger current account deficit, much lower government revenues, and continued large investment needs have posed significant challenges to growth.

The growth rate was high until August 2008, reaching 11.3%; however, the negative impact of the global slowdown has been felt across all major sectors in the real economy.

The fall in copper exports, a significant decrease in official gold production by 17.3% in 2008—despite high

Table 6 Mongolia: Real GDP Growth

	2006	2007	2008	2009	2010
Real GDP growth	8.6	10.2	8.9	0.5	3.0

world prices—and a slowdown in investment flows to both the mineral sector and construction, led to a decline in economic growth down to 0.5% in 2009, from 8.9% in 2008 (IMF staff have recently decreased their estimate of economic growth from 2.7% in real terms to 0.5% in 2009) (Table 6).

This reflects developments in key sectors of Mongolia's economy, such as agriculture—the result of falling prices of cashmere and other livestock-related products—and the mining sector, which is exhibiting stagnation in real terms. Its contribution was nil in 2008 and is projected to remain so in 2009. Manufacturing (textiles and basic metals) declined by 30-60% on the previous year.

With the aim of overcoming the external shock, the Mongolian government has made a request to the IMF to support the country's economic stabilization program, which was approved in April 2009.

Key objectives of the IMF-supported program are: to restore macroeconomic stability through fiscal, monetary and financial sector policies, and to protect the poor, as they were the ones who suffered most from the economic downturn.

Poverty and unemployment. The World Bank study on the implications of the crisis for household living standards, conducted in April 2009, found that the effects of the economic slowdown had a widespread social and poverty impact in Mongolia, as real effective income has fallen by approximately 60% in some informal urban labor markets compared to April 2008, due to high inflation affecting real wages and due to reduced job availability.

The food consumption effect also contributed to the increase of the incidence of poverty in the country; in 2007-2008 it increased to 35.2% of the total population, against 32.2% in 2006, as the poor spend 52-55% of their household budget on food.

Until November 2008 the registered unemployment rate had been decreasing almost continuously to 2.9% of the labor force. In January 2009, however, it began to increase for the first time, standing at 3.7% in June 2009, and further increased to 3.8% of the labor force in July 2009 as a result of the contraction in the real sector.

The registered unemployment rate decreased from 3.8% to 3.7% of the labor force in August 2009. This figure, however, excludes those unemployed who are not registered at the employment office, and the actual rate of unemployment may be much higher. According to unofficial estimates the unemployment rate could be as high as 21-26% of the labor force.

The number of informal workers is likely to increase due to rising unemployment in the formal sectors. In addition, there has been an increase in the number of people moving into the cities from the rural regions looking for new ways to make a living, due to foreclosures on their herders' loans.

Employment conditions are also becoming less favorable for informal workers in the rural regions, and for herders to cope with decreasing job availability, falling wages, and increasing living expenses.

The recent World Bank study shows a modest improvement between April 2009 and September 2009. The number of informal workers increased in September 2009 by approximately 25% compared to April 2009, and workers' average real wages increased by approximately 12% from April 2009 to September 2009.

According to a conservative estimate of World Bank experts the decline in growth rate from a projected 8% to 2.7% in 2009 would mean that 20,000 to 40,000 less people would have been lifted out of poverty than would have been the case without the global financial crisis. The recent adjustment of the growth estimate by the IMF to 0.5% would mean that even more people would remain in poverty.

V Recent developments

In September 2009 the price of copper increased to US\$6,195 per tonne. The international prices for Mongolia's other main export commodities (coal, zinc, cashmere, and crude oil) also rose slightly. Mongolia's main trading partners are showing signs of a slow recovery.

In August 2009, gold exports resumed, after no shipments in June and July. Gold exports are still 55%

lower than in August 2008, however, despite consistently high prices and a special gold bond issued by the government to ease the liquidity constraint on gold producers.

The trade deficit is narrowing (Figure 4) due to imports decreasing faster than exports, and showing a continued slowdown in the economy, which is limiting demand for imports due to a continued slowing down in domestic spending. Imports during the first eight months of 2009 decreased in value by 39.8% compared to the same period in 2008.

As a result the current account deficit, which reached 15.2% of GDP in the second quarter of 2009, started to contract in July-August 2009. This deficit was mainly financed by net foreign direct investment inflows and the IMF loan disbursement under the Stand-By Arrangement. The services account, however, deteriorated further due to the fall in tourism revenues and remittances from Mongolians working abroad—a result of the global downturn.

The exchange rate has depreciated slightly, while the central bank's net international reserves (NIR) increased further, reaching US\$684 million at the end of July 2009.

The fiscal situation, however, continues to be difficult: falling revenues contributed to a continued deterioration through August 2009. Total revenues and grants during the first eight months of 2009 declined by 26% in real terms compared to one year before, due to falling mining revenues, whereas expenditure has been increasing (4% in real terms).

Core inflation declined to 6.2% (compared to the same time the previous year) in August 2009, from over 25% at the beginning of the year. The overall CPI has also decreased in 2009, becoming a deflationary 0.9% in August 2009 (Figure 5).

According to the Stand-By Arrangement with the IMF the government has taken a number of measures for cutting public investment and expenditure on wages, freezing hiring, and targeting social transfers, and has revised the blanket deposit guarantee law; the central bank has

Figure 4 Mongolia: Trade Balance

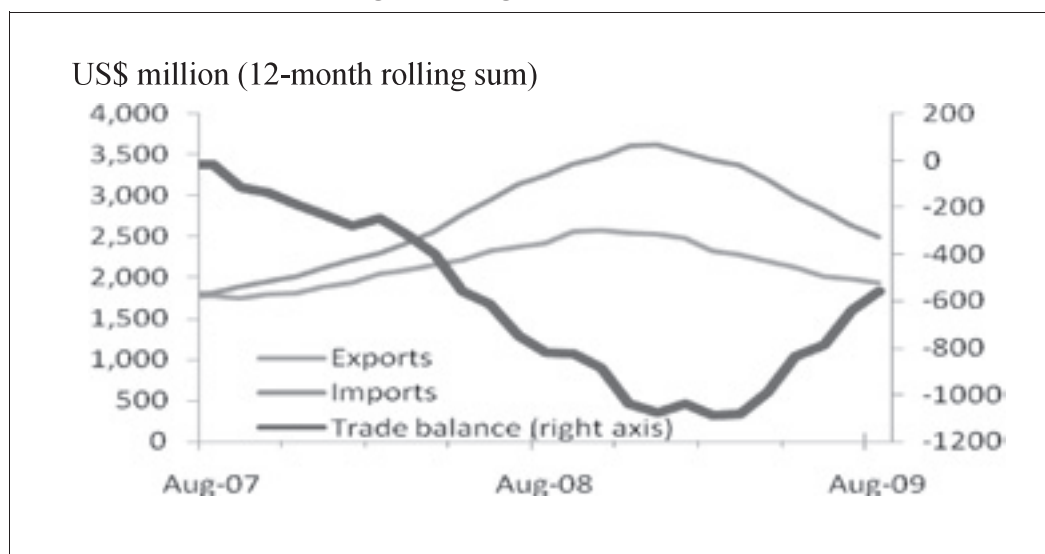
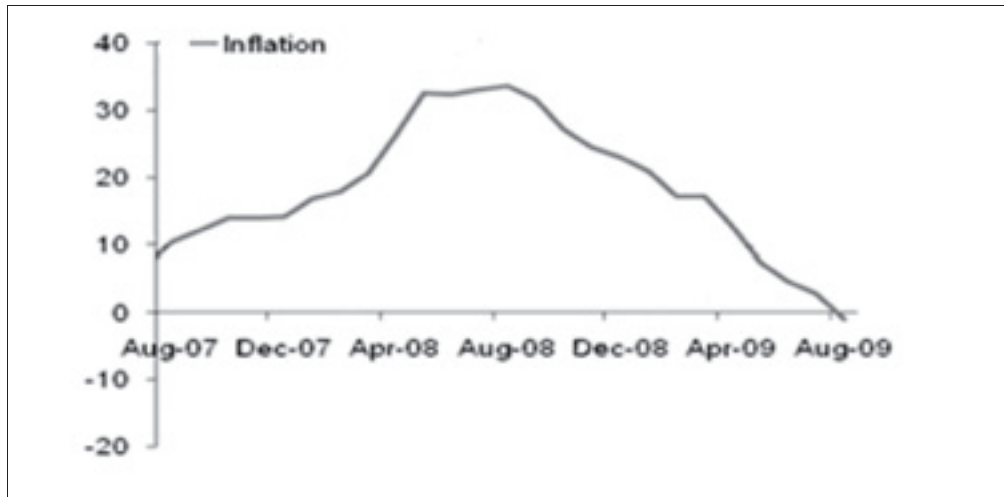


Figure 5 Mongolia: Inflation

increased the capital adequacy requirements for the banks.

The government of Mongolia now intends to submit the new fiscal management legislation to parliament—a new organic budget law and a fiscal stability law.

VI Conclusion

A large external shock due to the fall of the price of copper (rather than exposure to the world financial crisis) hit Mongolia hard. This shock was exacerbated by expansive fiscal and monetary policies, a pegged exchange rate and an overheated financial sector at the time of the fall of the price of copper.

The Mongolian government initially responded inadequately, which led to macroeconomic instability at the end of 2008. From the beginning of 2009, however, the government, with the strong financial assistance of its key development partners, has taken a series of policy actions to address the crisis.

Mineral prices continue to increase; the trade balance is improving. Monetary tightening and the introduction of transparent foreign exchange auctioning helped to keep the exchange rate stable and also allowed the central bank to build up net international reserves. The external sector

is now stabilizing due mainly to contracting imports, the result of the economic downturn.

The fiscal balance remains under stress as revenues continue to decline, whereas expenditure still remains high despite cutting unnecessary investments, freezing hiring and containing the wages of civil servants.

In the financial sector, non-performing loans have continued to increase, and bank lending to the private sector has almost stopped, as banks prefer to purchase safe central bank bills. This in turn puts further downward pressure on domestic activities.

The overall CPI decreased in 2009, becoming a deflationary 0.9% in August 2009.

The people who suffered most from the economic downturn were the poor. The incidence of poverty in 2007-2008 increased on that in 2006. Formal unemployment has continued to increase since the beginning of the year, and real wages for unskilled workers in the informal sector have been declining substantially.

The government intends to submit to parliament a new budget law and a new fiscal stability law in order to improve the fiscal responsibility framework.