

Mongolia—Assessment Letter for the Asian Development Bank March 13, 2024

This letter updates the assessment of Mongolia's economic conditions since the conclusion of the IMF's 2023 Article IV consultation on September 14, 2023. The assessment has been requested in relation to the program loan under the Asian Development Bank's Policy Based Lending modality.

Recent Developments

1. Mongolia's economic outturn in 2023 was markedly better than expected, primarily due to record-high coal production and exports. Real GDP grew by 7.0 percent in 2023, underpinned by an unprecedented increase in coal exports to China and associated transportation activities, and increasing consumption in 2023H2. Coal export volumes more than doubled year-on-year, greatly exceeding the historically high projections already embedded in the 2023 supplementary budget and IMF staff forecasts. This surge was driven by strong demand from China after a sharp decline in its coking coal imports in 2021–22. Despite the large and permanent wage and pension increases in the 2023 supplementary budget and a large non-mineral primary deficit (NMPD), the budget recorded an overall surplus as a result of higher mineral revenues. The public debt to GDP ratio declined significantly due to a surge in nominal GDP and debt repayments.

2. Inflation continued to decline due to lower global food and fuel prices and some exchange rate appreciation. Despite strong domestic demand in 2023H2, headline inflation was 7.6 percent in January 2024, within the Bank of Mongolia's (BOM) target band (6±2 percent).

3. External balances improved and external debt as a percent of GDP declined. Despite a robust increase in import volumes, Mongolia recorded a current account surplus due to the sharp increase in coal export volumes. Gross international reserves (GIR) rose to US\$4.9 billion at end-February 2024 (3.6 months of imports or 110 percent of the IMF Assessing Reserve Adequacy Metric (ARA)). The improved external position and global financial conditions allowed the authorities to effectively manage external debt rollover risks in 2023 despite large external financing needs. In late 2023, the government refinanced a part of its 2024 Eurobond repayments, while the Development Bank of Mongolia (DBM) repaid its Eurobond and utilized domestic bridge financing to refinance its Samurai bond. The BOM also repaid a portion of the outstanding balance of its swap line with the People's Bank of China. Major private external debt maturing in early 2024 have also been successfully refinanced, and the remaining external financing needs for 2024 are moderate.

Outlook and Risks

4. Growth is expected to remain high in 2024 and moderate thereafter. The full-year impact of the 2023 supplementary budget and additional wage and pension increases in 2024, combined with the distribution of dividends to households by Erdenes Tavan Tolgoi, are expected to stimulate growth in the near term. However, the growth boost is expected to fade over time due to an increase in external pressures and higher inflation. Mining sector growth is expected to remain robust, driven by an increase in higher-grade copper exports from Oyu Tolgoi's (OT) underground mine which became fully operational in 2023Q1; coal exports to China are assumed to remain in line with the record highs of 2023. On the other hand, heavy losses in the livestock sector due to severe winter conditions are likely to be a drag. GDP growth is forecast to be 6½ percent in 2024 and

moderate toward potential growth over the medium term. The current account balance is expected to revert to a sizable deficit due to high imports volumes and declining coal prices, keeping GIR largely unchanged at the end-2023 level (US\$4.8 billion, 3.6 months of imports, 108 percent of ARA).

5. The outlook is subject to considerable uncertainty reflecting Mongolia’s heavy reliance on mineral exports and its dependence on China as the primary market. While external vulnerabilities have decreased due to higher GIR and lower debt levels, a sharper slowdown in the demand for commodity exports (in particular, coal demand from China) or a negative commodity price shock could have an adverse impact on the Mongolian economy and external balances. Furthermore, additional pre-election fiscal support, while further boosting growth, could increase external and inflationary risks. Natural disasters and geopolitical developments introduce additional uncertainty. On the upside, a further acceleration of coal exports to China or stronger-than-expected commodity prices could provide an economic windfall. The outlook could also be affected by large infrastructure projects currently under discussion but not yet formalized, and the scope for the production and export of higher quality copper and coal, selling at a premium.

Policies to Preserve Macroeconomic and External Stability

Fiscal Policy

6. With unchanged fiscal policies, public debt is projected to rise above 50 percent of GDP in the medium-term. Public debt dynamics remains vulnerable to macroeconomic shocks and exchange rate dynamics and could rise if downside risks to the outlook, fiscal risks, contingent liabilities, and natural disaster shocks were to materialize. Based on the assessment of the 2023 Article IV consultation, Mongolia faces a high risk of sovereign stress.¹

7. Fiscal consolidation continues to be necessary for ensuring macroeconomic stability and debt sustainability. The NMPD is expected to widen significantly due to the sizable fiscal expansion in 2024 and could worsen if fiscal risks were to materialize. A draft Law on Sovereign Wealth Funds proposes to expand extrabudgetary funds to finance existing government spending, potentially generating new fiscal risks, especially if the extrabudgetary funds were not well governed. Should Parliament approve the proposed amendments to the DBM law in March 2024 before DBM’s governance has been strengthened, DBM’s engagement in EXIM banking operations could also give rise to additional contingent fiscal liabilities. Given Mongolia’s heavy reliance on volatile commodity revenues which are also susceptible to geopolitical factors, a broad-based fiscal consolidation encompassing the wage bill, public investment management, progressivity in personal income taxes and means-tested social assistance targeting, would be warranted. The government should refrain from further fiscal loosening.

¹ The Sovereign Risk and Debt Sustainability Framework (SRDSF) provides a sovereign risk assessment and a debt sustainability assessment. This assessment focuses solely on the risk of sovereign stress (as a surveillance country, the debt sustainability assessment is optional for Mongolia). Even when sovereign stress risks materialize, debt will only be assessed as unsustainable if there are no feasible adjustment policies capable to stabilize the debt and achieve acceptably low rollover risk without restructuring or exceptional measures. The impact of the improved outlook on debt dynamics will be reassessed in the next Article IV consultation after taking into account prospective infrastructure projects, extrabudgetary funds and quasi-fiscal activities.

8. Fiscal structural reforms should focus on enhancing governance to reduce fiscal risks.

The fiscal framework should be further strengthened by introducing a well-defined escape clause and corrective mechanisms; realigning ministerial/agency responsibilities; and ensuring the independence of the Fiscal Stability Council. The efficiency, oversight, and accountability of public investment management should be bolstered, including through an arms-length review of investment plans of major state-owned enterprises. Extrabudgetary funds should be well governed and fully integrated into the budget. It would be important to strengthen DBM's governance by appointing an independent external advisor to conduct a diagnostic balance sheet review.

Monetary and Exchange Rate Policy

9. Given the substantial fiscal stimulus in 2024 and the expected rise in inflation, monetary and macroprudential policies should maintain tight domestic financial conditions.

In the absence of a well-functioning domestic securities market, the BOM should continue mopping up the excess liquidity due to FX inflows through the issuance of central bank bills and maintain its tighter monetary policy stance. To contain excessive salary-backed consumer credit growth, the debt service to income (DSTI) limits in banks should be effectively enforced, while the DSTI of the non-bank financial sector be harmonized with those of the banking sector. Maintaining a flexible exchange rate and further increasing external buffers would build resilience against external shocks. Domestic debt issuance should resume to support the BOM's ability to mop up excess liquidity.

Other Policies

10. Financial sector supervision should continue to be strengthened. The financial sector remains broadly stable with some recovery in bank profitability in 2023H2, supported by increasing credit growth. Supervisors should effectively implement onsite and off-site supervision, prioritizing high-risk banks and operations, and ensure bank capital is high quality and from fit and proper investors. Parliament should extend the deadline for shareholder diversification of domestic systemically important banks once the Banking Law amendments are resubmitted to Parliament.

11. It is critical to address corruption and strengthen governance and institutions. The anti-corruption and regulatory framework should be upgraded and effectively enforced. The draft Whistleblower Protection law should be passed without further delay. The government should implement measures to attract FDI, enhance public sector efficiency and diversify the economy, including by accelerating the overhaul of the Minerals Law.

IMF Relations

12. Mongolia is on a standard 12-month Article IV consultation cycle. It received an SDR allocation of US\$98.3 million in 2021 and received emergency assistance from the IMF through the Rapid Financing Instrument in 2020. Mongolia is also a major recipient of IMF technical assistance.

Mongolia: Selected Economic and Financial Indicators, 2021–29

	2021	2022	2023	2024	2025	2026	2027	2028	2029
	Actual			Projections					
(In percent of GDP, unless otherwise indicated)									
National Accounts									
Nominal GDP (in USD million)	15,286	17,146	20,095	21,925	23,490	25,362	27,224	29,191	31,301
Real GDP growth (percent change)	1.6	5.0	7.0	6.5	6.0	5.5	5.4	5.2	5.2
Contributions to Real GDP (ppts)									
Domestic Demand	17.6	11.4	1.8	16.2	8.6	9.1	5.3	6.3	5.9
Exports of G&S	-7.5	13.9	23.2	-2.2	5.4	4.4	5.1	3.4	2.6
Imports of G&S	-8.5	-20.3	-18.0	-7.4	-8.0	-8.0	-5.0	-4.6	-3.3
Consumption	67.9	65.8	61.1	67.9	66.0	65.4	66.4	67.5	68.2
Private	53.0	51.9	47.8	53.5	51.9	51.4	52.5	53.7	54.3
Public	14.9	13.9	13.3	14.4	14.1	14.0	14.0	13.8	13.8
Gross Capital Formation	36.7	42.3	32.4	32.8	36.5	37.1	34.5	33.2	32.3
Gross Fixed Capital Formation	26.8	29.8	27.4	28.6	29.6	30.2	27.6	26.3	25.3
Public	6.8	7.1	7.5	7.9	7.9	7.9	7.9	7.9	8.0
FDI	13.5	14.2	8.4	8.6	9.3	9.8	7.9	6.8	5.7
Domestic Private (including SOEs)	6.5	8.6	11.5	12.1	12.4	12.5	11.8	11.5	11.7
Gross national saving	22.9	28.9	33.6	25.3	27.3	28.1	26.8	25.7	25.0
Prices									
Consumer Prices (Avg; percent change)	7.4	15.2	10.3	9.7	10.0	8.9	7.8	7.1	6.8
Consumer Prices (EoP; percent change)	13.9	13.2	7.9	10.8	9.5	8.2	7.4	6.8	6.8
Copper prices (US\$ per ton)	9317	8829	8491	8551	8661	8676	8668	8656	8669
Coal prices (US\$ per ton)	150	123	131	110	100	100	100	100	100
GDP deflator (percent change)	14.4	17.7	19.5	8.5	8.6	9.5	7.7	7.0	6.7
General government accounts									
Primary balance (IMF definition)	-1.1	2.1	4.3	1.9	0.9	1.1	1.1	1.0	0.9
Total revenue and grants	32.8	34.4	35.3	34.8	33.5	33.4	33.2	33.0	33.0
Primary expenditure and net lending	34.0	32.3	31.0	32.9	32.6	32.3	32.1	32.0	32.0
Interest	1.9	1.5	1.6	1.9	1.9	1.9	2.0	1.9	1.9
Overall balance (IMF definition)	-3.0	0.7	2.7	0.0	-1.0	-0.8	-1.0	-0.9	-1.0
Non-mineral primary balance (in percent of GDP)	-8.7	-6.3	-6.4	-8.2	-8.2	-7.8	-7.5	-7.4	-7.3
Gross financing needs	13.3	3.8	16.6	4.3	5.9	15.5	9.5	12.1	10.8
General government debt 1/	67.7	64.5	48.0	47.9	47.9	48.1	49.0	50.5	51.8
Domestic	3.2	4.4	3.4	5.0	6.5	6.6	7.8	9.6	11.2
External	64.6	60.1	44.7	42.9	41.4	41.5	41.2	40.9	40.6
Monetary sector									
Broad money growth (percent change)	13.8	6.5	26.8	15.0	13.9	14.3	13.5	12.7	13.3
Reserve money growth (percent change)	6.5	39.9	7.4	12.3	13.5	13.3	14.2	12.0	13.3
Credit growth (percent change)	18.1	9.0	20.6	14.5	14.0	13.5	13.5	13.0	13.0
Balance of payments									
Current account balance	-13.8	-13.4	1.2	-7.5	-9.2	-9.0	-7.7	-7.5	-7.3
Exports of goods 2/	53.2	57.5	69.1	60.1	58.4	58.0	57.5	56.5	55.0
Imports of goods	44.3	50.3	47.2	48.8	49.4	49.6	48.7	47.7	46.3
Gross official reserves (in USD million) 3/	4366	3400	4921	4918	5293	6070	6981	7766	8531
(In months of imports)	4.3	3.0	3.9	3.6	3.6	4.0	4.4	4.7	4.9
(net of bank's FX deposits held at the BOM)	3612	1949	3612.1	...	...	...	...	...	...
Net international reserves (NIR) 4/	779	-797	720	...	...	...	...	...	...
Exchange rate									
Togrog per U.S. dollar (eop)	2849	3445	3410	...	...	...	...	...	...

Sources: Mongolian authorities; and IMF staff projections.

1/ Excludes BOM liabilities to PBOC. Domestic debt in 2022-23 includes government's liabilities to BOM related to the TDB settlement with regard to Erdenet as well as DBM's domestic FX borrowing. Assumes full rollover of the government's remaining Eurobonds maturing in 2024.

2/ The projections assume higher coal export volumes than the 2023 Article IV consultation and the 2024 budget (65 million tons in 2024, gradually rising to over 70 million tons in 2027) reflecting higher coal demand from China and better coal transportation services; Oyu Tolgoi's revised medium-term copper production and FDI plans; and updated information on SOE off-take contracts.

3/ Gross official reserves includes drawings from the PBOC swap line assumed to be rolled over in 2026 and IMF SDR allocation in 2021.

4/ NIR is defined as GIR excl. commercial banks' and government's US\$ deposits held at the BOM, the PBOC swap line, and liabilities to the IMF. The projections do not assume a further repayment of the PBOC swap line beyond the CNY1.3 billion already repaid by the BOM.