

Mongolia: Second Post-Program Monitoring Discussions

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on September 20, 2011, with the officials of Mongolia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 25, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Staff Supplement of November 8, 2011 updating information on recent developments.
- A Public Information Notice (PIN).

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

MONGOLIA

Second Post-Program Monitoring

Prepared by the Staff Representatives for the Second Post-Program Monitoring

Approved by Nigel Chalk and Claire Waysand

October 25, 2011

Context. An 18-month Stand-By Arrangement was successfully completed in October 2010. The Mongolian economy is undergoing a rapid expansion underpinned by strong commodity prices. Macroeconomic policies, however, have been too expansionary and the economy is now overheating. A steady erosion of fiscal discipline, set against a backdrop of heightened global economic risks, has raised the risk of macroeconomic instability. There is an urgent need to reorient policies to contain overheating and strengthen the economy's ability to endure deterioration in the global environment. This will mean restraining fiscal spending and tightening monetary conditions.

Summary. Discussions focused on the following:

- ***Fiscal spending.*** Expenditure restraint is critical for containing overheating pressures. This year's budget, therefore, should not be amended to increase expenditure. Nominal spending next year should adhere to the targets already agreed by parliament in the medium-term budget framework.
- ***Monetary policy.*** Monetary policy needs to play a more active role in countering inflationary pressures. Policy rates should be increased and macro-prudential measures introduced to contain the risks from the recent surge in credit growth.
- ***Exchange rate policy.*** There was agreement that the flexible exchange rate regime is working well and provides an important shock absorber in the event of an external shock.
- ***Risks.*** The economy remains vulnerable to a commodity price downturn which has become a rising risk in the current global environment. Overheating threatens to push inflation up further, which will exact a heavy toll on the poor. Finally, the surge in credit growth is increasing banking system risks and reinforces the importance of strictly enforcing prudential regulations.

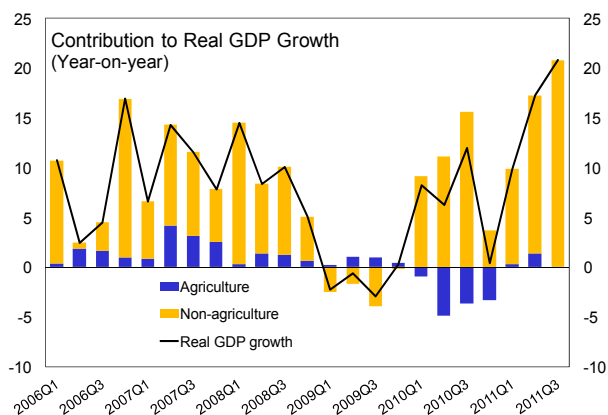
Discussions. A staff team visited Ulaanbaatar, September 14–20, 2011, consisting of Mr. Barnett (Head), Mr. Ojima (APD), Mr. Park (FAD) and Mr. Ramlogan (Resident Representative). Mr. Ishii (Director of the Regional Office for Asia and the Pacific (OAP)) joined the mission for the senior policy discussions.

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I. BACKGROUND

1. **Context.** Mongolia completed successfully its Fund-supported Stand-by Arrangement last October. The government's commitment to implement sound policies was a critical ingredient to the success of the program. Since the end of the program, however, macroeconomic discipline has eroded, placing in jeopardy the gains achieved during the course of the program. Parliamentary elections are scheduled for June 2012 and electoral politics are already starting to exert a stronger influence on policies.

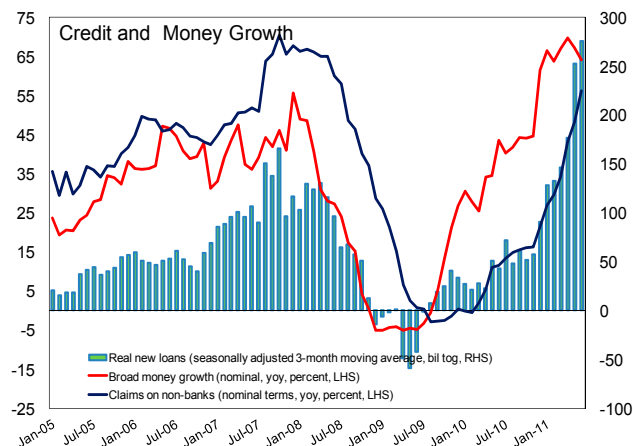
2. **Macroeconomy.** The economy is undergoing a vigorous recovery, fueled by strong global commodity prices and excessively loose macroeconomic policies. Mining output, moreover, is set to increase substantially as two huge mineral projects start production (Box 1). Growth accelerated sharply this year, reflecting booming mineral exports driven by global prices and rising coal production, ongoing development of large mining projects, surging credit growth, improved agricultural output (primarily a base effect from last year's severe winter), and expansionary macroeconomic policies (Figures 1 and 2). The economy is now overheating and inflation has accelerated sharply in the past few months.



II. POLICY DISCUSSIONS

A. The Economy is Overheating

3. **Growth.** Real GDP growth in the third quarter reached 20 percent, making Mongolia one of the fastest growing economies in the world. At the same time, private sector credit has increased by nearly 50 percent in real terms and imports of consumer goods have increased by over 80 percent. Such rapid growth is not sustainable and is driving inflation upwards. Momentum in underlying inflation—which excludes food and administered prices—has remained high throughout this year and is running well-ahead of the authorities' policy targets. The mission's projections assume that monetary policy is tightened in line with our recommendations, the 2011 budget is amended to increase spending 8 percent of GDP, and fiscal expenditure in 2012 is as specified in the draft budget submitted to parliament. With these assumptions, real GDP growth would surpass 10 percent both this year and next. End-year



Box 1. Mongolia: Large Mining Projects

The economy is expected to grow rapidly in the next few years as two large mining projects start production. As a result, U.S. dollar GDP per capita could triple from 2010 to 2016.

- **Oyu Tolgoi.** Oyu Tolgoi, located in the south near the border with China, will be one of the largest copper and gold mines in the world. Sizeable deposits of silver were also recently discovered during drilling. The government owns 34 percent of the mine, and the rest is owned by Ivanhoe Mines (Canada), in which Rio Tinto has a 46.5 percent stake. Mine construction is ahead of schedule, and production is expected to start in mid-2012.
- **Tavan Tolgoi.** Tavan Tolgoi, also located in southern Mongolia, is one of the world's largest untapped coal deposits with estimated reserves of about 6.4 billion tonnes. Erdenes Tavan Tolgoi LLC, a subsidiary of a 100 percent state-owned enterprise, has the mining license for what is called the eastern bloc. It is currently negotiating an operating contract with foreign companies. An initial public offering of 30 percent of Erdenes Tavan Tolgoi shares is expected to take place in the first quarter of 2012, another 10 percent of the shares will be sold to national companies at a nominal price, and 10 percent will be distributed at no cost to all Mongolian citizens. For the western block, the government is negotiating with international and domestic mining consortiums for the mining rights, and hopes to finalize the selection of companies and conclude investment agreements later this year.

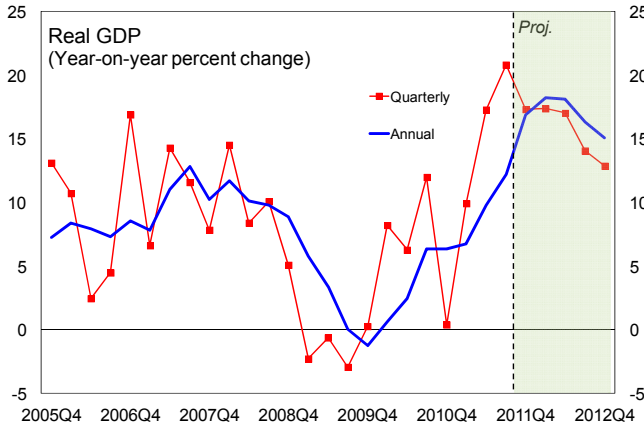
The government is receiving prepayments of taxes and sales revenue from these two projects. The advance payments are used for general budget financing, and in particular to help pay for the universal (monthly) cash transfers that were put in place to fulfill a promise from the last election. In June, the final US\$100 million (out of a total of US\$250 million) in Oyu Tolgoi related prepayments were received. In July, Erdenes Tavan Tolgoi signed an agreement with a Chinese firm to supply coal in exchange for advance payments that would total US\$250 million, money that will be transferred to the budget.

When operational, the mines will lead to massive increases in export earnings and fiscal revenue. Staff project that export proceeds from these mines will total US\$2.4 billion in 2013, rising to US\$10 billion by 2020. The 2020 export earnings are, for comparison, equal to about 140 percent of 2010 GDP. Fiscal revenue is projected to grow in tandem, though with some delay, as much of the initial government proceeds from Oyu Tolgoi must be used to repay the advance payments and a loan used to finance the government's equity stake. By 2016, however, fiscal mineral revenue is projected to amount to 28 percent of non-mineral GDP, compared with 18 percent of non-mineral GDP in 2010.

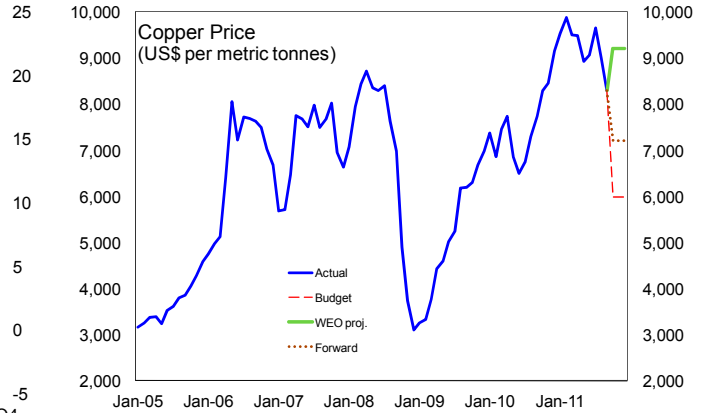
Figure 1. Mongolia—Macroeconomic Developments

Main Message: The economy has undergone a vigorous recovery, boosted by mineral exports, and overheating is now a key concern.

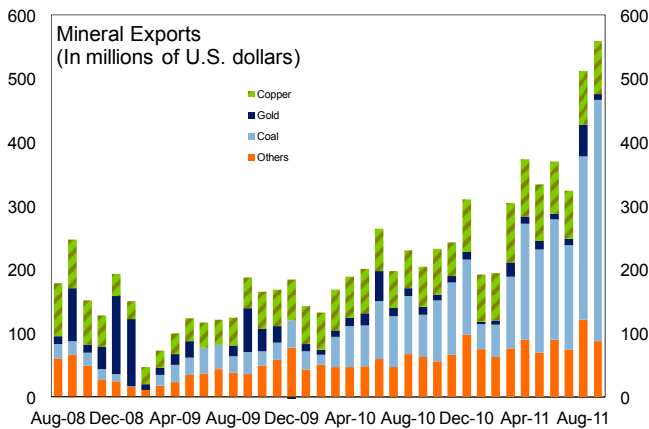
The economy bottomed out late 2009 and has bounced back strongly...



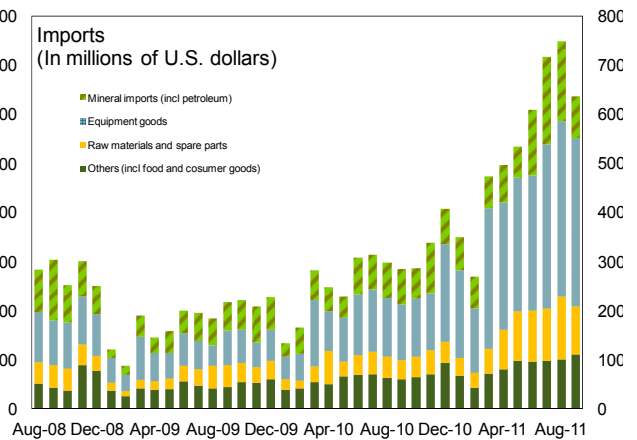
...in part due to the sharp rebound in copper prices...



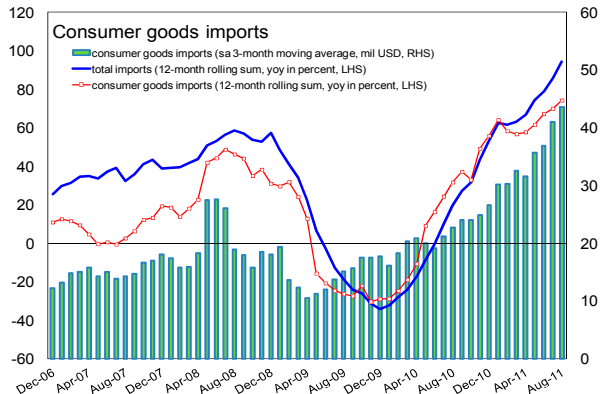
...that is driving export earnings along with a sharp increase in coal exports as production capacity increases.



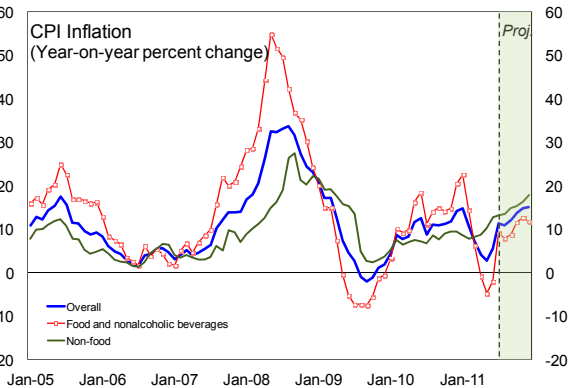
The ongoing development of the mineral sector is boosting imports, especially of equipment...



...as is strong domestic demand (indicated by surging imports of consumer goods).



Inflation has re-emerged, while volatility in food prices disguises more persistent price pressures in non-food inflation.

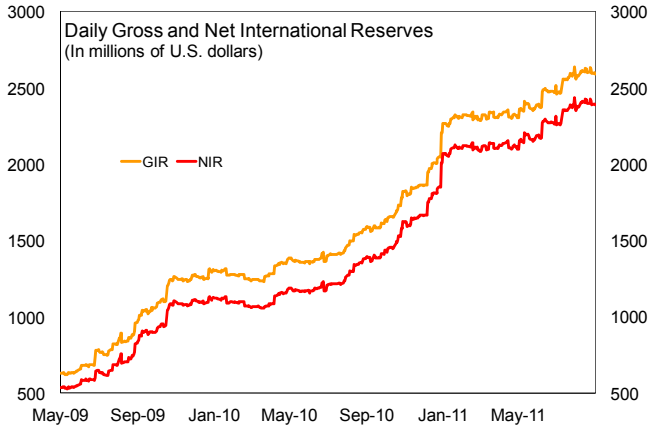


Sources: Mongolian authorities; and IMF staff estimates.

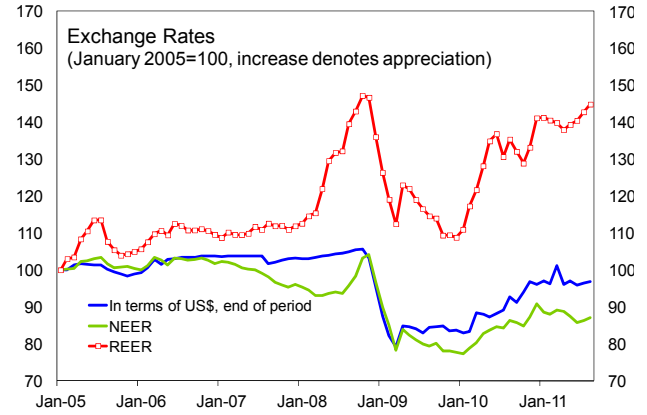
Figure 2. Mongolia—Monetary and Exchange Rate Developments

Main Message: Monetary policy has not been proactive enough to reign in credit growth, which is also being fueled by rapid growth in monetary aggregates.

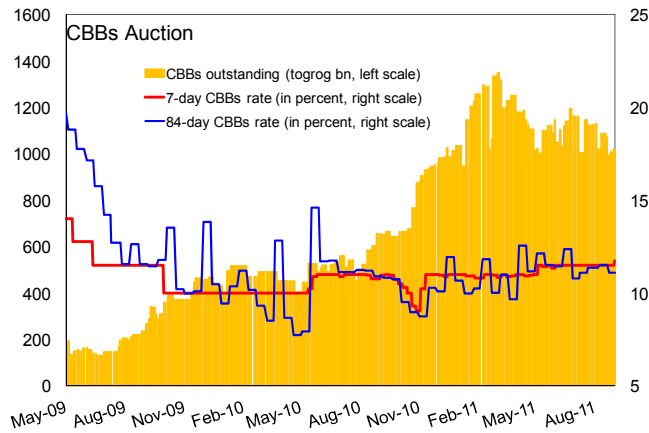
International reserve accumulation has slowed as the central bank has largely refrained from intervening in the market...



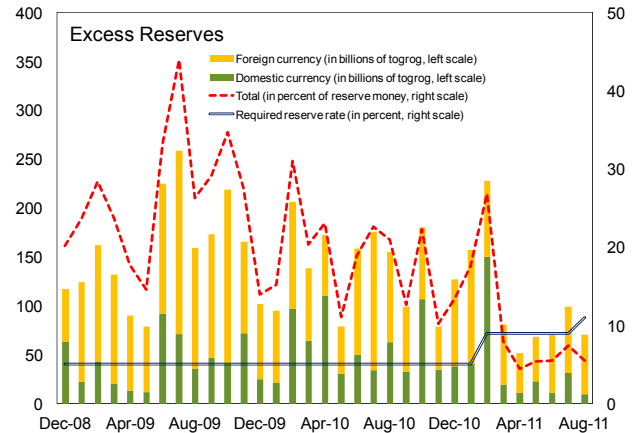
...and, despite the lack of intervention, the exchange rate has remained fairly stable in real effective terms.



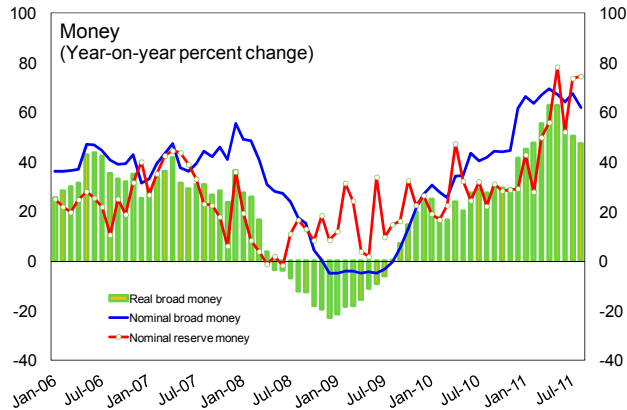
Central bank bill issuance has slowed and the policy interest rate has only been hiked twice this year...



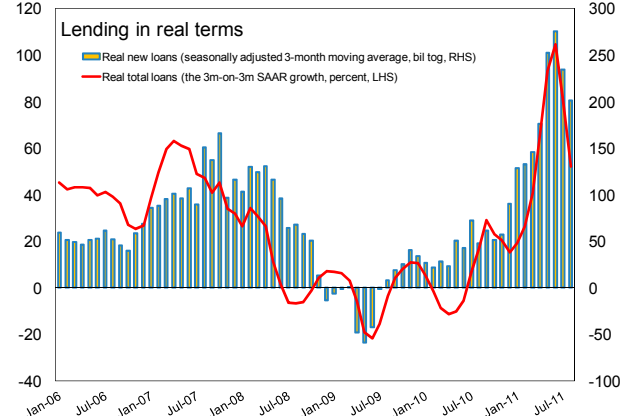
...and the two reserve requirement increases have been partly absorbed by a decline in banks' holding of excess reserves.



Monetary aggregates, meanwhile, continue to grow briskly.



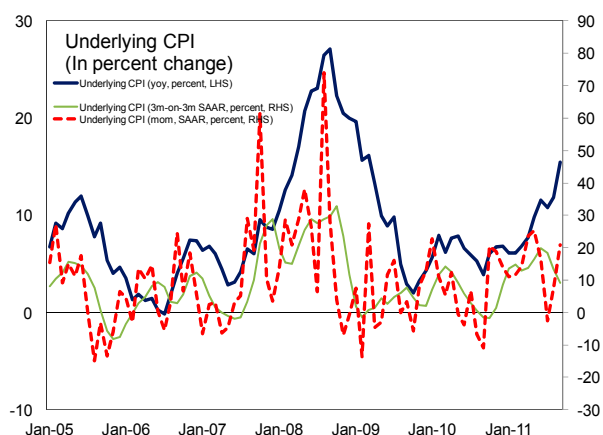
And, therefore, not surprisingly credit growth is surging.



Sources: Mongolian authorities; and IMF staff estimates.

inflation would exceed the authorities' target this year by a considerable margin and remain firmly in the double-digits in 2012.

4. **Inflation.** Inflation in Mongolia is volatile, making it difficult to discern underlying inflation pressures crucial for guiding macroeconomic policy. Changes in headline inflation have been heavily influenced by supply shocks to food, with the sharp decline in inflation earlier this year largely reflecting a drop in meat prices as the government sold stocks from its strategic meat reserves. Looking past this food price volatility, the momentum in underlying inflation has remained strong and well above the government's target of single-digit inflation. Staff emphasized the need for fiscal policy to stop adding to inflationary pressures and for monetary policy to be more proactive.



5. **Risks.** Mongolia is susceptible to a global downturn, and would be especially hard hit by a collapse in commodity prices. This is all the more worrying since copper prices have fallen sharply in recent weeks. Global financial volatility could also lead to delays in the two large mining project investments that are underway. This would hurt growth in the short run, reduce the value of contracts under negotiation, and delay the eventual fiscal revenue and export inflows. The economy, however, is more resilient to external shocks than before, largely thanks to the reforms put in place as part of the Stand-by Arrangement. International reserves are at their all time high, the flexible exchange rate will act as a critical shock absorber, and the recently signed renminbi swap line with the People's Bank of China provides a further buffer. At the same time, there are similarities between the current episode and the macro-policies in the run-up to the last crisis (Figure 3). The downside risks to the global outlook, moreover, add urgency to the need for tighter macroeconomic policies and avoiding a repeat of the missteps that fueled the 2009 crisis.

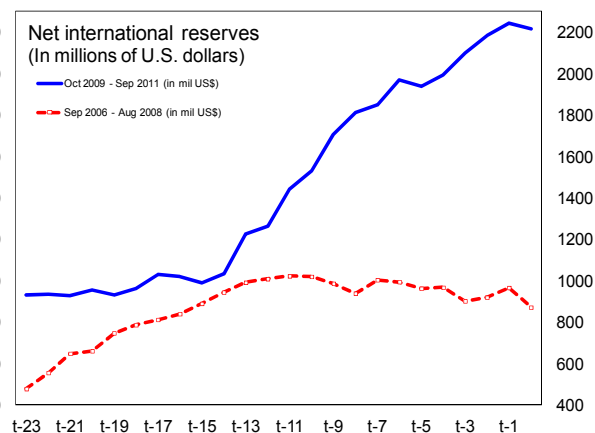
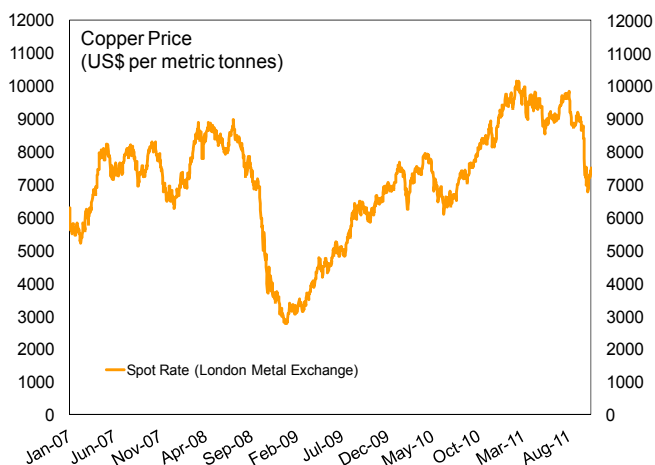
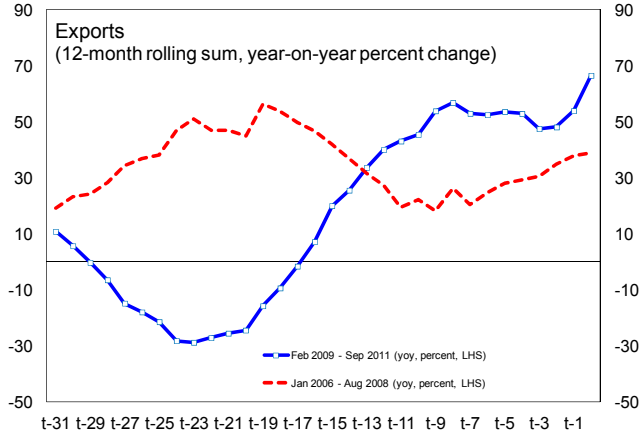


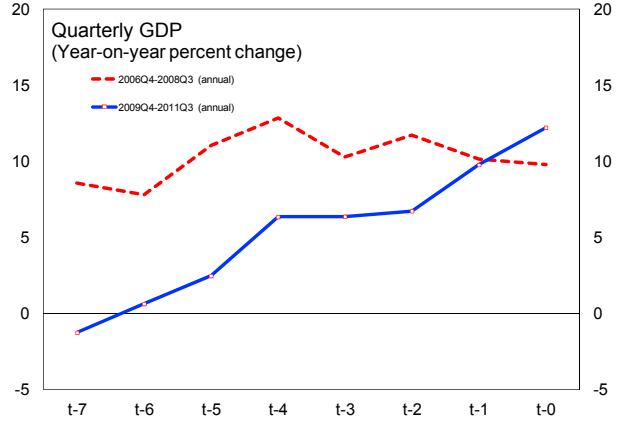
Figure 3. Mongolia—Comparing Now and Then

Main Message: An export boom is mixing with excessively loose macroeconomic policies to drive up growth and overheat the economy, showing striking similarities to the run-up to the last crisis.

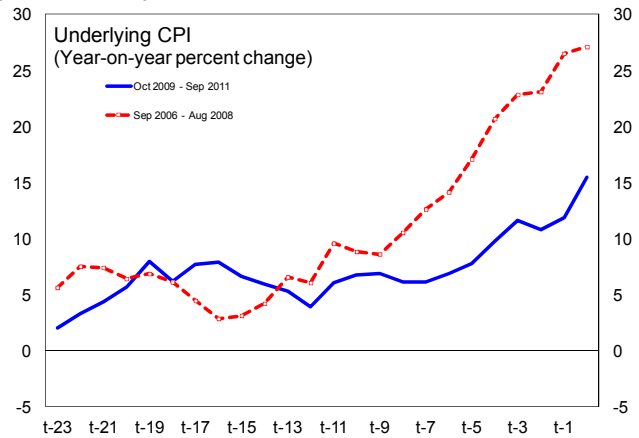
Exports are booming due to strong global commodity prices



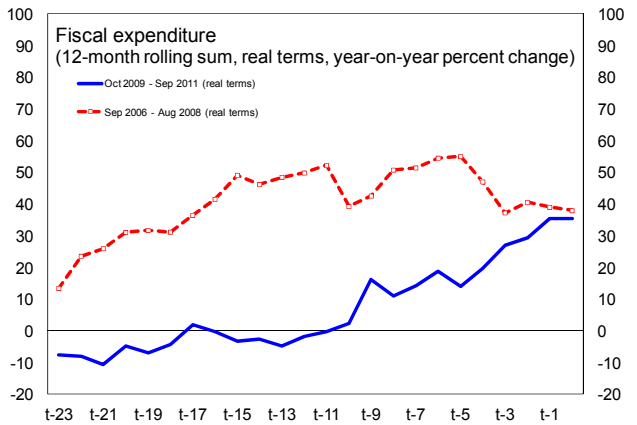
...helping push GDP growth to the pre-crisis rate...



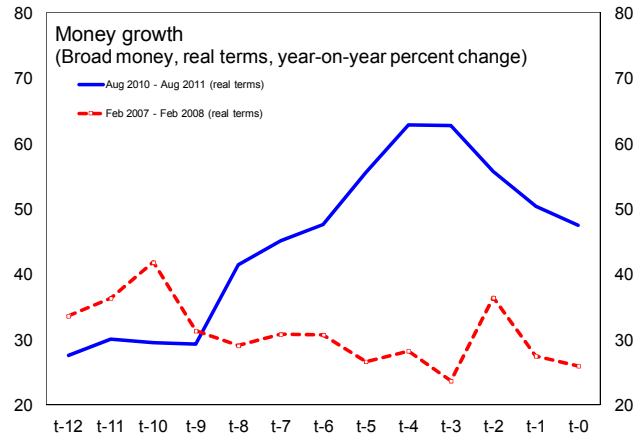
...and driving up inflation, which nonetheless remains well below the peaks reached just before the crisis.



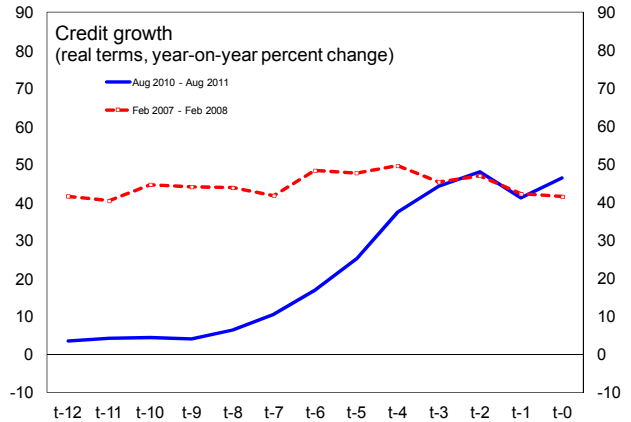
Fiscal expenditure is again growing strongly...



...and money supply is growing faster than pre-crisis speeds...



...helping fuel another credit boom.



Sources: Mongolian authorities; and IMF staff estimates.

6. **Authorities' views.** The authorities expect rapid growth to continue and the draft 2012 budget assumes real GDP growth of some 20 percent for this year and next. However, they did not believe the economy was overheating and thought that inflation could be contained to single-digits in 2012 (and below 8 percent in 2013–14) in line with their policy objective. Nevertheless, the budget assumes an increase in the GDP deflator of around 20 percent. More broadly, they cited under-developed infrastructure as the key impediment to sustaining high growth with moderate inflation and underlined the importance of their plans to increase infrastructure spending through both the budget and the Development Bank. They understood the risks to the global outlook, and the implications for Mongolia, but were confident that the economy was now much more resilient than in the past and that they would be able to adjust policies, if needed, in the event of a sharp drop in global commodity prices.

Mongolia: Authorities' Forecast, 2011-12						
	2011			2012		
	Baseline	Authorities 1/	Staff's recommendations	Baseline	Authorities 1/	Staff's recommendations
	(In billions of togrogs)					
Total revenue and grants	4,262	4,139	4,248	5,287	6,733	4,999
Total expenditure and net lending	4,945	4,912	4,016	7,093	7,093	4,880
Overall balance	-683	-773	232	-1,806	-360	118
Nominal GDP	11,535	11,852	11,464	15,274	18,003	14,517
	(In percent of GDP)					
Total revenue and grants	36.9	34.9	37.1	34.6	37.4	34.4
Total expenditure and net lending	42.9	41.4	35.0	46.4	39.4	33.6
Overall balance	-5.9	-6.5	2.0	-11.8	-2.0	0.8
Memorandum items:	(In percent)					
Real GDP growth	16.9	20.0	16.2	15.1	25.6	11.1
Real Expenditure Growth	50.8	---	22.5	20.9	---	2.4
GDP deflator inflation	17.3	17.4	17.3	15.0	20.9	13.9
CPI inflation (eop) 2/	15.1	12.5	14.5	17.9	9.9	9.9
1/ Based on NDIC projection for 2012 budget proposal, except for CPI inflation.						
2/ The authorities' forecast is based on the draft 2012 Monetary Policy Guideline.						

B. Fiscal Policy has Returned to the Boom-Bust Ways of the Past

7. **Fiscal pressures.** Strong revenue collection means that the overall balance would almost certainly register a small surplus this year if spending is not increased. However, rather than saving this additional revenues, the government has decided to increase spending by some 8 percent of annual GDP in the last two months of this year. This includes nearly 4 percent of GDP in government loans—to small enterprises and processors of cashmere and wool—and 3 percent of GDP in new capital spending. Staff emphasized the negative impact on the poor of the current macroeconomic trajectory and the risks such a large jump in spending posed for inflation.

8. **Development Bank.** A development bank was recently established and will soon start operations. The Development Bank is supervised by the Ministry of Finance and is not subject to the standard commercial bank regulations nor supervised by the bank regulator, which is the

central bank. Staff expressed concern that this government-owned bank would be used primarily as an off-budget vehicle for additional spending. Planned lending by the bank is expected to be concentrated in non-commercial projects such as roads which will generate little to no cash flow and it is expected that the budget would repay these loans over time. Such quasi-fiscal activity would undermine the very goals of the recently-passed fiscal responsibility law.

9. **2012 budget.** The medium-term budget framework approved by parliament was consistent with the fiscal responsibility law's numerical targets. These include the high profile commitment to achieve a 2 percent of GDP structural deficit by 2013.¹ However, the spending path already skewed the adjustment burden to 2013, to the point that nominal spending was actually set to decline in that year. Staff argued, therefore, that nominal spending in the 2012 budget should be kept at or below the level in the medium-term budget framework that had already been approved by parliament, especially in light of rising inflation and the solid near-term growth prospects. Instead, the budget that was recently submitted to parliament includes sharply higher nominal spending that is 13 percent of GDP above that in the medium-term budget framework. In addition, the budget assumes extraordinary forecasts for both nominal growth and revenues. It also includes a wage increase of roughly 50 percent during the first half of the year, which would add substantially to inflation and further hurt Mongolia's competitiveness (since private sector wages are likely to follow the government's lead). Parliament is expected to pass the budget by the end of November. Based on the draft 2012 budget, fiscal spending in 2013 would have to be cut by some 25 percent in real terms in order to comply with the fiscal responsibility's law structural balance rule in 2013. Staff proposed a much lower path of fiscal spending in 2011–12, which would create room for a modest real increase in spending in 2013 (3 percent in real terms) rather than a precipitous decline. Further, such a path for spending would substantially reduce the overheating pressures in 2012 and beyond (see staff's recommendations presented in the previous text table). Staff did, however, welcome the inclusion in the 2012 budget of the long-delayed targeted poverty benefit. This social assistance would provide a higher level of support to the most needy and protect the poor from the planned cut in universal transfers in the second half of 2012.

¹ The structural balance is calculated by using smoothed mineral prices—derived as the average price during a 16-year period (12 years of historical data and projections for the current year and subsequent three years)—to estimate revenue. It does not adjust for the business cycle and thus differs conceptually from what is usually referred to as a structural balance. The other prominent numerical rules require (i) spending, starting in 2013, to grow less than the greater of non-mineral GDP growth in the budget year or the average of the previous 12 years, which allows for counter-cyclical spending; and (ii) a ceiling on the net present value of public debt, broadly defined to include state-owned enterprises and government guaranteed debt, that falls from 60 percent of GDP in 2012, to 50 percent of GDP in 2013, and 40 percent of GDP in 2014.

Mongolia: Fiscal Indicators, 2006-13 1/ (In percent of non-mineral GDP)								
	2006	2007	2008	2009	2010	Projected		
						2011	2012	2013
Overall balance (In percent of GDP)	7.6	2.6	-4.5	-5.0	1.2	-5.9	-11.8	-1.0
Structural balance (In percent of GDP)	0.2	-7.5	-10.1	-6.8	-2.7	-7.9	-13.1	-2.0
Non-mineral balance	-3.3	-16.1	-21.2	-17.9	-17.4	-24.3	-28.7	-13.1
Non-mineral revenue	38.0	41.9	36.3	35.5	41.9	47.2	43.1	40.7
Total expenditure	41.3	58.0	57.6	53.5	59.3	71.6	71.8	53.7
Fiscal effort (change in cyclically adjusted) 2/	-0.9	-13.4	-8.6	7.4	4.1	-12.7	-3.5	18.9
Real expenditure growth	32.2	53.3	11.2	-11.4	16.3	50.8	20.9	-24.9
Memorandum items:								
Real non-mineral GDP (growth in percent)	10.1	11.6	10.3	-1.8	6.0	17.5	12.5	2.0

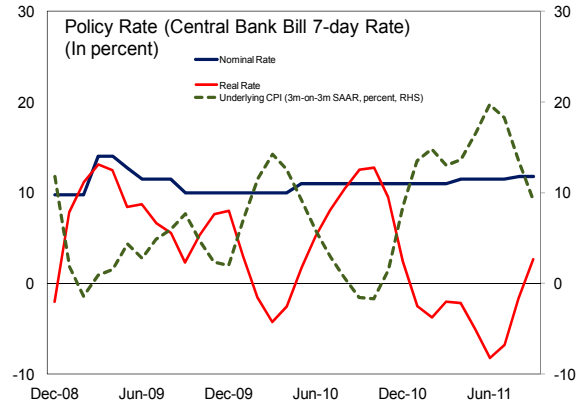
Sources: Mongolian authorities; and IMF staff calculations.
1/ Staff forecasts based on application of the numerical rules in the fiscal responsibility law.
2/ In percent of potential non-mineral GDP. The elasticity assumptions are 1 for revenue and 0 for spending.

10. **Authorities' views.** The authorities understood the risks from an increase in spending. They emphasized, however, the political importance of delivering on the campaign promises from the last election to distribute resources from the Oyu Tolgoi project to the population, invest in essential infrastructure, and significantly increase government wages. They noted that, despite the additional spending in the 2011 budget amendment, buoyant revenue collection would mean that the fiscal deficit would end the year well below the 9.9 percent of GDP target in the original budget. At the same time, much of the spending in the amendment was either in the form of loans that had been approved by parliament earlier in the year or would be used to finance investment projects which were underfinanced in the original budget. They were confident, moreover, that spending pressures would ease following the election and that the announced cut in universal transfers would take place allowing them to reach the fiscal responsibility law targets in 2013. To safeguard the poor from these cuts, they highlighted their intention to introduce a targeted social safety net in 2012. The higher spending in 2012, relative to the medium-term budget framework, reflects changes in macroeconomic assumptions and the authorities' highlighted that they consider the key variable to be the structural balance as a share of GDP. By this metric, the 2012 budget was actually more prudent than the medium-term fiscal framework. Finally, regarding the Development Bank, they highlighted that it had a modern governance structure and was under prudent foreign management (a management contract was agreed with the Korean Development Bank, which includes supplying the CEO and half of the management team).

C. Monetary Policy has been Tightened, but More Needs to be Done

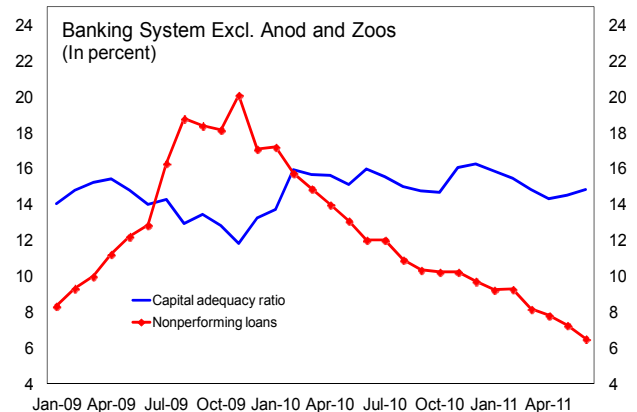
11. **Monetary policy.** Credit growth in real terms has surged to around 50 percent year-on-year with much of the credit concentrated in the larger banks. In August, the central bank announced increases of 25 basis points in the policy rate and 200 basis points in reserve requirements. These were welcome steps but certainly not enough given the pace at which inflation is rising. Staff advocated a further tightening of monetary conditions and suggested that the central bank use a variety of tools. First, the central bank should further raise the policy rate to send a strong signal to the market. In particular, the real policy rate has been consistently

negative for most of this year. In addition, a range of macro-prudential measures should be implemented to contain credit risks, including a further hike in reserve requirements, caps on the loan-to-value and debt-to-income ratios for real estate lending, tightening the liquidity ratio, tougher capital adequacy requirements, and additional provisioning. These would complement an interest rate hike and, in any event, be warranted on prudential grounds to stem the excessive growth in bank lending. MCM has been discussing these measures with the authorities and plans to soon field a technical assistance mission.



12. **Exchange rate policy.** The flexible exchange rate regime continues to work well and the central bank has intervened only sparingly over the past year. Staff advised, therefore, continuing with the current regime. In line with MCM technical assistance, the central bank has decided to use foreign currency swaps only as a liquidity management tool and has not been intervening using forward transactions.

13. **Banking.** Banking sector indicators have held up so far. However, these indicators are backward looking and the rapid acceleration in bank lending is increasing the banks' vulnerability and putting stress on the system (Figure 4). Moreover, even these indicators may not be representative of the true health of the system. For example, the decline in NPL numbers is distorted by the surge in credit and some banks have needed more time to implement the stricter rules put in place earlier this year on the treatment of



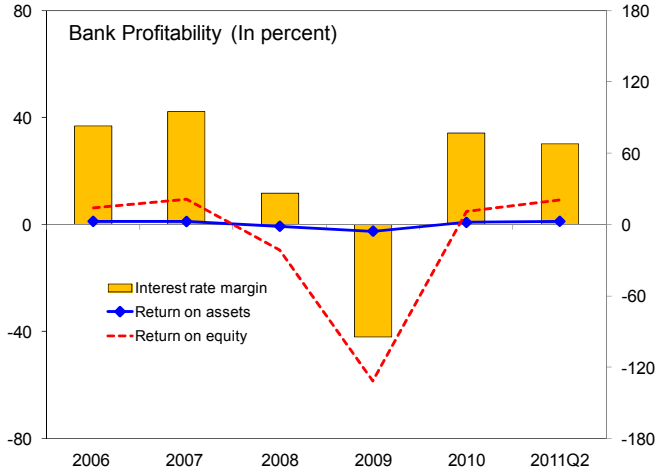
restructured loans and lending to related parties. Staff underscored that the supervisor must be willing, as needed, to take tough action against banks that are not in compliance with regulations. In particular, for such banks, a bank-by-bank restructuring plan should be put in place with time bound action plans that are closely monitored. The supervisor should also move towards risk-based and forward-looking supervision. At this stage in the business cycle, it is especially important to strictly enforce prudential regulations and proactively manage risks to prevent the buildup of future problems.

14. **Authorities' views.** The central bank emphasized that their policy response has been more proactive than in 2008, that the tightening measures put in place are showing signs of working (especially the hike in reserve requirements). They felt that the fundamental source of inflationary pressure was fiscal spending and monetary policy could only do so much to offset the large increases in spending that Mongolia was now absorbing. Nevertheless, they continued to watch incoming data and stood ready to implement further tightening measures if needed.

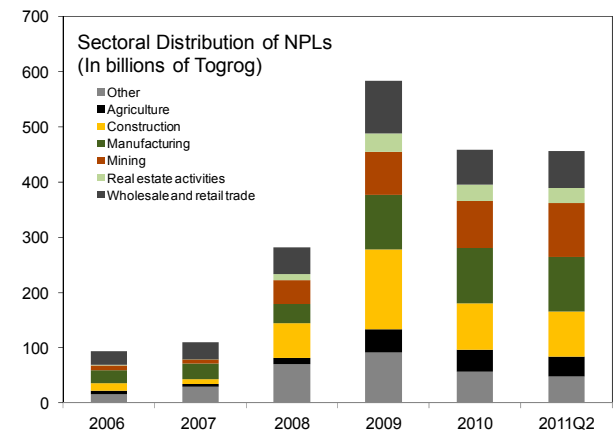
Figure 4. Mongolia—Banking System

Main Message: The banking system is recovering from the crisis and credit is now growing rapidly, which is raising concerns about credit quality.

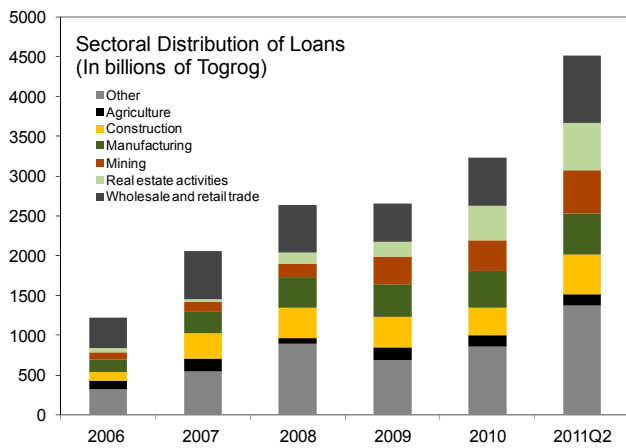
The banking system has returned to profitability...



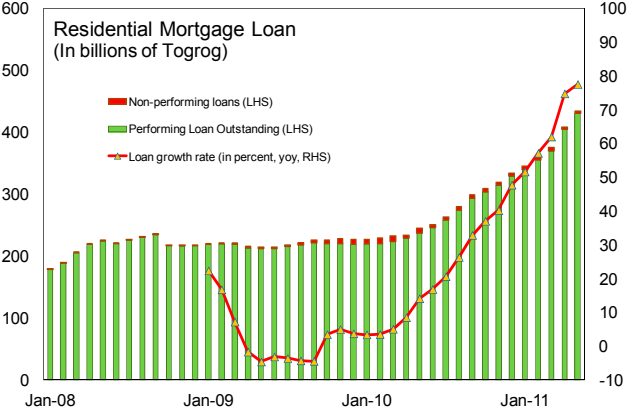
...and the stock of NPLs has fallen.



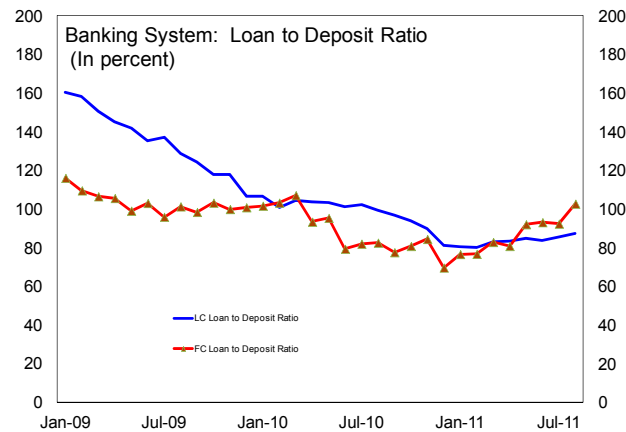
Credit has risen sharply, led by the real estate and mining sectors.



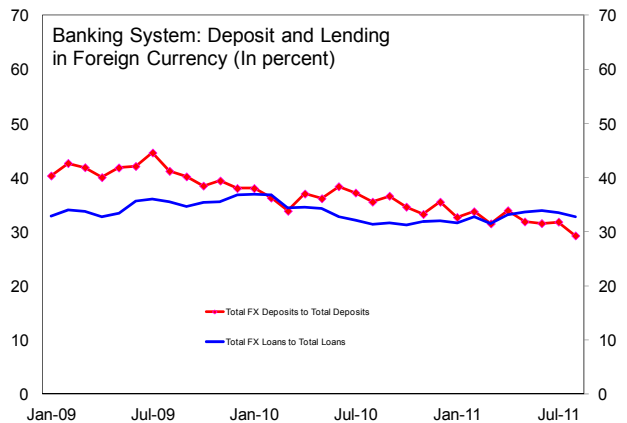
Residential mortgages, in particular, are growing fast.



Deposit growth, moreover, has kept pace with lending growth in local currency, though not for foreign currency...



...as foreign currency deposits, while growing, fell as a share of total deposits.



Sources: Mongolian authorities; and IMF staff estimates.

They agreed that interest rate hikes alone would not be sufficient, and were considering macro-prudential measures as a complementary tool. They shared staff's views that the flexible exchange rate continues to be well suited for Mongolia and that it, along with the substantially higher international reserves, would provide a critical buffer to a global shock. Regarding banks, they emphasized that supervision has made great strides since the crisis—supported by IMF technical assistance—and they agreed on the importance of strict enforcement. Parliament does not plan to take up the broader bank restructuring program.

III. STAFF APPRAISAL

15. **Context.** Mongolia has a bright economic future. Its vast mineral deposits offer the potential to create strong and sustained growth, lasting economic prosperity, and a substantial reduction in poverty. Success, however, will depend on a shift in approach in managing the economy. At present, macroeconomic policies are too expansionary. This has created inflationary pressures and made the economy vulnerable to external shocks. This is especially dangerous at this juncture given the heightened downside risks to the global economy. The large mining projects under development, moreover, are still some time away from full production. If global mineral prices drop precipitously, exports and fiscal revenue would fall sharply and pressure would come on international reserves. This would necessitate a potentially painful and disorderly reduction in fiscal spending that would exact a heavy toll on the economy, particularly on the poor. Top priority, therefore, should be to restrain fiscal spending and tighten monetary conditions to cool the overheated economy and provide insurance in the event of future commodity price shocks.

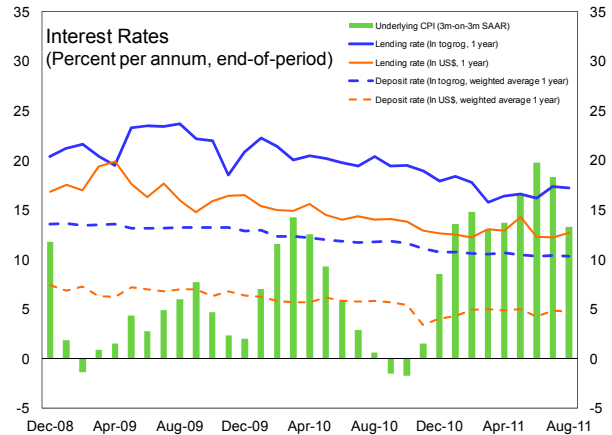
16. **Expenditure restraint.** The 2011 budget is too expansionary and a major source of the persistent inflationary pressures. Government spending, which was slated to grow by some 30 percent in the original budget, accounts for some two-thirds of the non-mineral economy and is thus a key determinant of aggregate demand. Any further increase in spending this year, therefore, is clearly not warranted, yet alone an increase of 8 percent of annual GDP, in just one quarter, as has been proposed. Additional spending this year would further overheat the economy, hurt the poor by driving up inflation, increase the vulnerability to a global commodity shock, and undermine credibility in fiscal policy and the fiscal responsibility law. Monetary policy, moreover, would not be able to offset a fiscal stimulus of this magnitude but in trying would inevitably lead to a crowding out of private sector activity.

17. **2012 budget.** Given the pressures facing the economy, nominal spending in 2012 should be kept at or below the level parliament has already approved in the medium-term budget framework. To better orient fiscal policy toward protecting the poor, a targeted poverty benefit should be introduced, starting in 2012. This would provide a welcome offset to the loss of income from the planned reduction in universal cash transfers, and make it much easier to protect the poor from budget cuts in the event of a global shock. In addition, the medium-term budget

framework includes a sharp reduction in spending in 2013 in order to adhere to the fiscal responsibility law. It would be much better to plan for a smoother path of spending.

18. **Development Bank.** The Development Bank poses significant fiscal risks. It is critical that the bank is not used as a vehicle for off-budget spending which would circumvent the very purpose of the fiscal responsibility law. To guard against this, the bank should be operated on commercial terms, with a high degree of transparency, and a board that is accountable for overseeing the bank's operations, risk management, and internal controls. The bank should also be subject to prudential requirements and independent prudential review, including external audit.

19. **Monetary policy.** The recent tightening of monetary policy is welcome but is still not enough given the coming inflationary pressures. Volatility in food prices has disguised the fact that underlying inflationary momentum has remained firmly in the double-digits. Despite this, the policy rate has been raised by less than 1 percentage point this year. Further rate hikes are necessary. In addition, and as a complement to rate hikes, the central bank should implement a range of macro-prudential measures to ensure that inflation pressures are contained and credit growth is brought under control. These measures include further hikes in reserve requirements, tightening of the liquidity ratio, requirement to provision against all new lending, limits on the loan-to-value and debt-to-income ratios, and an increase in capital adequacy requirements.



20. **Exchange rate policy.** The flexible exchange rate regime has been working well and continues to be well suited for the Mongolian economy. It will help control inflation, provide a shock absorber against external shocks, and facilitate the real exchange rate changes that are likely to take place over the medium term with the rapid growth in the mineral sector. The flexible exchange rate and the fact that international reserves are now at record highs will make the economy more resilient to a global commodity shock.

21. **Banking system.** The rapid acceleration in bank lending is increasing the banks' vulnerability and putting stress on the financial system. It is especially important to strictly adhere to the existing prudential regulations and proactively manage risks to prevent the buildup of future problems. Recent international experience has made painfully clear that a key to avoiding a banking crisis is to prevent the buildup of risks during economic booms. The macro-prudential measures described above are a key line of defense in this regard. Moreover, the banking supervisor must be willing, as needed, to take tough action against banks that do not comply with regulations. The supervisor should also move towards much more risk-based and forward-looking supervision.

Table 1. Mongolia: Selected Economic and Financial Indicators, 2009–12

Nominal GDP (2010): US\$6,244 million 1/
 Population, end-year (2010): 2.78 million
 Per capita GDP (2010): US\$2,233 2/
 Poverty incidence (2007/08): 35.2 percent 3/
 Quota: SDR 51.1 million

	2009	2010	Proj.		Article IV	
			2011	2012	2011	2012
(Percent change)						
Real sector						
Real GDP growth	-1.3	6.4	16.9	15.1	10.3	7.6
Mineral	0.2	7.4	15.3	22.0	13.4	12.6
Non-mineral	-1.8	6.0	17.5	12.5	9.0	5.5
Consumer prices (period average)	6.3	10.2	10.2	18.7	16.4	16.0
Consumer prices (end-period)	1.9	14.3	15.1	17.9	20.0	12.0
GDP deflator	1.8	20.0	17.3	15.0	14.1	8.9
(In percent of GDP)						
General government budget						
Revenue and grants	30.2	36.5	36.9	34.6	35.1	35.0
Expenditure and net lending	35.2	35.3	42.9	46.4	38.5	38.9
Current balance	2.6	9.2	8.1	4.3	4.4	6.8
Primary balance	-4.5	1.7	-5.5	-10.6	-3.1	-3.7
Overall balance (including grants)	-5.0	1.2	-5.9	-11.8	-3.5	-3.9
Non-mineral overall balance	-11.8	-10.4	-14.6	-18.6	-13.3	-11.8
Structural balance 4/	-6.8	-2.7	-7.9	-13.1	-6.3	-6.5
(Percent change)						
Money and credit						
Broad money	26.9	61.6	68.6	44.2	45.0	23.5
Broad money velocity (GDP/BM)	2.3	1.8	1.5	1.4	1.5	1.5
Interest rate on 7-day central bank bills, end-period (percent)	10.0	11.0	...	...	...	...
(In millions of US\$)						
Balance of payments						
Current account balance (including official transfers)	-410	-931	-1,821	-2,031	-1,302	-1,438
(In percent of GDP)	-9.0	-14.9	-19.5	-16.3	-15.1	-13.6
(In percent of GDP, excluding mining related imports)	-5.8	-5.7	0.2	-2.4	2.5	0.1
Trade balance	-194	-278	-1,285	-1,349	-1,049	-1,107
Exports	1,876	2,899	4,296	4,922	3,825	4,083
Imports	-2,070	-3,177	-5,581	-6,271	-4,874	-5,190
Foreign direct investment	496	1,574	2,412	894	1,130	548
Gross official international reserves (end-period)	1,328	2,288	2,984	3,302	3,586	4,127
(In months of next year's imports of goods and services)	4.0	4.2	4.9	5.8	7.1	8.8
Trade prices						
Export prices (US\$, percent change)	-13.2	33.1	18.9	-0.5	9.8	-1.4
Import prices (US\$, percent change)	-16.0	11.6	14.6	-0.6	7.4	0.5
Terms of trade (percent change)	3.3	19.3	3.8	0.1	2.3	-1.9
(In percent of GDP)						
Public and publicly guaranteed debt						
Total public debt	46.6	42.2	47.1	47.6	38.6	37.1
Domestic debt 5/	3.4	12.0	25.4	30.6	15.8	17.3
External debt	43.3	30.2	21.7	17.0	22.8	19.8
(In millions of US\$)	1,977	2,023	2,064	2,097	2,064	2,097
Exchange rate						
Togros per US\$ (end-period)	1,443	1,257	...	...	...	...
Togros per US\$ (period average)	1,441	1,348	...	...	...	...
Nominal effective exchange rate (end-period; percent change)	-15.8	3.4	...	...	...	...
Real effective exchange rate (end-period; percent change)	-11.1	11.3	...	...	...	...
Nominal GDP (In billions of togros)	6,591	8,415	11,535	15,274	10,382	12,166

Sources: Mongolian authorities; and IMF staff projections.

1/ Based on period average exchange rate and NSO revisions.

2/ Estimate, based on period average exchange rate and NSO revisions.

3/ Based on The Household Socio-Economic Survey 2007-08.

4/ As defined in the fiscal responsibility law, which uses smoothed instead of actual commodity prices to calculate revenue.

5/ Domestic debt in 2009 includes the Oyu Tolgoi tax-prepayment while the estimates for 2010 and the projections for 2011 additionally include the estimated fiscalization cost of bank restructuring and the financing of the government's equity share in Oyu Tolgoi.

Table 2. Mongolia: Summary Operations of the General Government, 2009–12

	2009	2010	Proj.		Article IV	
			2011	2012	2011	2012
(In billions of togrogs)						
Total revenue and grants	1,993	3,073	4,262	5,287	3,639	4,259
Total expenditure and net lending	2,322	2,974	4,945	7,093	3,999	4,738
Overall balance (incl. grants)	-329	99	-683	-1,806	-360	-478
Non-mineral overall balance	-778	-873	-1,681	-2,836	-1,380	-1,440
Structural balance	-445	-231	-907	-2,006	-652.2	-795.9
Financing	329	-99	683	1,806	360	478
Foreign (net)	300	-107	50	41	48	39
Domestic (net)	29	8	633	1,765	311	440
Privatization receipts (valuation adj.)	26	1	0	0	1	1
Domestic bank financing (net)	76	-29	396	1,965	-50	439
Domestic non-bank financing (net)	-73	36	462	0	361	0
Stabilization fund accumulation	0	0	-224	-200	0	0
(In percent of GDP)						
Total revenue and grants	30.2	36.5	36.9	34.6	35.1	35.0
Current revenue	29.8	36.0	36.7	34.6	34.7	34.6
Tax revenue and social security contributions	24.5	31.8	32.1	29.3	30.4	29.5
Income taxes	7.9	11.6	7.3	6.6	8.1	7.5
Social security contributions	3.9	3.8	4.0	4.3	4.0	4.3
Sales tax and VAT	4.9	6.9	8.8	7.9	7.4	7.7
Excise taxes	2.5	3.2	3.0	2.7	3.1	3.0
Customs duties and export taxes	1.8	2.3	2.8	2.4	2.5	2.3
Other taxes	3.5	4.0	6.2	5.3	5.3	4.7
Non-tax revenue	5.3	4.2	4.6	5.3	4.3	5.1
Capital revenue and grants	0.4	0.5	0.2	0.2	0.4	0.4
Total expenditure and net lending	35.2	35.3	42.9	46.4	38.5	38.9
Current expenditure	27.2	26.8	28.6	30.4	30.3	27.9
Wages and salaries	8.8	7.7	7.0	8.1	7.6	8.2
Purchase of goods and services	5.9	6.2	6.0	5.7	6.1	6.1
Subsidies to public enterprises	0.6	1.0	1.1	0.7	0.9	0.9
Transfers 1/	11.5	11.4	14.2	14.6	15.3	12.4
Interest payments	0.4	0.5	0.4	1.3	0.4	0.3
Capital expenditure and net lending	8.0	8.6	14.3	16.1	8.2	11.1
Capital expenditure	6.9	6.7	9.7	15.7	7.3	10.0
Net lending	1.1	1.8	4.6	0.4	0.9	1.0
Overall balance (incl. grants)	-5.0	1.2	-5.9	-11.8	-3.5	-3.9
Non-mineral overall balance (incl. grants)	-11.8	-10.4	-14.6	-18.6	-13.3	-11.8
Structural balance	-6.8	-2.7	-7.9	-13.1	-6.3	-6.5
Financing	5.0	-1.2	5.9	11.8	3.5	3.9
Foreign (net)	4.5	-1.3	0.4	0.3	0.5	0.3
Disbursements	5.9	0.2	1.1	1.1	1.2	1.2
Project loans	1.4	0.9	1.1	1.1	1.2	1.2
Program loans	3.0	0.4	0.0	0.0	0.0	0.0
Gold financing loan	1.4	-1.1	0.0	0.0	0.0	0.0
Amortization	1.3	-0.7	0.6	0.8	0.7	0.9
Domestic (net)	0.4	0.1	5.5	11.6	3.0	3.6
Banking system (net)	1.2	-0.3	3.4	12.9	-0.5	3.6
Non-bank	-0.7	0.4	4.0	0.0	3.5	0.0
Of which: Oyu Tolgoi tax-prepayment	2.2	0.8	1.1	0.0	1.2	0.0
Stabilization fund accumulation	0.0	0.0	-1.9	-1.3	0.0	0.0
Memorandum items:						
Overall balance incl. banking sector restructuring costs (percent of GDP) 2/	-5.0	-0.3	-6.9	-11.8	-4.6	-3.9
Mineral revenue (percent of GDP)	6.8	11.6	8.7	6.7	9.8	7.9
Non-mineral revenue (percent of GDP)	23.0	24.5	28.3	27.9	24.9	26.7
Nominal GDP (in billions of togrogs)	6,591	8,415	11,535	15,274	10,382	12,166
Copper price (US\$ per ton)	5,165	7,538	9,204	8,880	9,000	8,500

Sources: Ministry of Finance; and IMF staff projections.

1/ Includes reclassifications between goods and services and transfers starting in 2009, which accounts for about two-thirds of the increase in transfers relative to GDP in 2009.

2/ Includes the estimated fiscalization cost of bank restructuring.

Table 3. Mongolia: Statement of Operations and Stock Positions of the General Government, 2009–12

	2009	2010	Proj.		Article IV	
			2011	2012	2011	2012
(In billions of togrogs)						
Revenue	1,990	3,065	4,248	5,266	3,629	4,246
Expenditure	2,247	2,813	4,404	7,007	3,898	4,598
Expense	1,792	2,254	3,300	4,637	3,147	3,389
Net acquisition of nonfinancial assets	455	559	1,104	2,370	751	1,209
Operating balance	198	811	948	629	482	857
Net lending/borrowing (Overall balance)	-257	252	-157	-1,741	-269	-352
Net acquisition of financial assets	205	175	751	265	89	125
Net incurrence of liabilities	462	-77	907	2,006	359	477
Domestic	162	30	857	1,965	310	439
Foreign	300	-107	50	41	48	39
(In percent of GDP)						
Revenue	30.2	36.4	36.8	34.5	35.0	34.9
Income tax	7.9	11.6	7.3	6.6	8.1	7.5
VAT	4.9	6.9	8.8	7.9	7.4	7.7
Excise tax	2.5	3.2	3.0	2.7	3.1	3.0
Customs and import duty	1.7	2.3	2.8	2.4	2.5	2.3
Royalty	2.2	2.4	4.6	3.6	3.6	2.9
Social contributions	3.9	3.8	4.0	4.3	4.0	4.3
Others	7.0	6.2	6.3	7.0	6.2	7.2
Expense	27.2	26.8	28.6	30.4	30.3	27.9
Compensation of employees	8.8	7.7	7.0	8.1	7.6	8.2
Use of goods and services	5.9	6.2	6.0	5.7	6.1	6.1
Interest	0.4	0.5	0.4	1.3	0.4	0.3
Subsidies	0.6	1.0	1.1	0.7	0.9	0.9
Social benefit	11.5	11.4	14.2	14.6	15.3	12.4
Net acquisition of nonfinancial assets	6.9	6.6	9.6	15.5	7.2	9.9
Operating balance	3.0	9.6	8.2	4.1	4.6	7.0
Net lending/borrowing (Overall balance)	-3.9	3.0	-1.4	-11.4	-2.6	-2.9
Net acquisition of financial assets	3.1	2.1	6.5	1.7	0.9	1.0
Policy lending	1.1	1.8	4.6	0.4	0.9	1.0
Stabilization fund	0.0	0.0	1.9	1.3	0.0	0.0
Net incurrence of liabilities	7.0	-0.9	7.9	13.1	3.5	3.9
Domestic	2.5	0.4	7.4	12.9	3.0	3.6
Foreign	4.5	-1.3	0.4	0.3	0.5	0.3
Stock positions:						
Net financial worth	-0.3	2.8	0.7	-10.9	-	-
Financial assets	59.4	48.6	42.0	33.4	-	-
Currency and deposits	20.4	16.3	13.8	11.7	-	-
Securities other than shares	0.1	0.1	0.1	0.0	-	-
Loans	28.4	24.1	22.1	17.1	-	-
Shares and other equity	0.0	0.0	0.0	0.0	-	-
Other accounts receivable	10.4	8.2	6.0	4.5	-	-
Liabilities	59.7	45.8	41.3	44.3	-	-
Securities other than shares	11.3	8.5	6.2	4.7	-	-
Loans	45.0	34.7	33.2	38.2	-	-
Other accounts payable	3.4	2.6	1.9	1.5	-	-

Sources: Ministry of Finance; and IMF staff projections.

Table 4. Mongolia: Monetary Aggregates, 2009–12 1/

	2009	2010	Proj.		Article IV	
			2011	2012	2011	2012
(In billions of togrog; end of period)						
Monetary survey						
Broad money	2,880	4,655	7,847	11,314	6,750	8,333
Currency	285	390	785	1,131	675	833
Deposits	2,595	4,266	7,062	10,182	6,075	7,500
Net foreign assets	1,533	2,740	3,495	3,998	4,013	4,668
Net domestic assets	1,347	1,915	4,352	7,316	2,737	3,665
Domestic credit	1,987	2,448	5,030	7,836	3,553	4,244
Net credit to government 2/	-717	-836	-319	1,646	-765	-326
Claims on non-banks	2,704	3,284	5,349	6,190	4,318	4,571
Other items, net	-640	-533	-678	-520	-816	-579
Monetary authorities						
Reserve money	733	947	1,534	2,071	1,231	1,477
Net foreign assets	1,539	2,530	3,285	3,788	3,803	4,458
BOM defined reserves 3/	1,652	2,628	3,498	3,945	4,269	4,993
Net international reserves (NIR) 4/	1,335	2,140	3,281	3,728	3,781	4,505
Other BOM defined reserves	318	488	217	217	488	488
Other assets, net	-114	-98	-213	-157	-466	-536
Net domestic assets	-806	-1,583	-1,751	-1,717	-2,572	-2,981
Net credit to government	-265	-493	-497	-432	-663	-324
Claims on deposit money banks	198	131	4	20	15	16
Minus: Central bank bills (net)	393	1,101	1,299	1,377	1,777	2,628
Other items, net	-346	-120	41	72	-147	-45
Memorandum items:						
(In percent; unless otherwise indicated)						
Annual broad money growth	26.9	61.6	68.6	44.2	45.0	23.5
Annual reserve money growth	26.4	29.2	62.0	35.0	30.0	20.0
Velocity	2.3	1.8	1.5	1.4	1.5	1.5
Broad money/reserve money	3.9	4.9	5.1	5.5	5.5	5.6
Claims on non-banks growth	0.4	21.5	62.9	15.7	---	---
Claims on non-banks (in percent of GDP)	41.0	39.0	46.4	40.5	---	---
Total loans/deposits	104.2	77.0	75.7	60.8	71.1	60.9
BOM defined reserves (in millions of US\$) 3/	1,145	2,092	2,783	3,138	3,392	3,967
Net international reserves (NIR, in millions of US\$) 4/	925	1,704	2,610	2,965	3,004	3,580

Sources: Mongolian authorities; and IMF staff projections.

1/ Previously based on program exchange rate (1,560 tog/USD).

2/ Including bank restructuring cost

3/ Evaluated at end-2010 exchange rate for 2011 and 2012.

4/ Previously referred to as net international reserves under program definition. The definition of NIR has been revised in line with the recommendation of the IMF Safeguard Assessment, and does not include commercial bank foreign currency deposits and foreign currency current accounts held at the Bank of Mongolia. Evaluated at end-2010 exchange rate for 2011 and 2012.

Table 5. Mongolia: Balance of Payments, 2009–12

(In millions of US\$, unless indicated otherwise)

	2009	2010	Proj.		Article IV	
			2011	2012	2011	2012
Current account balance (including official grants)	-410	-931	-1,821	-2,031	-1,302	-1,438
Trade balance	-194	-278	-1,285	-1,349	-1,049	-1,107
Exports	1,876	2,899	4,296	4,922	3,825	4,083
Mineral Export 1/	1,560	2,521	3,742	4,392	3,382	3,655
Non-mineral Export	316	378	554	530	443	428
Imports	-2,070	-3,177	-5,581	-6,271	-4,874	-5,190
Oil imports	-528	-676	-1,099	-1,211	-903	-1,005
Food imports	-311	-336	-586	-666	-534	-555
For investment in mining 2/	-143	-576	-1,839	-1,738	-1,517	-1,445
Other	-1,088	-1,589	-2,056	-2,657	-1,920	-2,186
Services, net	-164	-279	-430	-447	-268	-291
Income, net	-190	-561	-253	-393	-133	-197
Current transfers	138	186	147	158	147	158
General government 3/	-1	49	24	34	24	34
Other sectors	140	137	123	124	123	124
Of which: workers remittances	120	102	103	103	103	103
Capital and financial account	737	2,180	2,520	2,385	2,602	2,013
Capital account	208	175	96	96	96	96
Financial account	529	2,005	2,424	2,289	2,506	1,917
Direct investment	496	1,574	2,412	894	1,130	548
Portfolio investment	-93	879	387	391	457	343
Trade credits, net	13	53	35	43	35	38
Currency and deposits, net	-45	-624	-624	-935	-506	-574
Loans, net	274	94	361	2,490	1,108	2,045
Other, net	-116	31	-148	-594	282	-483
Errors and omissions	187	-311	0	0	0	0
Overall balance	514	938	699	354	1,301	575
Financing	-514	-938	-699	-354	-1,301	-575
Gross official reserves (- increase)	-670	-960	-695	-318	-1,297	-540
Use of IMF credit (+)	156	23	-4	-36	-4	-35
Memoranda items:						
Current account balance (in percent of GDP)						
Including official grants	-9.0	-14.9	-19.5	-16.3	-15.1	-13.6
Excluding mining related imports	-5.8	-5.7	0.2	-2.4	2.5	0.1
Excluding official grants	-8.9	-15.7	-19.8	-16.6	-15.4	-13.9
Gross official reserves (end-period)	1,328	2,288	2,984	3,302	3,586	4,127
(In months of imports of goods and services)	4.0	4.2	4.9	5.8	7.1	8.8
Copper price (in US\$ per ton)	5,165	7,538	9,204	8,880	9,000	8,500
Oil price (in US\$ per barrel)	62	79	103	100	90	90
Gold price (in US\$ per troy oz.)	973	1,225	1,582	1,758	1,362	1,405

Sources: Mongolian authorities; and IMF staff projections.

1/ Including copper, coal, gold and others.

2/ This covers Oyu Tolgoi copper project and Tavan Tolgoi coal project.

3/ Starting in 2009, investment-related grants have been reclassified in the capital account per BPM5.

Table 6. Mongolia: Selected Economic and Financial Indicators, 2008-16 1/

	2008	2009	2010	Proj.					
				2011	2012	2013	2014	2015	2016
(In percent of GDP; unless indicated otherwise)									
Real sector									
Nominal GDP (in billions of togrogs)	6,556	6,591	8,415	11,535	15,274	18,641	22,145	24,129	29,064
Per capita GDP (in US\$) 2/	2,108	1,688	2,233	3,288	4,321	5,226	6,156	6,516	7,684
Real GDP growth (percent change)	8.9	-1.3	6.4	16.9	15.1	12.2	12.3	4.5	14.1
Mineral real GDP growth	5.2	0.2	7.4	15.3	22.0	37.1	25.7	0.6	25.6
Non-mineral real GDP growth	10.3	-1.8	6.0	17.5	12.5	2.0	5.0	7.0	7.0
GDP deflator (percent change)	21.4	1.8	20.0	17.3	15.0	8.8	5.8	4.3	5.6
Mineral GDP deflator	7.9	-0.4	40.7	18.1	-4.5	0.1	-1.7	3.3	1.8
Non-mineral GDP deflator	25.9	4.5	9.0	17.2	27.2	11.5	10.2	5.1	8.1
Consumer prices (end-period; percent change)	23.2	1.9	14.3	15.1	17.9	9.0	8.5	7.9	7.3
Copper prices (US\$ per ton)	6,963	5,165	7,538	9,204	8,880	8,800	8,640	8,450	8,210
General government accounts									
Total revenue and grants	33.1	30.2	36.5	36.9	34.6	31.4	29.9	31.7	32.9
Mineral revenue	9.4	6.8	11.6	8.7	6.7	6.9	6.8	8.4	10.8
Non-mineral revenue	23.4	23.0	24.5	28.3	27.9	24.5	23.1	23.3	22.1
Total expenditure and net lending	37.6	35.2	35.3	42.9	46.4	32.4	31.2	33.1	33.5
Primary balance	-4.2	-4.5	1.7	-5.5	-10.6	0.6	0.2	0.1	0.8
Overall balance	-4.5	-5.0	1.2	-5.9	-11.8	-1.0	-1.3	-1.4	-0.6
Non-mineral overall balance	-13.9	-11.8	-10.4	-14.6	-18.6	-7.9	-8.0	-9.8	-11.4
Structural balance	-10.1	-6.8	-2.7	-7.9	-13.1	-2.0	-2.0	-2.0	-1.1
(In percent of non-mineral GDP)									
Non-mineral revenue and grants	36.2	35.5	41.7	47.4	43.2	40.7	39.5	38.4	37.9
Total expenditure and net lending	57.6	53.5	59.3	71.6	71.8	53.7	53.1	54.5	57.5
Non-mineral overall balance	-21.2	-17.9	-17.4	-24.3	-28.7	-13.1	-13.7	-16.1	-19.6
(In percent of GDP; unless indicated otherwise)									
Monetary sector									
Broad money (percent change)	-5.1	26.9	61.6	68.6	44.2	26.7	23.6	13.5	25.7
Velocity (GDP/M2)	2.9	2.3	1.8	1.5	1.4	1.3	1.3	1.2	1.2
Balance of payments									
Current account balance	-12.9	-9.0	-14.9	-19.5	-16.3	-2.2	3.0	4.4	6.8
Excluding mining related imports	-9.5	-5.8	-5.7	0.2	-2.4	7.7	12.0	11.6	14.2
Gross official reserves (in millions of US\$)	658	1,328	2,288	2,984	3,302	3,679	3,976	4,850	5,722
(In months of next year's imports of goods and services)	3.0	4.0	4.2	4.9	5.8	6.2	6.7	7.5	8.0
Debt indicators									
Total public debt	31.0	46.6	42.2	47.1	47.6	39.8	33.0	28.0	24.1
Domestic public debt 3/	0.0	3.4	12.0	25.4	30.6	25.9	20.5	15.4	12.7
External public debt	31.0	43.3	30.2	21.7	17.0	13.9	12.5	12.6	11.3
(In millions of US\$)	1,602	1,977	2,023	2,064	2,097	2,149	2,271	2,469	2,654

Sources: Mongolian authorities; and IMF staff projections.

1/ The medium-term projections are based on the assumption that the fiscal responsibility law will be adhered to.

2/ Based on period average exchange rate.

3/ Includes the expected fiscalization cost of bank restructuring, the financing of the government's equity share in Oyu Tolgoi and the Oyu Tolgoi tax-prepayment.

INTERNATIONAL MONETARY FUND

MONGOLIA

Second Post-Program Monitoring—Informational Annex

Prepared by the Asia and Pacific Department

October 25, 2011

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ANNEX I. MONGOLIA—FUND RELATIONS

(As of September 30, 2011)

I.	Membership Status:	Joined: February 14, 1991; Article VIII	
II.	General Resources Account:	SDR Million	Percent Quota
	Quota	51.10	100.00
	Fund Holdings of Currency	173.61	339.74
	Reserve Position in Fund	0.14	0.27
III.	SDR Department:	SDR Million	Percent Allocation
	Net cumulative allocation	48.76	100.00
	Holdings	45.88	94.11
IV.	Outstanding Purchases and Loans:	SDR Million	Percent Quota
	Stand-by Arrangements	122.64	240.00
	ESAF/PRGF Arrangements	3.66	7.17
V.	Latest Financial Arrangements:		

	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	04/01/2009	10/01/2010	153.30	122.64
ECF 1/	09/28/2001	07/31/2005	28.49	12.21
ECF 1/	07/30/1997	07/29/2000	33.39	17.44

1/ Formerly PRGF.

VI. **Projected Obligations to Fund:** (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2011	2012	2013	2014	2015
Principal	0.41	22.71	61.03	40.24	1.92
Charges/interest	0.42	1.55	1.06	0.33	0.03
Total	0.83	24.25	62.07	40.57	1.94

VII. **Safeguards Assessments:**

An update safeguards assessment of the Bank of Mongolia (BOM), conducted with respect to the Stand-by Arrangement approved in April 2009 was finalized on June 17, 2009. Previous safeguards assessments were completed in March 2002 and November 2003. The 2009 update assessment found that the BOM has continued to

improve its safeguards framework since the 2003 assessment. The BOM's financial reporting and audit practices generally comply with international standards. The assessment made recommendations to (i) strengthen certain aspects of the BOM's oversight mechanism, (ii) remove external audit qualifications caused by lack of access to central bank's vaults, and (iii) improve the timeliness of audit completion and publication of the bank's financial statements. The authorities have since confirmed that the auditors were granted access to its vaults at end-2009 and end-2010, and the timing of audit completion has improved. Publication of the English version of the financial statements remains protracted however. The full set of 2010 audited financial statements including the signed audit opinion should be published without further delay.

VIII. Exchange Arrangement:

On May 27, 1993, Mongolia moved from a fixed exchange rate against the U.S. dollar to a floating exchange rate system. The de jure exchange rate arrangement is floating. BOM's official exchange rate is the midpoint of the same days' average buying and selling rates of transactions in the interbank market and transactions between banks and their clients. The official rate is announced each weekday except for national public holidays, and the BOM reserves the right to intervene in the foreign exchange market. Effective February 2, 2009, the classification of the de facto exchange rate arrangement had been changed from a conventional pegged arrangement to a stabilized arrangement, retroactively to April 30, 2008, due to the revision of the classification methodology. This change reflected only a methodological modification and did not imply a judgment that there had been a substantive alteration in the country's exchange arrangement or other policies. Due to rapid currency depreciation between October 2008 and February 2009, the exchange rate arrangement was reclassified to "other managed arrangement" from a stabilized arrangement as of November 1, 2008. On March 24, 2009, the BOM instituted a foreign exchange auction allowing the determination of the exchange rate mainly by market forces and therefore, effective March 24, 2009, the de facto exchange rate arrangement has been reclassified to floating. Since 2011, the authorities no longer disclose the quantity of foreign exchange bought or sold in the auction and just publish the cut off rate. Mongolia has no explicitly stated specific nominal anchor, but rather monitors various indicators in conducting monetary policy.

Mongolia accepted the obligations of Article VIII, Sections 2, 3, and 4 on February 1, 1996. Mongolia maintains two multiple currency practices (MCPs) subject to Fund jurisdiction. First, the modalities of the multi-price auction system give rise to an MCP since there is no mechanism in place that ensures that exchange rates of accepted bids at the multi-price auction do not deviate by more than 2 percent. The Executive Board approved the multi-price auction MCP until June 22,

2010 (Decision No. 14365 of June 23, 2009), and its further extension until March 15, 2012 or the next Article IV consultation, whichever is earlier (Decision No. 14669 of June 23, 2010 and Decision No. 14865 of March 16, 2011). In addition, Mongolia has an official exchange rate (reference rate) that is mandatorily used for government transactions (as opposed to the commercial market rate). Therefore, by way of official action, the authorities have created a market segmentation. While the recently approved Order no. 699 of the central bank of Mongolia sets forth that the reference rate is determined based on the weighted average of market rates used from 4 PM of the previous day to 4 PM of the current day, staff is of the view that this Order does not eliminate the market segmentation and the multiplicity of effective rates arising from it. Accordingly, in the absence of a mechanism to ensure that the commercial rates and the reference rate do not deviate by more than 2 percent, the way the reference rate is used in government transaction gives rise to an MCP subject to Fund approval. Since the criteria for approval of this MCP are not in place, it remains unapproved. Mongolia imposes exchange restrictions for security reasons in accordance with United Nations Security Council Resolution No. 92/757 concerning certain transactions with the Federal Republic of Yugoslavia (Serbia and Montenegro) that have been notified to the Fund under Decision 144 (11/4/94).

IX. Article IV Consultation:

The 2011 Article IV consultation (IMF Country Report No. 11/76) was concluded by the Executive Board on March 16, 2011. Mongolia is on a 12-month cycle.

X. ROSC Assessments:

- Data Dissemination, May 2001 (www.imf.org)
- Fiscal Transparency Module, November 2001 (Country Report No. 01/218)
- Fiscal update, May 2005 (www.imf.org)
- Data Dissemination, April 2008 (www.imf.org)
- Monetary and Fiscal Policy Transparency, September 2008 (www.imf.org)
- Banking Supervision, September 2008 (www.imf.org)

XI. Recent Financial Arrangements:

An 18-month Stand-by Arrangement in an amount equivalent to SDR 153.3 million (300 percent of quota) was approved on April 1, 2009. Following the first review completed on June 23, 2009, the second on September 21, 2009, the third on December 22, 2009, the fourth on March 19, 2010, and the combined fifth and sixth on September 8, 2010, the program was successfully completed on October 1, 2010.

A three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF) in an amount equivalent to SDR 40.81 million (80 percent of quota), with a first

annual arrangement in an amount of SDR 18.55 million (36.3 percent of quota), was approved on June 25, 1993. The second annual arrangement in an amount of SDR 11.13 million (21.8 percent of quota) was approved on November 23, 1994. The ESAF arrangement lapsed on June 24, 1996.

A three-year arrangement under the ESAF/PRGF in an amount equivalent to SDR 33.4 million (65.4 percent of quota), with a first annual arrangement in an amount of SDR 11.13 million (21.8 percent of quota), was approved by the Executive Board on July 30, 1997. The first year arrangement lapsed on July 30, 1998. The second annual arrangement of SDR 14.8 million (29 percent of quota) was approved on June 16, 1999. The first review under that arrangement was completed in January 2000 and the arrangement lapsed on June 15, 2000. The ESAF/PRGF arrangement lapsed on July 29, 2000.

A three-year arrangement under the PRGF in an amount equivalent to SDR 28.49 million (55.8 percent of quota), with the first year of the arrangement in an amount of SDR 12.21 million (23.9 percent of quota), was approved by the Executive Board on September 28, 2001. The first and second review under the PRGF was completed on September 12, 2003, and the Executive Board approved the extension of the PRGF through July 31, 2005. The arrangement expired on that date without the completion of the third and subsequent reviews.

XII. FSAP Participation:

Mongolia participates in the Financial Sector Assessment Program (FSAP). The first, second and third FSAP missions took place in May 2007, September 2007 and November 2010, respectively, and the latest report (IMF Country Report No. 11/107) was published in May 2011.

XIII. Technical Assistance:

Missions:

- Tax administration (FAD), August–September 2011
- Monetary and Financial Statistics (STA), July –August 2011
- Taxation (LEG), June 2011
- Monetary policy (MCM), April 2011
- IBL (FAD), January, March, June, 2011
- Strengthening LTO operations (FAD), February–April 2011
- Strengthening LTO operations (FAD), April, July and November 2010
- Monetary Policy (MCM), October 2010
- National Statistics (STA), August 2010
- Fiscal Decentralization (FAD), June–July 2010
- Tax Policy (FAD), June 2010

- Banking Supervision (MCM), May 2010
- Banking Supervision (MCM), January–February 2010
- Strengthening LTO operations (FAD), November 2009
- Budget Preparation and Budget Legal Reforms (FAD), January, June, July, and December 2009
- External Sector Statistics (STA), November 2009
- Banking Restructuring (MCM), October–November 2009
- Monetary and Financial Statistics (STA), September 2009
- Supervisory and Regulatory Capacity Building of the FRC (MCM), February, April, and September 2009
- Bank Restructuring (MCM), August 2009
- Foreign Exchange Market and Monetary Policy (MCM), May 2009
- Strengthening Forex Market Operations (MCM), March 2009
- Foreign Exchange Market (MCM), March 2009
- Fiscal Expenditure Review (FAD), January 2009
- Operational Framework of Monetary Policy (MCM), December 2008
- Supervisory and Regulatory Capacity Building of the FRC (MCM), September, November, and December 2008
- Banking Supervision and Accounting Framework (MCM), November 2008
- Budget and Legal Reforms (FAD), October 2008
- External Sector Statistics (STA), October 2008
- Real sector Statistics (STA), August 2008
- Monetary and Financial Statistics (STA), June 2008
- Budget Preparation (FAD), February–March 2008
- Budget Preparation (FAD), February 2008
- Bank Supervision (MCM), February 2008
- Enhancing Foreign Exchange Market (MCM), February 2008
- Monetary Operations (MCM), January 2008
- Real Sector Statistics (STA), November–December 2007
- Poverty and Social Impact Analysis (FAD), December 2007
- Measures to Combat Money Laundering and the Financing of Terrorism (LEG), December 2007
- ROSC Data Module (STA), October 2007
- Fiscal Affairs Department Scoping Mission (FAD), September 2007
- Real Sector Statistics (STA), June–July, 2007
- International Market Access (MCM), May 2007
- Bank Supervision and Reserves Management (MCM), April 2007
- Real Sector Statistics (STA), March–April 2007
- Government Finance Statistics (STA), March–April 2007
- Fiscal Regime for the Mining Sector and the Development Fund (FAD), January 2007

- Government Finance and Monetary and Financial Statistics (STA), September 2006
- Improving Banking Supervision and Reserve Management (MCM), September 2006
- Value-Added Tax, Income Tax and Excise Tax Legislation (LEG), August 2006
- Cooperation between Mongolia's NSO and STA, May 2006
- Management Structure of the Bank of Mongolia (MFD), April 2006
- Monetary and Financial Statistics (STA), October 2005
- Banking Supervision and Payment Systems (MFD), June 2005
- Options for Expenditure Savings and Efficiency Improvements (FAD), January 2005
- Banking Supervision and Prudential Framework (MFD), October 2004
- Reforms of Tax Policies (FAD), October 2004
- Government Finance Statistics (STA), August 2004
- Balance of Payments Statistics (STA), July–August 2004
- Banking Supervision and Prudential Framework, (MFD), May–June 2004
- AML/CFT Action Plan and Legislative Awareness, May 2004
- Banking Supervision and Accounting (MFD), October 2003
- Government Finance Statistics (STA), August 2003
- AML/CFT (MFD), June 2003
- Banking Supervision and Accounting (MAE), November 2002
- Revenue Administration (FAD), September 2002
- Banking Supervision and Accounting (MAE), May 2002
- Review of Treasury and Intergovernmental Fiscal Reforms (FAD), August 2001
- Banking Supervision and Accounting (MAE), May–June 2001
- Money and Banking Statistics (STA), May 2001
- Government Finance Statistics (STA), March 2001
- Fiscal Transparency and ROSC (FAD), March 2001
- Intergovernmental Fiscal Relations and Budget Reform (FAD), January 2001
- Visits by MAE Peripatetic Experts on Banking Supervision, Payments System, Monetary Policy, and Accounting and Audit, November 2000
- Consumer Price Statistics (STA), September–October 2000
- ROSC Data Module (STA), May 2000
- Restructuring Bonds and Other Securities (MAE), March 2000
- National Accounts Statistics (STA), February 2000

Resident Advisors:

- Budget Planning (FAD), June 2009–June 2011
- National Accounts Statistics (STA), August 2001–September 2003

- Treasury Reform (FAD), June 1999–November 2003
- Balance of Payments (STA), March 1999–May 2001

Technical assistance for the period May 1995–October 1999 is reported in Annex II of the staff report for the 1999 Article IV consultation.

XIV. Resident Representative:

The Fund's resident representative in Mongolia, Mr. Ramlogan, returned to headquarters in September 2011 and is not being replaced. The local office is being maintained and managed from the Regional Office for Asia and Pacific in Tokyo, Japan.

ANNEX II. MONGOLIA—STATISTICAL ISSUES

As of September 30, 2011

I. Assessment of Data Adequacy for Surveillance	
General: Data provision to the Fund is broadly adequate for surveillance. The priority areas for improvement are national accounts and government finance statistics.	
National Accounts: The national accounts statistics compiled by the National Statistics Office (NSO) are broadly in line with the guidelines of the 1993 SNA. They have improved the quality of national accounts data, but weaknesses remain, including in the estimation of capital formation, estimation of GDP price deflators, and coverage of the informal sector and small-scale activity (especially in the services sector). The compilation of constant price expenditure-based national accounts, in line with the pilot done in 2008, would serve as a useful check for the production side estimates. NSO plans to disseminate annual expenditure-based GDP series in value terms and to pilot quarterly estimates of GDP by expenditure in 2011.	
Price Statistics: The consumer price index (CPI) was rebased in January 2008 with expenditure-derived weights from the 2005 Household Income and Expenditure Survey. NSO has published a national CPI for Ulaanbaatar and 21 aimags (provinces) since January 2008, and a housing price index since October 2008. Priority areas for improvement are data on wages and earnings. NSO plans to disseminate a producer price index and a retail price index in 2011.	
External Sector Statistics: The Bank of Mongolia (BOM) follows the concepts and methods in the Balance of Payment Manual fifth edition and is expected to begin implementing the recommendations of the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) in 2012. The BOM disseminates the data according to the IMF standard presentation table. The coverage of the balance of payments statistics has been broadened by extending the International Transaction Reporting System (ITRS) to nonbank financial institutions and by increasing the number of direct reporting private enterprises. Priorities for improvement are in the analysis of balance of payments and the quarterly survey of foreign investment enterprises. The BOM compiled an experimental International Investment Position (IIP) for 2007, and started to publish IIP in 2011.	
Monetary and Financial Statistics: BOM's monetary and financial statistics conform to the concepts and definitions of the MFSM methodology as the authorities implemented recommendations of the June 2008 and September 2009 missions. In particular, the monetary data were improved by the proper classification of repurchase agreements, accrued interest, and financial derivatives. The coverage of monetary statistics was expanded beginning in February 2010 to include data of Savings and Credit Cooperatives (SCCs) that collect deposits and since May 2010, data for other financial corporations (NBFIs) have been disseminated in the BOM monthly statistical bulletin. The September 2009 mission also provided recommendations to reconcile the BOM and the Ministry of Finance data on government financing, and finalized the standardized report forms for the data of the BOM and other depository corporations in International Financial Statistics beginning in November 2009.	
Government Finance Statistics: The concepts and definitions used to compile fiscal statistics generally follow the guidelines of the GFSM 1986. The classifications used for sub-annual and annual fiscal statistics also follow broadly its classifications. No formal decision has yet been taken on adopting a migration path to the GFSM 2001 methodology, but Mongolia has over several years availed itself on training, technical assistance, and thus no substantial problems for achieving a GFSM 2001 presentation are anticipated	
II. Data Standards and Quality	
Mongolia participates in the General Data Dissemination System (GDDS), and maintains its efforts to subscribe the Special Data Dissemination Standards (SDDS).	A data ROSC mission visited Mongolia in September 2007 to update the May 2000 assessment of the macroeconomic statistics, complemented by an assessment of data quality based on the IMF's Data Quality Assessment Framework. The report was published in April 2008.

Mongolia—Table of Common Indicators Required for Surveillance
As of September 30, 2011

	Date of Latest Observation	Date Received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶	Memo Items: ⁷	
						Data Quality-Methodological soundness ⁷	Data Quality – Accuracy and Reliability ⁸
Exchange rates	9/30/11	9/30/11	D	M	D		
International reserve assets and reserve liabilities of the Monetary Authorities ¹	9/30/11	9/30/11	D	M	M		
Reserve/base money	8/2011	9/20/11	M	M	M	O, LO, LO, LO	O, O, O, O, LNO
Broad money	8/2011	9/20/11	M	M	M		
Central bank balance sheet	8/2011	9/20/11	M	M	M		
Consolidated balance sheet of the banking system	8/2011	9/20/11	M	M	M		
Interest rates ²	8/2011	9/20/11	M	M	M		
Consumer price index	8/2011	9/20/11	M	M	M	O, LO, O, O	LO, LO, LO, O, O
Revenue, expenditure, balance and composition of financing ³ – general government ⁴	8/2011	9/20/11	M	M	M	LO, LNO, LO, O	LO, O, LO, LO, LNO
Revenue, expenditure, balance and composition of financing ³ – central government	8/2011	9/20/11	M	M	M		
Stocks of central government and central government-guaranteed debt ⁵	2010	3/2011	A	A	A		
External current account balance	Q2 2011	8/2011	Q	Q	Q	O, O, O, LO	LO, O, LO, LO, LO
Exports and imports of goods	8/2011	9/20/11	M	M	M		
GDP/GNI	2010	1/2011	A	A	A	O, LNO, O, LO	O, LO, LO, LO, LNO
Gross external debt	2010	4/2011	A	A	A		

¹ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

² Both market-based and officially determined, including discount rates, money market rates, and rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵ Including currency and maturity composition.

⁶ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), Not Available (NA).

⁷ Reflects the assessment provided in the data ROSC or the Substantive Update (published in April 2008, and based on the findings of the mission that took place during September 1–28) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

⁸ Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

ANNEX III. MONGOLIA—MAIN WEBSITES OF DATA**National Statistics Office (www.nso.mn)**

- National Accounts
- Consumer Price Inflation
- Agricultural and Industrial Production
- Petroleum Imports
- Electricity Production and Consumption
- Coal Production
- Retail Prices
- Employment
- Exports and Imports

Bank of Mongolia (www.mongolbank.mn)

- Monetary Survey
- Consolidated Balance Sheet of Commercial Banks
- Distribution of Bank Credit to the Nongovernment Sector
- Net Credit to Government
- Interest Rates
- Balance of Payments
- Services and Income Accounts
- Official Reserves of the Bank of Mongolia
- Selected Indicators of Commercial Bank Foreign Exchange Operations
- Nominal and Real Exchange Rates
- Securities Market Data
- Government Budget Accounts

Ministry of Finance (www.mof.gov.mn)

- Government Budgetary Operations

National Development and Innovation Committee (www.ndic.gov.mn)

- Long- and medium-term development strategy
- Economic and social policies
- Investment policy coordination
- Development Bank of Mongolia

Financial Regulatory Commission (www.frc.mn)

- FRC decisions
- Total assets of regulated entities (insurance companies, securities and broker firms, non-bank financial institutions, savings and credit unions)
- Consolidated income statements of regulated entities (insurance companies, securities and broker firms, non-bank financial institutions, savings and credit unions)

INTERNATIONAL MONETARY FUND

MONGOLIA

Second Post-Program Monitoring—Supplementary Information

Prepared by the Staff Representatives for the Second Post-Program Monitoring

Approved by Nigel Chalk and Claire Waysand

November 8, 2011

1. This supplement is to update the Board on the events that have taken place since the issuance of the Report on the Second Post-Program Monitoring. It does not change the thrust of the staff's assessment.
2. **2011 budget amendment.** The Mongolian Parliament approved the 2011 budget amendment on October 28. The amendment was as described in the Report on the Second Post-Program Monitoring and included the substantial increase in budget spending of some 8 percent of annual GDP.
3. **Monetary policy tightening.** In a welcome development, the central bank raised the policy rate (7-day central bank bill) by 50 basis points to 12.25 percent, effective October 26. The hike is consistent with the policy advice in the Report on the Second Post-Program Monitoring and staff maintains the view that more will need to be done to contain inflation, slow credit growth, and prevent a further overheating of the economy, especially given the direction of fiscal policy. The rate hike, therefore, should be complemented by the implementation of macro-prudential measures and, depending on incoming data, further rate hikes will also likely be needed.



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IMF Executive Board Concludes the Second Post-Program Monitoring with Mongolia

On November 9, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Post Program Monitoring¹ with Mongolia, and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.²

Background

Mongolia completed successfully its Fund supported Stand-by Arrangement last October. The government's commitment to implement sound policies was a critical ingredient to the success of the program. Since the end of the program, however, macroeconomic discipline has been steadily eroded, placing in jeopardy the gains achieved during the course of the program. Parliamentary elections are scheduled for June 2012 and electoral politics could, therefore, start to exert a stronger influence on policies.

The economy is undergoing a vigorous recovery, fueled by strong global commodity prices and excessively loose macroeconomic policies. Mining output, moreover, is set to increase substantially as two huge projects underway will soon start production. Growth has accelerated sharply this year, reflecting booming mineral exports driven by global prices and rising coal production, ongoing development of large mining projects, surging credit growth, improved agricultural output (primarily a base effect from last year's severe winter),

¹ Post-Program Monitoring provides for more frequent consultations between the Fund and members whose arrangement has expired but that continue to have Fund credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 200 percent of quota would engage in Post-Program Monitoring.

² The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

and expansionary macroeconomic policies. The economy is now overheating and inflation has accelerated sharply in the past few months.

Executive Board Assessment

In concluding the second post-program monitoring with Mongolia, Executive Directors endorsed staff's appraisal, as follows:

Context. Mongolia has a bright economic future. Its vast mineral deposits offer the potential to create strong and sustained growth, lasting economic prosperity, and a substantial reduction in poverty. Success, however, will depend on a shift in approach in managing the economy. At present, macroeconomic policies are too expansionary. This has created inflationary pressures and made the economy vulnerable to external shocks. This is especially dangerous at this juncture given the heightened downside risks to the global economy. The large mining projects under development, moreover, are still some time away from full production. If global mineral prices drop precipitously, exports and fiscal revenue would fall sharply and pressure would come on international reserves. This would necessitate a potentially painful and disorderly reduction in fiscal spending that would exact a heavy toll on the economy, particularly on the poor. Top priority, therefore, should be to restrain fiscal spending and tighten monetary conditions to cool the overheated economy and provide insurance in the event of future commodity price shocks.

Expenditure restraint. The 2011 budget is too expansionary and a major source of the persistent inflationary pressures. Government spending, which was slated to grow by some 30 percent in the original budget, accounts for some two-thirds of the non-mineral economy and is thus a key determinant of aggregate demand. Any further increase in spending this year, therefore, is clearly not warranted, yet alone an increase of 8 percent of annual GDP, in just one quarter, as has been proposed. Additional spending this year would further overheat the economy, hurt the poor by driving up inflation, increase the vulnerability to a global commodity shock, and undermine credibility in fiscal policy and the fiscal responsibility law. Monetary policy, moreover, would not be able to offset a fiscal stimulus of this magnitude but in trying would inevitably lead to a crowding out of private sector activity.

2012 budget. Given the pressures facing the economy, nominal spending in 2012 should be kept at or below the level parliament has already approved in the medium-term budget framework. To better orient fiscal policy toward protecting the poor, a targeted poverty benefit should be introduced, starting in 2012. This would provide a welcome offset to the loss of income from the planned reduction in universal cash transfers, and make it much easier to protect the poor from budget cuts in the event of a global shock. In addition, the medium-term budget framework includes a sharp reduction in spending in 2013 in order to adhere to the fiscal responsibility law. It would be much better to plan for a smoother path of spending.

Development Bank. The Development Bank poses significant fiscal risks. It is critical that the bank is not used as a vehicle for off-budget spending which would circumvent the very purpose of the fiscal responsibility law. To guard against this, the bank should be operated

on commercial terms, with a high degree of transparency, and a board that is accountable for overseeing the bank's operations, risk management, and internal controls. The bank should also be subject to prudential requirements and independent prudential review, including external audit.

Monetary policy. The recent tightening of monetary policy is welcome but is still not enough given the coming inflationary pressures. Volatility in food prices has disguised the fact that underlying inflationary momentum has remained firmly in the double-digits. Despite this, the policy rate has been raised by less than 1 percentage point this year. Further rate hikes are necessary. In addition, and as a complement to rate hikes, the central bank should implement a range of macro-prudential measures to ensure that inflation pressures are contained and credit growth is brought under control. These measures include further hikes in reserve requirements, tightening of the liquidity ratio, requirement to provision against all new lending, limits on the loan-to-value and debt-to-income ratios, and an increase in capital adequacy requirements.

Exchange rate policy. The flexible exchange rate regime has been working well and continues to be well suited for the Mongolian economy. It will help control inflation, provide a shock absorber against external shocks, and facilitate the real exchange rate changes that are likely to take place over the medium term with the rapid growth in the mineral sector. The flexible exchange rate and the fact that international reserves are now at record highs will make the economy more resilient to a global commodity shock.

Banking system. The rapid acceleration in bank lending is increasing the banks' vulnerability and putting stress on the financial system. It is especially important to strictly adhere to the existing prudential regulations and proactively manage risks to prevent the buildup of future problems. Recent international experience has made painfully clear that a key to avoiding a banking crisis is to prevent the buildup of risks during economic booms. The macro-prudential measures described above are a key line of defense in this regard. Moreover, the banking supervisor must be willing, as needed, to take tough action against banks that do not comply with regulations. The supervisor should also move towards much more risk-based and forward-looking supervision.

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Mongolia: Selected Economic and Financial Indicators, 2009–12

	2009	2010	Proj.	
			2011	2012
Real sector			(Percent change)	
Real GDP growth	-1.3	6.4	16.9	15.1
Mineral	0.2	7.4	15.3	22.0
Non-mineral	-1.8	6.0	17.5	12.5
Consumer prices (period average)	6.3	10.2	10.2	18.7
Consumer prices (end-period)	1.9	14.3	15.1	17.9
GDP deflator	1.8	20.0	17.3	15.0
General government budget			(In percent of GDP)	
Revenue and grants	30.2	36.5	36.9	34.6
Expenditure and net lending	35.2	35.3	42.9	46.4
Current balance	2.6	9.2	8.1	4.3
Primary balance	-4.5	1.7	-5.5	-10.6
Overall balance (including grants)	-5.0	1.2	-5.9	-11.8
Non-mineral overall balance	-11.8	-10.4	-14.6	-18.6
Structural balance 1/	-6.8	-2.7	-7.9	-13.1
Money and credit			(Percent change)	
Broad money	26.9	61.6	68.6	44.2
Broad money velocity (GDP/BM)	2.3	1.8	1.5	1.4
Interest rate on 7-day central bank bills, end-period (percent)	10.0	11.0	...	...
Balance of payments			(In millions of US\$)	
Current account balance (including official transfers)	-410	-931	-1,821	-2,031
(In percent of GDP)	-9.0	-14.9	-19.5	-16.3
(In percent of GDP, excluding mining related imports)	-5.8	-5.7	0.2	-2.4
Trade balance	-194	-278	-1,285	-1,349
Exports	1,876	2,899	4,296	4,922
Imports	-2,070	-3,177	-5,581	-6,271
Foreign direct investment	496	1,574	2,412	894
Gross official international reserves (end-period)	1,328	2,288	2,984	3,302
(In months of next year's imports of goods and services)	4.0	4.2	4.9	5.8
Trade prices				
Export prices (US\$, percent change)	-13.2	33.1	18.9	-0.5
Import prices (US\$, percent change)	-16.0	11.6	14.6	-0.6
Terms of trade (percent change)	3.3	19.3	3.8	0.1
Public and publicly guaranteed debt			(In percent of GDP)	
Total public debt	46.6	42.2	47.1	47.6
Domestic debt 2/	3.4	12.0	25.4	30.6
External debt	43.3	30.2	21.7	17.0
(In millions of US\$)	1,977	2,023	2,064	2,097
Exchange rate				
Togrogs per US\$ (end-period)	1,443	1,257	...	...
Togrogs per US\$ (period average)	1,441	1,348	...	...
Nominal effective exchange rate (end-period; percent change)	-15.8	3.4	...	...
Real effective exchange rate (end-period; percent change)	-11.1	11.3	...	...
Nominal GDP (In billions of togrogs)	6,591	8,415	11,535	15,274

Sources: Mongolian authorities; and IMF staff projections.

1/ As defined in the fiscal responsibility law, which uses smoothed instead of actual commodity prices to calculate revenue.

2/ Domestic debt in 2009 includes the Oyu Tolgoi tax-prepayment while the estimates for 2010 and the projections for 2011 additionally include the estimated fiscalization cost of bank restructuring and the financing of the government's equity share in Oyu Tolgoi.