

**IMMEDIATE
ATTENTION**

EBS/11/156
Supplement 2

November 3, 2011

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Mongolia—Second Post-Program Monitoring—Draft Public
Information Notice**

Attached for consideration by the Executive Directors is the draft Public Information Notice (PIN) relating to the paper on the second post-program monitoring discussions with Mongolia (EBS/11/156, 10/26/11), which is being considered on a lapse of time basis. In the absence of a request for a Board discussion by **noon on Wednesday, November 9, 2011**, the Executive Board Assessment section of the PIN will be based on the staff appraisal, as attached.

At the time of circulation of this paper to the Board, the authorities of Mongolia have indicated that they need more time to consider whether they will consent to the Fund's publication of this PIN. Publication will only proceed upon the receipt by the Fund of the member's explicit consent. Any requests for modifications for publication are expected to be received two days before the Board concludes its consideration.

Questions may be referred to Mr. Barnett, OAP (ext. 34439) and Mr. Ojima, APD (ext. 35944).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat forthwith; and to the Asian Development Bank, the European Investment Bank, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No.[XX/XX]
FOR IMMEDIATE RELEASE
November [XX], 2011

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

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

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.

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.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

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	1574	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.