FOR INFORMATION

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To: Members of the Executive Board

From: The Acting Secretary

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Questions:	Ms. Banerji, APD (ext. 34780) Mr. Gupta, APD (ext. 37137)

***The authorities have not consented to the publication of this assessment by the AsDB.**

Mongolia—Assessment Letter for the Asian Development Bank
September 1, 2023

This letter updates the assessment of Mongolia's economic conditions and policies since the completion of the 2022 Article IV consultation which was concluded by the IMF's Executive Board on November 30, 2022. The assessment has been requested in relation to the program loan under the Asian Development Bank's Policy Based Lending modality.

Recent Developments

1. Mongolia's economic conditions stabilized by 2023H2, helped by China's reopening. The economy was in a challenging position in 2022 with widening external and internal imbalances due to multiple global shocks, policy excesses and governance lapses. However, greater exchange rate flexibility; the government's strenuous efforts to facilitate exports; an influx of new private external financing, and some moderation of global shocks helped lift economic activity, moderate inflation, and stabilize the external position by end-2022. Effective public debt management by the government mitigated rollover risks. GDP growth surged in 2022 and in 2023Q1. Inflation is moderating, largely due to global factors.

2. However, external imbalances remain large. Notwithstanding the export recovery, the 2022 current account deficit remained wide due to weaker exports prices and large imports related to public sector infrastructure, FDI, consumer goods and transportation services. The external position at end-2022 is assessed to be weaker than implied by fundamentals and desirable policy settings. Notwithstanding a large depreciation in the ER since early 2022 in response to external pressures, a small REER gap remains. Gross international reserves (GIR) continue to be low (US$3.8 billion at end-July 2023, 3.4 months of imports and 87 percent of the ARA metric). Finally, while the sound execution of debt management operations has mitigated sovereign rollover risks, rollover risks for other entities (e.g., the private sector) remain high.

3. While other policies have tightened, fiscal policy is set to become expansionary in the run-up to the June 2024 Parliamentary elections. The fiscal position is expected to deteriorate by end-2023, despite better-than-expected performance through 2023H1 mainly reflecting a large overperformance of commodity revenues. The supplementary budget approved in mid-2023 introduces large and permanent spending increases in the wage bill and pension benefits—amounting to 6 percent of GDP on an annual basis. As a result, the non-mineral primary balance, which would have continued to record a deficit relative to pre-pandemic levels in the original 2023 budget, is now expected to deteriorate by year-end.

4. Major governance lapses are being addressed. Public outcry regarding alleged coal theft from Erdenes Tavan Tolgoi (ETT) led to the declassification of ETT's off-take contracts, an investigation of ETT by the anti-corruption agency and the hiring of an international audit firm to examine its operations. SOE reforms were introduced to improve operational transparency and governance. A more transparent pricing mechanism for coal exports through online auctions was introduced on a pilot basis and is expected to extend to all SOE commodity exports starting

January 1, 2024. Legal proceedings are also ongoing regarding the Development Bank of Mongolia (DBM). The modalities for DBM's external debt repayment are being decided.

5. **Other reforms are advancing gradually**. The legislative agenda is moving forward with Parliament approval of the public-private partnerships (PPP) law, medium-term budget framework and fiscal oversight and accountability reforms, and a package of Social Insurance laws, including the Pension law. Banking sector reforms continue. Following the BOM's Asset Quality Review, all five domestic systemically important banks have launched initial public offerings (IPO).

Outlook and Risks

6. **The procyclical fiscal stimulus from the supplementary budget will lift near term growth and inflation but entails increased macroeconomic stability risks**. The growth boost from the stimulus is expected to fade from 2024 onwards as higher inflation and external pressures begin to weigh on the non-mining sector. The mining sector is, however, likely to grow strongly due to improving operational capacity. Therefore, while growth in 2023 has been upgraded to 5½ percent, medium-term forecasts envisage below-potential GDP growth despite stronger mining sector performance following the completion of the Oyu Tolgoi project and strong coal exports to China. Inflation is expected to rise in 2023H2–25 and decline to the BOM's 6±2 percent target range over the medium term. Despite stronger exports, the current account deficit is likely to remain large due to lower commodity prices and large imports. As a result, GIR is likely to remain low in 2023–25.

7. **The outlook is subject to downside risks**, notably from the possibility of additional domestic policy slippages before the June 2024 Parliamentary elections, weaker-than-expected coal exports to China, tighter global financial conditions, and commodity price volatility. Mongolia's sizeable negative NIIP position, weak external buffers, import and commodity export dependence make it vulnerable to external shocks.

Policies to Preserve Macroeconomic and External Stability

Fiscal Policy

8. **With unchanged fiscal policies, public debt is projected to increase** due to rising pension liabilities, development spending needs, and the global transition toward lower emissions. Public debt could rise further if downside risks, contingent liabilities, and macroeconomic shocks related to natural disasters were to materialize. Mongolia faces a high risk of sovereign stress.[1]

9. **Fiscal consolidation and adherence to fiscal rules are imperative to preserve Mongolia's hard-won recent economic stabilization**. An adjustment of 4 percent of GDP in 2023–24 underpinned by fiscal reforms could help achieve an orderly resolution of macroeconomic and external pressures, while improving debt dynamics. Such adjustments would be in line with the

[1] The Sovereign Risk and Debt Sustainability Framework (SRDSF) provides a sovereign risk assessment and a debt sustainability assessment. This assessment focuses solely on the risk of sovereign stress (as a surveillance country, the debt sustainability assessment is optional for Mongolia). Even when sovereign stress risks materialize, debt will only be assessed as unsustainable if there are no feasible adjustment policies capable to stabilize the debt and achieve acceptably low rollover risk without restructuring or exceptional measures.

stated intentions to adhere to the FSL. Fiscal reforms should prioritize capital expenditures to projects with high returns and strong performance; contain the wage bill by reversing pay supplements, holding real wages constant for a few years and gradually rationalizing civil servants; reducing tax arrears and tax expenditures; targeting social assistance; allowing greater PIT progressivity; and undertaking pension reforms.

10. Strong structural measures to enhance fiscal discipline could boost investor confidence. This includes strengthening tax administration and the customs regulations; strengthening public investment management (PIM) to improve efficiency, oversight, and accountability; and adopting a simplified fiscal framework based on a nominal debt anchor . PPPs should be integrated in the PIM process, and the MOF's role as a gatekeeper to manage PPP-related fiscal risk should be strengthened. Mineral wealth management should be properly integrated into the fiscal framework and underpinned by clear accountability.

11. Contingent fiscal liabilities should be reduced. Appointing an independent external advisor to conduct a diagnostic balance sheet review of DBM remains essential. If DBM's governance cannot be credibly and durably strengthened and the long-term viability of its business model clarified in the context of a revamped PIM, there may be need to consider winding DBM down to reduce fiscal risks. The SOE privatization agenda should be carefully designed and executed.

Monetary and Exchange Rate Policy

12. External buffers should be strengthened to build resilience to external shocks. The Bank of Mongolia (BOM) should continue to allow greater ER flexibility and opportunistically accumulate GIR, especially if mineral exports exceed the government's targets or external financing inflows improve. Besides fiscal consolidation, the government should refinance DBM's maturing debt, better enforce SOE repatriation and the currency settlement law, and undertake reforms to attract new FDI and external private financing.

13. Monetary and macroprudential policies will need to ensure that domestic financial conditions remain tight. The government should assist the BOM to mop up excess liquidity by undertaking its planned 2023 domestic debt issuance through market auctions. The BOM should effectively enforce the debt service to income limits (DSTI) in banks, while the DSTI of the non-bank financial sector should be harmonized with those of the banking sector to contain excessive salary-backed consumer credit. Although the current monetary policy stance remains appropriately tight, further policy rate hikes may be needed if external imbalances worsen resulting in broader pressures for dollarization. The BOM's operational autonomy should be strengthened but so should independent oversight over, and internal controls within, the BOM. The cessation of BOM's quasi fiscal operations should not be resuscitated.

Financial Sector

14. Financial sector supervision should be strengthened and intensified. Supervisors should effectively implement off-site supervision, prioritizing high-risk banks and operations; conduct full scale onsite supervision for domestic systemically important banks more frequently; and ensure bank capital is of high quality and from fit and proper investors; avoid regulatory forbearance. The end-2023 deadline for shareholder diversification should be delayed.

Policies to Boost Economic Potential

15. Addressing corruption and strengthening governance and institutions are critical. The anti-corruption and regulatory framework should be upgraded and effectively enforced. The draft Whistleblower Protection law should be passed without further delay. A comprehensive development agenda is needed to reduce medium-term vulnerabilities. This includes measures to attract FDI, enhance public sector efficiency and diversify the economy by effectively implementing the Investment Law and accelerating the overhaul of the Minerals Law.

IMF Relations

16. Mongolia is on a standard 12-month Article IV consultation cycle. The 2022 Article IV consultation and Post-Financing Assessment was concluded by the IMF's Executive Board on November 30, 2022.[2] Mongolia received an SDR allocation of US$98.3 million in 2021. Prior to that, Mongolia received emergency assistance from the IMF through the Rapid Financing Instrument in 2020 to address the economic impact of the pandemic. Mongolia is also a major recipient of IMF technical assistance.

[2] The PFA policy was initiated for Mongolia in May 2021. The PFA policy is described in Policy Paper No. 2021/026 (https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/05/19/Post-Program-Monitoring-During-The-Pandemic-460350)

Mongolia: Selected Economic and Financial Indicators, 2020–27

	2020	2021	2022	2023	2024	2025	2026	2027
	Actual			Projections				
	(In percent of GDP, unless otherwise indicated)							
National Accounts								
Nominal GDP (in USD million)	13,313	15,286	17,146	18,782	19,552	19,648	20,074	21,122
Real GDP growth (percent change)	-4.6	1.6	5.0	5.5	4.5	3.5	3.5	3.5
Contributions to Real GDP (ppts)								
Domestic Demand	-12.8	17.6	12.9	6.9	3.5	-1.1	1.4	3.5
Exports of G&S	-2.7	-7.5	13.4	10.6	4.5	5.7	4.7	3.1
Imports of G&S	10.9	-8.5	-21.3	-12.0	-3.5	-1.1	-2.6	-3.2
Consumption	76.3	67.9	64.9	64.4	67.5	67.6	69.7	71.0
Private	60.5	53.0	51.3	50.6	52.8	52.9	54.9	56.1
Public	15.8	14.9	13.7	13.8	14.7	14.7	14.8	14.9
Gross Capital Formation	22.4	36.7	39.9	38.3	36.8	33.4	29.5	27.3
Gross Fixed Capital Formation	23.6	26.8	25.2	27.0	26.4	24.2	20.3	19.5
Public	8.1	6.8	7.1	8.9	8.6	8.4	8.1	7.9
FDI	12.7	13.5	14.2	14.9	14.6	13.1	9.4	8.7
Domestic Private (including SOEs)	2.8	6.5	4.0	3.3	3.2	2.7	2.8	2.9
Gross national saving	17.3	22.9	26.5	27.4	24.2	23.1	20.4	18.9
Prices								
Consumer Prices (Avg; percent change)	3.7	7.4	15.2	12.3	12.3	12.0	10.5	8.9
Consumer Prices (EoP; percent change)	2.6	13.9	13.2	11.7	12.8	11.2	9.8	8.0
Copper prices (US$ per ton)	6175	9317	8829	8404	8191	8225	8250	8271
Coal prices (US$ per ton) 1/	74	150	123	125	110	100	100	100
GDP deflator (percent change)	3.7	14.4	17.7	11.4	9.6	10.2	9.6	8.6
General government accounts								
Primary balance (IMF definition)	-6.7	-1.1	2.1	1.0	-0.7	-0.2	0.1	0.4
Total revenue and grants	27.9	32.8	34.4	34.7	34.2	34.3	34.2	34.2
Primary expenditure and net lending	34.6	34.0	32.3	33.6	34.9	34.5	34.1	33.7
Interest	2.5	1.9	1.5	1.7	2.1	2.3	2.7	3.1
Overall balance (IMF definition)	-9.2	-3.0	0.7	-0.7	-2.8	-2.5	-2.6	-2.6
Non-mineral primary balance (in percent of GDP)	-12.8	-8.7	-7.3	-8.7	-9.6	-9.2	-8.9	-8.1
Gross financing needs	15.9	13.4	3.9	20.9	10.2	9.1	24.5	17.1
General government debt 2/	83.4	67.7	64.5	59.1	61.5	63.3	65.8	67.5
Domestic	5.6	3.2	4.4	6.3	6.0	9.3	12.6	15.7
External	77.8	64.6	60.1	52.8	55.5	54.0	53.1	51.8
Monetary sector								
Broad money growth (percent change)	16.2	13.8	6.5	12.3	9.9	11.8	11.9	11.8
Reserve money growth (percent change)	-12.7	6.5	39.9	5.3	8.7	9.5	9.8	10.2
Credit growth (percent change)	-3.8	18.5	8.6	8.6	8.9	9.6	10.0	10.0
Balance of payments								
Current account balance	-5.1	-13.8	-13.4	-10.9	-12.6	-10.3	-9.1	-8.5
Exports of goods	52.5	53.2	57.5	63.0	59.3	60.6	61.0	60.9
Imports of goods	39.3	44.3	50.3	51.0	49.7	48.5	47.5	46.6
Gross official reserves (in USD million) 3/	4534	4366	3400	3005	3412	3692	4419	5112
(In months of imports)	5.9	4.3	3.0	2.7	3.1	3.3	3.8	4.3
(net of bank's FX deposits held at the BOM)	3651	3612	1949	1695.6	...	...	...	...
Net international reserves (NIR) 4/	1066	779	-797	-1196	...	...	...	...
Exchange rate								
Togrog per U.S. dollar (eop)	2850	2849	3445	...	...	...	...	...

Sources: Mongolian authorities; and IMF staff projections.

Note: The projections assume higher coal export volumes (47 million tons in 2023 and 50 million tons/year in 2024-27) reflecting government forecasts, OT's revised medium-term copper production and FDI plans, and updated information on SOE off-take contracts. The forecasts take the 2023 supplementary budget into account.

1/ Historical data from China General Customs Administration.

2/ Excludes BOM liabilities to PBOC. Domestic debt in 2022 includes government's liabilities to BOM related to the TDB settlement with regard to Erdenet as well as the DBM's borrowing from BOM. Assumes DBM Eurobond maturity in 2023 is financed through new external borrowing by the government while DBM Samurai bond is repaid without external refinancing. Assumes full rollover of the government's Eurobonds maturing in 2023-24.

3/ Gross official reserves includes drawings from the PBOC swap line rolled over in 2023, 2026 and IMF SDR allocation in 2021.

4/ NIR is defined as GIR excl. commercial banks' and government's US$ deposits held at the BOM, the PBOC swap line, and liabilities to the IMF.