FOR INFORMATION

FO/DIS/15/123
Correction 1

August 4, 2015

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Mongolia—Assessment Letter for the Asian Development Bank**

Board Action:	The attached correction to FO/DIS/15/123 (7/29/15) has been provided by the staff:
Factual Error Not Affecting the Presentation of Staff's Analysis or Views	**Page 1**
Questions:	Mr. Mathai, APD (ext. 39996)

Mongolia—IMF Assessment Letter for the Asian Development Bank
July 29, 2015

The IMF's Executive Board concluded the 2015 Article IV consultation for Mongolia on April 4. The economic outlook and policy recommendations described in the Article IV staff report remain broadly valid. Since then, the agreement on the Oyu Tolgoi Underground Development Plan has been a major positive development, boosting market confidence and facilitating external borrowing that should considerably reduce the risk of a sharp balance-of-payments (BOP) adjustment in the near term. Nevertheless, reserves remain weak and on a declining path, partly on account of continued shocks to FDI and coal exports, and the new borrowing could complicate an already onerous external-debt situation. The authorities broadly agree with the Article IV policy advice and have made some progress in adjusting policies. Continued policy adjustment—the key to strengthening the economy—may face risks given recent political developments.

1. **Mongolia has promising medium- to long-term prospects, but the near-term outlook is challenging.** With mineral wealth estimated at $1 to $3 trillion for a population of just 3 million, the future looks bright. Within 5 or 6 years, when the second phase of the Oyu Tolgoi (OT) copper and gold mine comes into production, Mongolia could start running fiscal surpluses and accumulating savings for future generations. Right now, however, the fiscal deficit is large and the BOP is under serious pressure. Moreover, while sentiment has recently improved and borrowing spreads have tightened in the wake of the OT news, the real economy is under strain: GDP grew by less than 4½ percent in Q1, and weak revenues, trade, FDI, and credit growth suggest that activity remains soft. Inflation has dropped to around 7 percent, the policy target. Banks' asset quality deteriorated through May, and while the NPL ratio fell to 4½ percent in June, it remains substantially higher than it was a year ago.

2. **Charting a course toward developing Mongolia's mineral assets at Oyu Tolgoi was a major achievement with important consequences for the economy.** The authorities are also working on other major projects, including the Tavan Tolgoi coal mine. A deal on OT was already assumed in the baseline scenario of the Article IV, and while the IMF is not in a position to assess its specific features, it is clearly very significant for the country, bringing FDI of $6 billion (50 percent of GDP). As noted above, business confidence has picked up after the OT announcement, and Mongolian spreads have tightened—while Trade and Development Bank's (TDB's) government-guaranteed issue in May cost 9.375 percent, the authorities are now hoping for considerably lower yields on planned sovereign bonds of up to $1 billion.[1]

3. **External borrowing will alleviate the immediate BOP pressure but could add to already onerous debt risks.** Reserves are now considerably stronger than expected at the time of the Article IV, on account of bond issuances and other borrowing, and the risk of a sharp BOP adjustment this year has declined substantially. But reserves are still low and are expected to continue declining, given projected future BOP deficits.[2] The authorities intend to use new sovereign borrowings solely for debt management, and not to increase spending. Rolling over part of the ~~2017~~ 2018 Chinggis bond to smooth the repayment profile may be prudent, even if it entails higher interest costs, but the plan to replace expensive domestic borrowing with external debt

[1] The first issuance took place in late June—a 3~~½~~ year "dim sum" bond of RMB 1 billion at 7~~½~~ percent. After swapping the proceeds into dollars, the equivalent yield is around 6 percent.

[2] Of course, the outturn could be better should FDI or commodity prices recover more strongly, OT investment begin more quickly, or investors show greater appetite for Mongolian debt issuance than envisaged.