



MONGOLIA MONTHLY ECONOMIC UPDATE



April 7, 2009

Poverty Reduction and Economic Management

East Asia and Pacific Region

World Bank

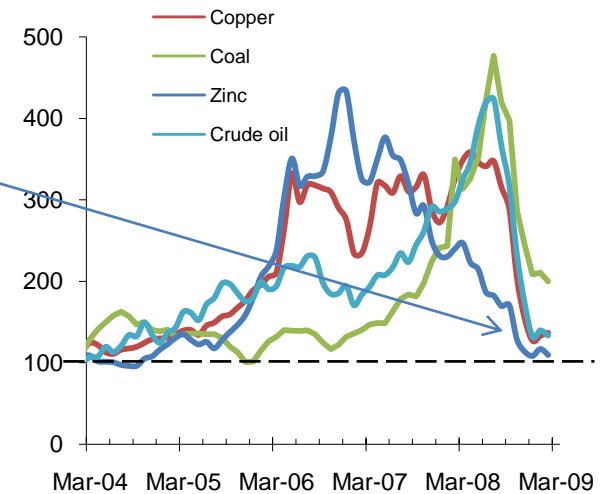
Contents

1. The crisis has hit Mongolia hard
2. Hopeful signs of improvement
 - IMF Board approved Stand-By Arrangement on April 1
 - Pledges for budget support received from several other external partners (ADB, Japan, World Bank) at meeting on March 14
 - Based on strong policy actions by authorities
 - Government medium-term plan outlined at external partners meeting
3. Caution is needed going forward

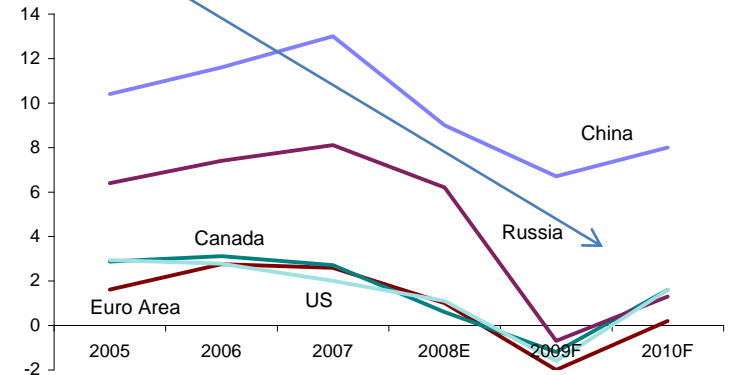
1. Crisis has hit Mongolia hard

- External factors:
 - Global prices of Mongolia's main exports have fallen back to their 2004 levels
 - Mongolia's export destinations facing prolonged slowdown given current global economic crisis
- Domestic factors:
 - But fiscal and external deficits had already emerged before the global slowdown, driven by domestic demand boom (consumption, social transfers)
 - Macro policies and banking sector problems also eroded confidence in tugrug (to be discussed later)

Index=100 in January 2004



% real growth

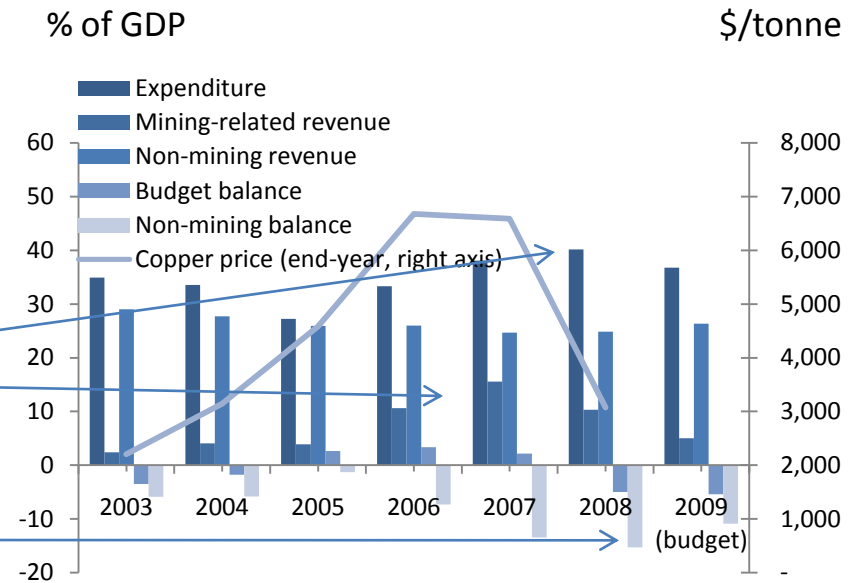


2. Hopeful signs of improvement

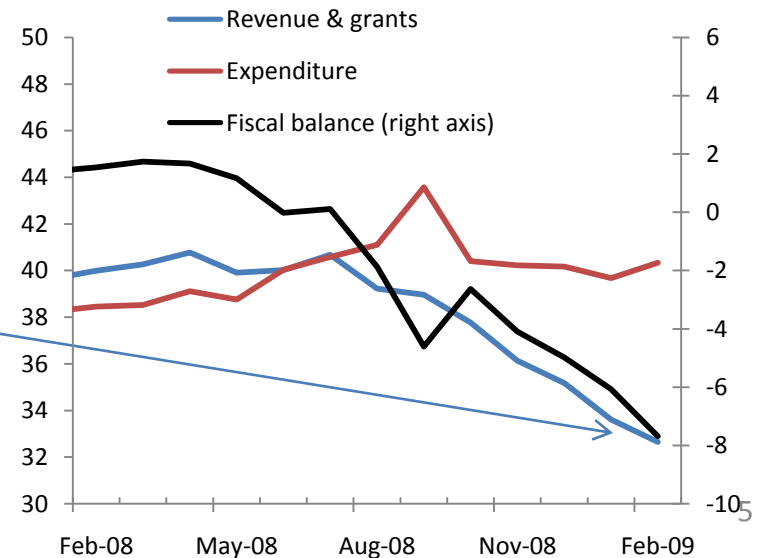
- External support:
 - IMF
 - 18-month Stand-By Arrangement (SBA)
 - \$229 million in BoP support for Bank of Mongolia
 - non-concessional loan to be repaid in 4 years (2 year grace)
 - exceptional access to IMF resources
 - External partners
 - To plug fiscal gap of \$140 mn in 2009, \$64 mn in 2010
 - Asian Development Bank, Japan and World Bank pledged total of \$160 mn
 - Other donors are expected to fill remainder
- Support possible because of strong measures taken by
 - Parliament: Budget amendment contains deficit through tough spending cuts
 - BoM: Took steps to restore confidence in currency

Fiscal policy actions taken

- How did we get here:
 - During “boom” years, large rise in overall expenditures, increasingly dependent on volatile mining revenues
 - Non-mining fiscal deficit strongly deteriorated
 - Approved 2009 budget needed to be revised after projected revenues too optimistic



% of GDP, 12-month rolling sum



Fiscal policy actions taken

- In March Parliament approved amended budget, taking large revenue shock into account, adopting large expenditure cuts
- 5.4% of GDP deficit projected (in line with IMF SBA)
- Key changes of March amendment versus November approved budget:
 1. Prioritizes capital projects, excludes projects if no feasibility study
 2. Protects infrastructure maintenance, because underfunding can be extremely costly in future
 3. Freezes public servants' wages and hiring
 4. Reduces projected interest payments on foreign loans, implying possible borrowing of \$50 mn
 5. Social transfers under Child Money Program (CMP)—overall cut of MNT 47 bn, but transfers remain universal (see next slide)

Fiscal policy actions

- Social protection
 - NSO's 2007/08 poverty analysis
 - No substantial reduction in poverty since 2002/03 despite years of stellar growth
 - Regional disparities, inequality increased
 - Shows importance of targeting social expenditures to really poor, especially during downturn
 - Large part of CMP directly financed by mining revenues, making it very much dependent on minerals prices
 - Government medium-term plans:
 - To target social transfers to poor
 - Consolidate existing social transfer programs into one social protection program
 - Introduce objective targeting mechanisms, so that social grants will effectively reach poorest families

Fiscal policy actions taken

- Fiscal policy:
 - Government medium-term plans:
 - Fiscal Responsibility Law, better manage mining revenues in future
 - Strengthen procedures to select and develop investment projects to be financed by state budget
 - Prioritize protection of infrastructure maintenance to be financed by state budget
- Steps in right direction by stabilizing deficit
- Bipartisan support
- But considerable risks to budget in months ahead (elections, more revenue shortfalls, expenditure surprises)

BoM key policy actions

- How did the confidence crisis in the financial sector happen?

- 3 phases since 2004

- Phase 1: Sustainable growth, 2004 to mid-2007

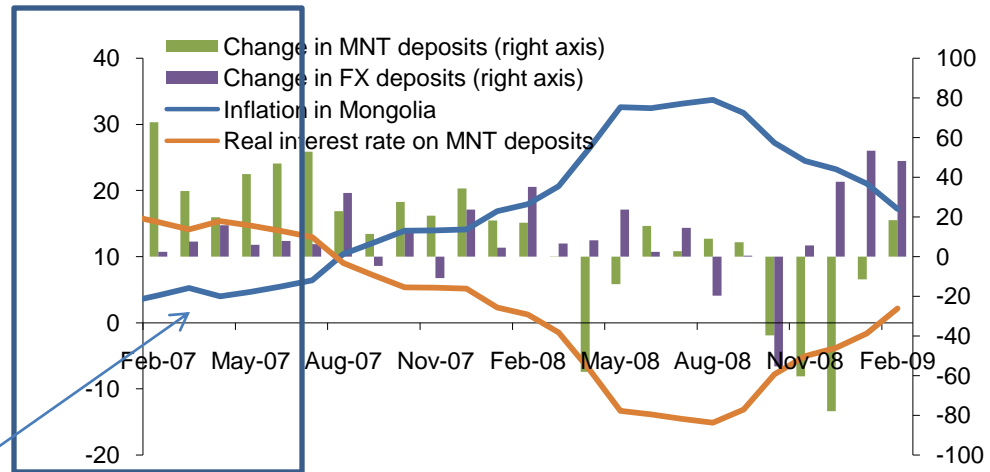
- Commodity prices rising
- Stable growth banking sector
- Single-digit inflation

- Appreciation pressure: BoM effectively pegs to USD

- But several savings&credit coop failures

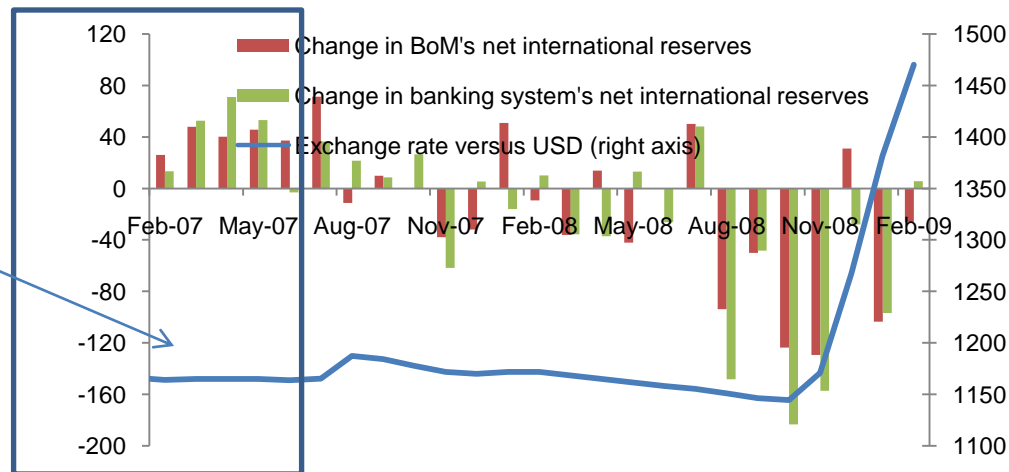
% yoy change

MNT billion, mom change



\$ million, mom change

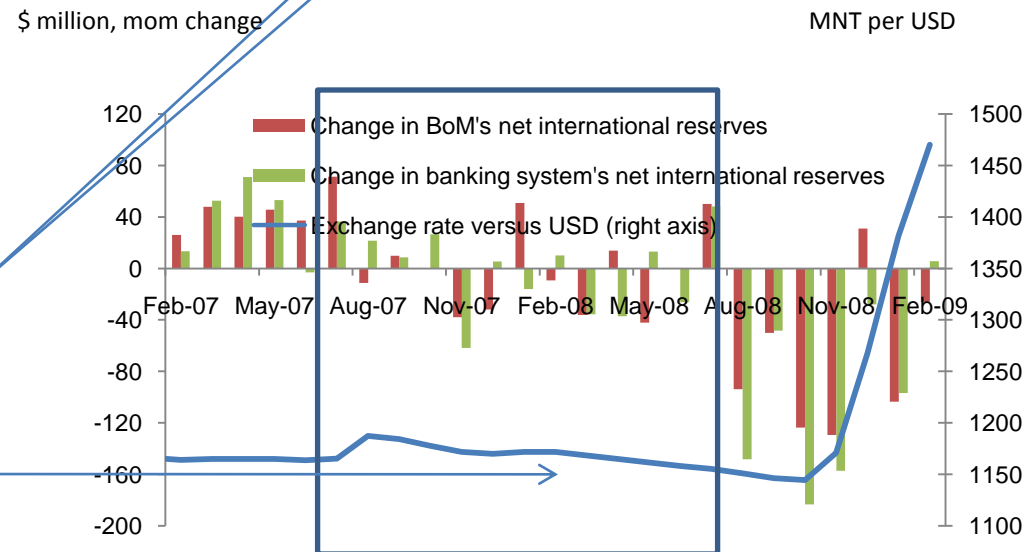
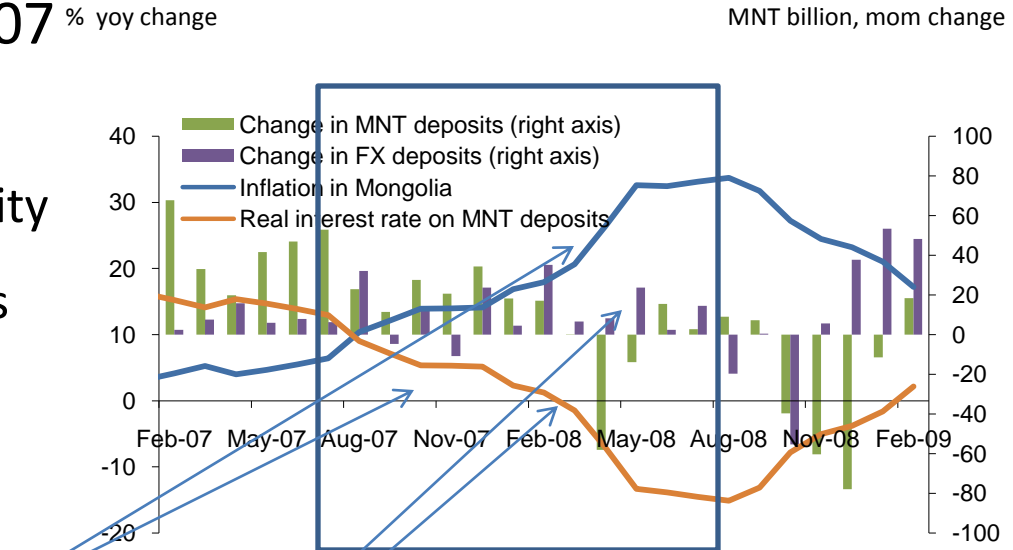
MNT per USD



BoM key policy actions

- Phase 2: Overheating, mid-2007 to mid-2008

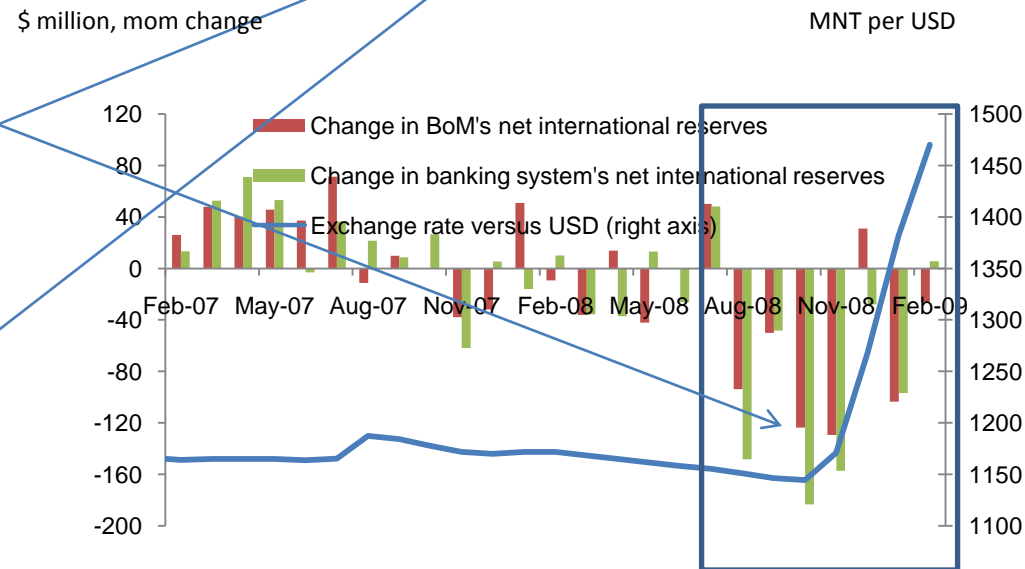
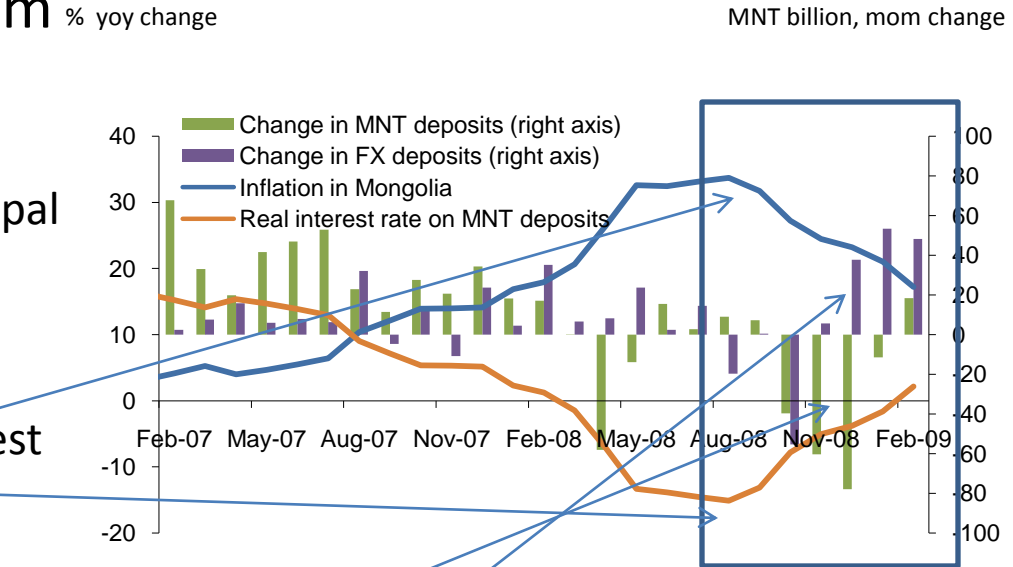
- High growth, increasing commodity prices, strong remittances inflows
- Accelerating growth in banking sector, housing prices rising
- Double-digit Inflation (at peak highest East Asia), negative real interest rates on MNT deposits
- Flight from MNT to FX deposits
- BoM continues pegging the exchange rate



BoM key policy actions

Phase 3: Loss of confidence, from mid-2008

- Collapse of commodity prices
- Increase in NPLs and loans with principal in arrears (growth&remittances slowdown, livestock prices drop and housing bust)
- Still high inflation: negative real interest rates
- Pressure on BoP due to export drop; BoM holding on to USD peg, \$500 mn loss of FX reserves and 38% depreciation in Q3-08/Q1-09
- Negative real interest rates, Anod failure: more MNT to FX deposits flight, MNT depreciation
- November blanket deposit guarantee in November partially stopped deposit flight



BoM key policy actions

- Key actions to restore confidence in tugrug
 1. Raised key policy rate to 14% from 9.75% (March 11)
 - Real interest rates still negative but close to zero
 - Signals fundamental shift in policy, easier to manage exchange rate while preserving FX
 - Although higher interest rates more costly to borrow, banks can only issue new loans if new deposits attracted
 2. Started auction of FX reserves via auction
 - Improved transparency
 - Will reflect more accurately actual demand and supply of FX
 3. Appointed auditor for Anod Bank
 - Will help set new standards in dealing with future bank failures
 4. Increased capital adequacy ratios to 12% from 10%
 - Will strengthen banks risk-bearing capacity
 5. Revised and clarified deposit guarantee law
 - Covers current accounts, savings accounts, time deposits and interbank deposits
 - Deposits of “related parties” and subordinated debt holder excluded

BoM key policy actions

- Since mid-March and end-March
 - Tugrug appreciated due to the increased supply of USD on market
 - So far: incentive to bet against MNT removed
 - BoM has been able to increase FX reserves

- **CPI inflation down**

- Will also bolster confidence

- **Risks**

- Continued slowdown may affect credit quality further
 - Banks exposed interest rate risks and exchange rate risk, half of corporate borrowing in FX

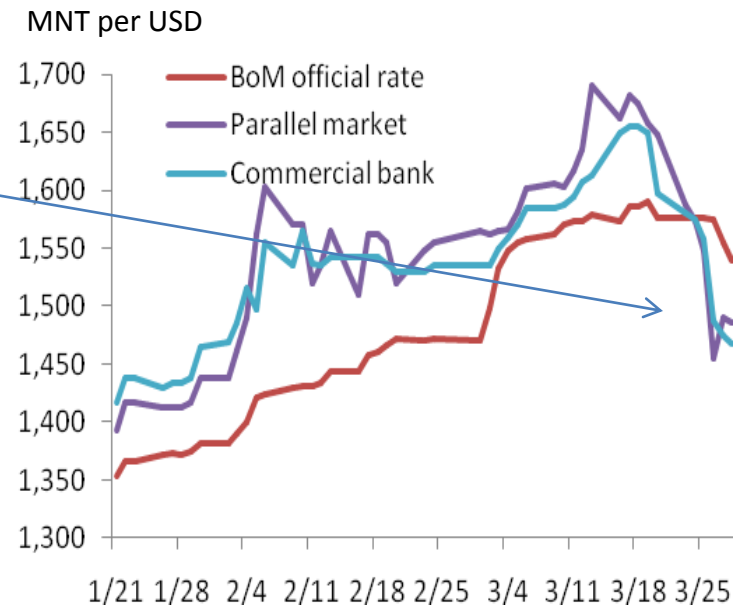
- **Government medium-term plans:**

- Banking sector stability:

- Improving BoM's supervision capacity and enhancing risk management in banks

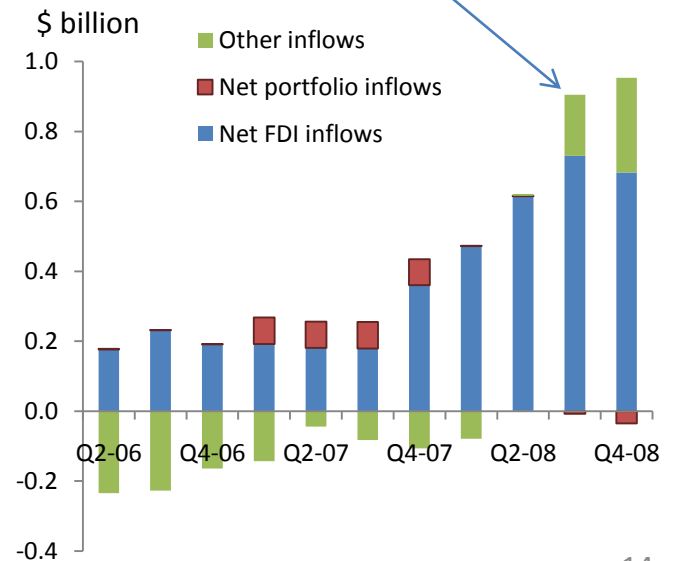
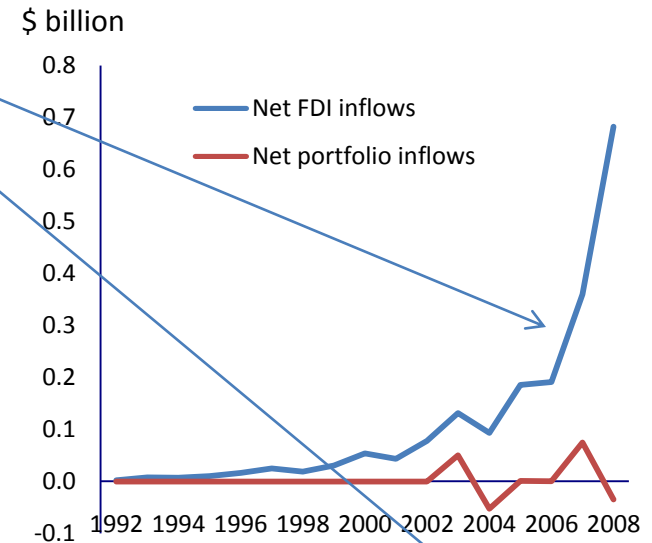
- Legal environment:

- Submit to Parliament number of key amendments, including laws on foreclosure of collateral



Some cautious optimism in mining sector

- Strong past growth in FDI into mining sector, but now some leveling off
- Some mining projects coming on stream
- If one or two large mining investment agreements currently being negotiated materializes, sentiment will pick up significantly
- Government medium-term plans:
 - Formulate draft standard mining investment agreements to reduce perceptions of instability in policy environment
 - Promote responsible mining practices
 - Increase number of Mongolians trained in relevant mining skills



3. Caution is needed going forward

- Government and Parliament:
 - Taken necessary, painful steps to address economic crisis
 - Laid out medium-term plan to make Mongolia more resilient
 - Positive moves!
- Risks:
 - Seasonality of revenues leads to very tight financing conditions in H1 2009
 - Unpopular fiscal and monetary adjustments could be reversed under populist pressures
 - Expenditure cuts could fail to protect maintenance of key infrastructure
 - Poor will be hurt if not adequately protected by targeted social transfer system
 - Although at low risk of external debt distress, little headroom for additional borrowing
 - Commodity prices could fall further, slow down recovery and impact FDI inflows
- Global environment grim, so need to be cautious about hopeful signs

Thank you

- Any questions?
- Further questions and feedback:
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