Mongolia—Assessment Letter for the Asian Development Bank

December 4, 2020

This letter updates the assessment of Mongolia's economic conditions and policies since the Rapid Financial Instrument (RFI) was approved in June 2020.

I. Recent Developments, Outlook, and Risks

1. **Mongolia has largely avoided an outbreak of COVID 19 but in November there was a sharp uptick in local cases.** When the virus initially hit Mongolia in early 2020, the government took prompt actions including a suspension of domestic activities and border crossings. As a result, total cases remained low. However, in November, there was the first recorded case of domestic transmission and confirmed infections in the year to date rose from 437 to 672 in two weeks. Daily new cases (1.1 per 100k people) remain low but the authorities announced a national lockdown and have isolated known secondary contacts of those infected.

2. **Over the course of 2020, the authorities have significantly loosened the policy stance in response to the impact of the pandemic.** A fiscal stimulus package announced in April (7¼ percent of GDP) scaled up health spending, increased social protection and provided broad-based tax-relief. The BOM cut the policy rate by 500 basis points to 6 percent and lowered the reserve requirement by 550 basis points. Parliament compelled the Bank of Mongolia (BOM) to resume quasi-fiscal activities (up to 2 percent of GDP) through end-2020. And in the financial sector, the BOM loosened both asset classification requirements and enforcement of prudential regulations through the middle of 2021.

3. **The loosening in the policy stance reduced Mongolia's limited buffers but also likely prevented a greater economic downturn.** The economic contraction moderated from 10 percent in 1H-20 to 3 percent in the third quarter of the year while employment indicators have remained largely resilient. At the same time, public debt is now projected to rise to 81 percent of GDP this year, reversing more than half of the progress made during the 2017 IMF-supported program. In addition, banks' capital buffers have likely deteriorated due to the large output contraction even though it is not apparent in official numbers given the forbearance in asset classification.

4. **If the recent outbreak can be contained, the nascent economic recovery is poised to continue in 2021.** We project economic growth to rise to 8 percent in 2021 even without a vaccine widely available in Mongolia. This assumption assumes that commodity exports to China continue to recover and domestic services can gradually normalize. The medium-term outlook also remains favorable under the assumption that the Oyu Tolgoi mine is completed broadly on time and global appetite for commodities and emerging market assets remains strong.

5. **The authorities have reduced some risks to the outlook while others persist.** Despite the challenges of the pandemic, the authorities sharply reduced short-term financing risks by rolling over the PBOC swap until 2023 and refinancing most of the Eurobond maturing in 2021. In addition, they have implemented sufficient reforms to be removed from FATF's Grey List which lowers reputational risk around banking operations. However, Mongolia continues to face significant risks from a COVID outbreak, a narrow economic base, large amortizations due in 2022–26, insufficient net FX reserves and limited capital buffers in the banking system.

II. KEY MACROECONOMIC CHALLENGES AND POLICIES

Mongolia continues to face three key macro challenges: high public debt, low net FX reserves and insufficient capital buffers in banks. It is not currently feasible to make considerable progress against these challenges due to the pandemic, but near-term crisis risks appear manageable. Nonetheless, as the pandemic recedes, it will be critical to pivot back to rebuilding buffers

6. There is still a high risk of public debt distress. Before the pandemic, there had been significant progress on fiscal policy. Public debt fell from 88 percent of GDP in 2016 to 69 percent of GDP in 2019. In addition, the share of official sector debt rose to 52 percent of total, helping reduce the average interest rate (from 6.9 percent to 3.7 percent) and increase the average maturity of public debt. Nonetheless, risks remain. Public debt is projected to rise to a relatively high 81 percent of GDP this year, 94 percent of public debt is in foreign currency, and Mongolia faces $3 billion (20 percent of GDP) in Eurobond amortizations in 2022–26. Loosening the deficit in 2020 was necessary to limit the impact of the pandemic. However, the stimulus was exceptionally large and not well targeted which reduced the multiplier. Going forward, the authorities have appropriately committed to resume fiscal consolidation when the pandemic recedes and refinance 2022–23 debt amortizations as soon as possible.

7. The Central Bank's foreign exchange reserves remain too low. Mongolia has $3.7 billion in gross foreign exchange reserves. At 155 percent of short-term debt, this level of reserves is sufficient to limit the risk of a capital account crisis over the next year. However, Mongolia faces a sharp increase in public and private external debt payments starting in 2022 and reserve adequacy will be insufficient. Moreover, unlike in most economies, there is an added uncertainty in Mongolia because the central bank's reserves are largely borrowed, either via the PBOC swap ($1.8 billion) or via swaps with domestic banks ($1.4 billion). To address this risk, the BOM should aim to steadily increase net FX reserves and ensure prudent policies to prevent a return to overheating when pandemic recedes. More broadly, Mongolia needs to move toward greater exchange rate flexibility and expand the tradable sector via a better investment climate for both the mining and non-mining sectors.

8. Concerns about capital adequacy in the banking system continue. During the 2017 IMF-supported program, a capital deficiency was identified in the banking system. Subsequent efforts to address this gap were not found to be sufficient in terms of the amount or type of capital raised. The pandemic has likely worsened this shortfall due to the sharp deterioration in the economy, and the Bank of Mongolia took appropriate forbearance measures this year to limit the burden on households and firms. Nevertheless, our concern is that some banks did not enter the pandemic with sufficient buffers to easily accommodate such forbearance. Moreover, these measures have reduced the transparency around risks facing banks. Against this background, it will be important to exit such measures as the pandemic recedes, closely monitor capital adequacy in concerned banks, and decisively act if banks begin to face liquidity pressures.

III. RELATIONS WITH THE FUND

9. Close IMF engagement with Mongolia continues. Following on the Rapid Financing Instrument which disbursed in June of this year, a virtual staff visit took place in early November and the Article IV consultation is tentatively scheduled for Spring 2021. The IMF continues to provide the authorities with technical assistance, focusing on revenue and customs administration, banking supervision, and debt management. At present, there are no discussions regarding a new IMF-supported program.

Table 1. Mongolia: Selected Economic and Financial Indicators, 2016-25

	2016	2017	2018	2019	2020		2021	2022	2023	2024	2025
	Act.				Pre-Covid-19 Proj.	Proj.	Proj.				
	(In percent of GDP, unless otherwise indicated)										
National Accounts											
Real GDP growth (percent change)	1.2	5.3	7.2	5.1	5.0	-5.0	8.0	7.5	6.0	5.0	5.0
Domestic Demand	0.4	12.1	12.8	17.3	11.4	-6.5	14.7	9.1	5.5	1.1	5.7
Consumption	-0.2	3.9	10.1	10.5	8.3	6.6	9.0	4.2	4.8	3.6	3.6
Private	-2.6	5.4	12.4	9.9	7.3	5.0	12.9	5.8	4.9	3.3	3.5
Public	10.6	-1.8	0.5	13.6	12.9	13.9	-7.3	-4.1	4.3	5.2	4.2
Investment	2.1	34.6	18.6	30.5	16.6	-28.4	28.9	19.4	6.9	-3.5	9.7
o/w GFCF	0.5	35.6	21.3	23.5	19.7	-18.4	24.1	21.3	8.2	-4.1	11.4
Exports of G&S	13.8	14.8	24.0	9.1	2.7	-4.9	13.4	11.7	15.6	11.6	8.7
Imports of G&S	12.7	24.8	30.9	22.3	9.8	-6.0	19.5	12.4	13.1	6.7	8.7
Contributions to Real GDP (ppts)											
Domestic Demand	0.4	11.8	13.3	18.8	13.0	-7.3	17.7	11.6	7.2	1.4	7.0
Net Exports of G&S	1.0	-6.3	-6.2	-13.8	16.0	2.3	-9.7	-4.1	-1.2	3.6	-2.0
Exports of G&S	8.8	10.6	18.8	8.2	13.0	-4.6	12.5	11.5	16.0	13.0	10.3
Imports of G&S	-7.8	-16.9	-25.0	-22.0	3.0	6.9	-22.2	-15.6	-17.2	-9.4	-12.4
Gross national saving	26.0	21.3	22.8	24.3	31.3	21.9	22.7	25.2	27.1	26.6	27.8
Public	-3.6	3.1	8.6	10.0	8.2	-4.0	3.3	6.0	6.7	6.3	6.1
Private	29.6	18.2	14.2	14.4	23.0	25.9	19.4	19.2	20.5	20.3	21.7
Gross capital formation	25.7	31.4	39.6	39.9	44.2	29.8	34.3	37.7	37.4	33.7	34.9
Public	9.9	5.9	5.0	8.2	9.0	7.4	6.8	9.1	9.5	9.3	9.0
Private	15.9	25.4	34.6	31.8	35.1	22.4	27.5	28.6	27.9	24.5	25.9
Prices											
Consumer Prices (EoP; percent change)	1.3	6.3	8.2	5.2	7.4	2.5	6.5	6.2	6.0	6.0	6.0
Copper prices (US$ per ton)	4868	6170	6530	6010	6144	6031	6543	6545	6569	6613	6660
Gold prices (US$ per ounce)	1248	1257	1269	1392	1565	1736	1862	1878	1901	1921	1938
Oil price (in U.S. dollars per barrel)	42.8	52.8	68.3	61.4	62.8	41.0	43.8	45.6	47.2	48.6	49.7
GDP deflator (percent change)	2.2	10.5	8.4	8.3	7.1	4.8	6.4	6.2	6.0	6.0	6.0
General government accounts											
Primary balance (IMF definition)	-11.2	0.4	6.2	3.4	0.8	-8.1	-0.3	0.0	0.0	0.0	0.0
Total revenue and grants	24.4	28.5	31.4	32.6	31.8	27.0	29.9	29.8	30.1	29.8	29.4
Primary expenditure and net lending	35.5	28.2	25.2	29.3	31.0	35.2	30.2	29.8	30.1	29.8	29.4
Interest	4.1	4.1	3.2	2.4	1.9	3.0	2.9	2.8	2.6	2.7	2.6
Overall balance (IMF definition) 1/	-15.3	-3.8	3.0	0.9	-1.1	-11.1	-3.2	-2.8	-2.6	-2.7	-2.6
Gross Financing Needs	18.0	3.6	4.3	0.8	2.9	13.8	6.4	14.6	13.5	15.2	11.1
General government debt 2/	87.6	84.6	74.3	69.1	69.6	83.6	79.8	74.6	71.4	69.2	66.4
Domestic	20.2	13.6	5.3	4.2	3.1	9.9	13.3	15.5	17.6	20.2	22.1
External	67.5	71.0	69.0	65.0	66.5	73.8	66.5	59.1	53.8	49.0	44.3
Monetary sector											
Broad money growth (percent change)	21.0	30.5	22.8	7.0	12.5	8.8	14.9	14.1	12.3	11.3	11.3
Reserve money growth (percent change)	24.6	28.6	24.5	5.4	12.5	1.9	14.9	14.1	12.3	11.3	11.3
Credit growth (percent change)	6.7	11.1	23.4	4.4	14.0	-2.5	20.9	14.1	12.3	11.3	11.3
Balance of payments											
Current account balance	-6.3	-10.1	-16.8	-15.6	-12.9	-7.9	-11.6	-12.5	-10.3	-7.2	-7.1
Exports of goods (y/y percent change)	8.0	21.4	12.4	9.6	-1.9	-11.2	12.8	7.6	13.1	7.9	5.1
Imports of goods (y/y percent change)	-10.8	25.2	35.5	2.4	2.9	-12.4	17.0	8.2	7.9	1.3	4.3
Gross official reserves (in USD millions) 3/	1296	3008	3549	4349	4502	3785	4095	3453	1685	1433	1371
(In months of imports)	2.4	4.0	4.6	7.0	5.7	5.2	5.3	4.2	2.0	1.6	1.6
Exchange rate											
Togrog per U.S. dollar (eop)	2490	2427	2644	2734	...	...	...	...	...	...	...
Memorandum item											
Population in million (eop)	3.1	3.2	3.2	3.3	...	...	...	...	...	...	...

Sources: Mongolian authorities; and Fund staff projections.

1/ Excludes privatization receipts; includes interest financed mortgage spending from 2017 onwards.

2/ General government debt data excludes SOEs debt and central bank's liabilities from PBOC swap line.

3/ Gross official reserves includes drawings from swap line.