

FINANCIAL ANALYSIS

A. Background

1. The project team reviewed financial position of the government and assessed the sustainability of the project at the fiscal and project levels in accordance with Asian Development Bank (ADB) guidelines.¹ The project has no revenue-earning component, so the financial costs and benefits were not assessed.

B. Government Fiscal Position

2. The government in 2012–2014 had a loose monetary policy in place to sustain growth, but this has since been rolled back to contain losses from the worsening external environment characterized by plummeting foreign direct investment, falling commodity prices, and growth moderation in the People’s Republic of China (PRC). Mongolia witnessed a deceleration in gross domestic product (GDP) growth from 12.3% in 2012 to 1.2% in 2016, although growth increased in 2017.² The foreign direct investment decline reduced foreign currency exchange and led to a significant fall in the value of the Mongolian togrog (MNT), which in combination with an expansionary fiscal policy resulted in inflationary pressures. Inflation decreased during 2015–2017 to below the 7% target—6.6% in 2015, 1.1% in 2016, and 4.3% in 2017. The current account deficit narrowed considerably to 4% in 2016 but widened again to about 10% in 2017 (Table 1).

Table 1: Selected Macroeconomic Indicators, 2012–2017

Item	2012	2013	2014	2015	2016	2017
1. GDP growth (%)	12.3	11.6	7.9	2.4	1.2	5.1
2. Inflation (%)	14.3	9.9	12.8	6.6	1.1	4.3
3. Current account balance (% of GDP)	(43.8)	(37.6)	(15.8)	(8.1)	(4.0)	(10.2)
4. GDP (MNT billion)	16,688	19,174	22,227	23,150	23,936	27,167
5. Central government expenditure (MNT billion)	4,379	4,683.0	5,229.2	4,996.9	7,394.2	7,097.9
6. Central government expenditure to GDP (%)	26.2	24.4	23.5	21.6	30.9	26.1
7. Government and Development Bank of Mongolia fiscal deficit to GDP (%) ^a	(9.2)	(9.7)	(11.2)	(7.8)	(17.7)	(2.2)

() = negative, GDP = gross domestic product, MNT = Mongolian togrog.

^a Fiscal deficit is the government’s on-budget deficit plus the Development Bank of Mongolia balance.

Sources: Asian Development Bank Mongolia Resident Mission; Government of Mongolia, Ministry of Finance; and International Monetary Fund.

3. The government’s fiscal deficit is significant because of (i) revenues that are below the target and increased pre-election investment spending in 2016, (ii) an on-budget structural deficit of 4.5% of GDP in 2014 (exceeding the 2% limit in the Fiscal Stability Law), and (iii) significant off-budget spending by the Development Bank of Mongolia. These factors resulted in a total deficit equivalent to 11.4% of GDP in 2014 and 15.4% of GDP in 2016. The official statement from the International Monetary Fund (IMF) Mission to Mongolia in November 2016 indicated: “the mission held very productive discussions with the Mongolian authorities on the 2016 Article IV Consultation as well as on policies that could become part of an IMF-supported economic and financial program. Common policy views were developed in many key areas.”³

¹ ADB. 2005. *Financial Management and Analysis of Projects*. Manila; ADB. 2009. *Financial Due Diligence: A Methodology Note*. Manila.

² International Monetary Fund. 2015. *Mongolia – 2015 Article IV Consultation Report*. Country Report No. 15/109. Washington, DC.

³ International Monetary Fund. 2016. *Press Release: Statement at the Conclusion of the IMF Mission to Mongolia*. 4 November. Washington, DC.

4. In 2017, the supplementary budget brought most spending on-budget, but the overall deficit is still projected to reach about 10.6% of GDP. Public debt became large—in 2014, it was at 77.4%, far exceeding the 40% limit stated in the Fiscal Stability Law. The IMF in April 2015 assessed Mongolia to be at high risk of debt distress. It is a major policy challenge to implement prudent macroeconomic management that allows sufficient scope for productive investment and social protection.

5. **Unreported off-balance budget activities.** A number of unreported off-balance budget activities appeared in 2012, jeopardizing the budget discipline. The percentage of such activities in the total consolidated budget expenditures were 16–39% from 2013 to 2015 (Table 2) and have gradually decreased since then. Although the consolidated budget deficit was reported as 1.3%–5.0% of GDP in 2013–2015, off-balance budget and budget-related expenditures reached 3.1%–12.7% of GDP, so the budget deficit in terms of the percentage to GDP reached 15.3% in 2016. The total budget expenditures have increased loan service spending.

Table 2: Consolidated Budget and Off-Budget Spending
(MNT billion)

Item	2012	2013	2014	2015	2016	2017
1. Total revenues	4,957.8	5,986.9	6,316.5	5,976.1	5,852.1	7,922.5
2. Total expenditures	5,993.8	6,164.7	7,144.6	7,136.9	9,519.9	8,981.0
3. Budget deficit	(1,036.0)	(177.8)	(828.0)	(1,160.8)	(3,667.8)	(1,788.6)
4. Budget deficit as percent to GDP (%)	(6.2)	(0.9)	(3.7)	(5.0)	(15.3)	(3.9)
5. Budget-related spending, of which:	255.7	2,236.5	1,474.0	1,156.6	1,407.7	355.3
Not included in the budget	255.7	2,236.5	1,378.7	722.9	524.9	111
Included in the budget or amendments	0	0	0	433.7	252.8	0.0
Percentage of non-reported items in total Expenditures	4.2%	36.3%	19.3%	16.2%	5.5%	1.3%

^a This includes proposed amendments for the 2017 budget.

Sources: Government of Mongolia, Ministry of Finance; Development Bank of Mongolia; Bank of Mongolia.

6. Dependence on mining income, the negative external and internal economic environment, and deficiencies in fiscal discipline and integrity led to a considerable increase in the budget deficit. Financing of this deficit by issuing high-interest rate bonds led to an accumulation of foreign debt as well as interest payments threatening fiscal sustainability.

7. The government reached a working agreement with the IMF on a \$440 million Extended Fund Facility to achieve a gradual decrease in budget deficit through (i) ensuring the integrity of the budget; (ii) increased fiscal discipline; (iii) ensuring sustainable revenue sources by introducing new taxes, increasing tax rates, expanding the tax base, and postponing the retirement age; and (iv) increasing the efficiency of budget spending.⁴

8. Real economic growth is expected to recover to 1.8% in 2018 and 8.1% in 2019 from the projected –0.2% in 2017. The last column of Table 2 of the estimates for 2017 incorporate the government's pre-agreement with the IMF on a working level and are the details contained in the draft law on budget amendments for 2017 submitted to Parliament for approval during the 2017 Spring Session.

⁴ International Monetary Fund. 2017. *Press Release: IMF Reaches Staff-Level Agreement with Mongolia on Three-Year Extended Fund Facility*. 19 February 2017. Washington, DC.

9. Parliament approved the amendments to the budget, and the IMF Extended Fund Facility program was approved in 2017. This will encourage investment and lending from development partners and private investors, easing the short-term pressure on government finances.

C. Financial Sustainability

10. To establish the fiscal impact of the project on the government budget and the financial sustainability of the project, the project team analyzed the historical expenditures of the Ministry of Road and Transport Development (MRTD). It examines budget size (Table 3); recurrent and capital expenditure budget shares (Table 4); and total and capital budget expenditures by budget plan, amendments, and executed budgets (Table 5).

11. The MRTD expenditures were volatile in absolute and relative terms, with huge increases in 2016 to MNT981.2 billion from MNT224.4 billion in 2015, reducing to MNT476.1 billion in 2017 budget amendments.

Table 3: Ministry of Road and Transport Development Actual Expenditures, 2012–2017

Item	2012	2013	2014	2015	2016	2017
MRTD expenditures (MNT billion)	446.5	509.3	344.6	224.4	981.2	476.1
Total central government expenditure (MNT billion)	6,017.8	6,164.7	7,144.5	7,138.0	9,519.9	8,569.1
GDP (MNT billion)	16,688.0	19,174.0	22,227.0	23,167.0	23,886.0	26,052.0
Total MRTD expenditure to total central government expenditure (%)	7.4	8.3	4.8	3.1	10.3	5.6
Total MRTD expenditure to GDP (%)	2.7	2.7	1.6	1.0	4.1	1.8

GDP = gross domestic product, MNT = Mongolian togrog, MRTD = Ministry of Road and Transport Development.
Source: Government of Mongolia, Ministry of Finance.

12. A breakdown of MRTD 2012–2017 expenditures for recurrent and capital costs (Table 4) shows that expenditure volatility is largely connected to capital expenditures. Recurrent expenditures have a clear decreasing trend in absolute terms from MNT20.4 billion in 2012 to MNT8.8 billion in 2017 and in relative terms from 4.6% of total expenditures in 2012 to 1.9% in 2017.

13. Capital expenditures had volatile performance in absolute terms but a clear rising trend in relative terms from 95.4% of total expenditures in 2012 to 98.1% in 2017.

Table 4: Ministry of Road and Transport Development Recurrent and Capital Expenditures, 2012–2017

Item	2012	2013	2014	2015	2016	2017
MRTD expenditures (MNT billion)	446.5	509.3	344.6	224.4	981.2	476.1
Recurrent expenditures	20.4	17.3	16.3	9.4	9.1	8.8
Capital expenditures	426.1	492.0	328.3	215.0	972.0	467.3
Recurrent expenditures in total expenditures (%)	4.6	3.4	4.7	4.2	0.9	1.9
Capital expenditures in total expenditures (%)	95.4	96.6	95.3	95.8	99.1	98.1

MNT = Mongolian togrog, MRTD = Ministry of Road and Transport Development.
Source: Government of Mongolia.

14. Significant discrepancies are evident between the MRTD budget plan, amendments, and execution, especially related to capital expenditure planning, amendments, and execution.

Table 5: Ministry of Road and Transport Development Total and Capital Expenditures, by Budget Plan, Amendments, and Executed Budgets, 2014–2017

Year	Budget Type	MRTD Portfolio (MNT million)		Difference between Budget Plan, Amendments, and Execution			
		Total Expenditures	Capital Expenditures	Total Expenditures		Capital Expenditures	
				MNT million	%	MNT million	%
2014	Plan	295,343	280,729				
	Amendments	303,824	289,649	8,481	2.9	8,920	3.2
	Execution	344,587	328,302	40,763	13.4	38,653	13.3
2015	Amendments1	203,237	189,803				
	Amendments2	158,495	149,251	(44,742)	(22.0)	(40,552)	(21.4)
	Execution	224,417	214,979	65,922	41.6	65,728	44.0
2016	Plan	242,620	234,416				
	Amendments	936,430	927,015	693,810	286.0	692,599	295.5
	Execution	981,155	972,015	44,725	4.8	45,000	4.9
2017	Plan	315,694	306,941				
	Amendments	476,134	467,292	160,440	50.8	160,351	52.2

() = negative, MNT = Mongolian togrog, MRTD = Ministry of Road and Transport Development.

Source: Government of Mongolia.

15. The difference in the MRTD's capital expenditures between the budget plan and the execution was 13.3% in 2014 and 44% in 2015. A huge amendment in 2016 almost tripled the planned budget, and almost all the amended amount was executed with only 4.8% discrepancy.

16. The 2017 amendments to the MRTD capital expenditure budget (agreed with the IMF program) also increased by more than half (52.2%) from the planned budget. This type of investment increase, packaged with the tax increase, made the 2017 budget amendments controversial, as civil society (trade unions), taxpayers (Chamber of Commerce and Industry), and other opposition parties had critical views of these proposals.

17. Parliament approved the amendments to the 2017 budget, and the IMF program was approved. The government has secured its financial position in the short run—it has paid its current international obligations, achieved support from major development partners such as the \$440 million Extended Fund Facility, and secured commitments from the Government of Japan (up to \$850 million on concessional terms).

18. The total length of the Mongolian paved road network is about 5,800 kilometers (km). Table 6 shows revenues and expenditures of the State Road Fund and Ulaanbaatar Road Fund. From 2011 to 2015, the total balance was –MNT123 billion, mainly because of investments in new road construction.

Table 6: Revenue Collected from State Roads from Vehicle Tax and Road Usage Fees
(MNT billion)

Year	Revenue		Expenditure	
	State Road Fund	Ulaanbaatar Road Fund	State Road Fund	Ulaanbaatar Road Fund
2009	9.9	6.7	9.1	9.0
2010	10.0	6.3	8.9	11.6
2011	11.2	11.3	9.8	29.0
2012	13.4	14.8	11.2	24.2
2013	39.0	17.4	19.0	64.3
2014	42.1	27.8	22.6	101.1
2015	16.2	30.2	18.0	41.7

Sources: Government of Mongolia, Ministry of Finance; Road and Transport Development Center; and Ministry of Road and Transport Development.

19. The road law amendment should ensure that the road fund remains fully available for the maintenance of existing roads. About 2,000 km needs periodic maintenance, and about 800 km requires rehabilitation. Periodic maintenance and rehabilitation requires an average cost of \$90,000 per km.⁵

20. Beyond periodic maintenance and rehabilitation, ordinary routine maintenance (cleaning, snow removal) is needed and a periodic maintenance and rehabilitation program will be required later covering another 3,000 km of the network (estimated cost of MNT28 billion). The reestablished road asset management system, based on recent road data (to be collected under the project), will deliver the outputs to plan annual routine and periodic maintenance programs, including budget requirements. It is therefore crucial to develop a stable road fund that can rely on gradually increasing revenues meeting the identified priorities.

21. Given the erratic trend in the revenues and maintenance spending, as well as the Mongolian Road Law Amendment, 2017, ADB will maintain a policy dialogue with the MRTD through capacity building activities. An additional assurance relating to the prioritization of operation and maintenance budget provision for the road project is included in the loan agreement. The Ministry of Finance and the MRTD reconfirmed that the project is a priority in the road sector. Despite the above worrying factors, Mongolia has the capacity to borrow to strengthen its infrastructure, especially if loans are concessional and in light of the approved IMF program and stabilization of the Government of Mongolia sovereign credit rating on the international markets.

⁵ The cost of periodic maintenance depends on the type of works required. Asphalt-concrete resurfacing (5-centimeter thickness) costs from \$95,000 to \$105,000 per km, varying according to the quantity of the base course. Surface dressing (chip seal) is a lighter form of rehabilitation that costs about \$40,000 per km.