Frontier's Strategy Note: 04/15/2016

"Mongolia Economic Update (April 2016)"

We have been alarming that the economic condition in Mongolia is still in a worst situation. As World bank has released Mongolia Economic Update recently, we have decided to re-examine the situation at a regional level.

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Mongolia Economic Update (April 2016)

In the six months since the previous East Asia and Pacific Economic Update, developing East Asia and Pacific (EAP) has faced a challenging external environment. Nevertheless, growth in developing EAP has generally remained resilient. Financial market conditions in the region, however, have been volatile over much of the past 6 months, as in the rest of the world. Over the next two to three years, growth in developing EAP is expected to ease modestly. China is expected to continue its gradual shift to a slower and more sustainable growth path. Among the large developing ASEAN economies, the Philippines and Vietnam enjoy the strongest growth prospects. In some small economies, growth will be affected by low commodity prices and weaker external demand. In the Pacific Island Countries (PICs), growth is likely to remain moderate. Poverty in developing EAP has declined rapidly in recent years, and is projected to fall further with continued growth; however, in several countries the pace of poverty reduction has been restricted by limited labor market opportunities, particularly for disadvantaged groups. The positive outlook for growth and poverty reduction in the region in this base case is subject to elevated risks. Across much of the region, the room for policy manoeuver has shrunk. Countries should instead prioritize monetary and fiscal policies that reduce their exposure to global and regional risks and strengthen credibility and market confidence. In China, there continues to be a need to reduce leverage—particularly in those industrial sectors where overcapacity is most evident—including by strengthening market discipline in the financial sector. A decisive approach to structural reform is even more important than usual, given the uncertain global environment and the constraints on macroeconomic policy.

First, several countries are hampered by weaknesses in governance; action is required to enhance transparency, strengthen accountability, and more generally redefine the role of the state.

Second, efforts to reduce barriers to trade in the region should be redoubled, with a particular focus on non-tariff measures and regulatory barriers, including to trade in services.

Third, the region must increase its readiness to benefit from the digital revolution, and to deal with the challenges it poses, particularly through a focus on developing the essential "analog complements" to digital technologies.

In China, a range of structural reforms will be required to support sustainable growth over the longer term. In commodity exporters and other countries highly exposed to China's economy, reforms should promote economic flexibility, particularly by removing barriers to the development of new sectors and the entry of new firms. The outlook for the Pacific Island Countries (PICs) is heavily dependent on their ability to overcome geographic constraints and take advantage of the relatively narrow set of opportunities available to them. Sustaining the pace of poverty reduction will require measures to enhance the business environment, improve education and health outcomes, and strengthen social safety nets.

Summary

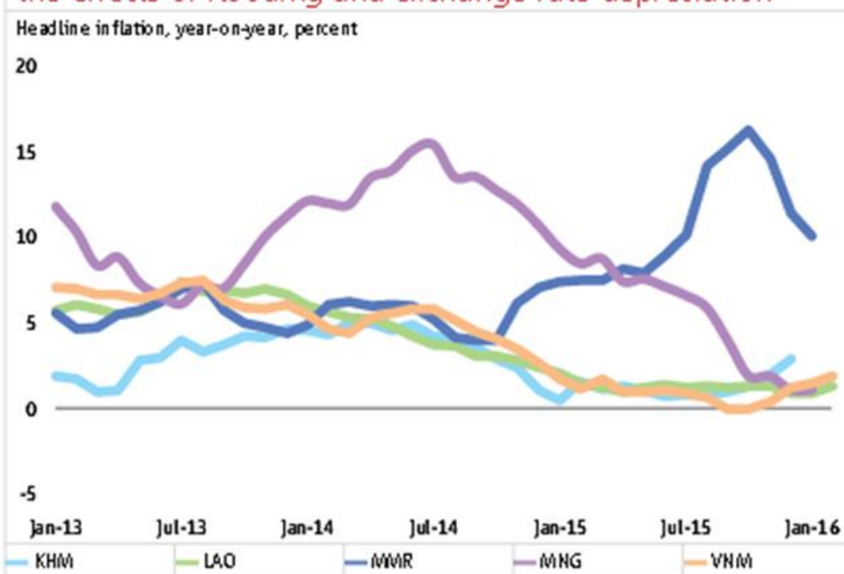
Growth is expected to remain sluggish in 2016 due to weaker mining production, likely increasing poverty particularly among urban households. The economy faces short-term challenges from a fragile external environment and large external debt repayments, with limited policy buffers. Staying the course on policy adjustment is important to strengthen economic resilience to external shocks and secure a sustainable growth path.

Recent Economic Developments Growth dropped to 2.3 percent (year-on-year [yoy]) in 2015, with a harp weakening of investment and exports (Figure 1). Mining GDP grew 13 percent (yoy) on the back of strong production of the Oyu Tolgoi (OT) mine.

Non-mining GDP contracted by 0.8 percent, reflecting subdued domestic demand. Growth in agriculture was maintained at 10.7 percent. Manufacturing growth slowed to 1.3 percent, and wholesale and retail services and construction growth contracted by 3.6 percent and 1.4 percent, respectively.

Exports dropped 36 percent (yoy) in the last quarter of 2015, followed by a 30.4 percent fall in January. Total imports fell by 19.5 percent in January, following a 21 percent drop in the previous three months, with oil product imports halving. Sharp import compression turned the current account into a US$24 million surplus in January, from a deficit of US$130 million in the previous three months.

Figure I.A.25. In Mongolia, policy tightening helped to rein in inflation, while Myanmar saw rapid inflation due to the effects of flooding and exchange rate depreciation



Source: Haver Analytics.

The balance of payments recorded a US$21.7 million surplus in January, following a US$95.6 million deficit in the final three months of 2015. A moderate current account surplus and a currency swap facility with the People's Bank of China (PBoC) helped ease the balance of payments pressure in January. Foreign direct investment (FDI) remained weak, displaying a US$26.7 million net inflow in January. Gross international reserves declined to US$1,197 million in February from US$1,323 million at end-2015, indicating escalating balance-of-payments pressure in February. The togrog depreciated by 2.5 percent against the US dollar in the first three months of 2016, following highly limited movement in the last four months of 2015.

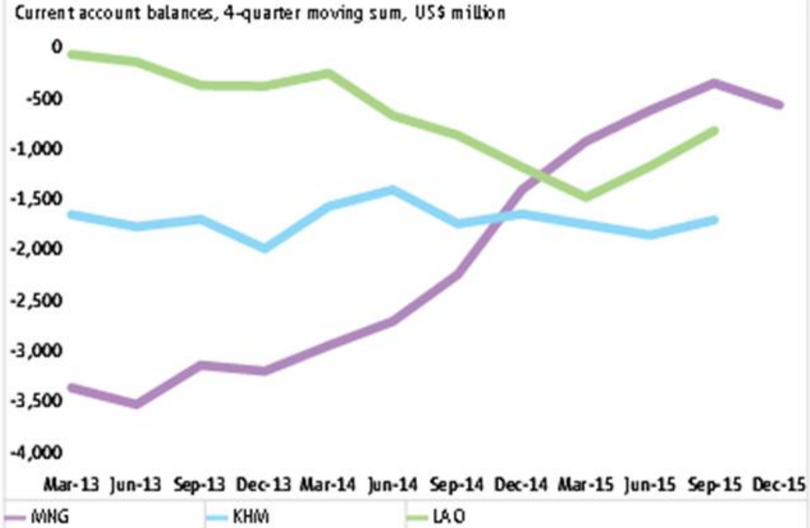
Bank loan growth continued to contract by 4.5 percent (yoy), and the nonperforming-loan ratio rose to 7.8 percent in February. Headline inflation remained subdued at 2 percent (yoy) in February. Amid tight credit conditions and slowing inflation, the Bank of Mongolia lowered its policy rate by 100 basis points to 12 percent in January.
The on-budget deficit, excluding the commercial project loans of the Development Bank of Mongolia (DBM), reached 5.1 percent of GDP in 2015, close to the 5 percent ceiling of the Fiscal Stability Law (FSL). Budget revenues declined by 5.4 percent compared with 2014 amid slowing growth and falling imports. Expenditures were cut through two supplementary budgets in response to the revenue shortage. Off-budget commercial loans of the DBM also declined to around 2.5 percent of GDP, from 3.9 percent in the previous year. Facing continued pressure on balance of payments and revenues, the government announced that a US$250 million five-year loan had been secured through a syndicated loan facility in March.

Outlook

Growth is projected to slow to 0.7 percent in 2016. Non-mining production will gradually recover with OT's second-phase investment. Mining production is projected to decline due to weaker external demand and lower-grade ores to be tapped by the OT mine. Inflation is expected to stay moderate amid a slow recovery in demand and lower oil prices.

Figure I.A.31. Mongolia's current account deficit narrowed rapidly, as imports fell

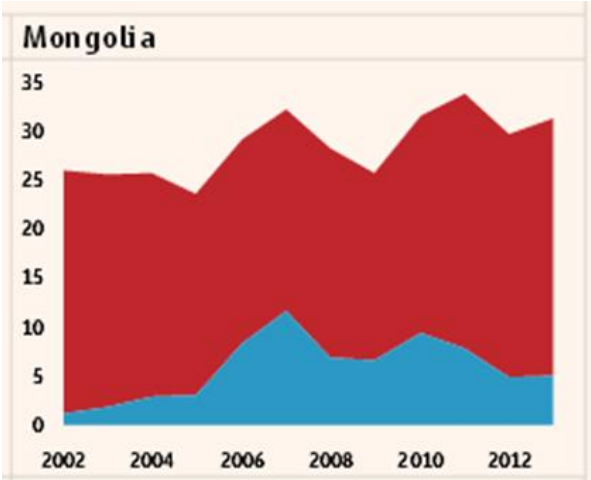
Current account balances, 4-quarter moving sum, US$ million



Sources: CEIC; World Bank.

Weak growth in key labor-intensive sectors such as construction and retail services would have adverse welfare impacts, particularly among wage-dependent urban households. The job share of paid workers declined to 47.6 percent in 2015, from 49.4 percent one year ago. Female labor force participation remained at 54 percent, since working-age women among the poor were constrained by child care responsibilities. Loss of wage income is thus expected to raise poverty among urban households that are dependent on a single wage earner in low-skilled jobs, most of whom barely make enough to keep their households out of poverty.

Resource and Non-Resource Revenue



The current account deficit is projected to widen to 9 to 10 percent of GDP in 2016, from 4.8 percent last year, with a sharp drop in mineral exports. The balance of payments will remain under pressure due to the widening current account deficit, while increased FDI inflows and the currency swap facility with the PBoC provide partial buffers.

The fiscal outlook remains weak. Weaker mineral exports are expected to undermine mineral revenues, demanding continued tight spending control to meet the FSL's deficit ceiling of 4 percent of GDP.

Emerging Challenges

Mongolia's long-term growth prospects remain strong, but its resilience will be tested by short-term challenges from the deteriorating external environment, in the absence of proper external and fiscal buffers.

Figure BI.A.5.1. Change in price of leading export commodity

Source: World Bank staff estimates.

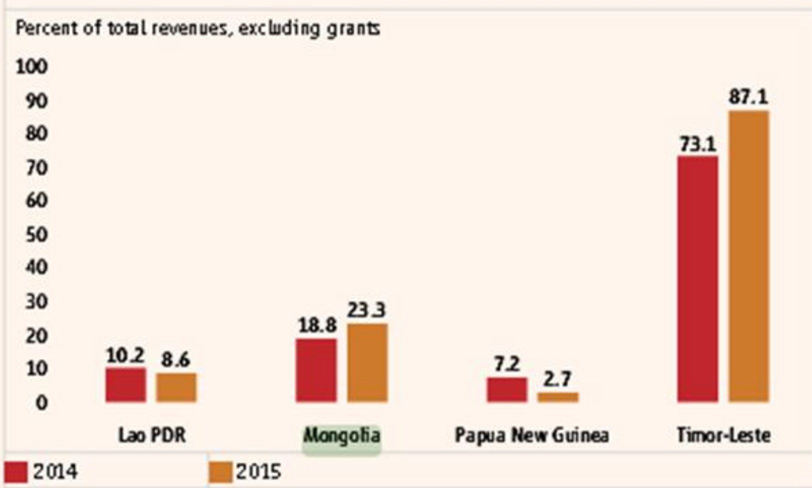
The economic prospects are subject to downside risks from the weak commodity market and China's slowdown.

A sharper drop in mineral exports would further dampen growth and erode limited reserve buffers unless foreign capital inflows significantly recover.

With its public external debt rising to 65 percent of GDP in 2015, Mongolia is vulnerable to global financial volatility, particularly exchange rate shocks and tighter refinancing conditions. Strong long-term growth prospects supported by large resource wealth indicate a low solvency risk, but the concentrated debt repayment of US$1,080 million in 2017–18 will likely pose a near-term challenge.

Priorities should be given to reducing external and fiscal vulnerabilities by deepening policy adjustment.

Figure BI.A.5.4. Mineral and petroleum tax revenue

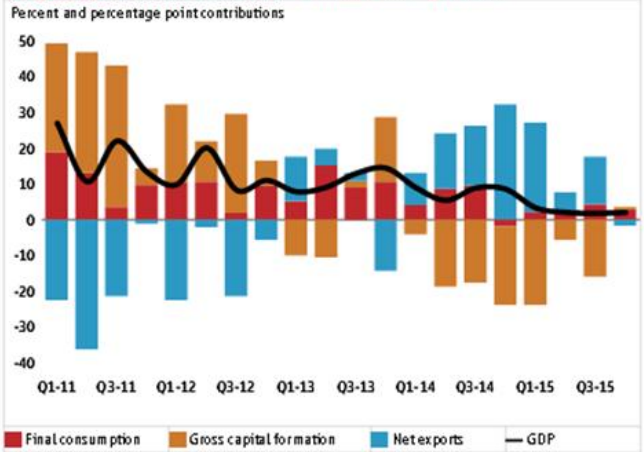


Source: World Bank staff estimates.

The fiscal policy should stay the course on reducing the budget deficit and managing the public debt at a sustainable level. Monetary policy should stay focused on maintaining price stability, avoid quasi-fiscal programs, and reduce external vulnerabilities by allowing a flexible exchange rate adjustment and safeguarding reserve buffers. Continued efforts to revamp foreign capital inflows are needed.

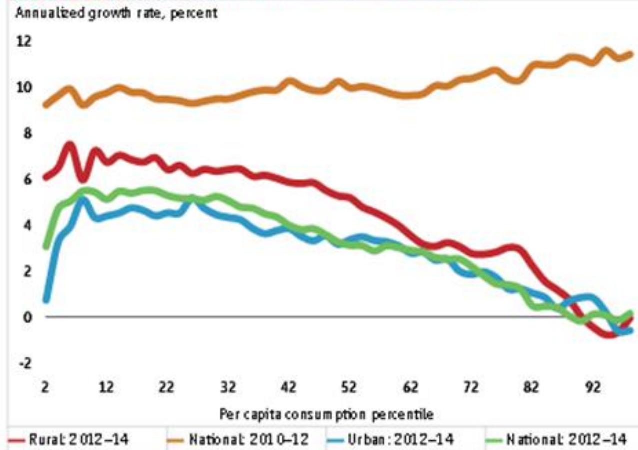
The weak economic prospects in the near term indicate the growing risk that many households close to the poverty line may slide back into poverty. To preserve poverty gains under tight fiscal constraints, it is important to redesign the social safety nets to mitigate adverse impacts on the newly poor and the vulnerable.

Figure 1. Contributions to annual GDP growth



Source: National Statistics Office.

Figure 2. Growth incidence curve: 2010–14



Source: World Bank staff estimates.

MONGOLIA Selected Indicators	*2013*	*2014*	*2015e*	*2016f*	*2017f*	*2018f*
Real GDP growth, at constant market prices	11.6	7.9	2.3	0.7	2.7	6.2
Private Consumption	15.4	6.3	7.8	4.9	5.0	5.2
Government Consumption	15.8	12.2	-7.8	1.5	0.6	0.7
Gross Fixed Capital Investment	-7.2	-21.7	-38.1	16.4	29.5	7.4
Exports, Goods and Services	12.8	53.2	-4.0	-13.4	-6.3	9.3
Imports, Goods and Services	7.6	6.8	-16.6	-5.5	5.8	7.5
Real GDP growth, at constant factor prices	11.6	7.8	2.3	0.7	2.7	6.2
Agriculture	19.3	13.6	10.7	9.5	9.5	8.5
Industry	15.3	16.1	8.8	-4.6	-2.8	7.8
Services	6.8	4.8	1.1	2.5	4.6	4.5
Inflation (Private Consumption Deflator)	12.3	11.0	1.9	3.8	5.0	6.5
Current Account Balance (% of GDP)	-25.1	-11.5	-4.8	-9.3	-14.2	-12.8
Net Foreign Direct Investment (% of GDP)	16.7	2.3	1.6	6.2	13.9	13.2
Fiscal Balance (% of GDP)	-9.2	-10.8	-8.1	-7.3	-6.8	-6.3
Debt (% of GDP)	49.4	57.7	65.6	74.3	75.3	75.4
Primary Balance (% of GDP)	-7.8	-8.5	-5.0	-3.8	-3.6	-2.1

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast.

Conclusion

Mongolia is experiencing a serious economic downturn due to commodities price plunge and Chinese export fall. As the region has a positive growth outlook and global commodities markets are going to recover, the Mongolian economy will benefit more in the coming years. Because of the upcoming parliamentary election this year, there may be some political influence on the economy.

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