

V.R.F. Series

No.449

Mar. 2009

**Macroeconomic Development Trends
in Mongolia Evolution**

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Foreword

The world economy has entered a period of financial market turmoil, characterized by slowing growth and heightened inflationary pressures, a reality that poses complex policy challenges for the international community. Although developing countries have weathered the storm well thus far, they cannot afford to be complacent, particularly with unusually high uncertainty in the global macroeconomic outlook and with their growing trade and investment linkages with high-income countries. It is imperative that policy makers in both developing and high-income countries take firm action to alleviate the impact of soaring food and energy prices on the poor while they address the long-term challenges of financial globalization and economic interdependence.

Today, the economies of the world are becoming more and more interrelated as they develop, and thus recession in the US economy directly affects other countries. The world economy is therefore currently affected by the financial crisis, but what is this financial crisis?

Researchers have concluded that the financial crisis started in the US housing market in July 2007. US mortgage growth was mostly based on 100% loans. However, this kind of lending entails great risks, since if housing prices fall, the value of the housing may become less than the loan taken. In this case, financial institutions and investors whose activities are based on housing loan payments face great losses. This has become the reason for the deepening of the financial crisis.

The US financial crisis is affecting the global economy severely. Today the nations of the world have become interdependent on each other. For example, industrial capacity in country one, financial resources in country two, raw materials in country three, and a cheap labor force in country four are interdependent. This has become the phenomenon of globalization.

The world financial crisis and globalization are severely affecting Mongolia's economy. There are two ways in which impacts are felt: First, direct impacts (limited private sector exposure to foreign financial resources); and second, indirect impacts (the effect of unstable copper prices on foreign investment inflows, possible delays in mining operations because of tightened international financial conditions).

Therefore, in analyzing Mongolian economic development, we need to study the development trends of the global economy. Especially, the Mongolian government's attention is focused on issues concerning how to provide appropriate public financial regulations, particularly to reduce public debt burden, increase the efficiency of budget expenditures, and create a tax elasticity, and this has led to a considerable refinement of public sector management. As well as this, studying and drawing on the experiences and lessons of other countries in the field of budget management is important.

This report is prepared by Sonom Baatar, a Visiting Research Fellow Program at the Institute of Developing Economies, JETRO, Japan.

Importance of the research subject:

During the last 10 years, over 100 financial crises have occurred in 90 countries; some countries have spent as much as 40-50% of their GDP in the effort to stabilize their economies. This means that a stable macroeconomic development trend is very important for all countries.

Research problem:

My main research problems include the following:

- The severe effect of the US financial crisis on the global economy
- Impact of the financial crisis on Mongolia's economy
- The current economic conditions in Mongolia
- Mongolia's economic development strategy

Relevance of the research:

- Strong dependency of Mongolian exports on world market trends
- Excessive concentration on seasonal and small types of products
- Regional development and globalization

Outline of the research:

The research paper is organized into four chapters, as follows.

In chapter one, I have studied the world economic outlook, macroeconomic policies in major regions, world economic imbalances, world prices for Mongolia's export commodities, and globalization development trends.

In chapter two, I have carried out an analysis of the recent economic conditions of Mongolia, especially focusing on the macroeconomic development trends, including economic growth performance, external trade policy, inflation, fiscal policy, and monetary and exchange policy.

In chapter three, I have studied the details of Mongolia's economic development strategy, especially focusing on **economic goals** for the future. I believe that Mongolia has some advantages and potentials that will assist in the achievement of these goals,.

In conclusion, I presented the future of Mongolia's economy where I have recommended the economic goal of reaching an annual per capita GDP income of USD11,000 by 2021. Although this goal may appear to be ambitious, I have deliberately made it so because, as the saying goes, pursuing a higher goal with little possibility of realization is better than pursuing a lower goal that is expected to be fully realized.

Acknowledgments

First of all, I would like to extend my sincere appreciation to all staff and researchers of IDE for their kind support and help during my stay in Japan and also for their assistance all through the research process. It was my first visit to Japan and I was not able to speak a single Japanese word, and yet I have been given many opportunities to see and experience Japan, which eventually enriched my understanding of the country and the people, not only in economic contexts but also in its splendid cultural contexts as well.

Especially, I would like to thank my counterpart, Dr Masahiro Kodama for his great help. He also has been very helpful in easing the pain of my settlement in Japan.

I would also like to thank my VRF colleagues; Dr Terefe Degefa from Ethiopia, Dr Hyon Soo Kim and Dr Jun Je-Goo from Korea in IDE as well.

The IDE staff, working in the International Exchange Division, have always been of great help and have always been readily reachable. I would like to thank Mr. Tetsuo Okubo, Director-General, International Exchanges and Training Department, Mr. Masayuki Sakurai, Ms. Miyuki Ishikawa, Ms. Etsuko Suzuki, and Mr. Katsuya Mochizuki for their great support and continued efforts on my behalf.

Finally, I would like to thank all the other VRFs, who were with me in IDE, for allowing me to enjoy the cozy international atmosphere and the global friendship. My stay with IDE was a whole cosmopolitan experience, where many different values, views and understandings were exchanged without any barrier.

I really would like to thank again IDE and JETRO for allowing me to enjoy this opportunity.

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1. World Economic Situation and Prospects

1.1 World economic outlook

Today, the economies of the world are becoming more and more interrelated as they develop, although recession in the US economy is directly affecting all countries. In 2007, world economic growth had already been slowing down before the financial crisis occurred, and currently the financial crisis and the world economic growth slowdown are mutually reinforcing. The policymakers of the leading powers of the world are taking prompt action against the crisis. In 2008, the USA approved a USD700 billion program in order to resolve the crisis. Some countries of the world have made the decision to reduce their policy interest rates.

The world economy is now facing some serious challenges in sustaining its brisk pace of growth. The end of the housing bubble in the USA, as well as the unfolding credit crisis, the decline of the US dollar vis-à-vis other major currencies, the persistence of large global imbalances and high oil prices will all threaten the sustainability of global economic growth in the coming years.

The growth of the world economy moderated somewhat from 3.9 percent in 2006 to a nonetheless robust 3.7 percent during 2007 (Figures 1.1 and 1.2).¹ High prices for oil and other inputs combined with some turbulence in financial markets have contributed to this slowdown. The baseline forecast of the United Nations for 2008 is for growth of the world economy to slow further to 3.4 percent, but the darkening clouds of downside risks are looming much larger than a year ago. Globally, growth rates were highest in the Commonwealth of Independent States (CIS) countries as well as in East Asia, with rates above 8 percent. Growth in developing countries declined only slightly from 7.0 percent in 2006 to 6.9 per cent in 2007 (UN 2008).

The major drag on the world economy is coming from a slowdown in the USA, driven by the slump in the housing sector. Growth in the USA slowed considerably in 2007 to 2.1 percent, down from 2.9 percent in 2006. The weakness is partly due to the decline in house prices and the crisis in the subprime mortgage sector, which together with high household debt has weakened consumer spending. Likewise, business capital spending has weakened since late 2006. For 2008, no major change is expected (UN 2008).

Growth in the European Union (EU) remained virtually unchanged in 2007 at 2.9 percent compared to 3 percent in 2006. This relatively good performance was driven by higher domestic demand, particularly investment expenditure and strong export performance. In 2008, a decline to 2.5 percent of GDP growth is expected, as the Euro remains strong. Growth in Japan remained stable in 2007 at 2.0 percent, compared to 2.2 per cent the

¹ The analysis is based on data from UN-DESA's WESP 2008.

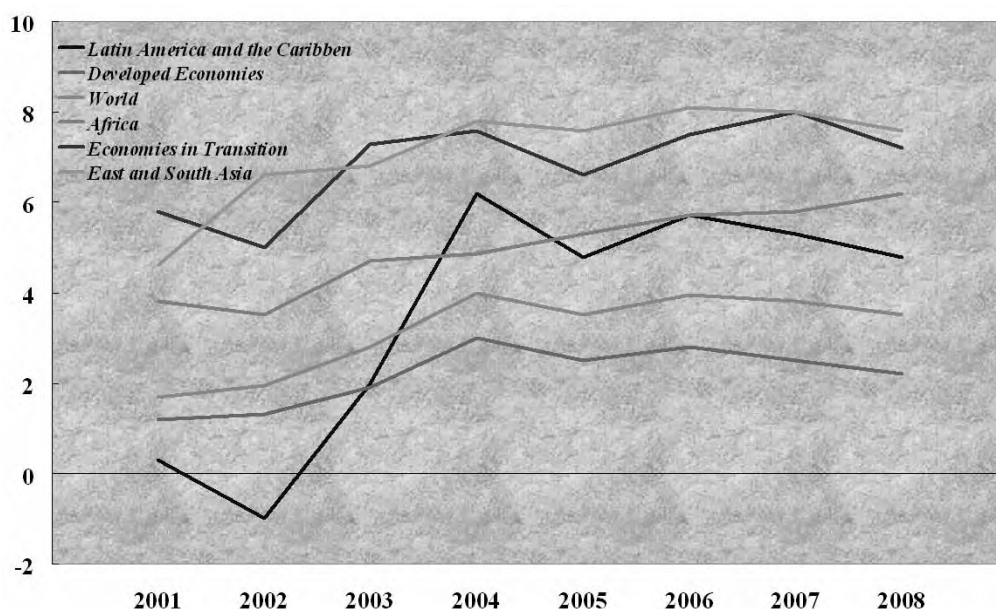


Figure 1.1: GDP growth rates of major regions, 2001-2008

Note: The reported estimates of growth rates for world gross product are obtained using country gross domestic product at market prices in dollars as weights. For comparison, world growth rates estimated using purchasing power parity-based weights would be 4.9 percent for 2007 and 2008.

Source: UN 2008. Estimates for 2007; forecasts for 2008.

previous year, but is expected to slow down in 2008 (to 1.7 percent). In both cases, improved labor market conditions contribute to overall performance (UN 2008).

Growth in East and South Asia remained strong with 8.0 percent in 2007, almost unchanged from the 8.1 percent in 2006. For 2008, it is expected that growth will slow down somewhat to 7.5 percent. This good performance is driven mainly by export, but also by recovery of domestic demand. With continued strong growth at 11.4 percent in 2007, China continued to gain in importance as an export destination for other East Asian countries. Growth in India slowed in 2007 to 8.5 percent, down from 9.4 percent in 2006, mainly due to high capacity utilization, inflationary pressures and monetary tightening (UN 2008).

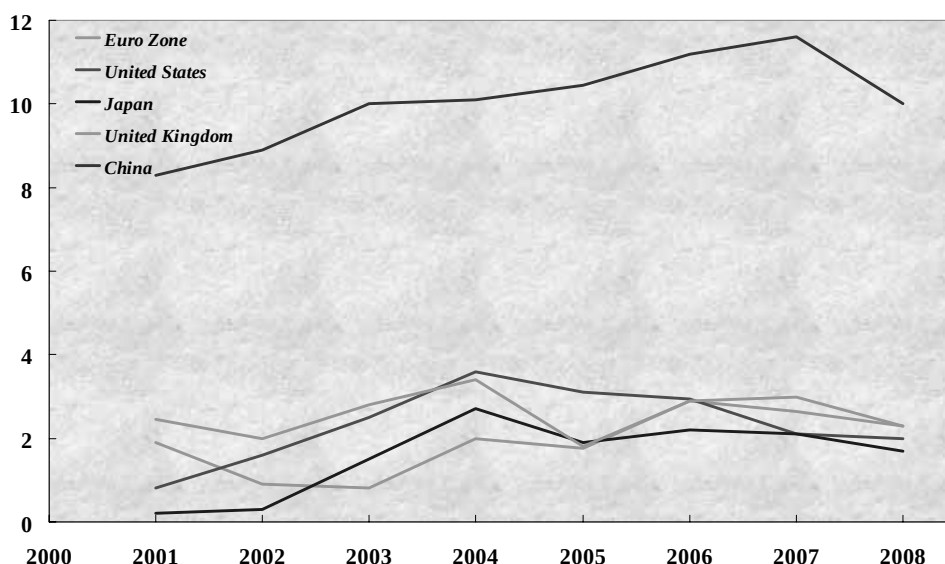


Figure 1.2: GDP growth rates of major economies, 2001-2008

Source: UN 2008. Estimates for 2007; forecasts for 2008.

Growth in Western Asia increased considerably to 5.7 percent in 2007 from 4.6 percent the previous year.

Growth in Latin America and the Caribbean declined slightly to 5.2 percent in 2007, down from 5.7 percent in 2006, but is still quite robust due to strong external and domestic demand, especially in the three largest economies (Brazil, Mexico and Argentina). For 2008, only a slight decline in GDP growth is expected (UN 2008).

1.2 Macroeconomic policies in major regions

Despite continued high oil prices, worldwide inflation remains low and even declined slightly in 2007 (Figure 1.3), partly due to restrictions on wage increases, a tight macroeconomic policy stance in both advanced and developing countries, and the supply of cheap manufactured goods from China. However, the prospects for the Organization for Economic Cooperation and Development (OECD) countries are characterized by scant spare capacity and unemployment rates close to their structural levels, as well as high energy prices and increasing food prices, which might trigger increases in interest rates, especially by the European Central Bank.

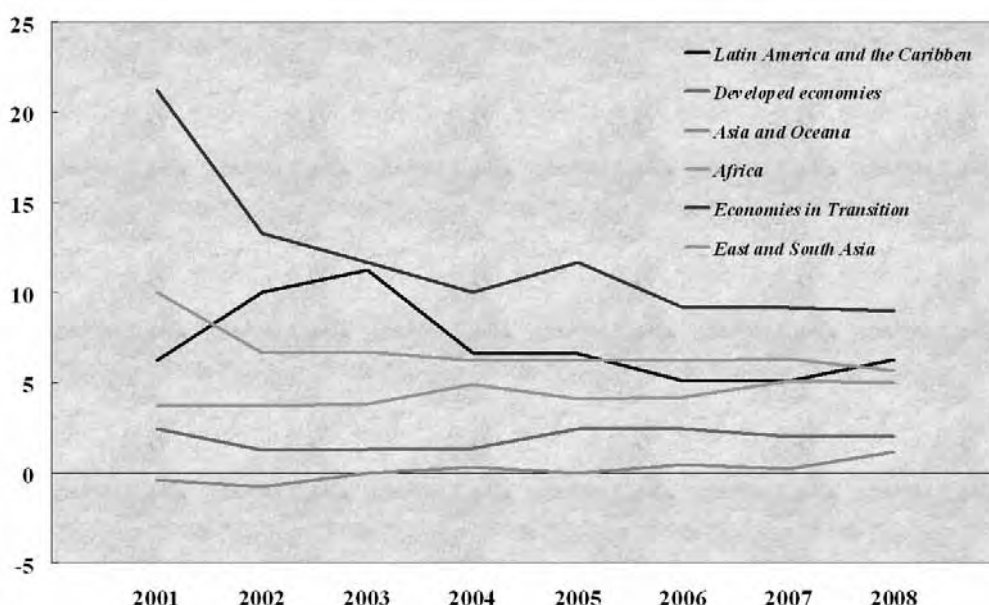


Figure 1.3: Inflation rates in major regions and economies, 2001-2008

Source: UN 2008. Estimates for 2007; forecasts for 2008.

The global trend is dominated by the deceleration of inflation in the developed countries in the second half of 2007 to an estimated 1.9 percent for the year, with a further deceleration to 1.7 percent in 2008. Inflation in the United States is expected to drop below 2 percent in 2008 on the heels of the slowdown in the economy, and is expected to remain low in Europe, at 2 percent. The appreciation of the European currencies is mitigating the inflationary pressures from higher world market prices for energy and food. The economies in transition are also expected to see a visible deceleration of inflation in 2008. Inflation in developing economies accelerated in 2007 to 5.6 percent, up from 5.0 percent in 2006. In general, there is little concern about overheating in most developing economies.²

However, inflation increased in Mongolia from 16.9 percent in 2007 to over 20 percent in 2008 mainly due to reduced subsidies for oil and increases in food prices. Recently, the business cycle in most major economies except Japan has converged, with these economies moving into a position of excess demand.

Mainly industrial countries have experienced higher government revenues due to higher growth over the past few years leading to a steady reduction in fiscal deficits (Figure 1.4). In 2007, the average fiscal deficit of OECD countries remained constant at 1.6 percent

² Overheating means that an economy is growing too fast and that its productive capacity cannot keep up with demand, implying rising inflation.

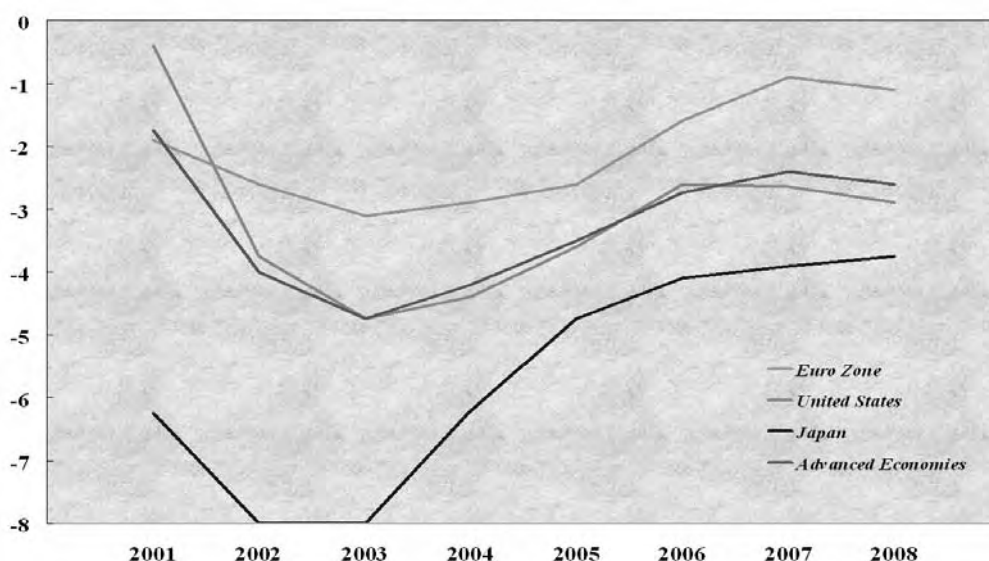


Figure 1.4: Central government fiscal balances for selected regions and economies, 2001- 2008 (% of GDP)

Source: IMF 2007. Estimates for 2007; forecasts for 2008.

of GDP. The deficit in the USA also remained flat, while the deficit in the Euro area was reduced to 0.9 percent in 2007 against 1.6 percent in 2006. This overall reduction in fiscal deficit is expected to stop in 2008, due to lower growth expectations (UN 2008).

1.3 World macroeconomic imbalances

Widening macroeconomic imbalances constitute a major concern for future growth prospects and economic stability. These imbalances cause uncertainty and increase the risk of financial instability, which have negative effects on economic growth.

Recently, equity, commodity, and currency markets have become more volatile, while short-term capital outflows from some emerging markets have increased. This has raised fears of a new global financial crisis.

Imbalances in the current accounts are large, but have stabilized in 2007 (Figure 1.5).

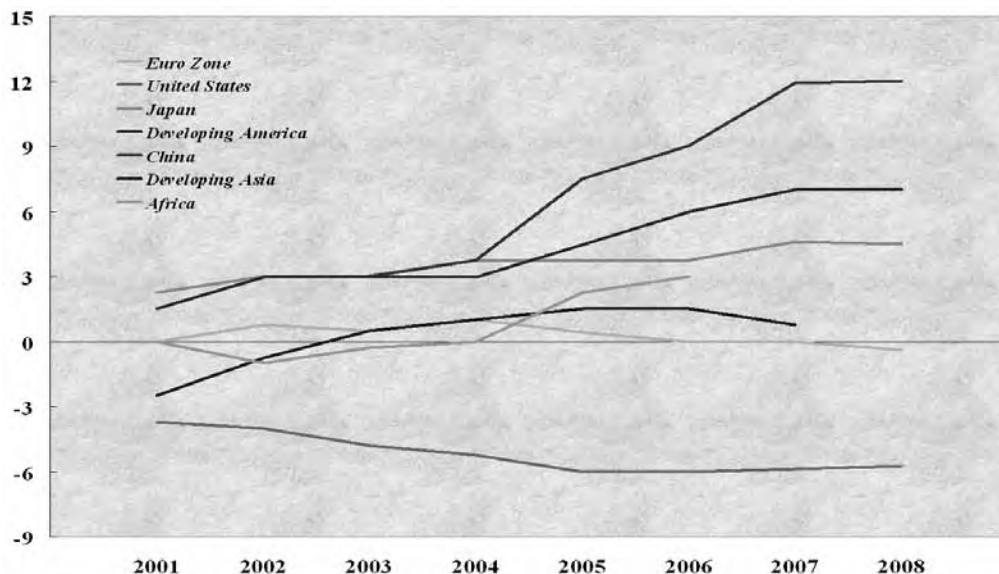


Figure 1.5: Current account balances for selected regions and countries, 2001-2008 (% of GDP)

Source: IMF 2007. Estimates for 2007; Forecasts 2008.

In developed countries, the deficit remained constant in 2007 at around USD600 billion, despite sizable surpluses in Germany and Japan. The USA trade deficit declined from a record high of USD844 billion in 2006 to USD780 billion in 2007, due to higher exports. Developing Asia's surplus exceeds USD200 billion, with China being the largest contributor (UN 2008). The current trends are expected to continue in 2008.

The recent crisis in the subprime mortgage market in the USA and its knock-on effects is a reminder of the fragility of international financial markets. Central banks in the USA, Europe and Japan have had to insert short-term liquidity to stabilize money markets. As mortgages have become more expensive in the USA, more house owners have had to sell their houses, leading to oversupply and a further decrease in prices. The construction sector has also been severely affected. Together with the decline in consumer spending, these effects resulted in lower than expected growth rates in the USA and lower demand for imports.

The losses from the subprime mortgage markets also affected the balance sheets of foreign banks, leading to increasing financial nervousness and risk aversion. The recent developments are a sign of imperfections in credit markets as financial innovations spread the risk from mortgage lending to many investors worldwide. Supervision of subprime mortgage markets has been insufficient and more transparency in credit markets is needed.

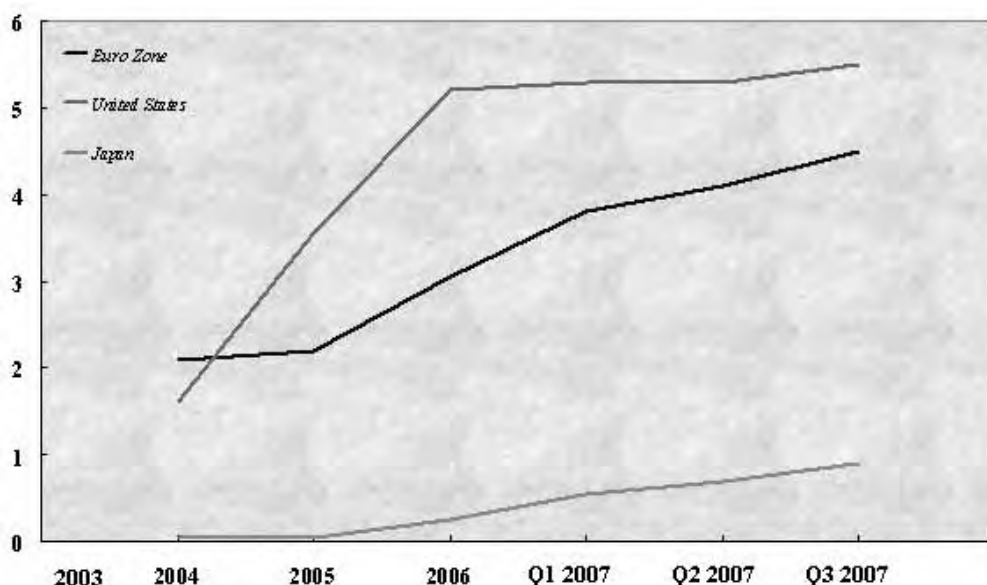


Figure 1.6: Money market interest rates: average 3-month deposit (2004-2007)

Source: ECB 2007.

As many emerging economies have accumulated large foreign exchange reserves and current account surpluses, and have also made exchange rates more flexible, they are less affected by the withdrawal of foreign investors. However, in Europe the banking sector has been severely affected.

The global financial turmoil that began in mid-2007 has led to monetary easing in the USA and in other major developed economies (Figure 1.6). Thus, the monetary policy stance remains roughly neutral in most developed economies.

1.4 World prices for Mongolian export commodities

In 2007, commodity producers continued to benefit from high prices. Global demand for oil has grown fast due to global growth, especially driven by China's high performance. The global shortage in refining capacity also continues to affect oil prices as investment is more geared towards gas and oil exploration (UN).

The prices of most other commodities have further increased in 2006, but are expected to moderate with increased volatility. Mineral, ore and metal prices have increased by 178 percent between 2000 and 2006. The price increase was highest for copper at 261 percent but it was also considerable for other important export commodities such as aluminum and gold. The increase in metal prices continued in 2007 but is expected to reverse in 2008 (see table 1.1; UNCTAD 2007a; UN 2008).

Table 1.1: Indices of selected primary commodity prices, 2001-2006 (2000=100)

Commodity	2001	2002	2003	2004	2005	2006	2007	2008
Agricultural raw materials	96,1	93,8	112,4	123,5	132,3	152,2		
Cotton	81	78,1	107,1	103,6	91,5	97	101,4	111,5
Tropical logs	106,4	95,2	114,3	136,3	136,7	130,2	152,3	156,9
Rubber	85,9	114,3	162	194,9	224,4	315,2	334,1	317,4
Minerals, ores and metals	89,2	86,8	97,6	137,3	173,2	277,7		
Aluminum	93,2	87,1	92,4	110,8	122,5	165,9	174,2	165,5
Copper	87	85,8	96,6	152,8	198,4	361,2	382,9	344,6
Gold	97,1	111,1	130,3	146,6	159,4	216,6		

Source: UNCTAD 2007a; estimates for 2007 and forecasts for 2008 based on UN 2008

The recent promotion of the use of bio-fuels has already led to a price increase for some agricultural commodities and is expected to change market structures. The price of maize is growing despite an increase in production. Political support for bio-fuels in the EU and the USA is mainly driven by concerns about future energy supply and the environment. In the USA, maize production for ethanol production is expected to double between 2006 and 2016. In the EU, both bio-diesel and ethanol production are expected to increase to reach the target of a 5.75 percent share in total transport fuel consumption. As bio-fuels replace other crops in most industrial countries, it is expected that new land will be cultivated in many developing countries.

Economies of the countries of the world are becoming more and more interrelated as they develop, and the recession in the US economy is directly affecting other countries. As a result of the global financial crisis and economic stagnation pressure, Mongolian policymakers have to develop an effective policy to prevent and avoid a crisis. It is inevitable that the financial crisis will affect Mongolia. The most important task before us is to overcome the financial crisis with minimal losses. The main issue that the Mongolian macro economy has faced in recent years is the high rate of inflation. Policymakers have defined the reasons for this high inflation rate as:

- Increases in prices of imported goods and petrol;
- Increases in cash and loans; and
- Increased government expenditure.

The Mongolian government and Mongol Bank are pursuing a policy to reduce inflation, but it still remains high. As events unfold in the global economy, Mongolian policymakers will face increasingly challenging problems. It is important to reduce inflation, but on the other hand there is a need to support real economic growth. The government needs to invest in sectors that have the potential to increase productivity in the future. It is very important to estimate the ramifications of stagnation in the global economy and take responsive action.

The main channel through which the effects of changes in the global economy will impact on Mongolia is the minerals market. Minerals make up 20 percent of Mongolia's GDP, 70 percent of its export goods, and 25 percent of government revenues. It is time to learn from the risk management mistakes that are affecting the world economy, and to assess and improve the current Mongolian financial sector risk management. This is very important for policymakers.

As the global economy is sliding into a recession, the consumption of copper is decreasing, which decreases the copper price. Copper is the main export commodity of Mongolia. Decrease in copper price negatively affects the economy and therefore we need to study the development trends of the global economy in order to analyze Mongolia's economic development.

1.5 Globalization development trends

The high growth of world exports that reached 14.8 percent in 2006 is moderating in 2007, due to a decline in import demand in the USA. In 2006, export growth in developed countries was relatively high, at 12.6 percent (see Figure 1.7).

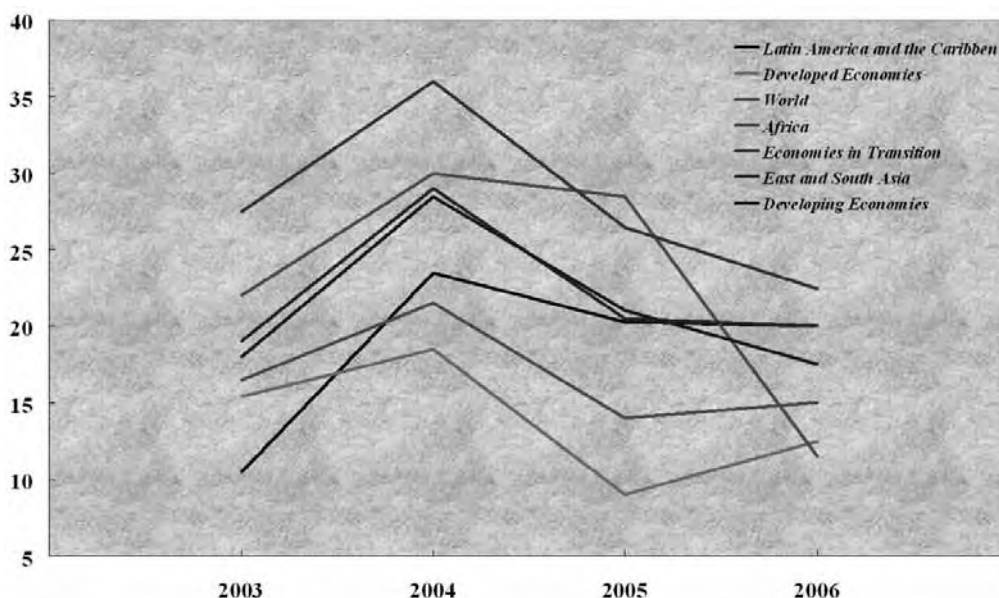


Figure 1.7: Annual average growth rates of exports by region (%)

Source: UNCTAD 2007a.

EU exports benefited particularly from increasing sales to oil-exporting countries in West Asia. The USA also registered the highest export growth since 2000 in 2006, at 10 percent, partly due to the depreciation of the dollar.

However, export growth was higher in developing countries at 17.6 percent, and even higher in transition economies at 22.8 percent. Global FDI flows have once more increased substantially, by 38 per cent in 2006, after an increase of 27 percent in 2005. All major regions except Latin America have benefited from this large increase in net FDI inflows (Figure 1.8).

The EU share in world FDI inflows remained high at 43 percent in 2006. Inward FDI to the USA recovered from its recent decline and grew by 73 percent in 2006. The share of Asia declined slightly in 2006 for the first time since 2000. Net inward FDI to China also declined for the first time by 4 percent in 2006, due to a large increase in outflows.

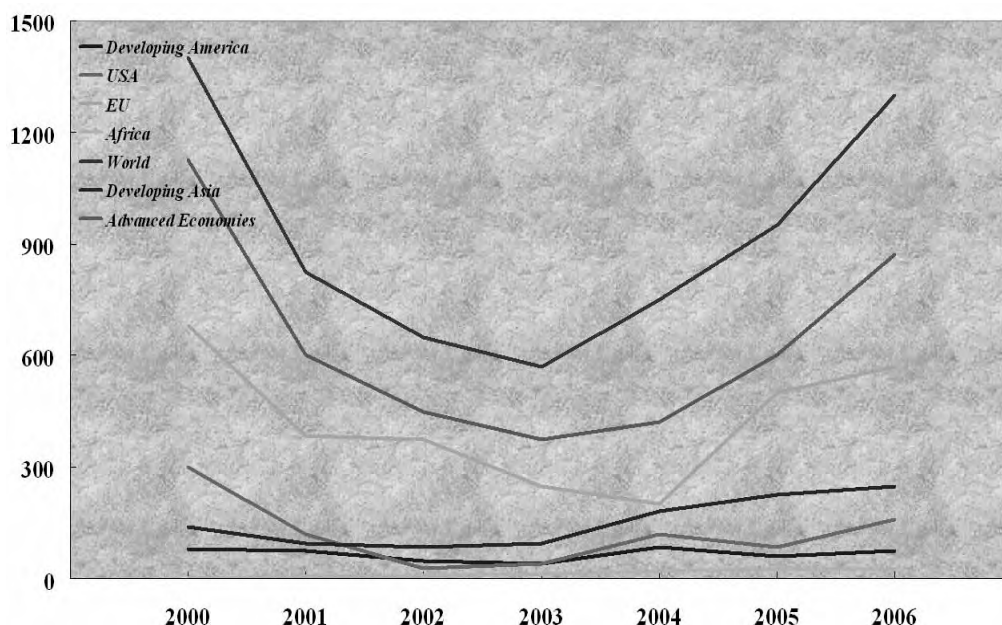


Figure 1.8: FDI inflows by region, 2000-2006

Source: UNCTAD 2007b.

2. Mongolia's Macroeconomic Situation and Prospects

2.1 Economic growth performance

The government of Mongolia will pursue a medium term economic expansion policy by boosting economic growth, solidifying economic sustainability, keeping inflation at sustainable rates or lower, facilitating public and private investment, and by promoting consumption by commercial units and private consumers. The mid-term target for the government of Mongolia is aimed at improving the living standards of society and reducing poverty and unemployment with an economic policy which promotes growth, improves credit rates, enhances external loan disbursement and by financing social programs and their policies.

Policies to maintain macroeconomic sustainability:

- Maintain the inflation rate between 3-5 percent, together with the Bank of Mongolia;
- Maintain the current account of the balance of payments sustainably and with a surplus in order to increase foreign reserves; and
- Promote policies to maintain economic growth at over 13 percent in the mid-term.

Policies to maintain budget sustainability:

- Follow a policy to limit the growth of disparity between budget revenue and expenditure in GDP;
- Pursue a policy to increase wages, pensions and allowances in line with economic growth and the inflation rate;
- Build an auto road network through concessional loans, build and create energy sources, produce substitute products for imported gasoline products, and reduce environmental pollution; and
- Set up a fair distribution of income from the mining sector for both Mongolian and investors interests.

Policies to intensify the development of the real sector and increase its effect in the economy:

- Utilize revenues derived from the mining sector as a tool for further economic growth;
- Organize activities such as building roads and connecting them to the Asian road network;
- Support the private sector throughout all sectors of the economy;
- Support agriculture and the growing of crops, and provide fresh water for remote areas; and

- Extensively increase national investment to provide households with energy sources, and improve air and ground road infrastructure by increasing investment to that sector.

Policies to follow a budget expenditure policy aimed at fully supporting the vulnerable side of society, poverty reduction, and human development:

- Increase the amount of foreign grants through close cooperation with external partners; and
- Improve the accessibility of schools and cultural organizations by use of some portion of foreign grants.

Policies to improve the quality of social services, as well as their accessibility and effectiveness:

- Improve the quality of public administration and the management of the state organization, final outcomes, quality of services, and continue following a policy to finance according to improvements in accessibility;
- Create levels of administrative and local units, and make them more independent; and
- Implement targets for providing better services and advice for citizens, and increase the transparency of customs and tax administration.

Mongolia has maintained the strong growth momentum of the last few years and achieved growth of 9.9 percent in 2007, which is 1.3 percent higher than that of 2006. In 2008 the economic growth is preliminarily estimated to be 12.4 percent.³

GDP real growth accelerated over the second quarter of 2008, reaching 11.3 percent over the last 12 months. The main engines of growth were services and agriculture, contributing 4.2 and 3.8 percentage points respectively to GDP growth. By contrast, as of July, real gross industrial output increased by only 2.3 percent year-on-year, with mining production even recording a decline of 1.9 percent in real terms. Reasons for this decline despite high world prices are: (i) an inelastic copper extraction due to depleted resources in Erudent copper mine and (ii) a marked slowdown of official gold production by 17.3 percent year-on-year, as a result of the windfall tax. Although the direct contribution of mining to economic growth is small or even negative, this remains Mongolia's main foreign exchange earner, with large export revenues from high world metals prices and sustained FDI flowing into the sector over the first half of the year.

³ National Statistics Committee, 2008

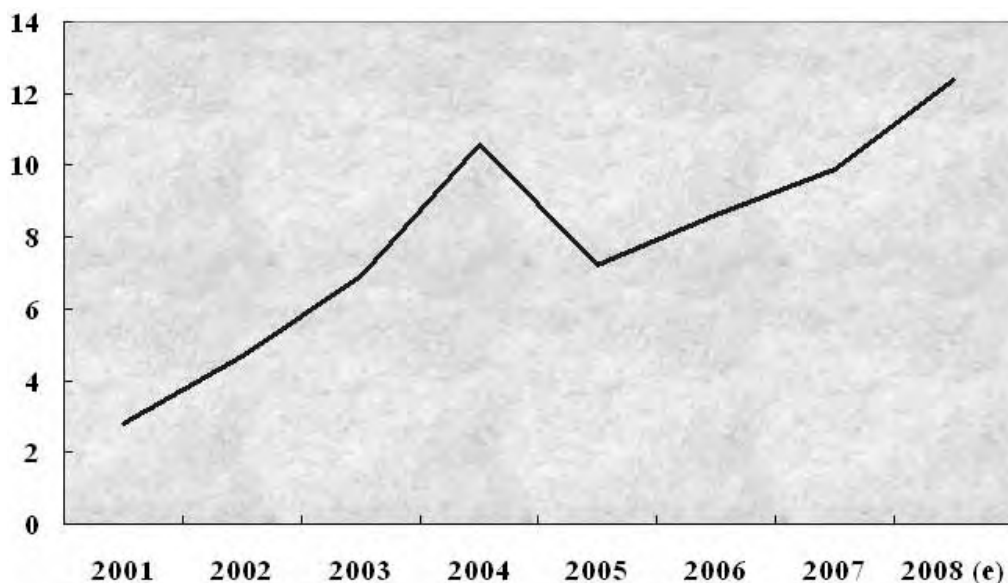


Figure 2.1: GDP growth rate of Mongolia, 2001-2009

Source: National Statistics Committee

Table 2.1: In the second quarter of 2008, economic growth accelerated further.

	Gross Domestic Product	Agriculture	Industry, construction	Services	Net taxes on products
2006	8.60%	1.60%	2.10%	2.20%	2.60%
2007	9.90%	3.40%	2.10%	3.20%	1.20%
I - 2008	10.20%	3.40%	1.70%	3.50%	1.60%
II - 2008	11.30%	3.80%	1.00%	4.20%	2.20%

Note: Quarterly figures are annualized growth figures over the previous 4 quarters.

Source: National Statistics Committee

Mongolia's medium-term economic outlook is favorable. Positive minerals prices have spurred minerals exploration and re-energized plans to exploit very large untapped deposits of copper, gold, coal, uranium, and other minerals. With the expected opening of the new Oyo Tolgoi copper and gold mine in 2011, the staff's baseline scenario envisages that real GDP growth will pick up from around 7-9 percent in 2008-10 to 12-14 percent in 2011-2012. Other large mining projects, including the development of huge coal deposits near China, are on the drawing boards but not yet incorporated in the baseline scenario, giving significant further upside potential to the outlook. With strong policy implementation, it should be possible to bring inflation down to single digits by the end of 2008 and to maintain a rate of 5-6 percent over the medium term. The external current account is expected to move into deficit during 2008-2011, reflecting expected declines in copper

prices and large FDI-financed imports of capital equipment for the mining sector, but it is projected to move back into surplus in 2012, after the Oyo Tolgoi mine comes on stream. The NPV of public debt, the debt service burden, and international reserves are expected to remain at comfortable levels.

However, the mission team and authorities agreed that major policy challenges need to be addressed if Mongolia is to fully exploit this potential. In the near term, rapidly rising inflation poses the biggest risk to sustainable growth, and both fiscal and monetary policies need to be tightened to maintain macroeconomic stability. The approach of parliamentary elections in June 2008 could add to the political difficulty of this task.

Looking ahead, it will be crucial to put in place a medium-term fiscal framework that can contribute to the maintenance of low inflation and fiscal sustainability, without sharp disruptive swings in government spending. To take full advantage of Mongolia's vast mineral wealth, it will be equally important to have transparent, stable, and internationally competitive fiscal and investment regimes. Continued progress in strengthening the financial sector will also be critical for sustained growth.

2.2 External trade

Mongolia joined the World Trade Organization (WTO) in 1997. External trade volume is increasing and as of today our country is maintaining trade relations with 100 countries of the world.

External trade total turnover in 2008 is estimated to have been USD5,664.7 million. Of this, exports were USD2,501.4 million, imports USD3,163.3 million, and the foreign trade balance is estimated to have run to a USD662.0 million deficit. This is due to decreases in textiles and woven goods exports, decreases in the copper price on the world market, and increases in machinery, equipment, oil, chemical and food product imports.

Mongolian imports consistently exceeded exports by approximately USD176 million on average over the entire period 2002-2005. However, exports turned to exceed imports by USD57.0 million in 2006. In 2007, again Mongolia recorded a trade deficit of USD221.9 million and in 2008 had an estimated trade deficit of USD662.0 million.

Mongolia remains an undiversified exporter, dependent on mineral commodities, copper, gold, zinc, and coal, for something over 70 percent of its export earnings in 2008. These developments point to Mongolia's vulnerability as a relatively undiversified economy. Newly emerging export commodities which may hold some promise for the future include crude oil and uranium.

Import demand has been strong, outstripping export growth over most of the post-1990 and early 2000 period. This is a reflection of growing domestic incomes, the relatively open trade regime and Mongolia's import needs, which cover a diverse range of goods.

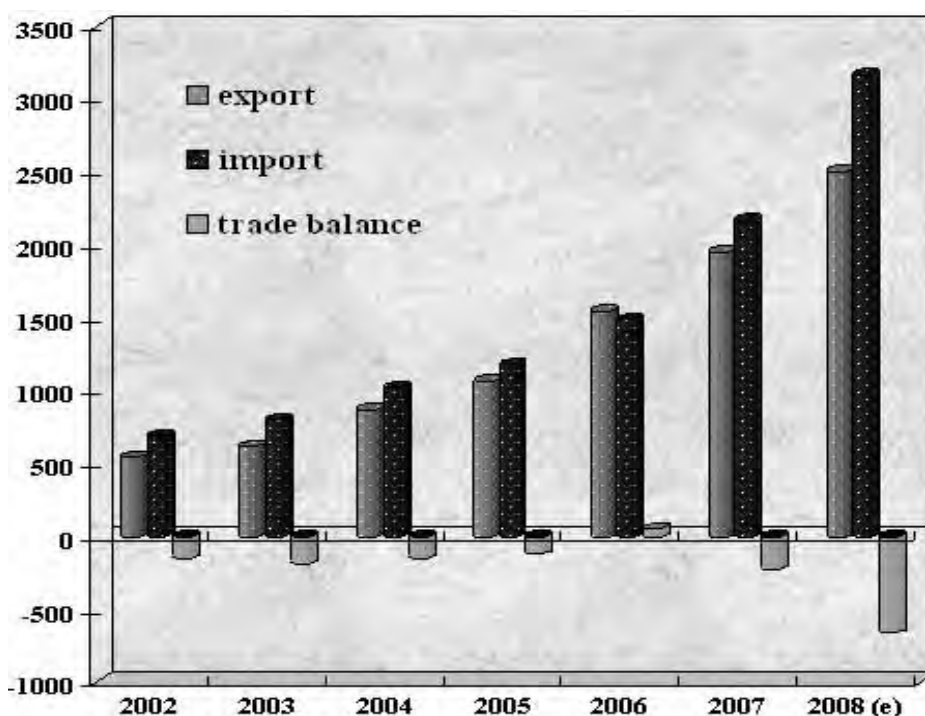


Figure 2.2: Mongolia's foreign trade indicators, 2002-2008

Source: Ministry of Finance.

Over the course of time the pattern of major trading partners has shifted significantly for Mongolia. During the 1990s, China and Russia were the two largest export destinations, accounting for some about 50 percent of total exports, each having nearly equal shares. Since 2000, China has emerged as the dominant export destination, accounting for more than 70 percent of total exports, while Russia has seen its share slip to 3 percent in 2007. The picture with respect to imports has been relatively static across the two time periods, with the major sources of imports remaining unchanged.

In 2008, the main goal of the foreign trade and foreign investment sectors was to enhance foreign relations, promote, protect and improve the quality of investment through obtaining the most favorable conditions for trade and creating favorable conditions for investment.

In 2008, the conclusion of free trade agreements was negotiated with the USA, Japan and Korea, and these will serve as an impetus to foreign trade.

Mid-term programs to develop economic and trade cooperation were formulated and put into implementation with the European Union, China, Korea and India.

2.3 Inflation

Inflation has increased rapidly in recent years. What are the policy needs for decreasing inflation? I think there are several ways which have not been mentioned sufficiently, including; helping to improve food security; supporting government efforts; improving social assistance targeting; and improving policy coordination to fight inflation.

The consumer price index (CPI) increased rapidly in the second half of 2007, rising from 6 percent to over 15 percent in December (Figure 2.3).

In terms of contributions, food prices accounted for two-thirds of inflation, with prices of bread and meat products rising by 38 percent and 20 percent, respectively, at the end of 2007, contributing to nearly half of inflation. Prices of utilities, transport, education, services, as well as housing rents also increased at double-digit rates.

Real GDP growth remains strong, but inflation increased to more than 20 percent during 2008. Food inflation contributed to almost three-quarters of headline inflation, while nonfood inflation also increased to 16 percent.⁴ On the demand side, rapid expansion of credit to the private sector and large increases in civil service wages (up 64 percent from the

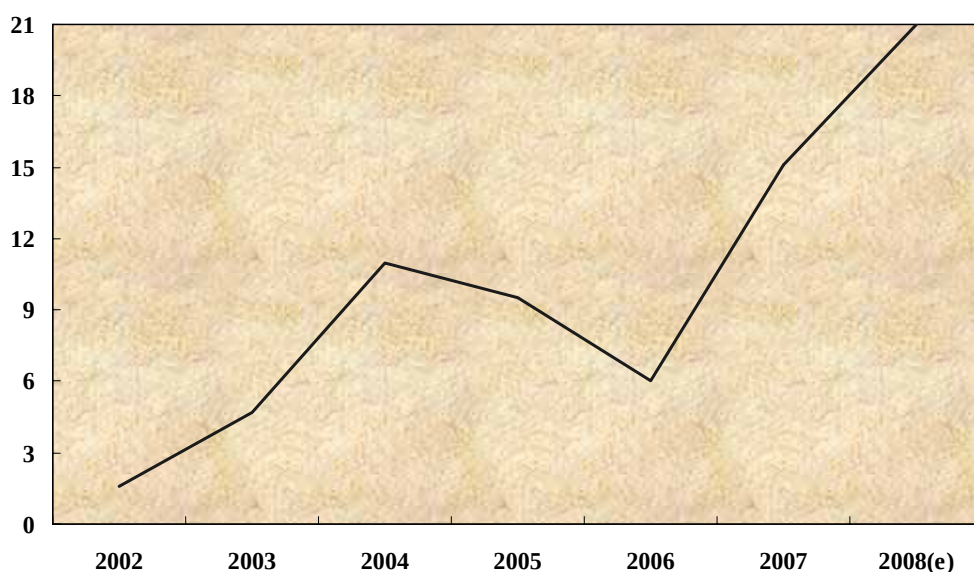


Figure 2.3: Inflation rate in Mongolia

Source: The Bank of Mongolia.

⁴ Domestic retail fuel prices have increased only 11 percent in the past 6 months. The authorities introduced measures to stabilize domestic oil prices, such as VAT and customs duties exemptions, and subsidies to reduce the interest expenses of oil importing companies.

2007 average) contributed to high inflation, while on the supply side, soaring import prices of food such as wheat, rice, fruit, and oil, played a crucial role. Wages and salaries have been increasing in all sectors in the economy (62 percent y/y in the first quarter of 2008), as the increase in civil service wages was followed by higher wages in the private sector, suggesting that second-round effects are at play. With international food and oil prices projected to stabilize in the remainder of 2008, favorable base effects, and assuming an unchanged fiscal and monetary policy stance, inflation is projected to end the year at about 27 percent.⁵

The sources of this inflation have shifted gradually from imported to domestic. Wages and salaries have more than doubled in two years. In 2009, as oil and food prices are now falling, the focus needs to shift towards containing domestic consumption (public and private). To do this, the most effective policy instrument in the current policy setting is firstly fiscal tightening, and secondly monetary tightening. A more flexible exchange rate could help soften the adjustment.

2.4 Fiscal policy

The budgetary and tax policy of the government in recent years has aimed of the stabilization of the macro economy; limitation of the portion of the public sector financed from domestic financial resources and promotion of the private sector.

Within this framework, a package of activities has been undertaken to create sustainable sources of budget revenues, to expand the revenue scope, to optimize the composition of budget expenditures, and to restrict inefficient expenditure and financing.

Significant progress has been made over the last years toward strengthening fiscal transparency and accountability. A new effective system for the monitoring and control over budget entities was established in 2002.

Mongolia's public finances are dependent on revenues from the mineral sector. Minerals made up 20 percent of Mongolia's GDP, 50 percent of its export goods, and 25 percent of government revenues last year. The combination of a growing economy and relatively stable macroeconomic conditions has led to an improving budget policy with respect to fiscal sustainability. This is reflected in the trends of government budget indicators.

The government's fiscal balance recorded a surplus again in 2007, for the third consecutive year. Preliminary outturns suggest a 2.2 percent fiscal surplus in 2007, with revenues reaching 40.6 percent of GDP and expenditures 38.4 percent of GDP. Reasons for this surplus are (i) higher than expected revenues, in particular coming from the windfall and value-added tax; (ii) under-budget expenditures, in particular capital expenditures.

⁵ Source: IMF staff calculations.

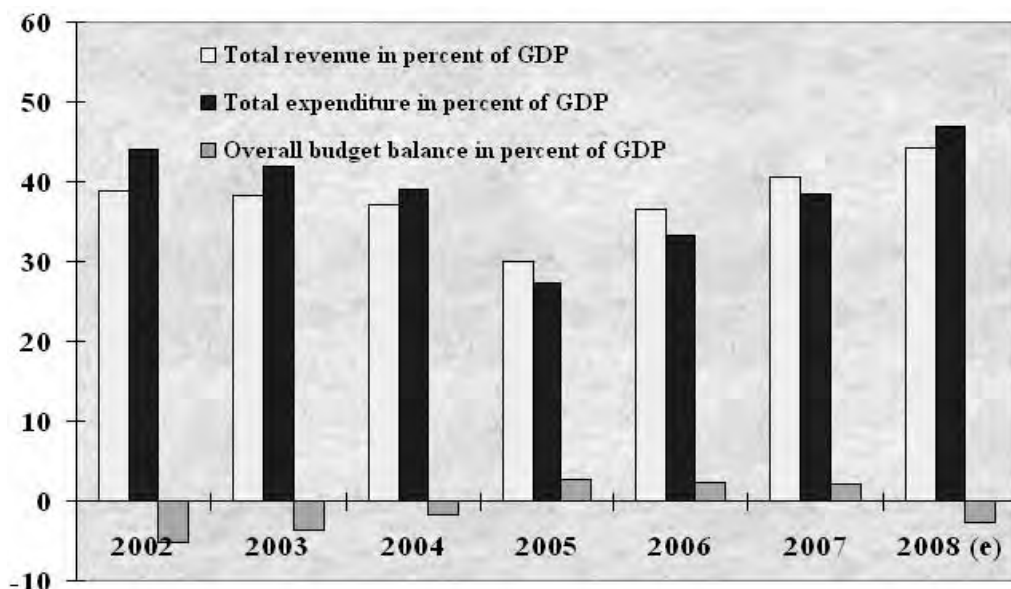


Figure 2.4: Government Budget Indicators, 2002-2008

Source: National Statistics Committee and Ministry of Finance, 2008

The implementation of measures to expand the taxation base caused positive effects on creating real economic growth. Within Mongolia's tax reform policy in 2007, a package of tax legislations was successfully implemented, which increased the base for taxation. Subsequently, through taxation income, an additional 500 billion Mongolian National Tugrogs (MNT) were consolidated in the state budget compared to that of 2006. In March 2008, a tax amnesty program was put into effect, which provides an opportunity for taxpayers to correct their tax information without penalty.

The mission team argued that the fiscal stimulus in the 2008 budget risked further aggravating inflation. To prevent higher inflationary expectations from becoming entrenched, the mission recommended maintaining a surplus of about 1½ percent of GDP in 2008. Such a target could be achieved, even with the civil service wage increases granted at the beginning of the year, by (i) strictly avoiding any further increases in civil service employment and wages during the remainder of the year; (ii) reducing overlapping social spending and improving its targeting; (iii) curtailing low priority capital spending. The mission also advised the authorities to avoid recourse to fiscal measures to control inflation.⁶

⁶ Measures for price stabilization include a temporary exemption of VAT (10 percent) and customs duties (5 percent) on wheat and flour imports, the building up of wheat and flour reserves, and subsidies to reduce interest expenses of petroleum importing companies.

In assessing the efficiency of a tax system and determining the scope for necessary reforms, analysts find the concepts of tax elasticity and tax buoyancy useful. The elasticity of tax is defined as the relative change in revenues from that tax under a given tax system (which remains unchanged) compared with the relative change tax base.

Elasticity provides a tax system with built-in flexibility. It can be written as:

$$\text{Elasticity of the tax revenue} = \frac{\text{Percent change in tax revenue (under an unchanged tax system)}}{\text{Percentage change in the tax base (GDP growth change)}}$$

If GDP is taken as a proxy for the tax base, then elasticity with respect to GDP is

$$\text{Elasticity (e)} = \frac{\Delta AT/AT}{\Delta GDP/GDP}$$

Where: AT - is the tax receipt from an unchanged tax system

Δ – Refers to the change during a period

Table 2.2: Growth comparison between GDP and government tax revenue

	2004	2005	2006	2007
GDP growth, %	110.6	107.2	108.6	109.9
Tax revenue growth, %	138.0	118.0	163.0	133.0
Tax elasticity rate	1.246	1.100	1.500	1.210

A tax system is elastic when it has an elasticity value greater than one, suggesting that tax revenues are increasing at a higher rate than GDP without new tax or increases in tax rates. Elasticity is desirable in a tax system and should be encouraged in countries such as Mongolia where government expenditures trend to increase more rapidly than GDP in the short run and medium term period.

In 2007, prices for gold and copper were high on the world market, and mining industry production expanded. Livestock numbers also increased, which positively affected the demand and supply of goods and products, promoting real economic growth. On the expenditure side, wages and salaries were significantly increased in 2007, and average salaries reached USD300 for civil servants.

Minimum wages are set at least once a year by the government, taking into consideration economic growth, productivity rate, employment status, population livelihood level, changes in their real income, social insurance, amount of pensions, allowances paid through welfare, and the general level of salaries within the nation. In 2008, the amount of pensions provided from the social insurance fund increased, and will be increased every year.

The execution rate for capital expenditure was much lower than budgeted. This was mainly due to absorptive capacity constraints at line ministries to execute their respective capital budgets.

Fiscal policy in recent years has been significantly expansionary, and so is the planned 2008 fiscal stance. The fiscal stance as assessed from the 2008 budget is expansionary, albeit ensuring that the overall budget deficit remains contained at 2.6 percent of GDP. The expansion in expenditures is driven by increased revenue collection, rather than resorting to deficit financing.

Parliament has authorized the government to issue commercial foreign debt of up to USD1.2 billion (25 percent of GDP). The mission stressed that borrowing and spending on this order of magnitude could further aggravate inflationary pressures and, as indicated in the Debt Sustainability Analysis (DSA), cause Mongolia's debt burden indicators to breach their indicative threshold in the medium term. The mission and the authorities agreed that Mongolia should continue to rely primarily on concessional borrowing in the near term, while recognizing that Mongolia's infrastructure investment needs were very large and that the country's eligibility for concessional lending facilities would likely taper off in the coming years as per capita income continues to rise. The authorities also indicated that capacity needs to be strengthened and a comprehensive risk management framework needs to be put in place.

Any foreign financing should be fully consolidated with the general budget to ensure fiscal transparency. The mission encouraged the authorities to continue the negotiations of overdue obligations with bilateral creditors.⁷

In 2008, growth in the economy caused the government to raise its expenditures. Increased expenditures created demand that increased the prices of products, and this increase in prices negatively affected the people's purchasing power. Therefore, it is crucial to have the right policy that offers a good balance of negative and positive factors. The results of the policy launched in 2008 show the need for work coordination between such financial institutions as the Finance Ministry and Mongol Bank.

In order to keep inflation low, Mongol Bank controlled the money supply, using the interest rates of securities for this purpose. The Finance Ministry, however, ran an expansive policy in 2008 (increasing salaries and pensions, distributed money for children and newlyweds). The expansive fiscal policy directly caused an increase in prices for goods and services. Budget expenditures and the money supply should be coordinated well; if the money supply is reduced then the budget expenditures should also be cut.

Theoretically financial and monetary policy should be coordinated in order to effectively bring about tangible results of development in the financial sector.

⁷ Negotiations to settle overdue obligations with bilateral creditors (Bulgaria, China, Finland, Romania, and Russia) are underway.

The 2009 budget:

In contrast to previous years, the government has prepared a balanced draft budget for 2009 with more moderate spending plans. Based on a projected real GDP growth of 14.1 percent and inflation of 12 percent, overall revenues are expected to increase modestly by 8 percent in nominal terms over the amended 2008 budget, and decline to 37.7 percent of GDP, while overall expenditures are budgeted to increase by 6 percent in nominal terms. The moderate increase in revenues comes mostly from assumed increases in VAT, excise and personal income taxes, while other categories such as the corporate income and windfall taxes are forecasted to decline by 5 and 9 percent, respectively. Expenditures will increase on account of (i) higher intergovernmental fiscal transfers by MNT137.2 billion, which include the creation of local funds (MNT50 billion) and (ii) transfers to students through various programs (lunch program, tuition grants, and living allowances). These relatively more modest fiscal targets are based on controls over wage increases, and a sharp reduction in the growth of capital expenditures compared to the trend over the past four years.

However, this budget is supported by very optimistic macroeconomic assumptions unlikely to materialize in 2009. In particular, revenue projections are based on a 14.1 percent economic growth, in conjunction with an assumed decline in average copper prices from USD7,500/ton in 2008 to USD6,700/ton in 2009. As noted at the outset, the price of copper has already reached levels below USD5,000/ton as of October 2008 and is therefore very likely to be lower in 2009 than the projected USD6,700/ton. Lower metal prices combined with a world economic slowdown and tightened financial conditions will have significant implications for economic growth in Mongolia in 2009 and the government revenue targets.

As a consequence, the 2009 proposed budget does not appear to be sufficiently realistic in light of the world economic turmoil and much lower copper prices. The budget presents a more prudent fiscal stance characterized by a balanced budget, restrained current expenditures and cuts in capital spending, which is commendable given the expansionary fiscal policy of the past two years, and the continued problems of high inflation. This planned fiscal stance does not seem realistic, however, with copper prices falling below USD5,000. The fall in copper prices can be expected to have a direct impact on revenue through much reduced revenues from the windfall and corporate income tax, and dividends transferred from the government-owned Erdenet copper mine. For example, a fall in copper prices of 25 percent from USD6,700 to USD5,000 would imply shortfall of revenue in the 2009 budget of 2.2 percent-3.5 percent of GDP (Box 1). A revision of revenue projections based on more realistic prices and economic growth forecasts would strengthen the credibility of the budget.

Box 1: How sensitive is the windfall tax to copper prices?

The windfall tax has become an important fraction of the government budget, contributing 7.8 percent of total public revenues in 2007, and is the main source of revenue of the government development fund. It is imposed on sales of copper ore and concentrates extracted and levied at a rate of 68 percent on the difference between actual copper prices on the London Metal Exchange and the sum of a base price (set at USD2,600 per ton) and smelting costs.

Given its contribution to the budget and the current rapid decline in copper prices, a key question is, therefore, how sensitive the windfall tax is to a fall in copper prices. The elasticity of the windfall tax to copper prices according to various levels of smelting costs was estimated at the following levels:

Smelting costs (USD per ton)	500	1000	1500	2000
Elasticity of the windfall tax to copper price	1.7	1.9	2.2	2.6

This means that a decline in copper price of 25 percent, from USD6,700 to USD5,000 per ton would lead to a decline in the windfall tax revenues of between 42 and 65 percent, and that would translate into a decline in revenue of between 2.2 and 3.5 percent of GDP in the 2009 budget, all else being constant. This decline does not include the likely decline in other taxes such as corporate income and value added taxes as well as dividends that would be induced by a domestic economic slowdown.

Of course, these calculations should be regarded with caution, as they rely on assumed smelting costs. These costs apparently could be used as a variable of adjustment to determine the level of the windfall tax to be paid between the government and Erdenet.⁸

The government's reliance on mining has increased since 2005 with the introduction of the windfall tax and reductions in the VAT. Figure 2.5 provides trends in taxes and expenditures over the past five years. Income tax revenues have increased from 7.5 percent of GDP in 2004 to 14.2 percent of GDP in 2007, and are projected at 11.6 percent for 2009, while VAT receipts declined from 8.5 percent of GDP in 2004 to 5.8 percent in 2007, and are estimated at 6.6 percent for 2009. Resources from the minerals boom have been used to finance increases in social transfers, public sector wages, and domestic investment, which grew from 7.8 percent to 11.5 percent, 6.7 percent to 9.3 percent, and 3.6 percent to 9.1 percent of GDP, respectively, between 2004 and the amended plan for 2008.⁹

⁸ Source: World Bank staff calculations.

⁹ Source : Ministry of Finance

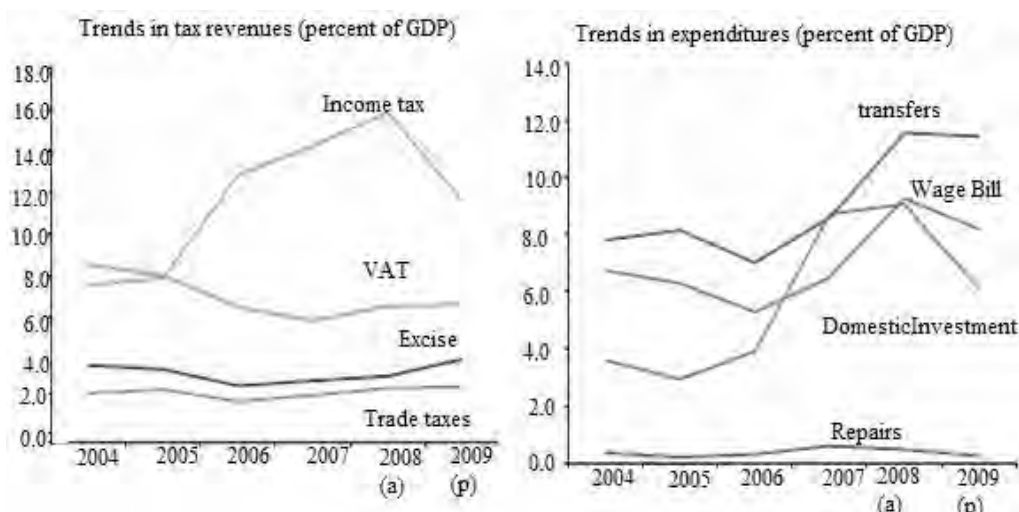


Figure 2.5: Trends in tax revenues and expenditures, 2004-2009.

Source: Ministry of Finance.

These increases in transfers and wages have increased the rigidity of the budget. The implication, therefore, is that the projected decline in revenue receipts for 2009 requires a concomitant reduction in capital expenditures. Domestic investment is projected to decline from 9.1 percent of GDP in 2008 (MNT520 billion) to 6.4 percent of GDP in 2009 (MNT452 billion). Maintenance and repairs continues to remain an area of neglect, expenditures dropping from an already low 0.6 percent of GDP in 2007 to a projected 0.3 percent in 2009. With the emphasis on capital investment, there is a need to increase the share of maintenance expenditures to between 7 and 10 percent of capital costs, as per international best practice.

The projected decline in income tax revenues in 2009 underscores the urgent need to adopt fiscal rules that smooth the fiscal stance over time and enable the government to maintain fiscal discipline. The government is exploring a variety of mechanisms to redefine the fiscal policy framework, such as adopting binding fiscal rules, and establishing a stabilizing and saving fund, to avoid these swings in capital expenditures.

2.5 Monetary and exchange rate policies

The Bank of Mongolia has two core purposes: (i) monetary stability, and (ii) financial stability. The two are connected, because in the financial system both would affect the implementation of monetary policy. The main objective of the monetary policy, as stated in the Monetary Policy Guidelines for 2008, is that inflation as measured by the CPI shall not exceed 6 percent annually. In 2008, inflation was estimated to be 27 percent, which was

the highest level in the past 10 years. This was 21 percentage points higher than the targeted rate.

This higher level of inflation was due to high domestic demand and strong foreign supply shocks. External factors affecting rising domestic prices were increases in the price of wheat, oil, vegetable oil, flour, and rice on the world market and increased inflation in the main trading partners. This demonstrates that our prices are heavily dependent on imports and their prices.

In addition, domestic demand factors affecting inflation were delays in domestic rail transport, increases in salaries, social security costs, government investments, lending, and an increase in the monetary supply in the past few years.

The Bank of Mongolia took the following monetary policy measures to reduce inflation:

- The short term interest rate on Central Bank Bills (CBBs) is increasingly recognized as a monetary policy operational target among central banks. Following this pattern, the Bank of Mongolia announced its 7-day bill rate as its policy rate in July 2007. By announcing changes in the policy rate, the Bank of Mongolia indicates its stance on monetary policy and aims to affect the inter-bank rate. In other words, the Bank of Mongolia expects the inter-bank rate to closely follow the average policy rate set by the central bank.
- The policy rate introduced by the Bank of Mongolia in July 2007 was higher than the weighted rate for 7-day CBBs auctioned previously. At the end of 2008, the Bank of Mongolia reduced its policy rate by 0.5 points to 9.75 percent. The Bank of Mongolia had been increasing its policy rate in light of increasing inflation during the previous 18 months.
- Inflation measured by the CPI increased to a level of 27.9 percent between October 2007 and October 2008, 23.2 percent since the beginning of the year, which represents a 1.1 point decline in the month of October.
- The general economic situation is changing and the prices of Mongolia's major export commodities are falling. Fiscal policy will develop in a manner such as to avoid an acceleration in inflation. Based on the National Statistical Committee, future inflation prospects are down.
- Since January 1, 2008 the reserve requirement ratio has been raised by 0.5 percentage points to reach a level of 5.5 percent due to inflation and bank credit growth. As a result, as of the first half of 2008, reserve requirement holdings of the commercial banks have increased from MNT7.8 billion to MNT8.5 billion.
- The Bank of Mongolia worked towards making the implementation of monetary policy more transparent and has improved information exchange between the Bank of Mongolia and the Ministry of Finance.
- The Bank of Mongolia introduced swap transaction between MNT and USD at the interbank market and banks selected their borrowers more carefully.

- Banks began to implement the liquidity risk management guidance which has been introduced by the Bank of Mongolia.

However, although monetary policy has been tightened, credit to the private sector continues to expand rapidly and interest rates remain negative in real terms (World Bank staff estimates, 2008).

Non-performing loans (NPL) increased by 16 percent year-on-year to October, but thanks to the fast growth in credit, the NPL ratio was slightly below 2.8 percent as of October 2008. Even so, it is important to be cautious, because the rapid growth of credit can often result in banks lending to less credit worthy borrowers. The growth of credit is relatively concentrated in a few banks (Golomt, 19.2%; Khan, 29.1%; Trade & Development, 17.0%).

As of the end of October 2008, the net foreign currency reserve was USD735.5 million. This covers 10.7 weeks or 2.7 months of imports (Figure 2.6).

High inflation poses the greatest risk to macroeconomic stability and could undo the poverty reduction gains of recent years. The projection of declining inflation in the second half of the year remains vulnerable to changes in international food and fuel prices. The

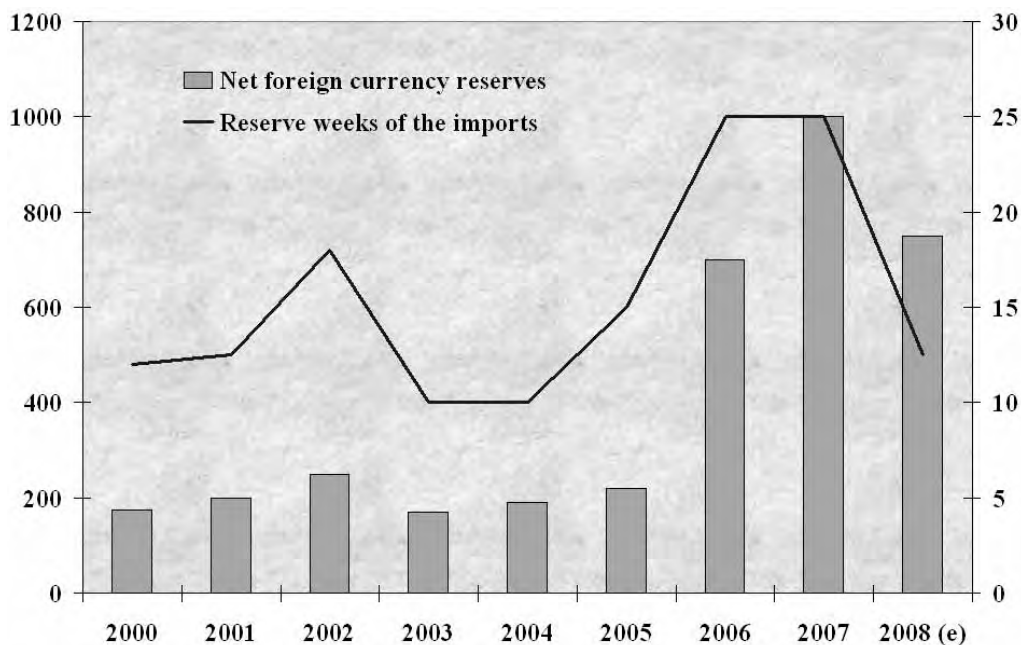


Figure 2.6: Net foreign currency reserves, million USD.

Source: The Bank of Mongolia, 2008.

incoming government could be tempted to implement election promises that would further ease fiscal policy, such as distributing the mineral wealth directly to the people. There is also a risk that persistently high inflation could entrench inflation expectations, making them difficult to reverse. High inflation is already creating pressures for higher wages and salaries, which could give rise to more generalized inflation. Moreover, high inflation hurts the poor disproportionately, particularly because they spend a much higher percentage of their consumption on food.¹⁰

There are no trends for improvement in the Mongolian financial and economic situation for the mid-term. Starting from 2012, however, if the Oyo Tolgoi and Tavan Tolgoi mines are operational, a radical improvement in the financial and economic situation is possible.

The Government was not able to carry out correct management of the extensive money gained from the mineral price climb.

What should be done now?

There is no country which has been able to address its development problems by budget money. Therefore, in order to boost the economy, funds should be raised from the world market and used for financing major projects.

In order to resolve the global financial crisis, the USA, Europe, and leading Asian countries have begun to inject money into the financial markets. It is wrong for our country to reduce the money supply in order to reduce inflation. The high inflation rate was caused by incorrect fiscal policy and discrepancies in the exchange rates. Therefore, monetary policy should be used to provide more money to the economy. This is a proper option for ensuring financial and economic development stability.

¹⁰ In 2006, the bottom quintile of the population, based on consumption groups, spent 80 percent of total consumption spending on food.

3. Mongolia's Economic Development Strategy

3.1 Mongolia's future economic goals

The Mongolian government is persistently undertaking policy measures to ensure the social security of citizens, to promote human development through increased investments into the social sector, and to address poverty through improved energy supply and infrastructure development in rural areas. However, the increase in the wages of civil servants, the wide-scale social assistance programs, the extensive investments with limited cost-benefit analysis into infrastructure and social sectors not only have deteriorated prices and tariffs, and reduced effectiveness of the private sector combined with the direct and indirect effect of the global economic and financial crisis that has increased living costs, but have also begun to influence the overall macroeconomic situation.

In this context the country faces the unavoidable need to identify the long-term development priorities and the Mongolian President has initiated the formulation of the Millennium Development Goals (MDG), based on the comprehensive national development strategy (NDS). The MDG-based NDS shall be implemented through three development phases: A preliminary phase in 2008-2011; a rapid economic development phase in 2007-2015; and transition to a knowledge-based economy in 2016-2021.

Rapid economic growth leads to changing requirements in the workforce that limit the supply of jobs to the market. Therefore, the success factor is to train a workforce with convertible skills and qualifications, and supply the labor market in the context of increased economic competitiveness and the open market economy.

The knowledge-based economy development strategy shall be implemented within the framework of the following six priority areas:

- Achieve the MDG and provide an all-round development of the Mongolian people;
- Exploit mineral deposits of strategic importance, generate and accumulate savings, ensure intensive and high economic growth, and develop a modern processing industry;
- Intensively develop export-oriented, private-sector-led, high technology-driven manufacturing and services, to create a sustainable, knowledge-based economy;
- Ensure intensive development of the country's regions, their infrastructure, reduce urban-rural development disparities;
- Create a sustainable environment for development through halting imbalances in the country's ecosystems and protecting them; and
- Consolidate further political democracy, foster a transparent, accountable, just system free from corruption.

The main economic goals set out in this research include the following:

- To intensify economic growth in all sectors including manufacturing;

- To improve the quality and efficiency of government management;
- To improve the living conditions of the people. To decrease the number of people living in poor conditions, to raise the quality of living to the same level as the people of the countries with an average livelihood; and
- To increase the income level.

To achieve the goals, Mongolia needs to achieve the following conditions:

- Development of the mineral resource sector;
- Industrialization and economic diversity;
- Intensification of farming and animal husbandry;
- Full supply satisfaction of domestic food needs; and
- Establishment of transparency, efficiency and responsibilities of the state administration.

In our country we have good development potentials and conditions, including:

- Huge mineral resources (Oyo Tolgoi; copper reserves estimated at over 30 billion tons, gold reserves estimated at over 1000 tons. Tavan Tolgoi; coal reserves estimated at 6.5 trillion tons);
- A large proportion of young people in the population (young people make up 70% of the population);
- International interest in investment in Mongolia (Russian Energy Resources, Sumitomo, Itochu and Mitsubishi of Japan, and many others);
- Low tax burden (a new tax law was implemented in 2007, according to which, the main tax rate has become 10%);
- Rising domestic investment financed by domestic investors/banks;
- Rising domestic investment financed by foreign investors/banks;
- Promoting international trade as an engine of development; and
- Increasing foreign ODA for development.

Domestic savings have a critical role to play in financing development in Mongolia. They are needed to provide resources for investment and boost the financial market, and stimulate economic growth.

So the key question on the minds of Mongolian policymakers is the extent to which the laudable objectives have been achieved in the following core areas, namely; mobilizing domestic financial resources for development, mobilizing international resources for development, promoting international trade as an engine of development, increasing international financial and technical cooperation for development, ending external debt relief, and sustainability.

How can the stated economic goals best be achieved?

I think there are five ways for Mongolia to expand its comparative advantage, including the following:

- Investing in human capital. The population itself is the greatest wealth of the country. Investment in human capital needs to be carried out in health and education, in higher education, in language skills, IT, and technical and communication skills;
- Building infrastructure (telecommunications, roads connecting industrial zones, water supply, and electricity) is the first important way to develop the mining and manufacturing sectors, since the mining and manufacturing sectors are strongly needed at present to intensify economic growth;
- Investing in technology. Technological upgrading is very important. For example, Finland diversified from raw-material-based industries to machinery, engineering products, transport equipment and services. Japan developed human capital and technology that helped them attain a high level of economic development.
- Liberalizing trade policy. What is the liberalizing trade policy? Let us imagine there is a country A. A US company wanted to invest in country A, but the company needed permission, which was very difficult to obtain. However, it later became easier to obtain the permission. This is a question of liberalizing trade policy. This type of policy is very important for investment in good technology and good infrastructure in Mongolia. To liberalize trade, the following policies are suggested by Mongolia: Relaxing the investment license policy, which is very much needed for Mongolia; giving tax privileges to foreign and national companies; and attracting FDI; and
- Encouraging diversification by active policy. Diversification has to be encouraged by a number of active policies, as follows. The manufacturing sector is very important for the development of the economy; government investment is therefore needed in the manufacturing sector and the government needs to invite FDI; protecting the natural environment (attract special interest tourism through the natural beauty of the country, establish national parks to protect nature).

3.2 Mobilizing domestic financial resources for development

Domestic savings have a critical role to play in financing development in Mongolia. They are needed to provide resources for investment and boost financial market development, and stimulate economic growth. Yet, Mongolia has difficulties mobilizing adequate domestic resources to meet its investment needs. Consequently, the country continues to have significant financing gaps that have to be closed to provide resources for public and private investments to meet the MDGs. While external assistance has played an important role in narrowing the financing gaps, it is not a sustainable solution to the development finance problems. More efforts are needed to boost domestic savings and use them as a critical and stable source of financing for development. More remarkable progress has been made in recent years. For example, in 2004-2007, the savings ratio increased on

average 38.9 percent (The Bank of Mongolia). The state is an important source of domestic savings because of its capacity to mobilize resources through taxation. An increase in public sector savings increases the ability of the government to provide and maintain such public services as education, health, infrastructure, and other social amenities that are vital for the realization of long-term development objectives.

Historically, private savings also play a critical role in Mongolia. However, the long-term trend of private savings has not been encouraging. Low levels of per capita income, high dependency ratios, and a high degree of dependence on foreign aid have so far led to lower rates of private savings. In addition, existing financial institutions are thinly spread and inefficient in mobilizing domestic resources. Capital markets can play an important role in the mobilization of domestic resources.

Presently, the financial sector in Mongolia is still dominated by commercial banks, which focus on short-term lending. This needs to change, as commercial banks do not cater to the long-term needs of both individual and institutional investors.

Therefore, to the extent that capital markets offer different kinds of financial services than the banking system, they provide an extra impetus to economic activity.

By protecting investors, ensuring fair, efficient and transparent markets and reducing systemic risk, efficient capital market regulation increases operators' confidence and attracts investors. The development and expansion of capital markets in Mongolia is constrained by factors such as limited market size and capacity, lack of trained human capital, market fragmentation and shortage of equity capital, information inefficiency, inefficient regulatory regimes and lack of investor confidence in stock exchanges.

Micro-finance institutions also have a role to play in the mobilization of domestic resources. The emergence of micro-finance institutions in Mongolia in recent years has created opportunities for smallholder farmers in rural areas and small business and households in urban areas to access credit for business development and employment generation.

While it is generally accepted that Mongolia needs to increase its savings ratio in order to enhance prospects for meeting the MDGs, it is important to stress that the availability of savings does not guarantee translation into productive investment. The government has to create an investment environment conducive for the private sector to have incentives to access existing domestic savings for investment. Therefore, the Mongolian government needs to make more efforts to improve the investment environment. In this regard, the recent establishment of the Investment Climate Facility to assist in building a business-friendly environment is welcome.

3.3 Mobilizing international resources for development

International financial resources, particularly FDI, are important complements to domestic resources and have the potential to facilitate economic development. They enhance transfer of new knowledge and technology, contribute to employment creation, improve competitiveness, and boost exports.

Since 2000, Mongolia has made progress in attracting FDI inflows (Figure 3.1).

Despite the recent improvement in the flow of FDI, its share in GDP remains small. In 2007 it was about 10 percent of GDP.

Therefore, one of the challenges facing Mongolia is how to increase its attractiveness to foreign investors in order to increase the country's share of global FDI inflows.

Globalization of the world economy has increased the competition for FDI, and countries such as China and India have become major players in this market. Consequently, Mongolia will have to make concerted efforts to be able to withstand competition for FDI in the global market. This requires measures to improve the state of infrastructure, reduce political risk, enhance macroeconomic stability, diversify the export base, and use regional integration as an effective vehicle for promoting trade and investment.

Mongolia should also pay more attention to boosting intra-Mongolian FDI flows and creating an incentive for firms and individuals to invest their wealth in the country rather than engage in capital flight. So far, Mongolia is the region that has most exploited the intra-

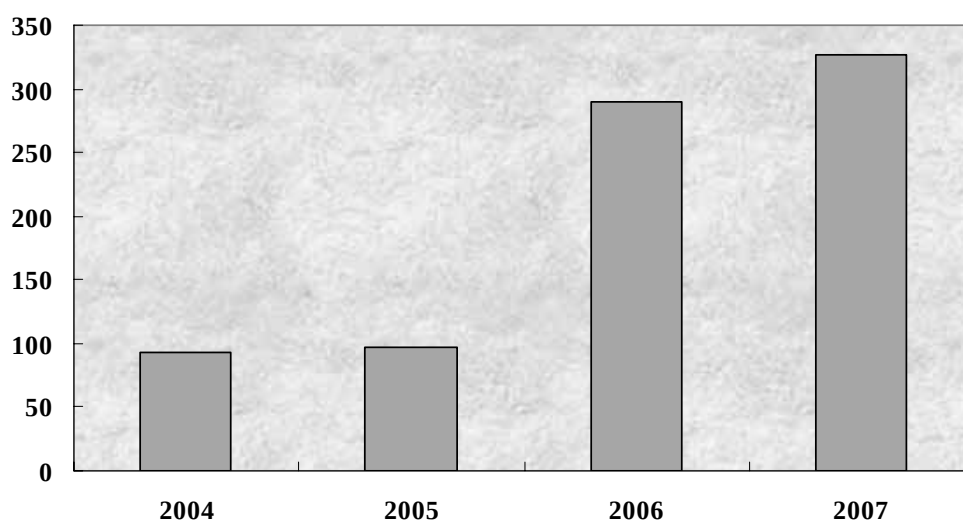


Figure 3.1: FDI, 2004-2007 (million dollars)

Source: Ministry of Finance.

Mongolian FDI flows. We have vast natural resources and initiatives such as that on managing natural resources can help in increasing both external resource inflows, growth, and poverty reduction gains.

The objectives were to engage in frank discussion on effective management of Mongolia's natural resources for growth and poverty reduction and to frame an agenda for future action.

The issues discussed included natural resources governance; ownership, participation and inter-generational equity; bargaining power, value and the role of emerging global actors; environmental stewardship; and capacity, partnerships and regional integration.

Despite the broad spectrum of views, there was consensus that Mongolia's natural resources are important assets for the country and for the world and should be properly managed. It was agreed that for this to happen:

- Mongolia must own its development process;
- Governance systems and institutional capacity (including for contract negotiations) must be strengthened;
- Local content must be developed; and
- Natural resources wealth must be invested efficiently in the creation of knowledge for economic innovation, and into social and physical capital, including infrastructure development.

While Mongolia needs sustained FDI flows, it is important to stress that the country should be cautious and selective in the type of investments it seeks to attract. Mongolia should encourage FDI in sectors that have linkages to the rest of the economy and ensure that it leads to the transfer of knowledge and local capacity building. Mongolia should also give preference to sectors that have high value added and significant potential for employment creation. The environmental impact of FDI flows should also be taken more seriously into consideration by the Mongolian government.

3.4 Promoting international trade as an engine of development

International trade is an important engine for growth and will play a major role in any meaningful effort aimed at accelerating the pace of development in Mongolia. By providing access to foreign exchange, expanding markets, increasing FDI, facilitating the transfer of technology, and boosting domestic productivity, employment can be created and domestic incomes increased.

Mongolian external trade volume is increasing and as of today our country is maintaining trade relations with 100 countries of the world. Growth in real exports from Mongolia has increased at an average rate of 30.4 percent in the last 5 years (Figure 3.2).

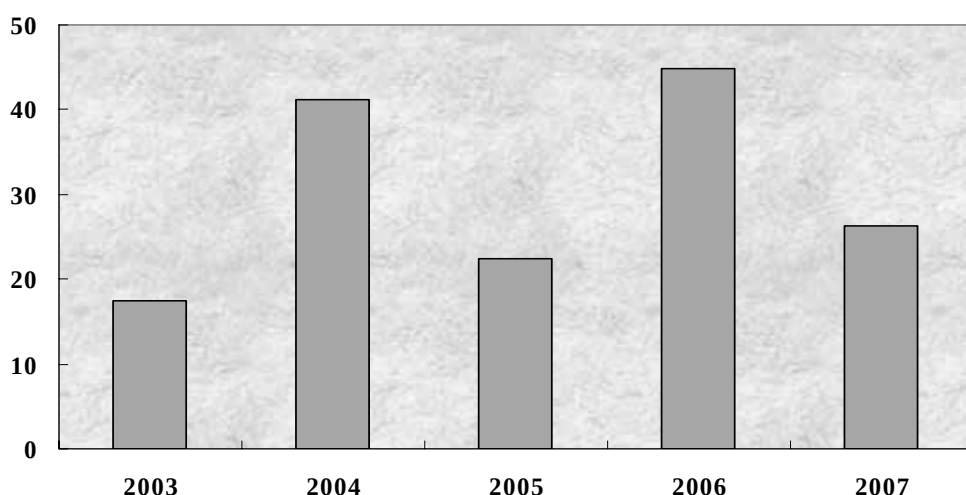


Figure 3.2: Growth of real exports in Mongolia, 2003-2007

Source: Ministry of Finance.

Despite the recent increase in the growth of exports from Mongolia, its share in global trade is still relatively small and it is increasingly facing more competition in global markets for its exports, which is likely to increase its marginalization in the global economy.

Mongolia must move into the export of new and final dynamic products in world trade if it is to increase the country's share in global exports. Diversification of the production and export structure is necessary to reach this objective. It is also a good way to protect the country from vulnerability to external shocks resulting from terms of trade instability.

The need to diversify and improve productive capacities has been acknowledged by Mongolia and the country is making conscious efforts to achieve these objectives. Clearly, to stimulate productive capacities, Mongolia needs to maintain stable macroeconomic conditions, create a legal and regulatory environment conducive to export promotion, support the private sector, promote the adoption of information and communication technologies, and develop adequate institutional, physical and social infrastructure. However, diversification is not a costless activity. It requires human and financial resources that are severely limited in the Mongolian economy.

Therefore development partners have an important role to play in assisting the country and the region to achieve its diversification objectives. There are at least three ways in which Mongolia's development partners could play a role in this area.

First, there is the urgent need for more meaningful market access opportunities for the region. Developed countries should offer duty and quota free market access for

Mongolian exports into their markets. This will create an incentive for the Mongolian economy to diversify its export structure in order to take advantage of improved market access and fast-track its integration into the multilateral trading system.

Second, developed countries can contribute to Mongolia's diversification efforts by increasing financial support for the development of infrastructure, which is a major constraint to rapid export market promotion. In this regard, there is the need for development partners to provide more support for regional infrastructure development projects to reduce transport costs and make Mongolia more competitive in the trading system.

Finally, there is the need for more technical assistance and capacity-building support in the area of trade and export development. Such support will help to bridge the gap between resource needs and resource availability and also put Mongolia in a better position to compete on the international market. Donor support can promote trade and export market development in Mongolia. However, the impact of such support will be maximized if the Mongolian economy makes more efforts to mainstream trade effectively into the Mongolian national development strategy.

3.5 Increasing foreign ODA for development

Success and progress in foreign ODA to a large extent determine whether or not Mongolia will be able to meet the MDGs by the 2021 deadline. Foreign ODA support is also one of the main factors influencing the growth of the Mongolian economy (Figure 3.3).

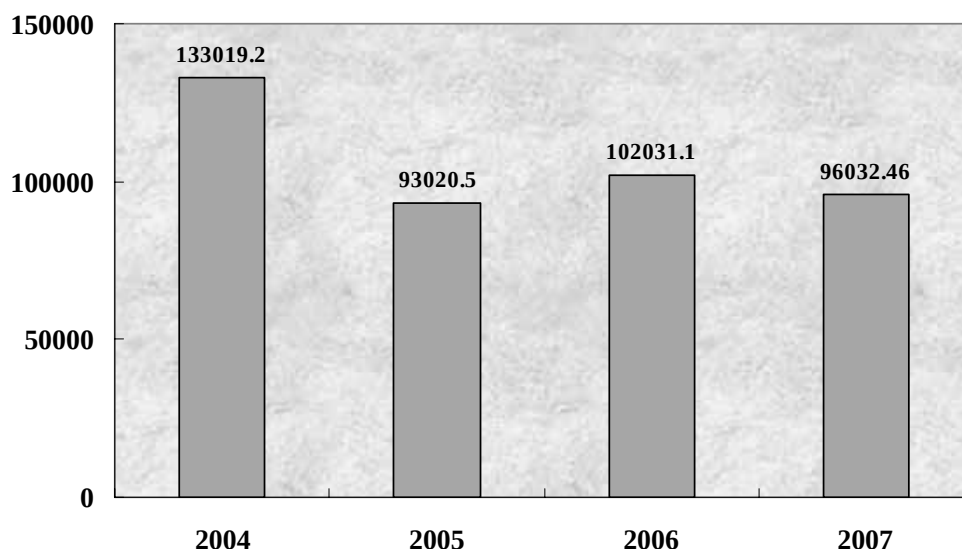


Figure 3.3: Exploitation of foreign ODA, 2004-2007 (million MNT)

Source: Ministry of Finance.

The Mongolian development strategy recognizes the role of ODA as a complement to other sources of financing in the Mongolian economy. It also stresses the fact that a substantial increase in ODA will be needed by developing countries if they are to achieve the internationally agreed development goals, including the MDGs. Regarding the internationally agreed ODA target of 0.7 percent of Gross National Income (GNI), developed countries are yet to make any significant progress in this regard.

A key concern for Mongolia is that most of the recent increases in aid are due to debt relief and humanitarian assistance and so do not reflect additional resources available to finance the development program. A key concern also called for development partners to make aid more effective. Clearly, the quality of aid affects its effectiveness and ability to make a positive contribution to development in recipient Mongolia. The 2005 Paris Declaration on Aid Effectiveness was the first comprehensive attempt made by developing and developed countries to take concrete steps to enhance aid effectiveness. It provides a framework for improvement of the quality of aid, anchored on five pillars: ownership; alignment; harmonization; managing for results; and mutual accountability.

Some attempts have been made to monitor progress in improving aid effectiveness, as emphasized in the key concern of Mongolia, and made more concrete in the Paris Declaration. The OECD survey conducted in 2006 led to the following conclusions:

- The Paris Declaration has increased awareness and promoted dialogue at the country level on the need to improve the delivery and management of aid;
- The pace of progress in changing donor attitudes and practices on aid management has been extremely slow and the transaction costs of delivering and managing aid are still very high;
- There is need to strengthen national development strategies, improve the alignment of donor support to domestic priorities, increase the credibility of the budget as a tool for governing and allocating resources, and increase the degree of accuracy in budget estimates of aid flows;
- Changing the way in which aid is delivered and managed involves new costs and this should be taken into account by donors and partners; and
- More credible monitoring systems need to be developed to ensure mutual accountability.

With respect to ownership, the studies show that Mongolia has taken actions to strengthen leadership and ownership of Mongolian development policies.

In the area of alignment, the studies show that some progress has been made in aligning donor support to the partner country's national development framework.

On managing for results, the studies show that capacity constraints, both human and financial, continue to hamper efforts at managing for results.

With respect to mutual accountability, the studies reveal that although Mongolia has made substantial progress in strengthening accountability to donor countries, limited progress has been made in strengthening accountability to domestic constituencies, including parliament, the private sector and civil society.

With respect to harmonization, the study's donors show a strong degree of willingness to pursue harmonization, including joint missions, joint analytical work, and joint donor-government assessment of technical capacity building.

4. Conclusions

In the 21st century, Mongolia is selecting an economic development strategy that could promote export-oriented industries and services. The Mongolian President N. Enkhbayar initiated implementation of this strategy and the main document to be followed is the “Policy on Comprehensive National Development based on the Millennium Development Goals of Mongolia” approved by Parliament in January 2008. The Mongolian President proposed three goals concerning the number 15: To increase annual economic growth by 15 percent and reach a GDP of USD10,000-15,000 per capita within 15 years.

However, I recommend an economic goal of reaching a GDP of USD10,000-12,000 per capita by 2021. Goals should be ambitious. As I have mentioned above, pursuing a higher goal with little chance of realization is better than pursuing a lower goal which is fully achievable.

Summary of the Main Future Targets

First Period (2008-2011) Preliminary Phase

State intervention in the economy, tax and fee burdens will be reduced, and measures to balance the state budget will be implemented in phases. A fulltime council will operate in the tax authority to protect taxpayers’ interests. Attention will be paid to create new forms of taxation on ecologically and environmentally harmful activities and consumption, and increase tax amounts in order to maintain ecological balance. Opportunities to increase reserve tax amounts will be studied and applied. Percentage in the GDP of salaries, pensions and allowance expenses of budget workers will be kept stable.

Efficiency of budget expenditures will be improved by clarifying performance indicators of budget organizations. Current budget balances will be maintained stably at about 10 percent of GDP and such amounts of state investment will be financed.

Foreign soft loans and the same amount of aid equal to 4 percent of GDP will be received and used. The state investment, loan and aid structure will be defined properly, improving management and organization and targeting priority sectors. A stabilization fund will be established and used on the grounds specified in the law.

Investment made in the priority sectors will be exempted from tax.

Monetary policy will aim at gradual reduction of interest rates.

Small and medium enterprises (SMEs) will be supported through increasing available cheap financial means for SMEs by increasing international loans and aid aimed at reducing unemployment and poverty.

The percentage of money outside banks will be decreased within the total money supply.

Inflation will be kept within 5-6 percent. A banking system that renders services genuinely focused on customers will be established.

The state will intervene to expand new forms of mediation activities by non-bank financial institutions and create a favorable environment for them.

Social insurance amounts will be properly defined.

Legal grounds for stock markets will be reformed in coordination with other financial legislations.

The following economic indicators are worked out in this research for the **period 2008-2011** on the basis of the above conditions:

- Average real growth of the economy: 13%
- Inflation percentage: 6%
- Nominal GDP in 2011: MNT5,404.0 billion
- Per capita GDP in 2011: USD3,200
- Budget revenue as percentage of GDP in 2011: 30%
- Government expenditures as percentage of GDP in 2011: 35%
- Official foreign currency reserves by total import months in 2011: 3 months

Second Period (2012-2016). Rapid Growth and Development Phase

State involvement in the economy, tax and levy burdens will be reduced, budget balance will be ensured through measures implemented in phases. The current budget balance will be maintained at about 11 percent of GDP and an equal amount of state investment will be made. Investment will be made in priority sectors.

Support will be given to attract investment in strategically important projects. Some types of taxes will be reduced in order to promote growth in industry and service sectors. Inflation will be reduced to 4 percent. Conditions will be created to cause real cuts in loan interest rates. The percentage of money outside banks will be maintained stably within the total money supply.

Foreign currency official net reserves will be increased and support will be given to reserve products with high price fluctuation. Amount of reserves to be kept by banks and their registered capital will be increased along with banks' self-controlling capacity.

Social insurance scope will expand, increasing insurance funds and independence.

The legal environment will be created for investment of citizens' savings and insurance fund capital into the stock market. On the basis of the above conditions, the following indicators are worked out for the **period 2012-2016**:

- Average real growth of the economy: 14%
- Inflation percentage: 4%
- Nominal GDP in 2016: MNT10,403.0 billion
- Per capita GDP in 2016: USD6,300
- Budget revenue as percentage of GDP in 2016: 28%
- Government expenditures as percentage of GDP in 2016: 33%
- Official foreign currency reserves by total import months in 2016: 4.5 months

Third Period (2017-2021).Stabilization and Sustainable Growth Phase

Consumption will be promoted by increasing salaries, expenses for goods and services, pension and allowance growth.

Loans and aid ratio will be reduced. Social welfare services will be replaced with multi-participant support systems based on social and community associations.

Investment will be made in priority sectors such as commercial projects.

VAT, official income tax on persons will be reduced to a certain extent in order to increase consumption growth.

Inflation will be kept at a low level to increase opportunities for banks to maintain low interest rates on loans.

Activities of international financial institutions will be introduced to Mongolia. Conditions will be created to render international financial services from Mongolia.

Social insurance funds will be transformed into a savings system.

Policies will be pursued to develop the potential of commercial banks and insurance institutions to become investors in the stock market. On the basis of the above conditions, the following indicators are worked out for the **period 2017-2021**:

- Average real growth of the economy: 13%
- Inflation percentage: 3.5%
- Nominal GDP in 2021: MNT19,040.0 billion
- Per capita GDP in 2021: USD11,000
- Budget revenue as percentage of GDP in 2021: 25%
- Government expenditures as percentage of GDP in 2021: 30%
- Official foreign currency reserves by total import months in 2021: 6 months

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This paper is the result of his five-month stay at the Institute of Developing Economies, Tokyo, Japan, from September 29, 2008 to February 27, 2009, as a Visiting Research Fellow.

List of Major Works

- 1) Monetary policy and its implementation, Finance and Economy Magazine, Ulaanbaatar, 2006
- 2) Budget policy and coordination, Finance-loan Magazine, Ulaanbaatar, 2006
- 3) Tax policy, Leader accountants, National meeting, Ulaanbaatar, 2007
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