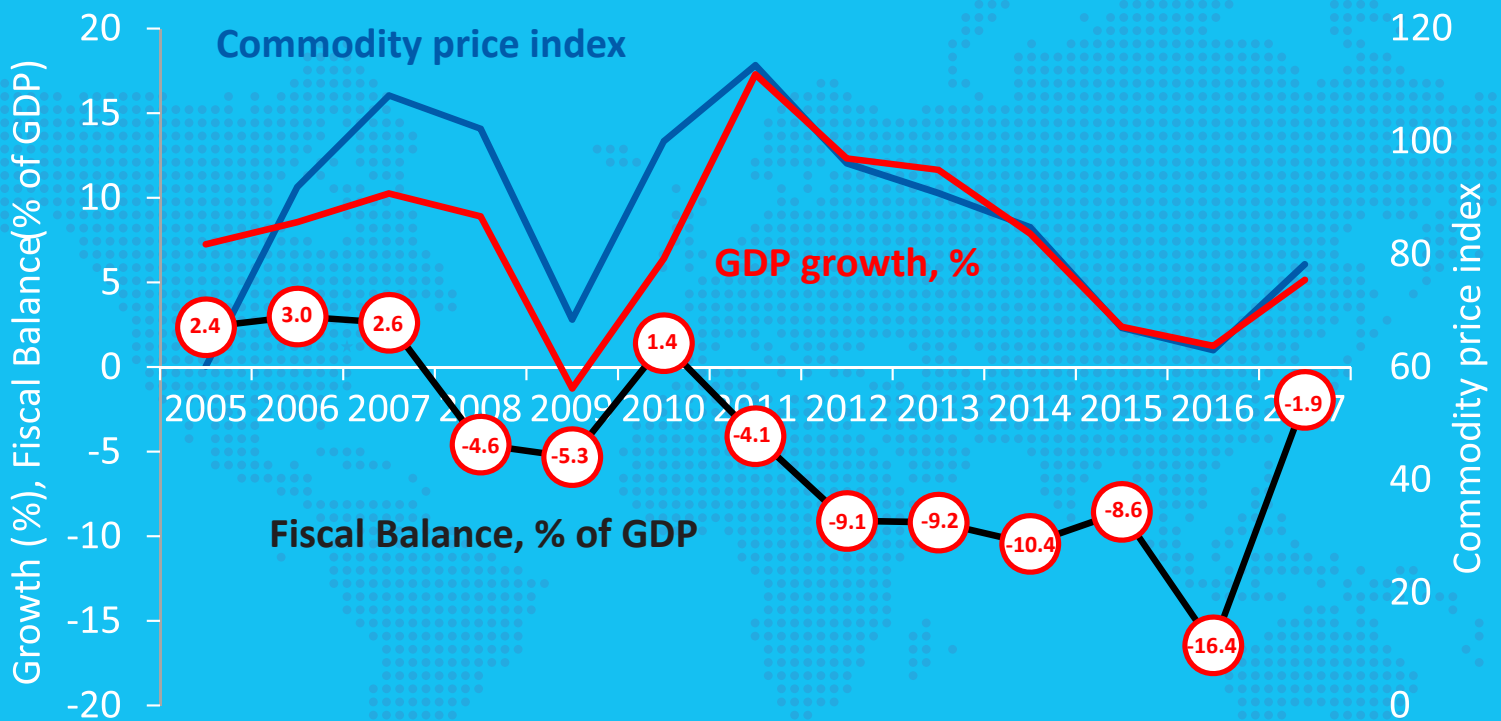


# MONGOLIA ECONOMIC UPDATE

## Fiscal Space for Growth The Role of Public Investment Spending Efficiency



Executive summary



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# **MONGOLIA ECONOMIC UPDATE**

## **Fiscal Space for Growth The Role of Public Investment Spending Efficiency**

July 2018

## **ACKNOWLEDGEMENTS**

This report was prepared by a core team led by Jean-Pascal Nganou (Senior Economist, TTL) and comprised of Davaadalai Batsuuri (Economist, MTI), Sulaiman Nyanzi (Consultant), and Altantsetseg Shiilegmaa (Economist, MTI). The team is grateful for comments and guidance received from Bert Hofman (Country Director), Deepak K. Mishra (Practice Manager, MTI), and James Anderson (Country Manager, EAPMF).

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## EXECUTIVE SUMMARY

### **This Report and this Summary:**

- (i) Review the recent economic and fiscal performance of Mongolia;
- (ii) Outline current medium-term prospects of Mongolia's economy;
- (iii) Discuss short-term risks and structural vulnerabilities; and
- (iv) Comment on the efficiency of past public investment programs and practices.

## I. A STRONG ECONOMIC RECOVERY IN 2017 AND 2018

**2017 was a good year for Mongolia. A strong economic recovery, accompanied by moderate inflationary pressures, led to lower fiscal and Balance of Payment (BoP) deficits and triggered a slight decline of the country's public debt.** Mongolia's economic performance is likely to further improve in 2018 and current prospects for the next couple of years assume continued or accelerated growth, and continued improvements in the country's public finance and balance of payments position, provided the government continues to implement its ongoing adjustment program with the support of its development partners.

**Mongolia's economic performance improved dramatically in 2017 and at the beginning of 2018** with the GDP growth rate increasing from 1.2 percent in 2016 to 5.1 percent in 2017 and 6.1 percent during the first quarter of 2018. Strong growth was accomplished without excessive inflationary pressures. Indeed, the consumer price index (CPI) increased from 1.3 percent in 2016 to 6.4 percent in 2017 (6.1 percent in May 2018), but remained below the central bank target of 8 percent.

**The economic recovery was not due – at least initially – to strong growth in the mining sector.** Despite a rebound of coal production, the mining sector contracted in 2017 because of the decline of the more important copper sub-sector still affected by unfavorable global commodity prices and geologically lower gold content in Oyu Tolgoi (OT)'s production. In 2018, copper production and exports increased significantly and, despite the mediocre performance of coal, there was a general rebound of the mining sector. In essence, the main factor behind the strong economic growth of the past eighteen months was large inflows of foreign direct investments, attracted by promising mega-projects in the mining sector in an increasingly positive external environment.

**The country's good economic performance had a positive impact on public finances.** The primary fiscal deficit, which had reached 12.5 percent of GDP in 2016, turned into a small surplus (2.1 percent of GDP) in 2017. The overall fiscal deficit including all DBM spending declined from 16.4 percent of GDP in 2016 to a low 1.9 percent in 2017. Improvements in the fiscal performance were due to a dramatic increase in government revenue and effective control of public spending, both recurrent and capital expenditures.

**On the revenue side, a gain of close to 5 percent of GDP was achieved,** as government revenue increased from 24.4 percent of GDP in 2016 to 29.2 percent in 2017. This was not the result of significant tax policy adjustments, as most of the tax changes adopted by the Parliament in 2017, would not be effective until 2018, when some of these measures were reversed. Consequently, the growth of revenue was entirely due to the economic recovery and substantial increases in mining-related revenue.

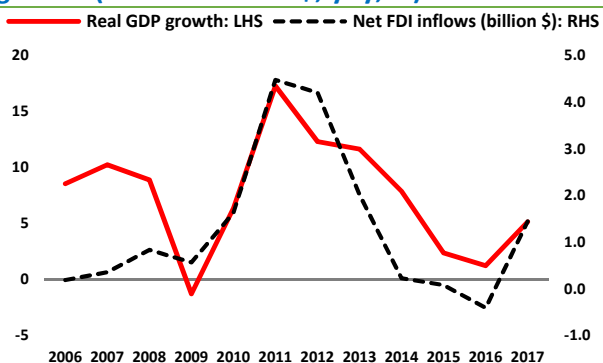
**On the public spending side, the gain was more than 9 percent of GDP** (from 40.5 percent of GDP to 31 percent in 2017). The reduction of recurrent expenditures was equivalent to less than 2 points of GDP (from 27.7 percent of GDP in 2016 to 25.8 percent in 2017). More radical were the cuts in capital expenditures (from 10.9 percent of GDP in 2016 to 4.3 percent in 2017), a welcome development since public capital spending in Mongolia, compared with similar countries, was extremely high and poorly managed and was largely responsible for large fiscal deficits, which increased from 4.1 percent of GDP in 2011 to 16.4 percent in 2016.

**Improvements in Mongolia’s economic performance also had a positive impact on external accounts.** Exports increased by 26.1 percent in 2017 (mainly coal) and by 14.6 percent during the first five months of 2018 (mainly copper). Imports increased by 29.1 percent in 2017, due to a combination of imports of capital goods (linked with FDI-financed investments) and consumer goods (linked with the general economic recovery). Despite the strong rebound of imports, the trade balance slightly improved, but the deficit of the income balance increased due notably to large and growing payments on the public debt and the repatriation of profits by mining investors.

**Nevertheless, the balance of payments improved and a US\$1.4 billion surplus in 2017 replaced a US\$18.2 million deficit of 2016.** Improvement in the BoP was mainly due to massive inflows of FDI, strong donor support and the successful refinancing (on better terms) of government guaranteed bonds maturing in 2017 and 2018.

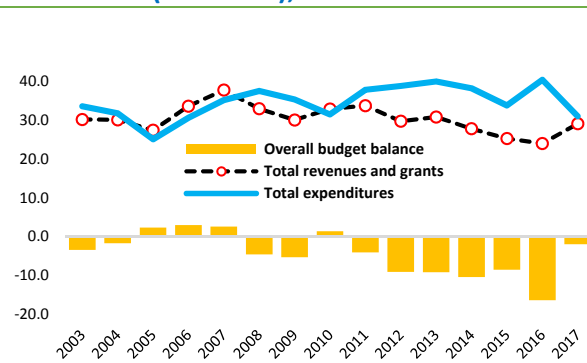
**Improvements in the balance of payments ended a long period of depreciation of the Tugrik.** A slight appreciation of the Mongolian currency was observed in 2017. This led to a moderate appreciation of the real effective exchange rate which had no significant impact on the country’s competitiveness.

**Figure (ES) 1. Net FDI inflows versus Real GDP growth (in billions of US\$, yoy, %)**



Sources: NSO; World Bank staff estimates.

**Figure (ES) 2. Budget revenue, expenditures and deficit (% of GDP), 2003–17**



## II. A POSITIVE OUTLOOK

**By and large, the country's short- and medium-term prospects remain positive.** The recovery should continue, perhaps accelerate (a GDP growth rate of over 6 percent in 2019-20). As in 2017-18, economic growth should be driven by large FDI-financed investments in mining. However, almost all the sectors would benefit, notably industry (including mining) and trade, transport and other services.

Agriculture (mainly livestock) – which was severely affected by harsh weather conditions during the winter – should grow more slowly. Inflation will likely rise although modestly – putting at risk the BOM medium term target of 8 percent as food and petrol prices are expected to continue to increase. Private consumption is also projected to further improve over the medium term. Accordingly, BOM is likely to gradually tighten monetary policy to contain inflation. Poverty should decline, at least in urban areas. As the poverty rate is higher in rural areas, a better performance of agriculture and a more significant decrease of rural poverty are essential to support the fight against poverty.

**Economic growth, higher exports and higher commodity prices should continue to have a strong positive impact on government revenue.** Fiscal deficits should therefore continue to decline, provided the government implements effectively most of the measures included in its Economic Reform Program, which form part of the adjustment programs supported by the country's development partners, including the IMF and the World Bank. The debt-to-GDP ratio should therefore continue to decline.

**Despite higher investment-related imports, economic growth supported by stronger exports and higher commodity prices, should also have a strong positive impact on the external sector.** Despite large public debt payments and repatriation of profits, the balance of payments should continue to improve, owing to large FDI inflows and donor assistance.

The following Table summarizes current economic projections for 2019-20, as envisaged in ongoing Bank-IMF supported adjustment programs.



**Table (ES) 1. Key Economic Indicators (2014-20)**

	2014	2015	2016	2017e	2018f	2019f	2020f
<b>Real GDP growth, at constant market prices</b>	<b>8.1</b>	<b>2.5</b>	<b>1.5</b>	<b>5.1</b>	<b>5.5</b>	<b>6.6</b>	<b>6.2</b>
Private Consumption	6.3	7.2	-8.2	4.3	5.1	6.3	6.7
Government Consumption	12.2	-4.7	11.0	-3.2	-1.8	0.5	4.2
Gross Fixed Capital Formation	-21.7	-34.4	7.8	32.8	11.8	34.7	9.4
Exports, Goods and Services	53.2	1.2	12.6	13.4	7.9	3.9	2.2
Imports, Goods and Services	6.8	-11.5	12.4	25.0	8.4	12.3	4.0
<b>Real GDP growth, at constant factor prices</b>	<b>7.9</b>	<b>2.4</b>	<b>1.2</b>	<b>5.1</b>	<b>5.5</b>	<b>6.6</b>	<b>6.2</b>
Agriculture	13.7	10.7	6.2	2.3	3.5	3.6	3.8
Industry (incl mining)	12.7	9.9	-0.6	-1.4	5.5	7.3	7.7
Services	7.8	0.6	1.5	8.8	6.1	7.1	5.8
<b>Inflation (Private Consumption deflator)</b>	<b>11.0</b>	<b>1.1</b>	<b>0.9</b>	<b>6.4</b>	<b>8.1</b>	<b>8.2</b>	<b>7.1</b>
<b>Current account balance (% of GDP)</b>	<b>-11.5</b>	<b>-4.8</b>	<b>-6.3</b>	<b>-10.5</b>	<b>-8.2</b>	<b>-8.1</b>	<b>-6.9</b>
<b>Financial and Capital account (% of GDP)</b>	<b>8.7</b>	<b>3.6</b>	<b>7.9</b>	<b>31.3</b>	<b>9.5</b>	<b>16.6</b>	<b>10.5</b>
Net Foreign Direct Investment (% of GDP)*	2.3	1.6	1.1	13.1	13.2	15.2	12.6
<b>Fiscal Balance (% of GDP)**</b>	<b>-10.4</b>	<b>-8.6</b>	<b>-16.4</b>	<b>-1.9</b>	<b>-4.7</b>	<b>-4.6</b>	<b>-2.8</b>
<b>Primary Balance (% of GDP)</b>	<b>-8.5</b>	<b>-5.4</b>	<b>-12.5</b>	<b>2.1</b>	<b>-1.0</b>	<b>-1.5</b>	<b>-0.1</b>
<b>Debt (% of GDP)***</b>	<b>57.9</b>	<b>60.1</b>	<b>87.2</b>	<b>84.4</b>	<b>79.3</b>	<b>76.3</b>	<b>72.4</b>
Memo items:							
Nominal GDP (millions US\$)	12196	11728	11056	11021	12560	14219	15800
Nominal GDP (billions MNT)	22227	23150	23936	27161	30978	35295	40073

\* In 2016, Net FDI number excluded the transactions of OT-2 project financing in May-June, 2016.

\*\*On-budget plus DBM spending

\*\*\*General government debt data excludes SOE's debt and central bank's liability from PBOC swap line.

### III. SHORT-TERM RISKS AND STRUCTURAL VULNERABILITIES

**The list of possible short- and medium-term risks is long. It includes political risks, regional instability, climate shocks, natural disasters, and sudden changes in the overall external environment and global commodity prices.** However, the most critical risk is a sudden relaxation of the government's commitment to full implementation of its adjustment program. This is what happened in 2010, when, encouraged by booming exports, high commodity prices, and growing government revenue, the government stopped implementing its own program and increased public spending, planting the seeds for the next public finance crisis.

**This, however, is not the most probable scenario.** It is true that some measures aimed at increasing revenue (a progressive personal income tax) and reducing the cost of the pension system (increasing the retirement age), which were expected to be effective in 2018, were approved by the Parliament only to be rescinded. So far, however, the government has been implementing all the most important components of its adjustment program, including drastic cuts in both recurrent expenditures (e.g., a hiring freeze) and capital expenditures.

**Perhaps more critical is the analysis of Mongolia's long-term structural vulnerabilities.** The first is the extreme vulnerability of Mongolia's economic performance to the fluctuations of global commodity prices. The second is the fact that most of the country's economic growth seems to come from physical capital accumulation, not from factor productivity.

**All the reviews of Mongolia's past and recent economic developments demonstrate the extreme vulnerability of the country's economic performance to frequent changes in global commodity prices.** The mining sector, whose performance depends on the performance and prospects of the world economy, accounts for only 20 percent of GDP, but produces 90 percent of the country's exports and in good years 20 percent of total government revenue. Minimizing this vulnerability to the external environment is intellectually easy but politically difficult. Substantial savings during the good years can create effective buffers against some of the worse effects of depressed commodity prices. This was well understood by the authors of Mongolia's Fiscal Stability Law of 2010, which limited fiscal deficits to 2 percent of GDP, calculated based on average commodity prices over 16 years. The rules of the Fiscal Stability Law, however, were not implemented. Political pressures were strong, and the governments did not resist the temptation to increase public spending when the economy was booming and government revenue increasing.

**Another critical long-term vulnerability of the Mongolian economy is what reveals a growth accounting model.** Apparently, most of the past economic growth came from physical accumulation of capital, not from improvements in factor productivity. The two structural vulnerabilities of the Mongolian economy are in fact closely related. Most of the accumulation of capital is financed by large inflows of FDI, which, of course, are based on the judgment of external investors on the medium- and long-term prospects of the country's mining production and exports.

**Clearly the best long-term protections against these two vulnerabilities would be the diversification of the Mongolian economy.** Consequently, government and donor policies should give a high priority to an economic diversification agenda that helps counter the ups and downs of the mining sector. Investment in human resources and developing the country's technical and technological capacity are probably the best way to support diversification, together with sound investments in the most appropriate infrastructure and systematic development of the country's economic institutions.

## IV. EFFICIENCY OF CAPITAL SPENDING

The analysis of Mongolia's public investment performance shows that most of the recent public investment programs were overambitious and unrealistic and were largely responsible for the fiscal crisis of the past few years. It also indicates that the mediocre quality of the programs created inefficiencies that must be addressed in the future years.

**The surge of capital expenditures until 2015 was the key factor behind the large increase of public finance deficits and the public debt.** In 2013, Mongolia's capital expenditures accounted for about 16 percent of the GDP, much higher than the 6.1 percent average of East Asian countries. This was not due to an increase of capital spending in the state budget. As the rules of the Fiscal Stability Law limited structural budget deficits, the increase in capital spending was entirely financed by off-budget funds, including DBM financing, promissory notes authorized by the Parliament since 2014, and more recently Build-Transfer (BT) operations.<sup>1</sup>

**Table (ES) 2. Capital expenditures and main sources of funding (in percent of GDP)**

	2010	2011	2012	2013	2014	2015	2016	2017
<b>Total Capital Expenditures</b>	<b>6</b>	<b>9.7</b>	<b>12.1</b>	<b>16.3</b>	<b>14.9</b>	<b>9.1</b>	<b>10.4</b>	<b>4.3</b>
<b>- On-Budget</b>	<b>6</b>	<b>9.7</b>	<b>9.1</b>	<b>7.8</b>	<b>8.4</b>	<b>6</b>	<b>9.3</b>	<b>6.1</b>
- - Investment	5.4	8	8.2	6	6.5	2.6	3.1	3.3
- - Maintenance	0.3	0.4	0.3	0.5	0.4	0.5	0.2	0.3
- - Foreign-Funded	0.3	1.3	0.6	1.3	1.1	1.1	2.3	2.4
<b>- Off-Budget (DBM)</b>	<b>0</b>	<b>0</b>	<b>3</b>	<b>8.5</b>	<b>6.5</b>	<b>3.1</b>	<b>1.1</b>	<b>-1.8</b>

**In 2015, the government took several measures aimed at improving fiscal management.** Reducing capital spending was a major component of the country's adjustment program. In effect, capital spending decreased from 14.9 percent of GDP in 2014 to 9.1 percent in 2015, rose to 10.4 percent in 2016 (as the government repaid outstanding promissory notes authorized since 2014), but declined again to 4.3 percent in 2017. At the same time, DBM-financing of non-commercial projects was included in the state budget and the use of promissory notes was stopped in 2016.<sup>2</sup>

**The large public investment program implemented over the past five years did not produce the expected benefits.** It did not prevent a sharp decline of GDP growth rates since 2011. In fact, the main legacy of the program was a major increase in public finance deficits and public debt, which will have a lasting impact on the country's economic and fiscal performance.

**Cross-country benchmarks highlight the inefficiency of Mongolia's public investment.** The country ranks 124th on efficiency of public spending in the Global Competitiveness Index. Similarly, according to the 2016 IMF Public Investment Management Assessment (PIMA), Mongolia's scores are much lower than for other emerging market comparators.

<sup>1</sup> A cash budget does not show the cost of promissory notes or BT operations until the government makes a payment.

<sup>2</sup> But BT financing continues.

**Three main factors explain the mediocre quality of Mongolia's past public investment programs.**

The first one is a policy bias. Too many Mongolian governments encouraged line ministries, government agencies and local governments to identify, finance and implement many new projects, large or small, without adequate consideration for the sustainability of the policy and the quality of the proposed operations. The second factor was an excessive decentralization and fragmentation of the decision-making process. The Ministry of Finance is only responsible for projects financed by the state budget. The use of off-budget financing techniques (DBM and promissory notes) enabled a wide variety of ministries and agencies to launch a large number of new projects outside any national strategic vision about the country's development priorities. Third, very few efforts were made to develop and disseminate adequate guidance on effective project appraisal techniques.

**Poor investment planning and project selection led to ineffective implementation of approved operations.**

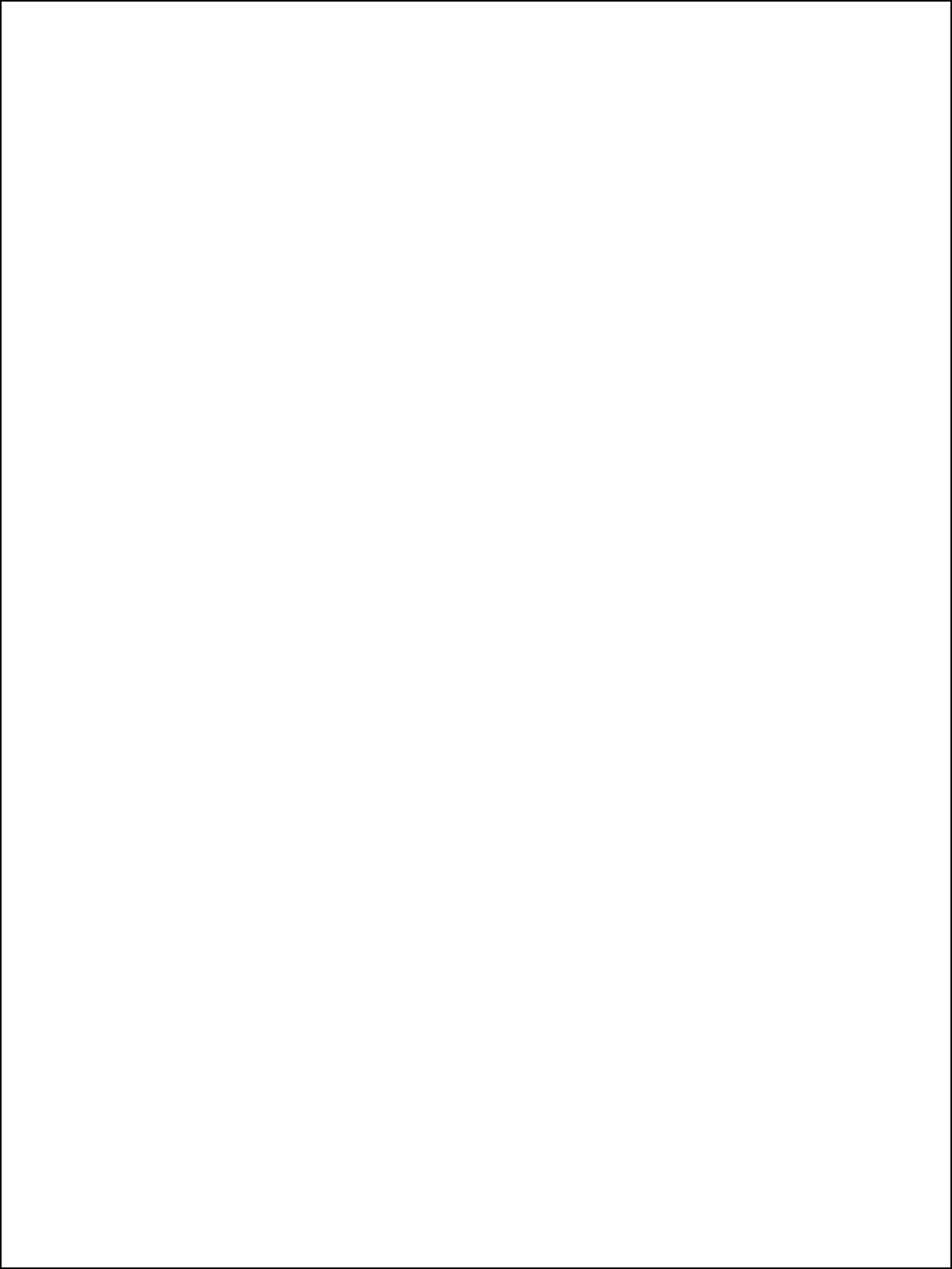
Actual public spending is only a fraction of amounts planned in the budgets and disbursement rates for capital expenditures are particularly low. Another efficiency issue is the lack of adequate funding for maintenance. Despite the recent increase in public investment, the capital maintenance budget did not increase substantially over the past ten years. The GDP ratio of maintenance spending increased from 0.3 percent of GDP in 2003-09 to an average of 0.4 percent in 2014-15 before declining to less than 0.2 percent in 2016. More importantly, the ratio of maintenance to total capital expenditures sharply declined from 5.1 percent in 2010 to 1.9 percent in 2016. The shortage of maintenance expenditures reduces the benefits and shortens the economic life of ongoing and new investments in infrastructure and other sectors.

**To conclude, Mongolia needs to review and reshape its public investment policies and decision-making processes.**

The pre-screening of projects should be based on well-conceived national and sector strategies. The approval of investment programs should be based on realistic revenue forecasts and sound medium-term economic and fiscal frameworks. The roles and responsibilities of the various stakeholders should be clarified. A central public investment management unit should be able to review project proposals for quality assurance purposes. A project data base should be developed and become the main source of information for all public investment projects. Finally, the ongoing investment program should also be rationalized, including restructuring or eliminating non-performing ongoing projects.









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