Mongolia: 2021 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Mongolia

INTERNATIONAL MONETARY FUND

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2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MONGOLIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Mongolia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 19, 2021 consideration of the staff report that concluded the Article IV consultation with Mongolia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 19, 2021, following discussions that ended on October 5, 2021, with the officials of Mongolia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 3, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Mongolia.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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PRESS RELEASE

PR21/350

IMF Executive Board Concludes 2021 Article IV Consultation with Mongolia

FOR IMMEDIATE RELEASE

Washington, DC – **November 19, 2021:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Mongolia.

The Mongolian economy is rebounding from its deepest recession in a decade, despite a lingering pandemic. The recovery is largely export-led, supported by the global recovery and base effects. Notwithstanding continued economic support and a successful vaccination program, domestic activity remains weak due to the pandemic. Many workers, especially female workers, are leaving the workforce, perhaps permanently. Inflation has risen recently but mainly due to transitory factors affecting import prices. Policies were appropriately supportive during the pandemic. However, large, untargeted and continuing fiscal, quasi-fiscal and financial forbearance measures due to Parliamentary measures have heightened macrofinancial vulnerabilities: public debt has sharply increased, bank balance sheets have further weakened, and the Bank of Mongolia's (BOM) operational independence has been compromised.

The government and BOM have appropriately managed Mongolia's external vulnerabilities. Taking advantage of supportive global financial conditions, Eurobonds coming due in 2022−23 were successfully rolled over on better terms. The BOM has opportunistically built its gross international reserves, aided by import compression and disruptions, a favorable terms of trade and the 2021 IMF SDR allocation of US$98.3 million (95.8 percent of quota). Even so, international reserves are assessed to be inadequate given large external liabilities.

The economic outlook remains strong, though uncertain. Real GDP is projected to grow by 4.5 percent in 2021, after contracting by 4.6 percent in 2020. In 2022-23, Mongolia remains poised for an export-led boom, with growth expected to accelerate to 6½–7 percent if export portals fully reopen and the Oyu Tolgoi copper mine is completed on schedule. As the pandemic is largely controlled, domestic activity is expected to gradually normalize. Medium term growth is expected to moderate to 5 percent, but output levels are likely to remain below pre-pandemic trends due to permanent losses in activity. Inflation is expected to return to the BOM's targeted range. Despite an export price boom, the 2020 current account improvements are likely to be temporary once recovery takes hold and imports pick up. This reflects Mongolia's lack of export diversification, heavy import dependence and high external debt.

Risks to the outlook are on the downside risks. A worsening of the pandemic, extended border closures, and tighter global financing conditions pose significant risks, given Mongolia's thin net international reserves and high external debt. Financial sector weaknesses, exacerbated by the pandemic, increase Mongolia's exposure to external shocks by forcing the public and private sectors to borrow externally. A major deterioration in asset quality could impact bank

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

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capital, and delay the recovery. Finally, procyclical policies could undermine macrofinancial stability and debt sustainability, reducing the policy space to address other major risks, undermining Mongolia's recovery.

Executive Board Assessment[2]

Executive Directors commended the authorities on a successful vaccination campaign and welcomed the export-led recovery underway. Notwithstanding the strong economic outlook, Directors noted that significant downside risks remain given uncertainties associated with the pandemic, Mongolia's limited buffers and high external public debt. In that context, they stressed the importance of managing the export boom prudently to secure the recovery while achieving the country's long-term development goals.

Directors agreed that in the near term, policies may need to remain supportive, given the lingering pandemic and weak recovery in domestic activity. Calling for an ambitious fiscal consolidation strategy, Directors emphasized the importance of bold structural fiscal reforms to address untenable debt dynamics. To this end, they underscored the importance of better targeted and more effective social assistance programs, ambitious pension reforms, improved public investment management, and tax administration. Commendable plans for e-governance and state enterprise reform should be fleshed out and implemented. Directors also emphasized that the integrity of the Future Heritage Fund should be preserved to maintain investor confidence.

Directors stressed the need to enhance the Bank of Mongolia's (BOM) operational independence to ensure monetary and external stability. Continued vigilance is needed to ensure that inflation does not become persistent. Directors emphasized that quasi-fiscal operations should be moved to the budget and phased out, and the Parliament should resist making decisions on monetary and financial operations. Greater exchange rate flexibility could serve as a shock absorber. The BOM should continue building its external buffers and drawdown non concessional external liabilities.

Noting with concern the possibility of potential vulnerabilities in the banking sector, Directors called for greater supervisory focus on strengthening banks and contingency planning. In that context, they stressed the importance of a well-sequenced approach to bank reforms to minimize the risk of systemic instability. Phasing out regulatory forbearance by end-2021 and promptly undertaking a fresh and independent asset quality review for potentially capital deficient banks would be imperative for transparency and a proper assessment of bank balance sheets. Emphasizing the need for putting in place the necessary pre conditions for successful IPOs and contingency plans, they called for delaying the deadline for the IPOs.

Directors welcomed the authorities' long-term development strategy focused on sustainable, inclusive, and green growth. To improve the business climate, they urged the authorities to decisively address the long standing concerns about corruption, governance, and AML/CFT to strengthen the investment climate and promote diversification. Revamping the insolvency framework and judiciary reforms should be prioritized to address impaired balance sheets. Directors stressed the importance of the publication of the full audit report on COVID related expenditures, including the missing information on beneficial owners.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Table 1. Mongolia: Selected Economic Indicators, 2020-22

Population (2019): 3.4 million	GDP per capita: 3,965
Quota: SDR 72.3 million	(U.S dollars, 2020)
Main products and exports: Copper, coal, gold and cashmere.	Poverty headcount ratio: 28.4
Key export markets: China, Russia.	(% of population, 2018)

	2020	2021	2022
	Act.	Proj.	
	(In percent of GDP, unless otherwise indicated)		
Output			
Real GDP growth (percent change)	-4.6	4.5	7.0
Prices			
Consumer Prices (EoP; percent change)	2.3	7.5	7.0
General government accounts			
Primary balance (IMF definition)	-6.7	-3.1	-1.1
General government debt 1/	77.4	81.5	76.8
Monetary sector			
Credit growth (percent change)	-3.9	9.0	11.0
Balance of payments			
Current account balance	-5.1	-12.8	-12.8
Exports of goods (y/y percent change)	-2.7	12.1	17.9
Imports of goods (y/y percent change)	-13.1	31.5	13.6
Gross official reserves (in USD millions) 2/	4534	4243	4508
Exchange rate			
Togrog per U.S. dollar (eop)	2850	…	…

Sources: Mongolian authorities; and Fund staff projections.

1/ General government debt data excludes SOEs debt and central bank's liabilities from PBOC swap line.
2/ Gross official reserves includes drawings from swap line.

MONGOLIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

November 3, 2021

KEY ISSUES

A strong export-led recovery is underway. Despite early actions and a successful vaccination campaign, the pandemic is lingering in Mongolia as positivity rates remain high and borders largely closed. An export-led recovery which began in mid-2020, is gathering steam due to booming prices for Mongolia's exports. Nevertheless, domestic demand, labor markets and the business sector remain weak. Policies were appropriately supportive during the pandemic. However, large, untargeted and continuing fiscal, quasi-fiscal and financial forbearance measures legislated by Parliament have heightened macrofinancial vulnerabilities: public debt has sharply increased, bank balance sheets have further weakened, and the Bank of Mongolia's (BOM) operational independence has been compromised. On the plus side, external and fiscal buffers have been built, helped by the 2021 IMF SDR allocation of US$98.3 million (95.8 percent of quota), and the rollover of large external liabilities has increased policy space.

The economic outlook is strong, though uncertain. The global recovery, continued policy support and base effects are expected to boost GDP growth in 2021 to 4½ percent following a sharp recession in 2020. Growth is expected to accelerate in 2022−23, as the Oyu Tolgoi (OT) copper mine comes onstream, boosting exports. Domestic demand is expected to improve once the pandemic is largely controlled. Output levels are likely to remain below pre-pandemic trends over the medium-term due to scarring. Inflation is forecasted to remain within the BOM's target given the slack in the domestic economy.

The outlook is fraught with downside risks. A major global or local resurgence of the pandemic, extended border closures, volatility in export prices, delays in completing the OT underground mines, and tighter global financing conditions pose significant risks, given Mongolia's thin net international buffers and high external public debt. Financial sector weaknesses increase Mongolia's exposure to external shocks by forcing the public and private sectors to borrow externally. A potential rise in non-performing loans could delay the recovery. Procyclical policies could undermine macrofinancial stability and debt sustainability, by reducing the policy space to address other major risks, undermining Mongolia's recovery.

Taking advantage of the export price boom, policies should secure the recovery, while managing the commodity boom prudently to achieve long-term goals.

- Continued policy support maybe needed in the near term until the recovery is entrenched. Any additional fiscal support should be targeted toward the vulnerable and used to bolster health systems. Monetary policy can stay on hold for now since the recent uptick in inflation is expected to subside.

- Mongolia should also use the opportunity provided by the export surge to pursue strong fiscal consolidation on the basis of high-quality reforms to ensure external debt sustainability, while taking care to adequately protect the poor and vulnerable. A 6½ percent of GDP consolidation over 2022−26—relative to the current baseline—would reduce public debt closer to the IMF-recommended nominal anchor (50 percent of GDP). Reforms in the pension system, public investment management, and tax administration, and greater progressivity in personal income tax rates, would be vital. A well-targeted and consolidated social safety net should be put in place which adequately supports the poor. In contrast, the draft 2022 budget proposal to make high levels of untargeted social assistance permanent risks further undermining Mongolia's difficult debt dynamics and damaging the integrity of the Future Heritage Fund.

- The BOM should remain vigilant on inflation. If inflationary pressures become persistent, the BOM should stand ready to raise interest rates and reserve requirements, reinstate the macroprudential measure, and mop up excess liquidity. Quasi-fiscal operations such as subsidized mortgage programs should be transferred to the budget and the BOM's operational independence and governance enhanced.

- A well-thought out and sequenced approach to bank restructuring is needed. Greater transparency and a proper assessment of the impact of the pandemic on banks is a priority, requiring phasing out regulatory forbearance by end-2021 and a fresh asset quality review for potentially capital deficient banks. The focus should be on strengthening bank capital—bank IPO deadlines should be delayed till necessary pre-conditions for success and contingency plans are in place. Capital shortfalls in capital deficient banks should be addressed.

- The BOM should allow exchange rate flexibility to serve as a shock absorber, while continuing to build its external buffers and drawdown its non-concessional external liabilities. Efforts to improve monetary transmission should continue, including by increasing domestic debt issuance by the government in the context of a comprehensive medium-term debt strategy.

- Long-standing concerns about corruption, governance, and AML/CFT should be decisively addressed to strengthen the investment climate and maximize the gains from the windfall from the export price boom. Long overdue improvements in public investment management, fiscal rules, and insolvency frameworks should be completed now.

Approved By
Krishna Srinivasan, (APD) and Daria Zakharova (SPR)

A virtual mission took place during September 13–October 5, 2021. The team included Angana Banerji (head), SeokHyun Yoon (Resident Representative), David Corvino, Pranav Gupta, (all APD), Olusegun Akanbi (FAD), and Paul Leonovich (MCM). The team was supported by Mmes. Selenge, Ardak, and Khulan (all economists in the IMF Resident Representative's Office, Mongolia), Sui Man Tam and Ms. Tolentino (all APD). G. Khurelbaatar (OEDAP) participated in the discussions, and K. Srinivasan (APD) joined the concluding meeting. The IMF team met with Speaker of the Parliament G. Zandanshatar, Finance Minister B. Javkhlan, Bank of Mongolia Governor B. Lhagvasuren, and other senior officials.

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FIGURES

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Acronyms

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
APL	Anti-Pandemic Law
APG	Asia Pacific Group for Money Laundering
ARA	IMF Assessing Reserve Adequacy Metric
AQR	Asset Quality Review
BOM	Bank of Mongolia
BL	Banking Law
CBB	Central Bank Bills
CIT	Corporate Income Tax
DBM	Development Bank of Mongolia
DICOM	Deposit Insurance Corporation of Mongolia
FATF	Financial Action Task Force
FHF	Future Heritage Fund
FRC	Financial Regulatory Commission
FSF	Future Stability Fund
FSL	Financial Stability Law
GIR	Gross International Reserves
IAAC	Independent Authority Against Corruption
JDC	Judicial Disciplinary Council
JGC	Judicial General Council
IIP	International Investment Position
MOF	Ministry of Finance
MNT	Mongolian Togrog
MSE	Mongolian Stock Exchange
MPC	Monetary Policy Committee of the Bank of Mongolia
MTBF	Medium-term Budget Framework
MTDS	Medium-Term Debt Strategy
NAO	National Audit Office
NIR	Net International Reserves
NPL	Non-Performing Loans
NPV	Net Present Value
PBOC	People's Bank of China
PFM	Public Financial Management
PIMA	Public Investment Management Assessment
PIS	Pension Insurance Scheme
PIT	Personal Income Tax
PPERL	Post-Pandemic Economic Recovery Law
SDG	Sustainability Development Goals
SME	Small and Medium Enterprises
TA	Technical Assistance
TDB	Trade and Development Bank