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MONGOLIA

November 2021

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.

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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

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[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.

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[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
Quota: SDR 72.3 million
Main products and exports: Copper, coal, gold and cashmere.
Key export markets: China, Russia.

GDP per capita: 3,965
(U.S dollars, 2020)
Poverty headcount ratio: 28.4
(% 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.

INTERNATIONAL MONETARY FUND

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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Acronyms

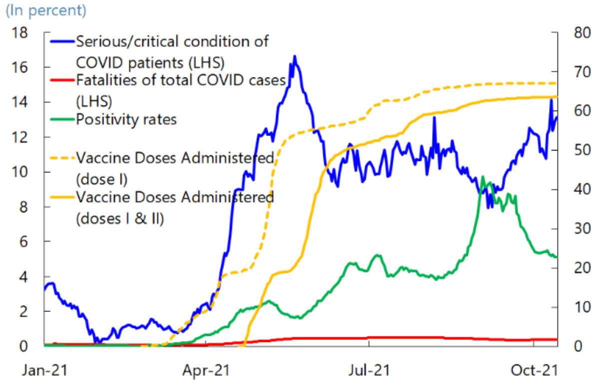
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
APL	Anti-Pandemic Law
APG	Asia Pacific Group for Money Laundering
ARA	IMF Assessing Reserve Adequacy Metric
AQR	Asset Quality Review
BOM	Bank of Mongolia
BL	Banking Law
CBB	Central Bank Bills
CIT	Corporate Income Tax
DBM	Development Bank 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

CONTEXT: A LINGERING PANDEMIC

1. The initial emergence of the pandemic was quickly contained. When the COVID-19 virus reached Mongolia in early 2020, the government immediately declared a state of high alert, introduced social distancing measures, and closed the border with China, its main export portal. These prompt and strong measures quickly and effectively halted the spread of the virus.

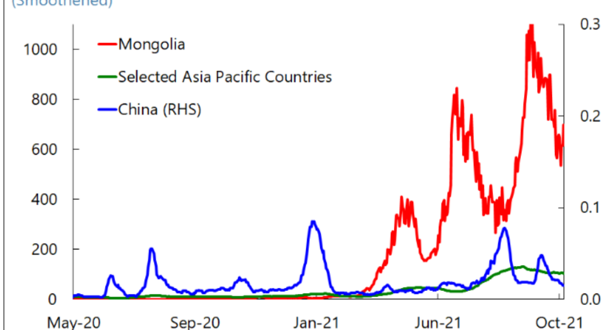
2. However, the 2021 pandemic wave is proving harder to control (Figure 1). A gradual relaxation of containment measures for the 2020 Parliamentary and 2021 Presidential election campaigns led to the first cases of domestic transmissions of COVID-19 in November 2020, followed by Mongolia's first wave of the pandemic in 2021. Stringent domestic containment measures were reintroduced, including intermittent nationwide lockdowns. External borders remain closed, except for cargo traffic. A vigorous vaccination campaign is underway: 95 percent of the adult population has been fully vaccinated with Sinopharm and other vaccines. Booster shots for adults and vaccination for ages 12–18 have started. Although fatality rates and critical cases have stabilized (Figure), daily cases and positivity rates remain high, with confirmed transmissions of the Delta variant. The healthcare system is buckling under pressure. A recent uptick in cases in China and its zero COVID approach has renewed border closures.

COVID-19 Key Indicators
(In percent)



Source: Ministry of Health, Mongolia.

Daily New Confirmed COVID-19 Cases per Million People
(Smoothened)



Source: Our World In Data.
Note: Selected Asia Pacific Countries includes Australia, Hong Kong SAR, Indonesia, India, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, and Vietnam.

3. The reform agenda remains broad, with little progress on major IMF recommendations (Annex I). The landslide 2021 Presidential victory ensures a consolidation of power within the ruling Mongolian People's Party (MPP) via the party's dominance over all state leadership positions for the second time since 1990. Although the President's power was largely restricted by the 2020 Constitutional Amendment, his victory ensures policy continuity, given the MPP's overwhelming Parliamentary majority. Nevertheless, the appetite for strong reforms maybe weak given the forthcoming 2024 Parliamentary elections.

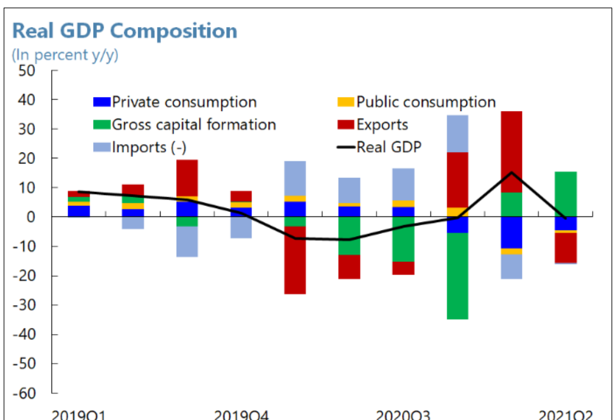
4. Policy priorities are being buffeted by the pandemic and rising spending pressures. The new government, which took office in 2020, adopted a long-term development strategy, *Mongolia Vision 2050*, which priorities macroeconomic stability and green and sustainable development, broadly in line with Mongolia's Sustainable Development Goals (SDG).[1] The priorities

[1] https://sustainabledevelopment.un.org/memberstates/mongolia.

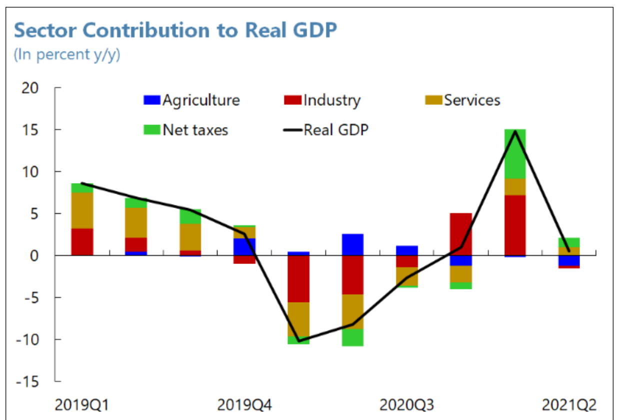
are: improving access to quality education and healthcare; social welfare system reforms; developing an inclusive financial sector; reducing corruption and improving governance; increasing labor productivity, export diversification, and the competitiveness of the small and medium enterprise (SME) sector; and, building a knowledge economy emphasizing technology and innovation. The immediate challenge, however, will be to address the pandemic amidst populist spending pressures for economic support; and to make good on campaign promises to address longer-standing concerns about an equitable distribution of mining wealth. The renegotiation of the investment agreement regarding Mongolia's flagship Oyu Tolgoi (OT) mining project—expected to become one of the top copper mines in the world—is underway.

2020–21: AN EXPORT-LED RECOVERY

5. The economy is rebounding after a deep recession (Figures 2–3). Mongolia experienced its first major recession in over a decade in 2020. Containment measures, closed borders and the global contraction led to export losses, delayed mining FDI, and subdued private sector domestic demand. Severe weather conditions during the 2020 winter also contributed to a weak domestic economy, especially in the agricultural sector. Mining exports started recovering since mid-2020 in line with the global recovery. GDP growth surged—beyond expectations—in the first half of 2021. The increase was largely export-led, reflecting a stronger global recovery and base effects (Figure), a resumption in mining FDI and private investment. However, recent border closures are hurting coal exports and production.

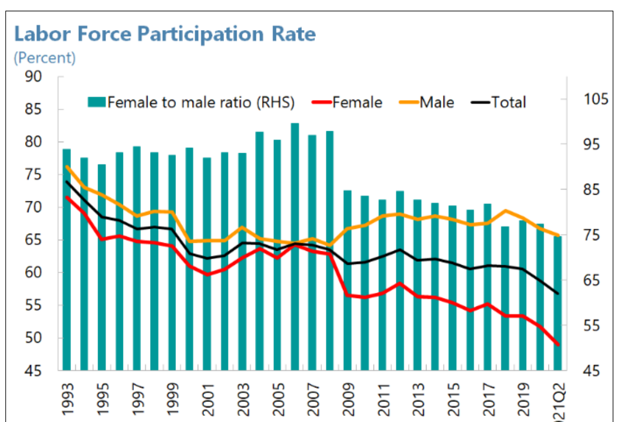


Source: Haver.



Source: Haver.

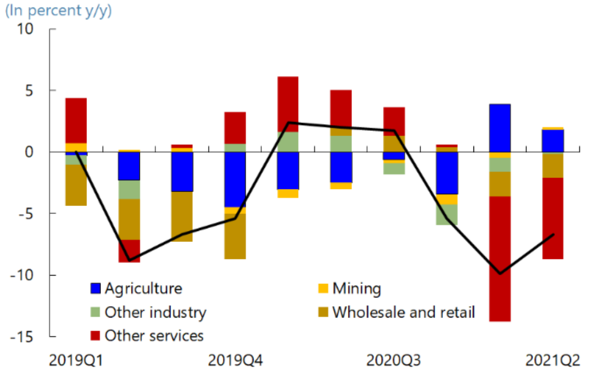
6. The domestic economy remains weak. Private consumption and non-mining investment continue to contract despite large policy support for the household and SME sectors. Lower employment rates and incomes (especially in the services sector due to the intermittent lockdowns), and a sharp credit contraction in 2020, restricted private sector activity (Figures below). Declining labor force participation (LFP) rates—especially female LFP, which predated the pandemic—point to possible scarring that may



Source: National Statistics Office, Mongolia.

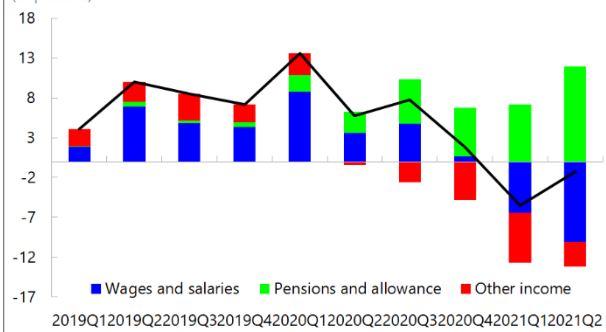
prove difficult to reverse (Figure). Inflation has picked up above the Bank of Mongolia's (BOM) 6±2 percent target at end-September 2021, reflecting base effects and transitory supply side factors affecting import prices.

Contribution to Employment
(In percent y/y)



Sources: National Statistics Office, Mongolia.

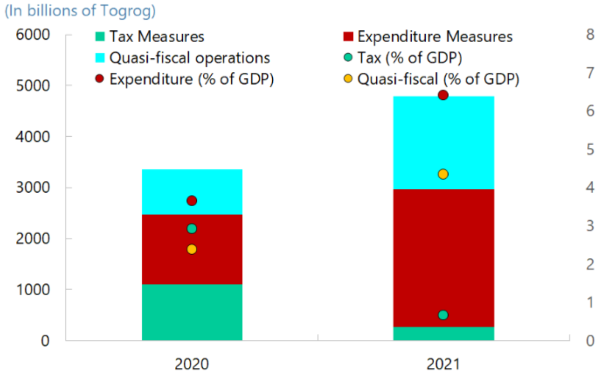
Average Real Monetary Income
(In percent)



Sources: National Statistics Office, Mongolia.

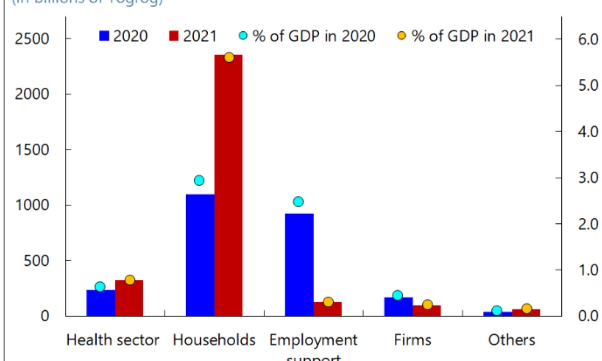
7. Policies have been highly supportive (Figures 4–5). In addition to higher health-related spending, a broad range of fiscal measures have been used to support the economy till end-2021 (Figures below). Monetary policy has been accommodative, with lower policy rates and reserve requirements. Moreover, the BOM and the Financial Regulatory Commission (FRC) implemented temporary financial forbearance measures on prudential requirements, loan classifications, and restructuring standards. The Anti-Pandemic Law (APL) of April 2020 effectively temporarily suspended the macroprudential limits on debt-income ratios and compelled the BOM to undertake quasi-fiscal activities including purchasing a public enterprise bond to finance a debt relief scheme, resume a subsidized mortgage program and extend concessional loans to gold miners. The APL, supposed to expire at end-2020, has been extended till end-2021, while some of the financial forbearance measures have been extended till end-March, 2022.

Pandemic Related Fiscal Support
(In billions of Togrog)



Sources: IMF Staff Calculations.

Fiscal Support By Sector
(In billions of Togrog)

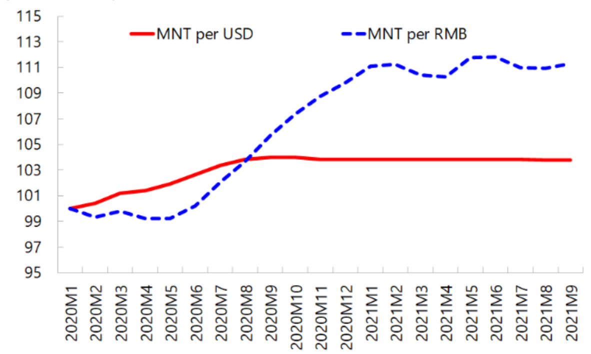


Sources: IMF Staff Calculations

8. Public debt is rising again (Figure 4). Public debt, on a downward track pre-pandemic, rose sharply to 77½ percent of GDP by end-2020 due to the economic contraction and fiscal support measures. Debt continued to rise in 2021, despite a one-off—and possibly reversible—budget transfer from OT to settle tax disputes (2.4 percent of GDP), restrained current spending and delayed investments. In line with Mongolia's fiscal framework, part of the revenue gains due to higher-than-budgeted mineral export prices have—appropriately—been saved, increasing domestic buffers in the FHF. Taking advantage of supportive global financial conditions (Figure 6), the government successfully rolled over US$1 billion of Eurobonds coming due in 2022−23, increasing fiscal space.[2]

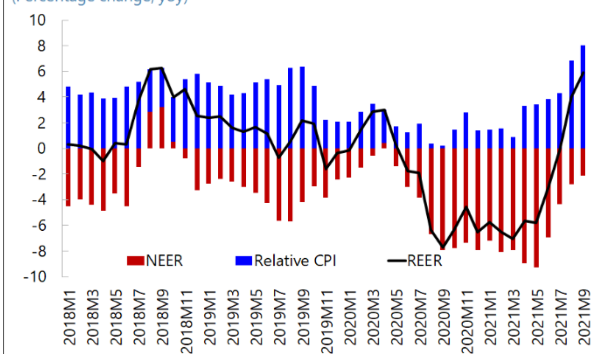
9. The BOM built buffers, while intervening to stabilize the exchange rate. The sharp drop in exports till mid-2020 due to the border closure prompted a US$1 billion drop in gross international reserves (GIR) as the BOM intervened heavily to prevent a sharp depreciation. Thereafter, improving exports, import compression and US$1 billion in official and IMF financing gave the BOM the opportunity to build back up its GIR to US$4.4 billion by end-August 2021. However, net international reserves (NIR) remains low due to significant BOM external liabilities, in particular a US$1.8 billion PBOC swap which was rolled over in July 2020 and now matures in 2023. Although the REER depreciated by 6½ percent in 2020, owing to subdued inflation and a nominal depreciation of the MNT vis-à-vis the renminbi reflecting the strong recovery in China, the recent inflation pickup has led to an REER appreciation in 2021.

Mongolia: Exchange Rates
(2020M1 = 100)



Sources: Mongolian authorities.

REER and NEER
(Percentage change, yoy)



Source: IMF.

10. Progress on financial stability remains challenging, undermining BOM's operational independence (Figure).

- The cancellation of the 2019 BOM administrative measures against banks that failed to raise legitimate capital following the 2017 AQR, and the introduction of blanket forbearance measures during the pandemic—due to the Parliament's intervention—may have increased capital shortfalls in some banks. The economic impact of the pandemic has added to these pressures, with reported non-performing loans (NPLs) rising (Figure 7). Although two-tiered reporting (with/without forbearance) to the BOM provides a range of possible deterioration in bank balance sheets, the untargeted forbearance measures and challenges in determining the true deterioration in underlying asset quality is once again obfuscating the size of bank capital needs. Efforts to ensure a well-capitalized and well-regulated banking sector has, therefore, taken a step back.

[2] In June 2021, two tranches of Eurobonds were issued with a face value of US$500 million each, 10-year and 5-year maturities, and interest rates of 4.45 and 3.5 percent. Potential vulnerabilities from large bullet amortizations of Eurobonds in 2021−24 have thereby been significantly mitigated.

- On the positive side, liquidity ratios remain adequate due to rising deposits and improving financial sector inclusion (Figure 7). A 2017 regulation requiring banks to meet a new minimum paid-in equity capital level (double the previous level) by end-2021 remains on track. Amendments to the Banking Law, and Parliament's adoption of a banking sector reform strategy in 2020 to strengthen bank capital and reduce shareholder concentration, are steps in the right direction.

Financial Sector Reforms: A Timeline

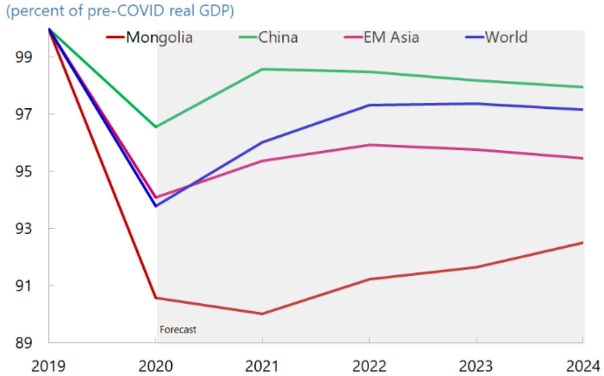
AQR finds asset classification problems, additional provisioning and capital needed at 7 banks	Independent forensic audit finds majority of capital raised by banks non-compliant with Mongolian regulations, illicit, fictional.	BOM rejects capital increases, places administrative restrictions, requires banks raise valid capital	BOM Governor replaced by Parliament	BOM accepts capital as Tier I, suspends administrative measures. Forbearance introduced: relaxed adverse loan classification, lower RR and LCR; loan restructuring	Two undercapitalized banks (TDB and UBCB) allowed to merge June 2020	Banking Sector Strategy adopted: single shareholder cap (20 percent), IPOs for systemic banks by July 2022, lower shareholder concentration by end-2023
2017		*2019*		*2020*		

Sources: IMF Staff Estimates.

OUTLOOK AND RISKS: ON THE CUSP OF AN EXPORT BOOM

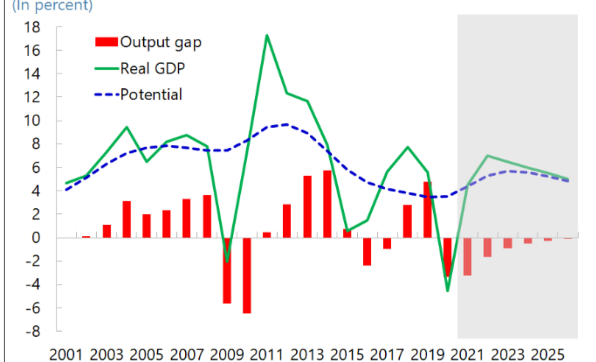
11. The near-term growth outlook is strong, though uncertain (Table 1). The global recovery, continued policy support and base effects are likely to boost GDP growth in 2021 to 4½ percent. Growth is expected to accelerate in 2022–23, as coal exports recover, the second phase of the OT copper mine comes onstream, boosting copper exports, and imports ease after the completion of the OT project (Table 2). Domestic demand is expected to improve if the pandemic is largely controlled by end-2021, leading to a gradual normalization of domestic activity and employment. A modest upturn in credit growth should also be supportive (Table 3). The recovery in private sector domestic demand will be somewhat offset by the winding down of policy support, set to expire by end-2021, with a gradual fiscal consolidation thereafter in line with the draft 2022 budget (Table 4).[3] Over the medium term, growth is expected to trend down to potential, but output levels are likely to remain below pre-pandemic trends due to the scarring effects of the pandemic in labor and product markets (Figure). Inflation is expected to return to the BOM's target given the economic slack.

Real GDP, 2019-2024
(percent of pre-COVID real GDP)



Sources: IMF staff calculations.

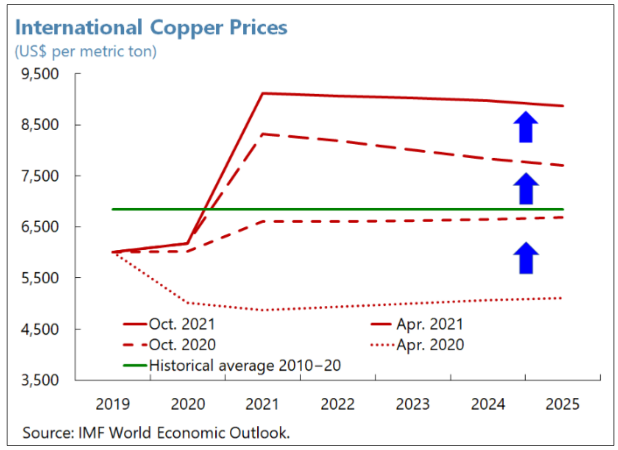
Estimated Output Gap
(In percent)



Sources: IMF Staff Calculations.

[3] The fiscal multipliers is estimated to be low (0.3) given Mongolia's high import propensity, in line with the literature (e.g., Batini and others, 2014).

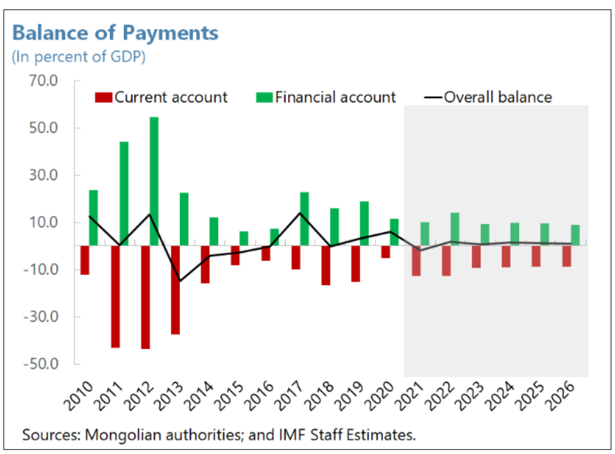
12. Despite a boost from export prices, external buffers are expected to remain inadequate (Table 2, Annex II). Mongolia's external position in 2020 is assessed to be (substantially) weaker than implied by fundamentals and desirable policy settings. The improvement in the 2020 current account deficit is likely to be temporary as the recovery takes hold and the pace of construction and imports picks up.

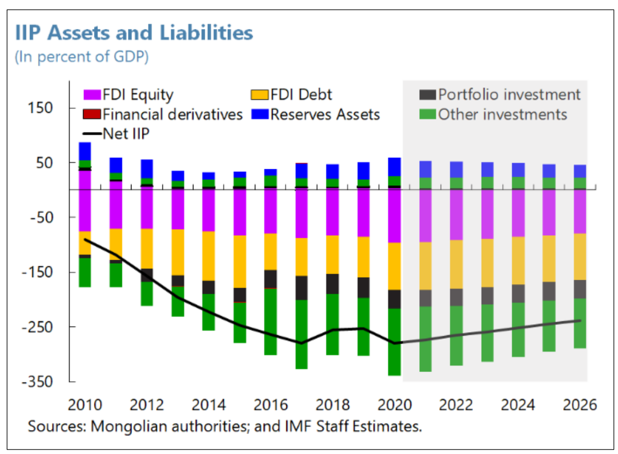


- The export price boom that is beginning to take shape is expected to boost export receipts significantly in 2021 and beyond (Figure). However, limited export diversification, heavy import dependence, high oil prices, and large investment needs of the mining sector will keep current account deficits high in the foreseeable future, despite the moderation of imports after the OT project concludes.

- Beyond OT, FDI inflows are expected to moderate due to weaknesses in the business climate. External liabilities will remain large in 2020 (338 percent of GDP) and beyond.

- The recent GIR accumulation is therefore likely to be short-lived. Despite the IMF SDR allocation (US$98.3 million) in 2021, and assuming a rollover of the PBOC swap in 2023, reserve coverage is expected to decline to a 4½-month import cover (111 percent of the ARA metric) over the medium term.





13. Risks are predominantly on the downside (Annex III), although rising commodity prices pose upside risks.

- *Global.* Another more virulent outbreak of the pandemic, either globally and/or domestically, could be especially dire it were to further prolong the border closures,[4] and/or trigger a slide in

[4] The 2-month closure of Mongolia's border with China in 2020 led to a temporary 30 percent decline in exports.

export prices. Given Mongolia's large external liabilities, a significant tightening of global financial conditions could raise funding costs, pressuring its limited external buffers.

- *Domestic.* Procyclical spending policies and reform delays in the runup to the 2024 Parliamentary elections may undermine macroeconomic stability and debt sustainability, and reduce investor confidence regarding sound policy management. Delays in renegotiating the OT investment agreement could worsen the economic and external outlook by hampering Mongolia's ability to reap a windfall from surging export prices, while increasing uncertainty. Financial sector weaknesses increase Mongolia's exposure to external shocks by forcing the public and private sectors to borrow abroad. A potential rise in NPLs could reduce bank lending, delaying the recovery. If unaddressed, undercapitalization in some banks could trigger instability and/or amplify the burden on households and small enterprises which are heavily in debt. The global shift away from coal to reduce carbon emissions could affect the external outlook, given limited export diversification.

Authorities' Views

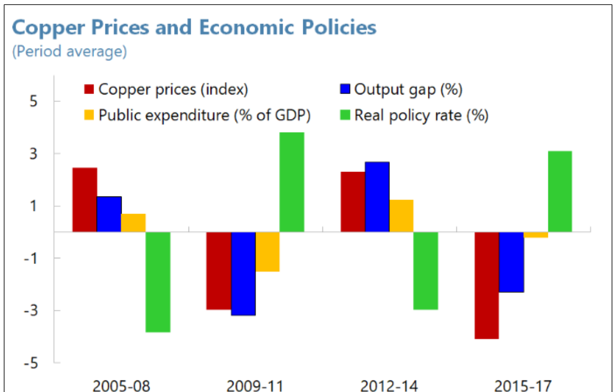
14. The authorities agreed with the assessment. In the near term, the economy is likely to continue to be affected by export disruptions and high infection rates. Despite strong measures to address the pandemic and favorable mineral prices, the outlook remains uncertain and subject to significant downside risks, particularly from a worsening of the ongoing outbreak and extended China border closures.

WILL THIS TIME BE DIFFERENT? POLICIES TO ACHIEVE MONGOLIA *VISION 2050*

Policies should focus on securing the recovery, while managing the mining boom prudently to achieve long-term goals. Fiscal support should be targeted towards the vulnerable and health systems. Monetary policy could stay on hold given transitory inflation pressures, but continued vigilance is warranted. High-quality fiscal reforms are needed to improve debt dynamics, notably sustainable pension and social assistance policies, improved public investment management, and strengthened fiscal frameworks. Quasi-fiscal operations must be terminated and the BOM's operational independence, enhanced. The BOM should allow the exchange rate to serve as a shock absorber, while continuing to build its net external buffers. Phasing out forbearance measures by end-2021 to improve transparency, stronger bank capital, and a prudent implementation of banking sector reforms would help improve financial stability. Long-standing concerns about corruption and governance should be decisively addressed to strengthen the investment climate and maximize the gains from the export windfall.

15. As Mongolia contends with the pandemic amidst surging export prices, sound policy management will be critical. Mongolia has been prone to booms and busts. Along with weather-related shocks and export price fluctuations, the significant swings in GDP have been due to procyclical macroeconomic policies (Figure). Policies should prioritize:

- Securing the recovery until it is entrenched,
- Managing the positive terms of trade shock prudently to avoid a future bust, and
- Using the windfall to achieve longer-term policy goals—*Vision 2050*—to develop Mongolia's significant untapped potential to lift living standards.



Sources: Haver; Mongolian authorities; and IMF staff calculations.
Note: Meaures average deviation from trend, calculated using HP filter (λ=6.25).

A. Fiscal Support With An Eye Toward Sustainability

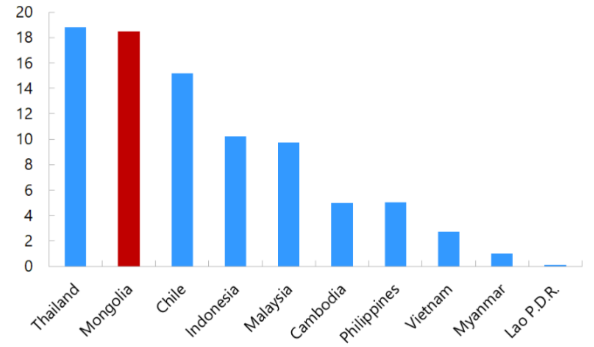
16. Despite planned fiscal consolidation and reforms in 2022, some underlying policies are concerning. The proposed consolidation largely reflects the lapse of temporary stays on social security contributions, stronger revenues from mineral trade and the normalization of economic activity and imports, interest savings from Eurobond rollovers, and planned current spending controls. Sweeping reforms have been announced in e-governance, social safety nets and pensions, civil services, state owned enterprises (SOE) and public private partnerships (PPPs). While these reform priorities are sound, policy details and, therefore, the fiscal impact remains unclear. Of particular concern is the proposal to permanently extend pandemic-era increases in untargeted social transfers, financed by forgoing planned savings in the Future Heritage Fund (FHF) in line with Mongolia's fiscal framework (Annex IV).

17. Mongolia's medium-term external debt dynamics are expected to remain challenging (Annex V–VI).[5] After sizeable fiscal consolidation during 2017–19, the budget deficit and public debt worsened significantly in 2020–21 due to the large fiscal support provided to mitigate the impact of the pandemic.

- **Mongolia's fiscal support through the pandemic was necessary but excessive.** Increased health spending (1½ percent of GDP during 2020–21) was dwarfed by untargeted and unconditional economic support measures costing 13 percent of GDP—far exceeding similar spending in peer economies (Figures below).

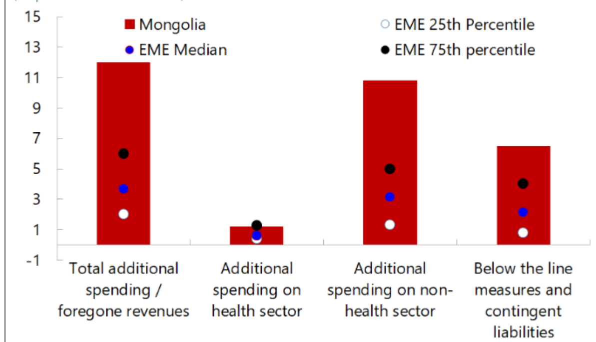
[5] For debt sustainability analysis purposes, public debt aggregates include the PBOC swap, consistent with IMF policy (2021 MAC DSA Review, Annex II (https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/02/03/Review-of-The-Debt-Sustainability-Framework-For-Market-Access-Countries-50060) and with the treatment of IMF credit.

Total Fiscal Measures for COVID-19 Response
(In percent of 2020 GDP)



Sources: IMF Database of Country Fiscal Measures in Response to the COVID-19.

Pandemic-Related Fiscal Support
(In percent of 2020 GDP)

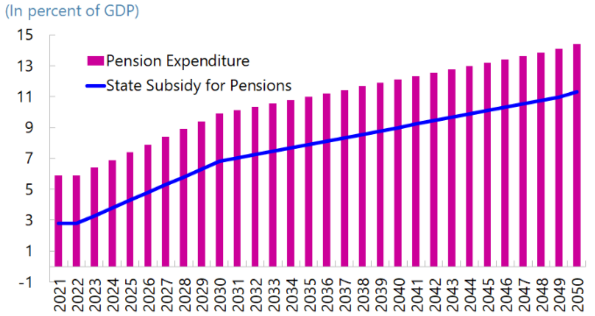


Source: IMF Database of Country Fiscal Measures in Response to the COVID-19 from January 2020 to September 2021.

- **On current trends and policies, fiscal balances are expected to deteriorate over the medium term** (Table 4) despite the planned consolidation in 2022. The main impetus for widening deficits comes from public expenditures: the permanently higher social transfers proposed in the 2022 budget; high capital spending given persistent difficulties in public investment management; and a gradual increase in pension, education, and health spending (elaborated below). At 68 percent of GDP by 2026, public debt is expected to stay well above the 50 percent of GDP recommended by the IMF (IMF, 2019a), though close to the authorities' medium-term target of 60 percent of GDP in net present value (NPV) terms (equivalent to some 71 percent of GDP).

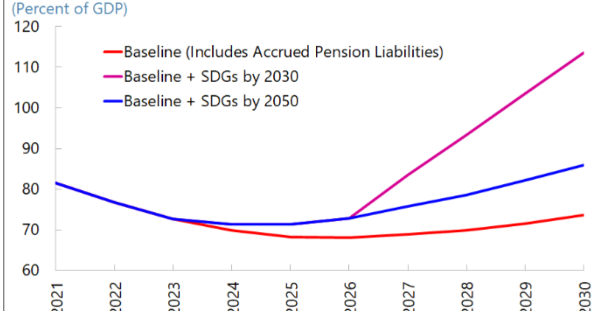
18. Longer-term debt dynamics could become untenable without reforms. Illustratively, without pension reforms, the rise in accrued pension liabilities due to overly generous parameters and unfavorable demographics would boost public debt rapidly (World Bank (2020), Figure). The cost of meeting the government's policy commitments on education and health by 2030 (SDG commitments), or by 2050 (*Vision 2050*) is likely to raise public debt even further (Figure). Additional spending to meet policy goals to develop the mining and renewable energy sectors, and transition to a knowledge-based economy would further aggravate debt pressures (not shown).

Mongolia: Projected Pension Expenditure and Subsidy
(In percent of GDP)



Source: World Bank (2020); IMF Staff Estimates.
Note: State subsidy forecasts based on World Bank (2020). Total pension expediture equals state subsidy plus budget transfers of social security contributions.

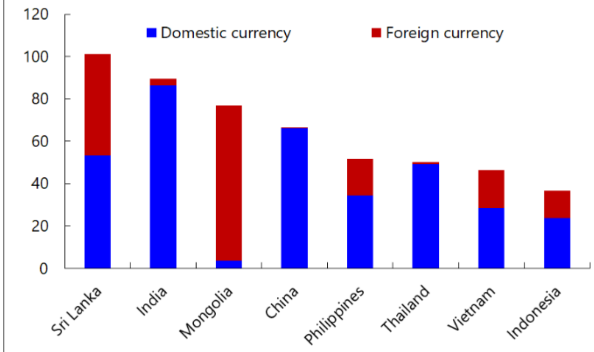
Public Debt Illustrative Scenarios
(Percent of GDP)



Sources: IMF staff calculations.
Note: Public debt includes BOM PBOC liabilities (all scenarios). Average annual additional spending on SDG based on Gaspar and others, (2019). The precise cost of meeting Mongolia's SDG goals are being estimated by the United Nations.

19. In addition, Mongolia's fiscal risks remain significant. Without recourse to a well-functioning domestic debt market (Section B), Mongolia is forced to rely on external financing, unlike most emerging market economies (Figure), increasing its susceptibility to external shocks. Debt dynamics could further deteriorate if downside risks were to materialize and/or if new borrowing were to be available on non-concessional terms. Contingent liabilities from the financial sector and the cost of addressing major natural disasters pose additional risks.

Domestic and External Government Debt, 2020
(In percent of GDP)



Source: World Economic Outlook.

20. The 2022 budget should strike a better balance between providing economic support and improving Mongolia's untenable debt burden. Fiscal support maybe needed in the near term, given the lingering pandemic and weak domestic economy. However, any additional fiscal support should only be targeted toward those in need, to support the healthcare response (procuring vaccines, strengthening treatment options), and to ensure export portals remain safely open. Permanent increases in untargeted social assistance will be unaffordable when growth slows or if there is a drop in commodity prices. These transfers increase budget spending regardless of whether or not they are saved by the recipients, and inevitably give rise to pressures for further increases over time, crowding out other priority spending. By raising the reservation wage for work, such transfers risk further weakening domestic activity and productivity by fostering a smaller workforce and labor shortages, thereby undermining the overarching objective of *Vision 2050* to diversify and modernize Mongolia's economy away from its mining dependence. To the extent these transfers are spent, they may increase external vulnerabilities by boosting imports.

21. Stronger consolidation is needed to secure debt sustainability. Illustratively, a 6½ percent of GDP consolidation over 2022–26—relative to the current baseline—could help bend public debt levels down to 56½ percent of GDP by 2026, closer to the IMF-recommended nominal anchor of 50 percent of GDP (Table). This scenario includes an additional consolidation of ½ percent of GDP relative to the baseline in 2022.

22. Taking advantage of the export boom, strong reforms should be put in place in 2022–23 to alleviate debt pressures. Implementing strong reforms during a recovery, while adequately protecting the poor and vulnerable, can be more socially and politically palatable than in a recession. The focus should be on fleshing out detailed plans to implement the many desirable policy reforms proposed in the draft 2022 budget to improve cost effectiveness, the governance of state operations and public investment, and tax administration. These reforms take time to design well and implement in a phased manner to achieve fiscal gains. They may also entail some near-term costs and capacity building to succeed in achieving the desired policy goals. Strong structural fiscal reforms which yield long-lasting declines in the budget deficit, and adherence to the fiscal framework, can help the government signal its commitment to fiscal sustainability, giving them the space to address the pandemic (IMF 2021d).

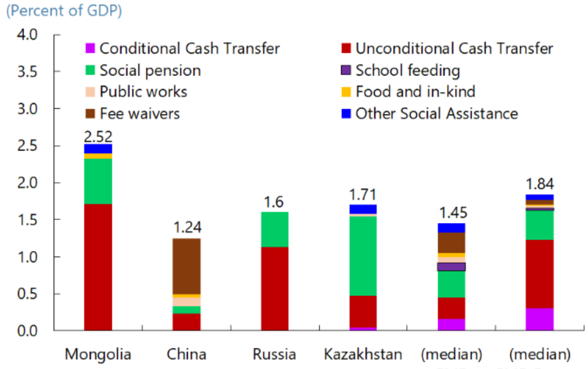
Mongolia: Fiscal Reforms To Improve Debt Sustainability
(In percent of GDP)

	2021	Medium-Term Estimates (2026)		Gains from Reforms
		Baseline	Reform	
Total Revenue & Grants	***32.1***	***31.9***	**34.1**	**2.2**
Tax Revenue 1/ 2/ 3/	*28.8*	*28.3*	30.3	2.0
Social Security Contributions 4/	*4.7*	*5.2*	5.4	0.2
Non Tax Revenue 1/3	*2.9*	*3.2*	3.4	0.2
Total Expenditure	***37.5***	***36.6***	**32.3**	**-4.3**
Current Expenditure	*31.0*	*28.1*	22.7	-5.4
Transfers 5/	*16.4*	*13.9*	9.0	-4.9
Pensions	*5.9*	*7.9*	5.2	-2.7
SDG (Heath & Education)	*0.0*	*0.0*	1.0	1.0
Other Transfers (incl. SSN)	*10.5*	*6.0*	2.8	-3.2
o/w Child Money	*3.4*	*3.4*	1.2	-2.2
Other Current Expenditure	*14.6*	*14.2*	13.7	-0.5
Capital Expenditures 6/	*6.4*	*8.4*	9.5	1.1
Gains from PIMA Implementation	*0.0*	*0.0*	-0.7	-0.7
SDG Infrastructure Spending	*0.0*	*0.0*	1.0	1.0
Maintenance Spending (PIMA)	*0.2*	*0.3*	0.8	0.6
Overall Balance	***-5.4***	***-4.6***	**1.8**	**6.4**
Primary Balance	*-3.1*	*-2.8*	3.2	6.0
Total Financing	*5.4*	*4.6*	-1.8	-6.4
o/w Annual accumulation in FHF	*-2.8*	*0.0*	-2.0	-2.0
Public Debt	*81.5*	*68.1*	56.5	-11.6

Sources: IMF Staff Estimates.
Note: For simplicity, the net impact of reforms on growth is on balance assumed to be zero, given low fiscal multipliers due to high import intensity; the incidence of several reforms (PIT, SSN targeting) on higher income brackets where spending propensities are lower; the growth-boosting effects of SDG related spending on education, health and maintenance and delayed retirement.
1/ Gains from tax administration reform (a total of 0.6 percent of GDP over 2023-25 across all revenue categories).
2/ Tax policy reforms includes progressivity in top PIT rate, trade taxes and tax base broadening.
3/ Includes one-off OT transfer of 2.4 percent of GDP in 2021 distributed across non-tax revenue and CIT.
4/ Reinstating the planned increase in SSC contributions (1pp starting 2022).
5/ Includes pension reforms savings (World Bank 2020), gradual reversal of permanent CMP expansion and better targeted SSN spending from 2022 onwards, additional spending on health & education starting 2025 in line with SDG (and *Vision 2050*) goals (Gaspar and others 2019).
6/ PIMA improvements to incorporate only sustainable levels of capital spending incorporated in MTBF (average capital spending in comparator countries is 7 percent of GDP); additional infrastructure spending to meet SDG (or *Vision 2050*) goals (e.g. on electricity access); and higher maintenance spending based on IMF 2018 recommendations.

- ***Better targeted social safety nets.*** Mongolia's social assistance program relies heavily on unconditional cash transfers to the entire population through the Child Money Program (CMP) (Figure). While costing more than other countries, the system is regressive and provides inadequate support to the vulnerable (Annex VIII). Using such a system for counter-cyclical policies in a crisis is expensive, and can worsen debt dynamics as it did during the pandemic. Amending the social safety net program to improve targeting and

Total Social Assistance Spending
(Percent of GDP)

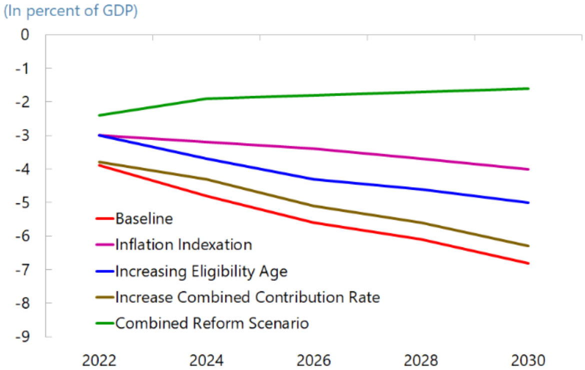


Source: IMF Staff Estimates (Based on most recent available data).

increase the coverage of, and the incidence and adequacy of benefits for the most vulnerable at the expense of the rich, can generate fiscal savings of about 3 percent of GDP and reduce poverty and income inequality. Various government databases and/or local government channels could be used to expand coverage of the vulnerable. In time, the unemployment benefit system[6] should be enhanced to make it a more effective automatic stabilizer in a downturn (IMF 2020b).

- ***Pension reforms.*** A parametric reform of the Pension Insurance Scheme (PIS) is needed to reduce the fiscal cost of pensions. A reform strategy comprising gradual increases in the retirement age to 65 and penalties for early retirement, automatic inflation indexation of benefits, and an extension of the wage base for pensions should produce fiscal savings of about 6½ percent of GDP by 2030 (Annex VII). Pension reforms take time to achieve consensus and phase in, and should therefore be initiated soon.

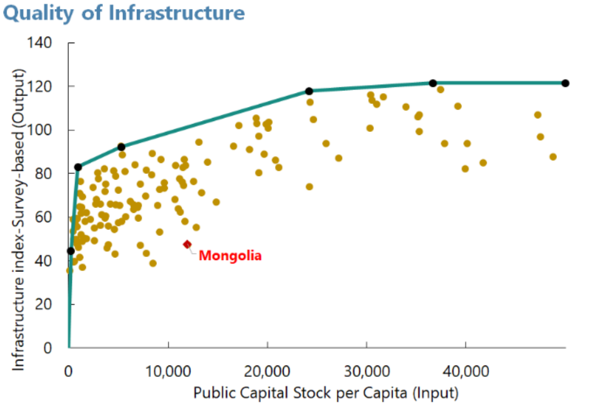
Pension Financing Gap
(In percent of GDP)



Source: World Bank Estimates (World Bank, 2020).

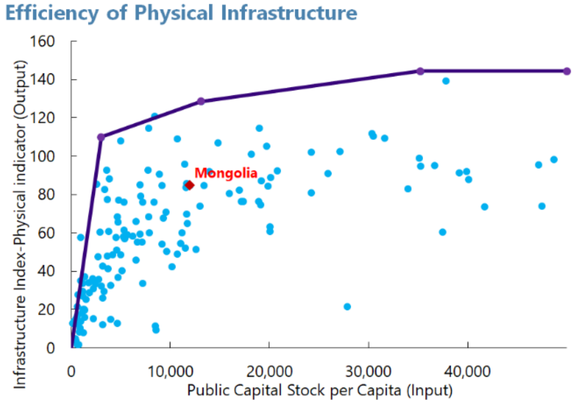
- ***Public investment management (PIM).*** Improving PIM to address concerns about value-for-money and to ensure sustainable levels of public investment are incorporated in the MTBF, can lower spending bills and reduce debt accumulation (Figures below, Section D).

Quality of Infrastructure



Source: IMF Template of Investment and Efficiency.

Efficiency of Physical Infrastructure

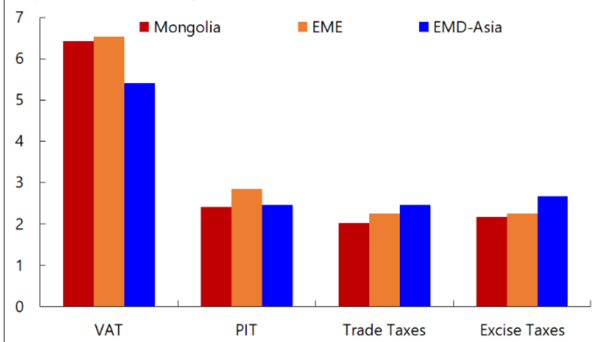


Source: IMF Template of Investment and Efficiency.

[6] Given a sizable informal sector, the unemployment benefit system covers about 23 percent of total unemployed in 2020.

- ***Tax policy.*** There is scope to increase additional revenues by reinstating planned increases in social security contributions and through a combination of tax policy measures, such as broadening the tax base and allowing greater progressivity in the top personal income tax (PIT) rate (currently 10 percent versus 27 percent in EMD-Asia) would boost PIT revenue above that of peer countries.

Tax Revenue Comparison
(In percent of GDP, Average 2017–2019)



Source: IMF Internal World Revenue Longitudinal Database (WoRLD); Mongolian Authorities.

- ***Ongoing tax and customs administration reforms*** could also yield revenue gains. The priorities are to implement annual compliance improvement plans, strengthen data and analytics, and introduce appropriate operational guidelines to improve the implementation of the 2019 tax policy legislation. Customs revenue leakages could be reduced by modernizing legislation, streamlining processes, and upgrading skills, thereby replacing a control-centric approach with a risk-based and targeted one.

- ***Debt management.*** Continuing efforts to improve public sector asset and liability management and increase debt concessionality would be beneficial, as would greater recourse to domestic financing, and a larger private sector role to achieve the government's policy goals. The former would require a fundamental course correction to address financial sector and governance weaknesses (Sections C and D).

23. Using fiscal buffers in lieu of reforms to contain debt is not advisable.[7]

- Without addressing the underlying factors driving the difficult debt dynamics,[8] such a strategy would not fundamentally alter the debt path. Moreover, it would undermine the fiscal rules governing the FHF—which would not warrant its use during an export price boom (Annex V) and come at a permanent cost to future Mongolian generations. Such a debt strategy is unsustainable.[9]

- Debt reduction through fiscal reforms, on the other hand, would create fiscal space for years to come, facilitate the achievement of the *Vision 2050* goals, and help Mongolia withstand large external shocks.

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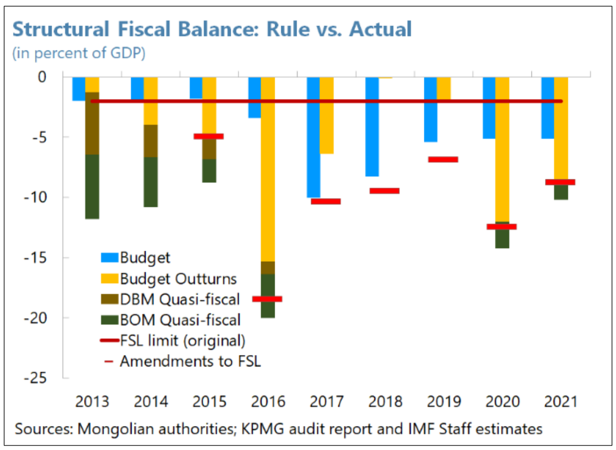
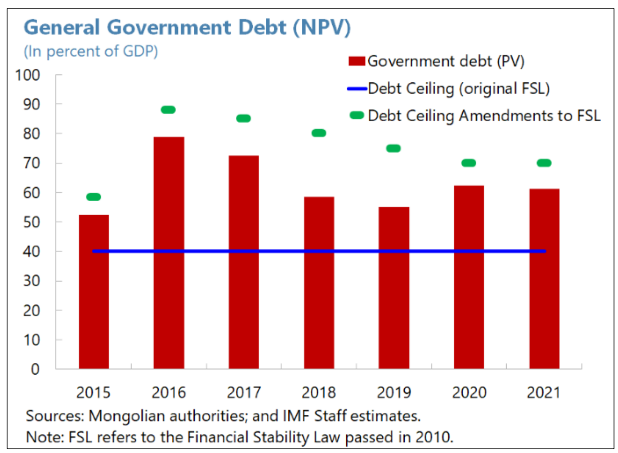
[7] Domestic buffers in the FHF have been rising and expected to reach 5.8 percent of GDP in 2021 (Table 4, Annex IV). The 2022 budget proposals imply no additional accumulation in the FHF from 2022–26, reducing FHF balances to 4.3 percent of GDP—instead of a previously expected 10.2 percent of GDP—by 2024. By law, these funds will be invested abroad from January 1, 2025.

[8] Structural weaknesses in the pension and social safety nets, tax policy and administration, investment management, and domestic debt markets.

[9] Using MNT buffers to paydown external debt would also not be advisable as it could create exchange rate pressures given thin FX markets. Moreover, at end-2020, 56½ percent of outstanding public debt was owed to official creditors including MDBs, and 39 percent to private creditors (which have been, and are being, rolled over). Financial conditions remain supportive given strong growth prospects, and the no net issuance commitment.

24. Adopting and complying with a streamlined fiscal framework can also strengthen the credibility of public finances (IMF 2021e). The 2013 Fiscal Stability Law (FSL) has been repeatedly amended (Figure), although savings in the FSF and FHF have appropriately increased recently (Annex IV). Mongolia should target a nominal debt anchor of 50 percent of GDP, as opposed to the current anchor of 60 percent in NPV terms, although it may not be able to achieve this target until after 2026.[10] Most emerging market economies have adopted 60 percent of GDP debt as a medium-term anchor, but a lower threshold—50 percent of GDP—could be considered appropriate for Mongolia given its greater reliance on external debt compared to peer economies and its fiscal risks (discussed extensively in IMF 2019a and IMF 2019b where staff argued that such an anchor would mitigate the risk of debt exceeding safe levels in case of adverse shocks). Such an anchor would reduce operational complexities and, being easier to communicate and monitor, be a better deterrent to political pressures, and should ideally cover budget liabilities incurred by the BOM.[11] Preserving the integrity of the FHF will be crucial for investor confidence. In this regard, undertaking legislative changes to forgo future savings in the FHF to fund untargeted social assistance permanently will undermine the only pillar of the fiscal framework that has worked so far. A more independent Fiscal Council is needed—with adequate budget and staffing capacity—to help monitor the budget process, with a formal correction mechanism to address non-compliance (IMF 2019a and b).





Authorities' Views

25. The authorities considered the proposed policies in the draft 2022 budget to be broadly appropriate for tackling near-term economic risks and consistent with the revised fiscal framework.

- The decision to sustain the CMP at the 2020–21 levels and transform it from a welfare to a savings program over the medium-term was appropriate as it aims to provide a financial guarantee for children in adulthood while limiting the fiscal impact of the program. Legislative changes to the FHF are consistent with the *Vision 2050* development strategy, and the authorities strongly disagreed with the assessment that using expected FHF accumulations to finance a permanent expansion of untargeted social assistance would jeopardize the integrity of

[10] The BOM's quasi-fiscal activities should be brought onto the budget and included in the coverage of public debt.

[11] Numerical rules promote fiscal prudence and strong fiscal frameworks can reduce borrowing costs (IMF 2021e).

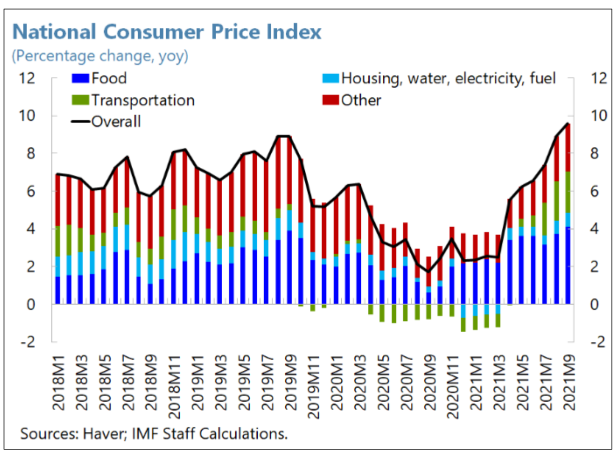
the FHF and the fiscal framework and undermine investor confidence. Public investment management systems are being amended. Pension reforms—to be discussed by Parliament in Fall 2021—will accommodate many of the recommended reforms, failing which state subsidies for pensions will continue to rise over time. Social welfare reforms will propose mechanisms to improve targeting, but this will require developing a database which may not materialize soon.

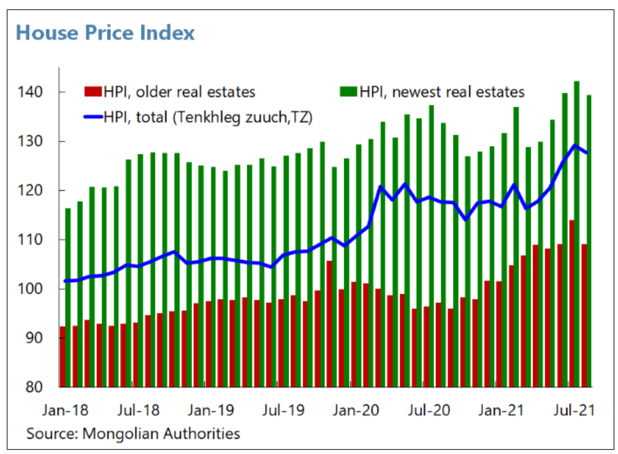
- Efforts to broaden the tax base by addressing the informal economy and improving tax administration will continue. But there are no plans to raise taxes or make the PIT progressive.

- Despite recent increases, public debt levels remain within the revised framework approved in 2021. The authorities recognized the benefits of establishing a nominal debt anchor but the current debt anchor (in NPV terms) is consistent with past IMF debt sustainability assessments. The NPV anchor remains relevant as most of Mongolia's debt is concessional. Given a preference for cheaper financing options, domestic debt issuance would be considered as a last resort.

B. Continue Securing Monetary and External Sustainability

26. Monetary policy should remain on hold. Inflation expectations and cost push pressures appear to be contained, although asset prices have increased somewhat (Figure). Private credit growth—the main monetary policy transmission channel—remains subdued due to increased risk aversion amidst economic uncertainty. On balance, therefore, the current accommodative stance remains appropriate since inflation is expected to be return to the BOM's target, given the large output gap. The BOM should continue to look through inflationary pressures driven by transitory supply-side factors and volatility in global prices. It should continue to sterilize interventions in the FX market to contain excess liquidity.





27. Nevertheless, the BOM should remain vigilant on inflation. Sustained inflationary pressures could arise due to excess liquidity generated by strong exports inflows, boosting credit growth. Inflation could also be triggered by the release of pent-up domestic demand after the pandemic, while the shrinking labor force could put push up wages if LFP remains low. The significant policy support already provided, and in the pipeline, and the challenges inherent in quickly reversing measures requiring Parliamentary action, could overstimulate the economy, boosting inflation. The BOM should stand ready to raise interest rates and reserve requirements, reinstate the macroprudential measure on debt-income ratios, and mop up excess liquidity if inflation trends up more persistently.

28. Quasi-fiscal operations should be discontinued as they are jeopardizing the operational independence and balance sheet of the BOM.[12] Despite the BOM's commitment to limit new quasi-fiscal activities to 2 percent of GDP under the 2020 RFI arrangement, quasi-fiscal operations totaled 5.2 percent of GDP by end-August 2021, and are expected to continue till end-2021. Furthermore, quasi-fiscal policies appear set to be expanded till 2023 in the draft post-pandemic economic recovery law (PPERL). Limited operational independence undermines the BOM's credibility and effectiveness, hampering its ability to control inflation and financial stability risks. The BOM's quasi-fiscal operations should be discontinued when the APL expires at end-2021; the subsidized mortgage lending program transferred to the government and phased out.

29. The exchange rate should continue to act as a shock absorber and FX intervention should be limited to disorderly market conditions. Although the BOM has adopted inflation as the *de facto* nominal anchor for the last decade, *de jure* it is the MNT/US$ exchange rate which serves as the nominal anchor because of concerns about financial dollarization and a disorderly depreciation in thin markets. Greater exchange rate flexibility would lend credibility to the inflation anchor, help build buffers, and facilitate external adjustment.

30. Stronger buffers are needed, given a large negative IIP and low NIR due to high external debt (Annex II).[13]

- ***Broad-based reforms.*** Improving the IIP durably will require sustainable (tighter) fiscal policies (Section A), a strong financial sector capable of intermediating long-term lending to serve Mongolia's mining and infrastructure needs, thereby reducing the need for external borrowing (Section C), and improvements in governance to attract FDI and ensure that risks from external borrowing are properly managed (Section D).[14]
- ***Bolster NIR.*** The BOM should continue to bolster NIR by opportunistically intervening in the domestic FX market to build buffers, without triggering a misalignment of the exchange rate from fundamentals. It could consider divesting the accumulated stock of non-gold precious metals (around US$450 million). Continuing to boost the FHF and FSF in line with the fiscal framework, will improve government assets; gradually investing these funds abroad could, over time, reduce currency risk and IIP, and build resilience to external shocks.

[12] At end-August 2021, BOM capital was – 2.9 trillion MNT (7 percent of GDP) due to large losses in previous years.

[13] A large share of private external debt comprises OT's debt to its parent company. The presumption is that OT's external liabilities can be financed by its exports and, in case of stress, absorbed/financed by the parent company.

[14] While much of the debt has financed tradable sectors like mining, significant amounts are also owed by non-bank private companies and SOEs. Some large mining projects face implementation risks, raising concerns about their ability to generate foreign exchange.

- ***Liability management.*** The BOM should continue to proactively reduce foreign liabilities by reducing its reliance on off-balance sheet swaps—a welcome policy shift in 2021. Taking advantage of the export price boom and high GIR, using the IMF 2021 SDR allocation to repay non-concessional liabilities could be considered as one option to improve external sustainability.

31. Improving monetary transmission will require financial sector and governance reforms. Structural excess liquidity in the financial system is the primary reason behind a suboptimal monetary policy transmission. Excess liquidity arises, in part, due to limited domestic investment opportunities, the lack of domestic securities,[15] risk-aversion by banks due to their weak capacity for credit risk assessment and the lack of a robust insolvency framework, and limited medium- to long-term funding available to banks.[16]

32. There is merit in restarting domestic government bond issuance. The government's intention to issue domestic securities through a conservative and staged process will appropriately help minimize execution risk and give markets time to adapt. In addition to developing a comprehensive medium-term debt strategy (MTDS) and an Annual Borrowing Plan, the government's debt management capacity should be adequately resourced and staffed and investor relations, market outreach, and coordination with the BOM should be significantly strengthened. Following market outreach to gauge investor demand, issuance could be initiated with small auctions at the short end of the curve, where the policy rate provides a natural anchor.

Authorities' Views

33. The authorities plan to maintain the current monetary policy stance as they shared the view that recent inflationary pressures are transitory. They agreed that monetary policy may need to be tightened if inflation persistently exceeds the target range. They noted that restarting government domestic bond issuances will stimulate interbank market trading, create a yield curve, and support financial market development.

34. The authorities also concurred with the thrust of the external sector assessment. They agreed that bolstering NIR through opportunistic interventions was necessary, while greater exchange rate flexibility—as was the case pre-pandemic—would act as a shock absorber. The BOM committed to end all quasi-fiscal activities by end-2021, except the subsidized mortgage program, which—according to the draft PPERL—will end in 2023 and subsequently, be transferred to the government.

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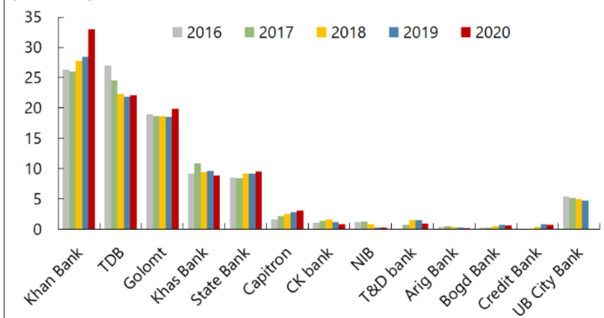
[15] The government stopped issuing domestic securities in 2017 due to an improving budget, availability of concessional external financing and the high costs of domestic bonds.

[16] At end-June 2021, 91 percent of bank deposits had a maturity of 12 months or less.

C. Restoring Banking Sector Health

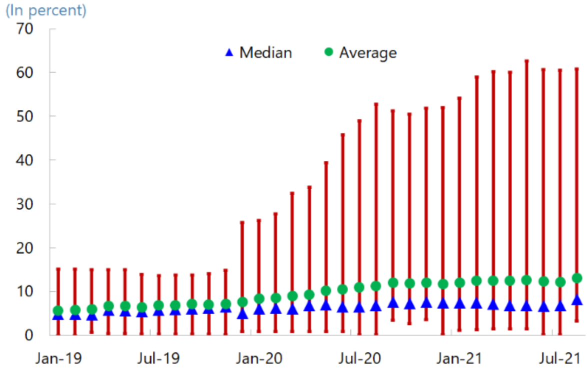
35. The banking system has begun to recover after being hit hard by the pandemic (Annex IX). While banks remain highly liquid and many banks maintain regulatory compliance with capital adequacy, tier 1, and leverage ratios, profitability declined sharply in 2020 and has only recently begun to recover. NPLs rose across the sector during the pandemic but have recently moderated, due to de-risking, COVID-relief program lending, and progress by some banks on NPL resolution. Nevertheless, NPLs are expected to expand further once forbearance measures are unwound (Figures below). There is, however, a wide variation across the system—which is highly concentrated (Figure)—reflecting important pockets of balance sheet weaknesses due to legacy issues, and governance and management challenges.

Market Share by Bank
(In Percent)



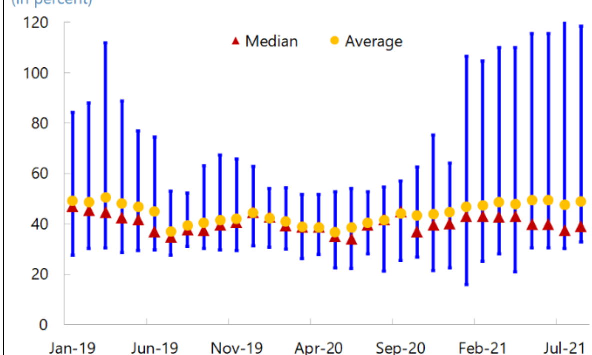
Source: IMF Financial Soundness Indicators.
Note: TDB (Trade and Development Bank); CKB (Chinggis Khan Bank); T&D Bank (Transport and Development Bank); NIB (National Investment Bank). TDB and UB City Bank merged in June 2020.

NPL Rates in Major Banks
(In percent)



Source: FSI; IMF Staff Calculations.

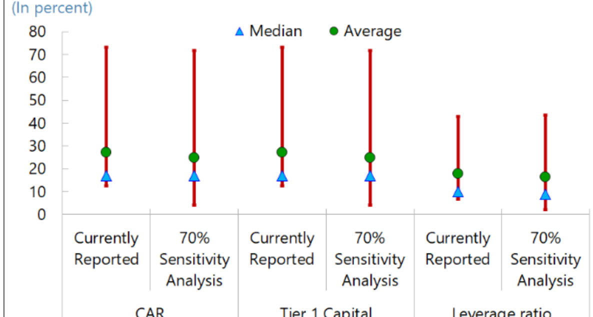
Liquidity Ratio in Major Banks
(In percent)



Source: FSI; IMF Staff Calculations.

36. Financial stability concerns remain. Sensitivity analysis suggests that many banks remain adequately capitalized and in full regulatory compliance even in a worst-case scenario requiring a 70 percent provisioning for loans currently under forbearance (Figure). However, capital needs are elevated for some banks. In the worst-case scenario discussed above, these capital deficient banks would need at least an estimated 1.3 percent of GDP in additional capital.

CAR, Tier 1 Capital and Leverage Ratio
(In percent)



Sources: FSI; IMF Staff Calculations.
Note: A 70 percent worst-case scenario is standard IMF practice, given uncertainty due to pandemic (Mongolia's 2017 AQR identified NPL underestimation of 164%). Based on (reported capital)–(capital similar to those rejected earlier)–(capital raised per BOM's October 2019 instructions).

37. A well-thought out and sequenced approach to bank restructuring is needed. The BOM's strategy—to strengthen capital and reduce shareholder concentration through bank IPOs by end-2023—has commendable goals. However, the strategy attempts to achieve multiple complex reforms within too a narrow timeframe without adequate preparation or contingency planning. Such an approach entails a high risk of failure, risking potential systemic instability and reputational risks for the BOM and other regulators. The BOM must use appropriate analytical tools to identify festering problems in the banking system, and prioritize its policy responses, while dealing with capital deficient banks to avoid destabilizing the banking system and triggering systemic contagion. Policies should ensure:

- ***Greater transparency and a proper assessment of the impact of the pandemic on bank balance sheets.*** To generate investor confidence, bank balance sheets should meet regulatory and accounting norms before the IPOs. To that end, forbearance measures should be increasingly targeted and phased out by end-2021; the current timeframe is excessive given the recovery underway. The BOM should carefully assess the quality of bank reporting and monitor financial soundness indicators as forbearance is phased out. A new, targeted asset quality review (AQR) should be conducted—ideally starting in 2022—by an independent international audit firm for capital deficient banks to arrive at reliable valuations, validate all additional capital increases, and identify other shortcomings. An AQR of the entire banking system should be pursued over the medium term.

- ***Near-term supervisory efforts are focused on strengthening banks.*** Most banks have already begun implementing plans to reach the new (higher) levels of minimum paid-in equity capital by end-2021, including through consolidation. The BOM should adhere to this deadline and ensure that plans comply with regulatory requirements and best practices. The BOM should urgently conduct updated Business Plan and Solvency Assessments of banks and stress tests to better assess the financial health of banks under adverse scenarios and a granular understanding of bank-specific weaknesses. Banks should preemptively provision for forborne loans, and address identified weaknesses.

- ***Capital deficient banks are addressed.*** Capital deficient banks should submit capital restoration plans to the BOM for review, approval, and monitored implementation. If a successful restructuring within a reasonable timeframe is not possible, the BOM should exercise its authority under the Banking Act and take appropriate measures until capital compliance is achieved. To avoid systemic challenges, the need for public solvency support cannot be excluded and should be operationalized without delay. The BOM and MOF should closely coordinate to ensure that public funds are utilized in a manner that guarantees the successful turnaround of the banks and maintain public and investor confidence. A crisis communications committee, including key stakeholders, should ensure a well-coordinated communication strategy to maintain confidence. The Deposit Insurance Corporation of Mongolia (DICOM) must carry out its functions transparently in line with established procedures, and play a critical role in preserving confidence. Provisions for government funding for DICOM that might be required in the event of the insolvency of a SIFI must be well-defined. Gaps related to collateral repossession, insolvency, and the inefficiencies of the court system should be addressed.

- ***Necessary pre-conditions and contingency plans are in place before bank IPOs.*** Banks must address any potential balance sheet deterioration before the IPO. This may be easier for some banks than others. The BOM should delay the IPO target deadline and avoid rushing to fully diversify shareholders as it could crowd the field of issuers on a stock exchange that has a low level of capitalization, and no history of significantly large IPOs, let alone successful bank IPOs.[17] [18]The FRC and the BOM should be prepared to effectively oversee the process, and ensure a careful assessment of the fitness and propriety of new (large) shareholders. Given the limitations of the Mongolian Stock Exchange, a successful IPO is not guaranteed even in the best-case scenario, and regulators should develop contingency plans for this eventuality.

38. Over the medium term, further strengthening of supervision capacity will be necessary. The BOM has implemented the new supervisory framework designed to move the institution toward risk-based supervision, however implementation is not fully consistent with Basel. Further training of supervisory staff could be helpful, particularly for reviewing and approving banks' NPL resolution strategies and restructuring plans.

39. Regulatory reforms are needed. To support the strengthening of balance sheets, insolvency and creditor rights needs to be improved in the near term in line with the advice provided by the IMF and other institutions (Section D). Further refinements maybe needed in laws amended in late 2020 (such as the Banking Law). In particular, appropriate codes of corporate conduct should be legally mandated giving the BOM the appropriate legal authority to address non-compliance. The Law on Deposit Insurance should be updated to improve creditor hierarchy of claims in line with international best practices. The Parliament should refrain from passing legislation that establishes policies and timetables that supersede the authorities of the regulatory bodies.

Authorities' Views

40. The BOM was confident that, as the economy recovers, the performance of loans under forbearance will not contribute to an increase in NPLs. The BOM's sensitivity analyses, which stresses for increases in overall NPL levels—rather than loans under forbearance—suggest no capital shortfalls would arise in downside scenarios similar to historical downturns.

41. The banking sector reform strategy aims to maintain the reform momentum within the current electoral cycle. Unless Parliament amends the Banking Law, the authorities plan to adhere to the legislation's deadlines which, the BOM was confident, can be met: to date, all SIFIs have submitted IPO plans for approval and surveyed potential pools of investors. The regulators are

[17] Only two banks have ever traded on the stock exchange, and both failed in 2008, severely damaging public confidence.

[18] The authorities should also be prepared to address legal challenges to shareholder diversification requirements launched by banks or shareholders that have questioned the constitutionality of the law.

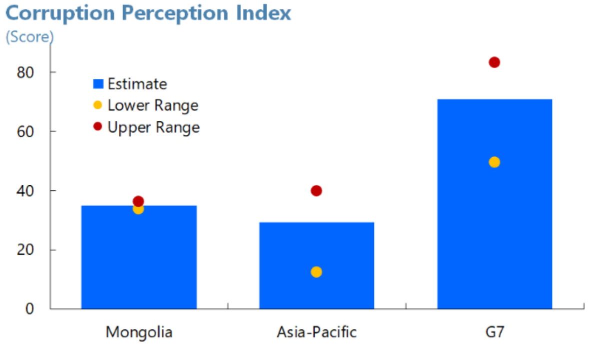
still developing rules governing the IPO process: all banks are required to complete year-end IFRS-9 compliant audited financial statements for IPO disclosures. The BOM was confident of its ability to conduct fit and proper vetting of qualifying share purchasers but acknowledged that vetting offshore investors would be more challenging. The authorities acknowledged the need to formulate contingency plans in case of financial instability.

D. Combatting Corruption and Weak Governance

42. A stronger business climate is needed to boost Mongolia's growth potential and bolster macrofinancial stability. Mongolia's business climate ranks well below mineral resource-rich peer economies (Figure 8), with marginal improvements in recent years. Notable problems exist in: electricity supply (infrastructure gaps); cross-border trading (widespread corruption); resolving insolvency (regulatory weaknesses and ineffective contract enforcement reflecting long and unpredictable judicial procedures and limited capacity for commercial dispute resolution); and initiating and operating businesses (weak governance and transparency). Progress is required on several fronts to maximize the gains from a commodity boom, attract FDI and diversify a narrow economic base. To this end, the forthcoming PPERL emphasizes cutting red tape through digitalization and e-governance.

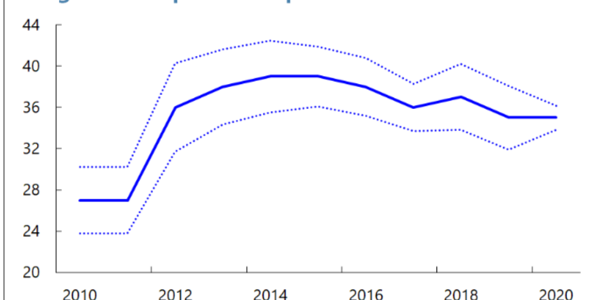
43. Weak governance and corruption remain major concerns. The anti-corruption legal framework has improved, but implementation is lagging, resulting in high corruption, particularly in several state functions (Figures below).[19] Progress is underway to strengthen revenue administration and modernize the customs regulatory framework with IMF assistance. Despite legislative measures to improve the independence of key institutions by limiting Presidential powers to appoint officials in the IAAC, JGC, and JDC, several prior governance-related concerns—notably inadequate transparency requirements for politically exposed persons and a lack of protection of whistleblowers—remain valid (IMF 2019b), and should be addressed.

Corruption Perception Index



Source: Transparency International (2020).
Note: The index compiles results of 13 surveys. "Estimate" is a weighted sum of survey resullts, "lower"("upper") reflects the lowest (highest) score among 13 data points. High scores reflect lower corruption perception.

Mongolia-Corruption Perception Index



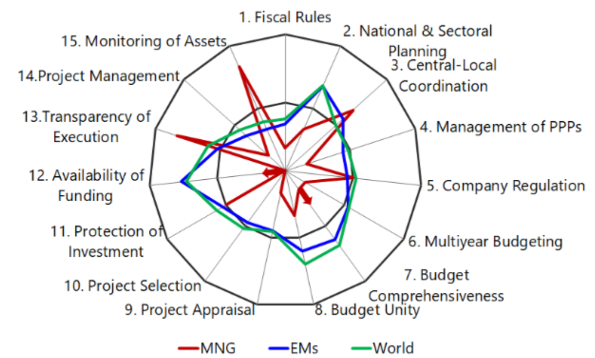
Source: Transparency International (2020).
Note: The index compiles results of 13 surveys. "Estimate" is a weighted sum of survey resullts, "lower"("upper") reflects the lowest (highest) score among 13 data points. High scores reflect lower corruption perception. Dotted lines represent upper/lower bound of the 90 percent confidence interval of the index score.

[19] Mongolia's rule of law index decreased in 2020 driven by a deterioration in corruption, regulatory enforcement, and civil service (World Justice Project).

44. Strengthening fiscal transparency and public investment management (PIM) is a priority. Mongolia fares poorly relative to comparators (Figure), with substantial scope to boost spending efficiency and investment quality. Several areas of weakness identified by the IMF remain relevant. Notably:

- *Strengthening fiscal transparency.* To better control substantial off-budget spending, a strong institutional framework is needed, with clear roles and responsibilities amongst various agencies such the National Audit Office (NAO), Fiscal Stability Council, MOF and Parliamentary offices.

PIM Institution Score



Source: PIMA report for Mongolia (2016).
Note: Better(worse) scores are closer to the exterior (center) of the circle. Arrows in red indicate improvements in PIM since 2016 assessment.

- *Medium-term budgeting for multi-year public investment.* All projects should be appraised prior to the budget process using an established project selection criteria, and incorporating appropriate levels of maintenance funding. Sustainable levels of public investment spending should be incorporated in the MTBF to improve project planning and reduce delays, arrears, cost overruns and cancellations.

- *Improved project appraisal, selection and management.* Although an electronic public investment management system has been recently adopted, there is room to enhance project selection/appraisal by using published criteria and methodology, and beefing up central oversight and support functions. Project selection must be directly linked with the budget process, even if they are reviewed by the National Development Agency. Project implementation plans should be prepared prior to approval. Payables reporting should be strengthened to better control project execution and arrears.

- *Adequate PPP management.* The planned PPP law to enact international best practices is commendable. The selection of PPP projects should be based on appropriate guidelines and management frameworks which effectively control contingent liabilities. The selection and approval of such projects should be embedded within the budget process.

45. Stronger SOE governance would help improve public sector management.[20] The draft 2022 budget aims to increase SOE contributions to the budget by increasing profitability and strengthening transparency and accountability. An immediate priority should be to consolidate all SOEs into the government's financial statements, and record fiscal support to SOEs on-budget to improve transparency and to provide an impetus for financial self-sufficiency. A clear time-bound

[20] At end-2019, Mongolia's 107 SOEs held 100 percent of GDP in debt while generating profits of about 4 percent of GDP. All but two mining SOEs are loss-making. Detailed IMF reform proposals will be developed in the next consultation cycle.

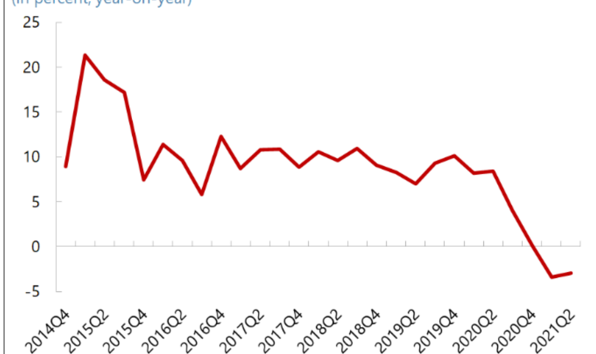
strategy for SOE reforms should be published, including proposals to address loss-making SOEs, increase productivity, and reduce vulnerability to corruption by strengthening SOE transparency, governance and oversight by the MOF and State Property Coordination Agency. Such measures will lower fiscal risk and help economic diversification.

46. An independent third-party audit and transparency of COVID-19 expenditures is important to secure continued donor support. The commitment to audit and publish the results by end-June 2021 (IMF, 2020a) has been delayed due to the pandemic but a NAO audit report on Covid-19 expenditures was recently published. Efforts to publish Covid-19 related contracts on the MOF website including information about awarded companies and beneficial owners are noteworthy, however, the identification of missing beneficial owners should continue.

47. Improving BOM governance is macro-critical. Weaknesses in governance continue to lead to high levels of quasi fiscal activities and supervisory challenges. Following the 2017 IMF Safeguards Assessment, the 2018 amendments to the Central Bank Law strengthened BOM governance,[21] as did the 2021 amendments which reinstated legal immunity for supervisors to ensure appropriate appointment and dismissal procedures with limited scope for misuse (see Informational Annex). Nevertheless, the BOM's operational independence remains weak due to Parliamentary actions. Notably, it was a Parliamentary decision—not an MPC decision—to keep extending the 2021 APL that is forcing the BOM to undertake large quasi-fiscal operations with significant monetary and financial implications. Enhancing the BOM's institutional and financial autonomy, further clarifying its mandate, and ensuring greater *defacto* protection of BOM management and staff from political pressure is a must.

48. A revamped insolvency framework is vital for addressing impaired corporate and financial sector balance sheets. The pandemic has increased insolvency risks, especially among SMEs, which are heavily represented in hard-hit sectors (Figure). It would be important to target assistance toward distressed but viable SMEs, while facilitating the orderly exit of non-viable SMEs. The latter is difficult under the existing 1997 insolvency law, which does not adequately protect a creditor's ability to collect collateral in the event of non-payment nor provide debtors an opportunity to rehabilitate their business. A revised corporate bankruptcy law will be submitted to Parliament in early 2022. To facilitate a speedy resolution of balance sheet distress, the revised insolvency framework should incorporate: an expanded scope to also cover

Number of Active Businesses
(In percent, year-on-year)



Sources: Mongolian Authorities.

[21] The amendments strengthened the BOM's mandate, limited monetary budget financing, prohibited the BOM from engaging in quasi-fiscal activities, allowed 4 of the 7 BOM Monetary Policy Committee (MPC) members to be appointed by Parliament rather than by the Governor with MPC decisions made by majority vote rather than by the Governor alone.

individual entrepreneurs/merchants; simplified insolvency tests to expedite resolution;[22] enhanced creditor notification to facilitate the commencement of insolvency proceedings; and, strengthened legal provisions on rehabilitation plans to appropriately protect creditors' rights.

49. The ongoing implementation of FATF recommendations should continue. A recent plenary meeting of the Asia Pacific Group for Money Laundering (APG) reports substantial progress on technical compliance and improved effectiveness in several areas.[23] However, there are still important implementation challenges that the authorities are working to address. In light of the existing ML/FT risks (especially in the extractive sector), progress should continue, focusing on preventive measures (i.e., customer due diligence, including politically exposed persons) and the transparency of beneficial ownership of legal persons, including those in dealings with, or dependent on, the public sector. This information should be accessible to reporting entities.

Authorities' Views

50. The authorities concurred that governance and transparency challenges remain. Efforts are underway to enhance implementation capacity and effective enforcement to help combat corruption among high-level officials. Public investment management is being strengthened to increase transparency and clarify responsibilities. SOE reforms aim to increase enterprise value and budget contributions by aligning corporate governance with international standards, improving financial reporting and transparency, and enhancing expenditure discipline and dividend payout policies. On AML/CFT, the focus is now on undertaking a second national risk assessment, developing a national strategy, and effective implementation of the AML/CFT framework including by issuing relevant guidance to the private sector. The authorities echoed the importance of upgrading the insolvency framework and enhancing the BOM's operational autonomy by continuing outreach to Parliamentarians.

E. Post-Financing Assessment[24]

51. Mongolia's capacity to repay the IMF has slightly improved since 2020. Mongolia is benefitting from a commodity price surge that is expected to boost exports significantly in 2021 and beyond, as copper exports from the OT mines come onstream. The recent strengthening in external balances has allowed the BOM the opportunity to bolster its GIR. External financing conditions remain favorable and the successful Eurobond rollovers have reduced short-term refinancing risks.

[22] This could comprise a simple cash flow test as the basic standard (inability to pay debts as they fall due) and use a balance sheet test (liabilities exceeding assets) only as an alternative.

[23] Mongolia was put on FATF's gray list in October 2019 but delisted in October 2020 due to decisive implementation of FATF recommendations, including (1) enforcement of a new supervisory framework covering all financial institutions and designated non-financial business and professions, (2) prosecutions of money laundering activity; (3) increased confiscation/seizure of non-declared currency; and (4) cooperation to prevent sanctions evasion of proliferation financing.

[24] This section reports on discussions under the Post-Financing Assessment (PFA) policy initiated for Mongolia in May 2021. The PFA policy is described in Policy Paper No. 2021/026 (https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/05/19/Post-Program-Monitoring-During-The-Pandemic-460350).

However, external liabilities will remain large and the recent GIR accumulation is likely to be short-lived. Under the baseline, Mongolia's capacity to repay the IMF remains adequate, with IMF debt service projected to be 0.7 percent of exports and 2 percent of gross reserves in 2024.

52. However, Mongolia's repayment capacity is subject to significant risks (Annex X). The biggest risk relates to a resurgence of an uncontrolled and super-contagious COVID-19 variant triggering costly containment efforts, lower global growth and commodity prices, and tighter risk premia. The impact of such a shock would be aggravated if borders with China are temporarily closed. Under such a scenario, Mongolia's capacity to repay the IMF would deteriorate somewhat but would still remain adequate (0.8 percent of exports and 2.3 percent of gross reserves in 2024).

53. In this eventuality, containing the pandemic and intensifying efforts to build buffers would be crucial. The government should step up support for the health system and initiate containment measures, while ensuring that export portals can stay safely open. The BOM should allow the exchange rate to act as a shock absorber, continue to opportunistically intervene to buildup reserves, and, rollover non-concessional external liabilities. Policy support should be targeted and accompanied by much-needed structural fiscal reforms (pensions, social safety nets, tax policy and administration, public investment management, domestic debt issuance) to create fiscal space over time. Discontinuing quasi-fiscal activities; adopting and adhering to a simplified fiscal fiscal framework; and, financial, regulatory and governance reforms can help create policy space by improving confidence in sound policy management.

Authorities' Views

54. The authorities agreed that Mongolia's capacity to repay the IMF has recently improved. However, significant downside risks remain mainly from a worsening of the pandemic and extended border closures. They broadly concurred with the policies needed to appropriately address risks to Mongolia's capacity to repay the IMF. However, there may be political constraints to undertaking some reforms at the current juncture.

STAFF APPRAISAL

55. An export-led recovery has begun, even as the pandemic lingers. The global recovery, continued policy support and base effects are expected to boost GDP growth in 2021 to 4½ percent. Nevertheless, domestic activity remains weak despite a successful vaccination program and considerable economic support for households and enterprises. Many workers, especially female workers, are leaving the workforce, perhaps permanently. Inflation has risen recently but mainly due to transitory factors affecting import prices.

56. The economic outlook is strong but uncertain. Mongolia remains poised for an export-led boom from 2022 onward. Growth is expected to accelerate in 2022−23 to 6½–7 percent if export portals fully reopen and the OT 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 expected to remain below pre-pandemic trends due to permanent losses in activity. Moreover, despite an export price boom, the 2020 current account improvements are likely to be temporary once recovery takes hold, given Mongolia's lack of export diversification, heavy import dependence and high external debt. Inflation is likely to return to the BOM's 6±2 percent target given economic slack.

57. Downside risks are likely to weigh on the outlook. A resurgent pandemic, tighter global financial conditions, extended border closures, delays in completing the OT mine could worsen the outlook. So could financial stability risks. Procyclical policies could undermine macrofinancial stability and debt sustainability and reduce policy space to address other risks. However, even in an adverse scenario, Mongolia's capacity to repay the IMF remains adequate.

58. As Mongolia contends with the pandemic amidst surging export prices, sound policy management will be critical. The government's long-term development strategy, *Vision 2050*, rightly prioritizes macroeconomic stability and green and sustainable development goals. The key challenge for policymakers will be to secure the recovery, while managing the mining boom prudently to achieve its long-term goals to lift living standards over time.

59. In the near term, policies may need to continue to be supportive, given the lingering pandemic and weak recovery in domestic activity. Any continued fiscal support should be better targeted toward those in need and to support health systems. Monetary policy should remain supportive as well given transitory inflationary pressures.

60. However, strong fiscal reforms are needed to address untenable debt dynamics. The draft 2022 budget will need to strike a better balance between providing economic support and more ambitious fiscal consolidation to improve the medium-term debt trajectory. To this end, better targeted and more effective social assistance programs, ambitious pension reforms, improved public investment management and tax administration, and a more progressive PIT system should be put in place in 2022–23 to achieve a faster pace of consolidation. A 6½ percent of GDP consolidation over 2022−26—relative to the current baseline—could help reduce public debt closer to the recommended nominal anchor (50 percent of GDP) over time. Commendable plans to reform SOEs, the civil service and introduce e-governance should be fleshed out and implemented. The integrity of the FHF—a key element of the fiscal framework—should be preserved to maintain investor confidence and equitably share Mongolia's mineral wealth with future generations. Continuing to improve asset-liability management and debt concessionality can improve fiscal space, and a gradual shift to domestic borrowing can reduce external liabilities.

61. The BOM's operational independence should be enhanced to ensure monetary and external stability. Continued vigilance is needed to ensure that the inflationary pressures do not become persistent. Quasi-fiscal operations should be moved to the budget and phased out, and the Parliament should resist making decisions on monetary operations. The exchange rate should continue to act as a shock absorber, limiting interventions to addressing disorderly market conditions. Stronger buffers are needed given the substantially weaker external position than implied by fundamentals and desirable policies, requiring tighter fiscal policies and a strong financial sector. The BOM should proactively reducing foreign liabilities.

62. Bank reforms must be properly sequenced to minimize the risk of systemic instability. While commendable, the strategy to strengthen capital and reduce shareholder concentration through bank IPOs by end-2023 presents potential systemic stability implications. To improve transparency and a proper assessment of the impact of the pandemic on banks ahead of the IPOs, forbearance measures should be phased out, followed by a new AQR, initially focused on potentially capital deficient banks and conducted by a reputable, independent international audit firm. Near-term supervisory efforts should focus on strengthening banks and addressing capital deficient banks. Necessary pre-conditions for successful IPOs and contingency plans should be put in place and the IPO deadline delayed.

63. Strong governance and a reduction in corruption are critical to ensuring a strong business climate to unlock Mongolia's growth potential. Recent improvements in the AML/CFT framework and legislative initiatives are noteworthy and should be effectively implemented. Strengthening the rule of law and the implementation of anti-corruption measures should be accelerated. To facilitate a post-pandemic recovery, reforms that improve public and private sector balance sheets are critical. These include: revamping public investment management to improve project planning and reduce delays and cost overruns. Revamping the insolvency framework and judiciary reforms should be prioritized to address impaired corporate and financial sector balance sheets. In addition to the publication of a summary audit report on Covid-19 expenditures, missing beneficial owners of companies awarded Covid-19 related contracts should also be identified and published, and the full audit report should be published to promote transparency and accountability and to secure continued donor support.

64. The next Article IV consultation is expected to take place on a standard 12-month cycle.

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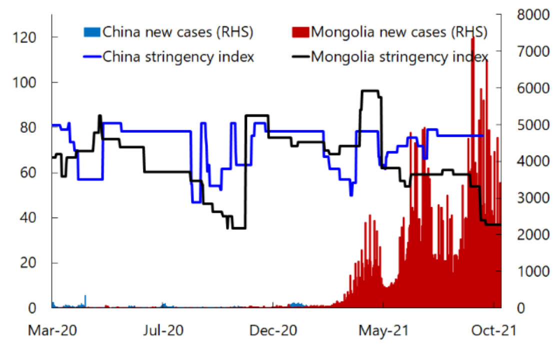
Figure 1. Mongolia: A Lingering Covid-19 Pandemic

Quick and decisive measures quickly contained the virus throughout 2020.

Stringency Index and number of new daily COVID-19 cases

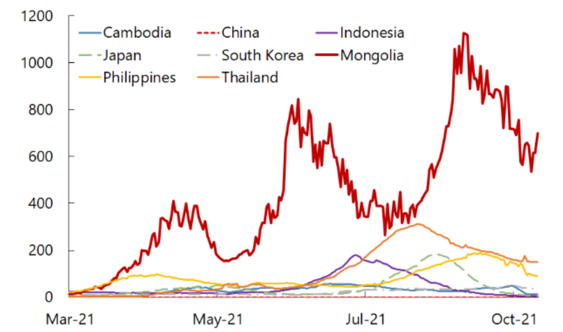


Source: Our World In Data.

However, cases surged in April, June, and again in September, 2021.

Daily New Confirmed COVID-19 Cases per Million People

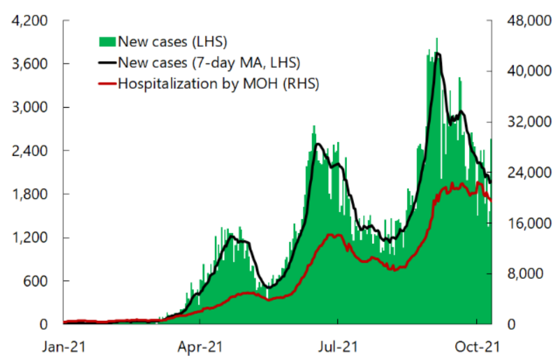
(Smoothened)



Source: Our World In Data.

New cases and hospitalizations remain high....

COVID-19 Cases

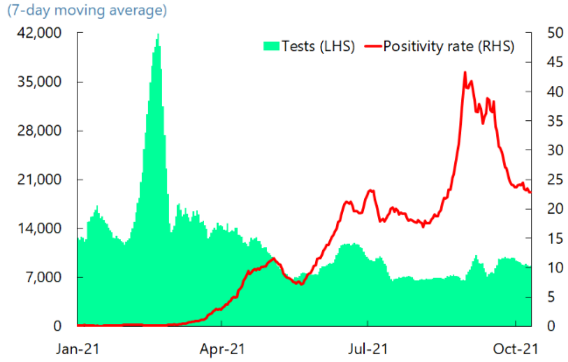


Source: Ministry of Health, Mongolia.

... as does the positivity rate.

COVID-19 Tests and Positivity Rates

(7-day moving average)

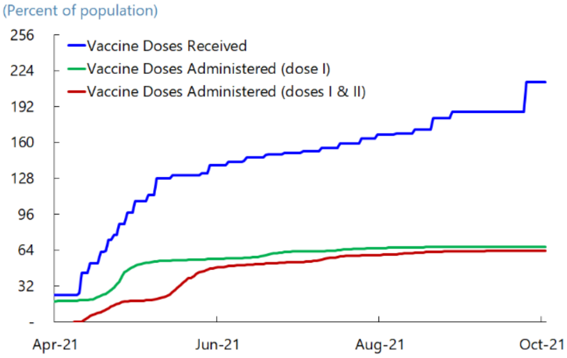


Source: Ministry of Health, Mongolia.

The vaccination campaign has been successful...

COVID-19 Vaccine Administration

(Percent of population)

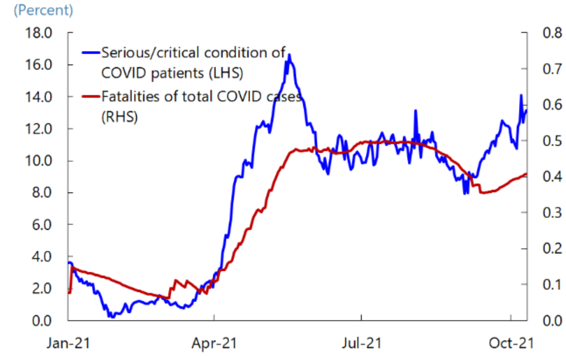


Source: Ministry of Health, Mongolia.

...and helped stabilize critical and serious cases.

COVID-19 Patients and Fatalities

(Percent)

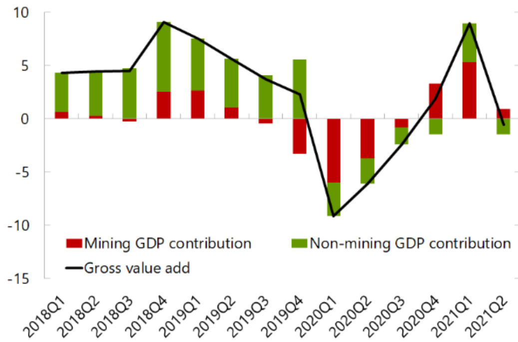


Source: Ministry of Health, Mongolia.

Figure 2. Mongolia: An Export-Led Recovery Has Started

After a collapse, the mining sector is recovering.

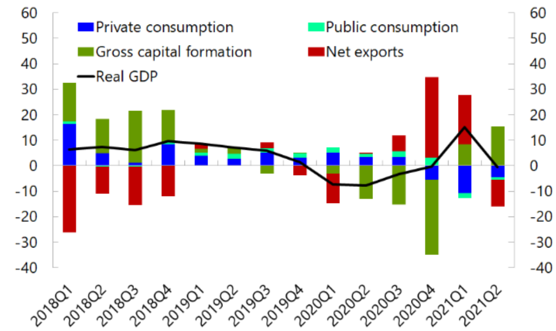
Mining Sector Contribution to GDP
(Percentage points)



Source: Haver

But containment measures are hurting private consumption.

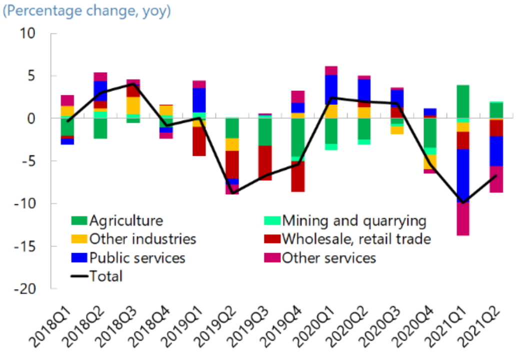
Real GDP
(Percentage change, yoy)



Source: Haver.

Service sector employment has been hit hard…

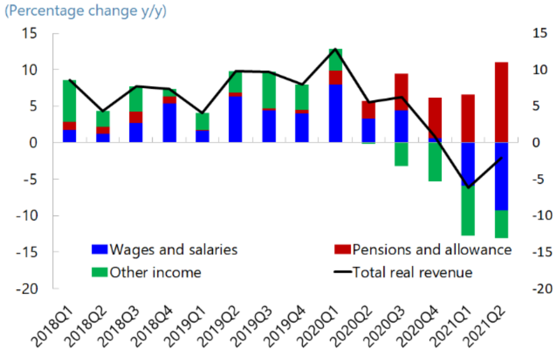
Contribution to Employment
(Percentage change, yoy)



Source: National Statistics Office.

…contributing to a sharp drop in real income…

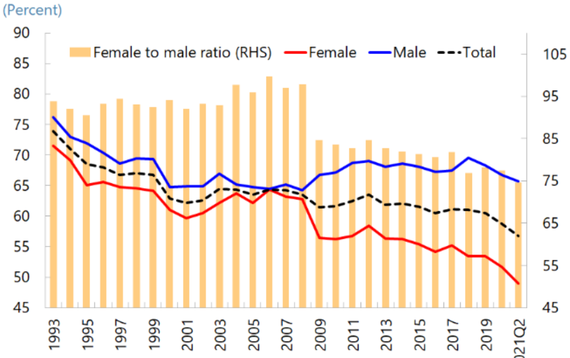
Real National Income
(Percentage change y/y)



Sources: National Statistics Office; Haver; IMF staff calculations.

…and accelerated workforce attrition, especially female.

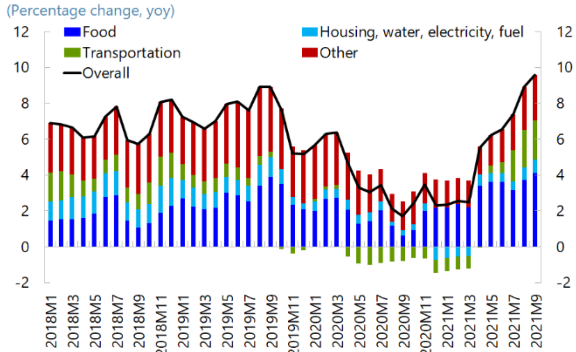
Labor Force Participation Rate
(Percent)



Source: National Statistics Office.

Inflation is on the rise, due to higher food and energy prices.

National Consumer Price Index
(Percentage change, yoy)



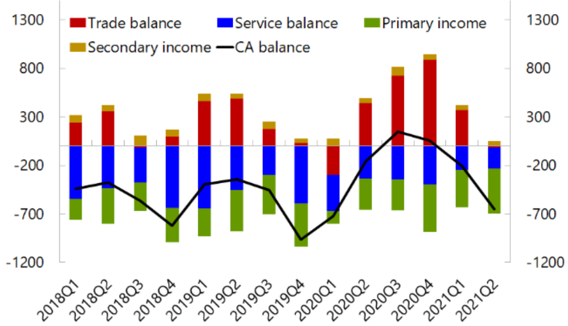
Sources: Haver; IMF Staff Calculations.

Figure 3. Mongolia: An Export Price Boom Is Helping to Build Buffers

Favorable terms of trade and import compression improved the current account balance in 2020.

Current Account

(USD million)

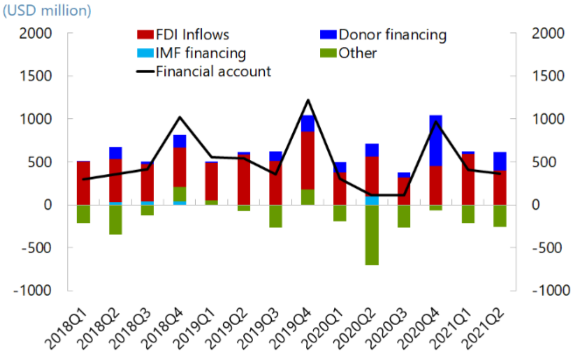


Source: Haver.

FDI and donors financing boosted financial inflows.

Financial Account

(USD million)

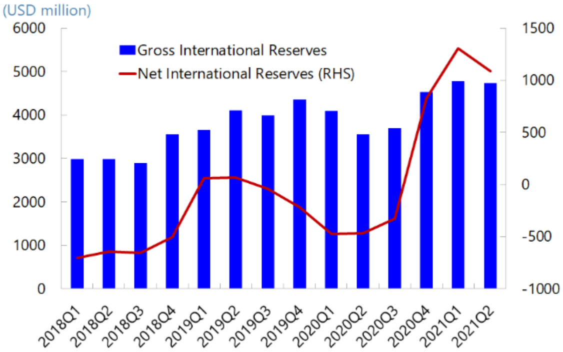


Source: Haver.

This led to a sizeable improvement of gross and net international reserves.

International Reserves

(USD million)

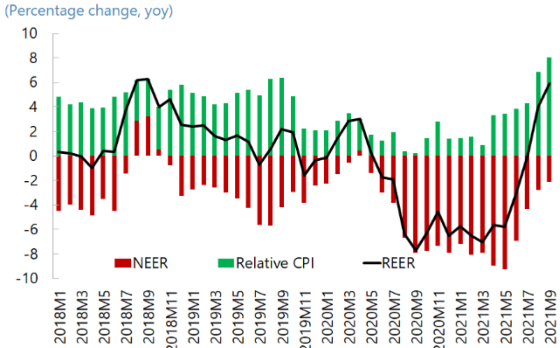


Sources: Haver; IMF Data

The REER depreciated, aided by low inflation and nominal depreciation vis-à-vis the Renminbi.

REER and NEER

(Percentage change, yoy)

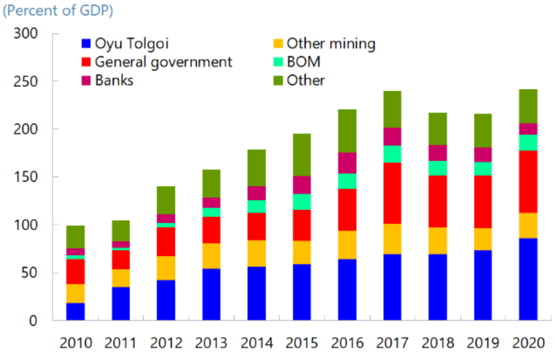


Source: IMF.

External debt rose due to fiscal support and continued investments in the mining sector.

External Debt

(Percent of GDP)

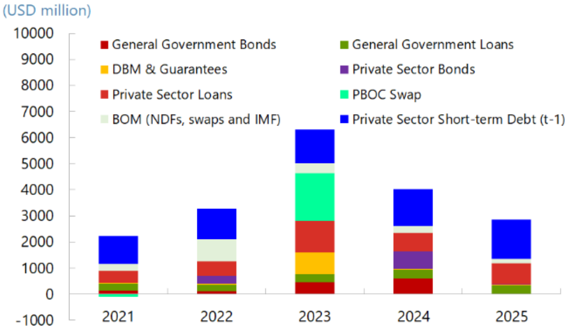


Sources: Bank of Mongolia; IMF WEO data; IMF staff calculations.

The medium-term amortization schedule remains challenging.

External Debt Amortization

(USD million)

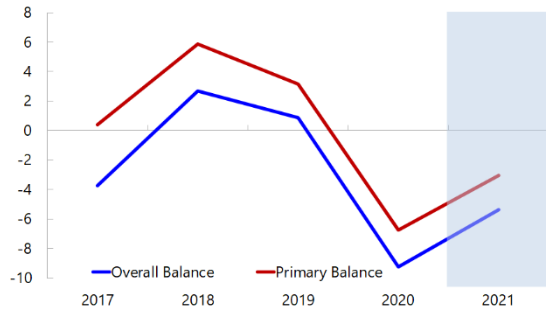


Sources: Bank of Mongolia; IMF WEO data; IMF staff calculations.

Figure 4. Mongolia: Large Fiscal Support Is Increasing Public Debt Again

The fiscal deficit increased sharply in 2020 but will likely improve in 2021.

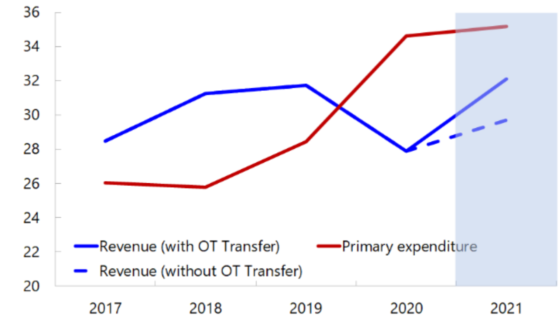
Fiscal Balance
(In percent of GDP)



Sources: Mongolian Authorities and IMF Staff Estimates.
Note: The balance excludes DBM. 2021 is an estimate.

Revenues and spending reflect pandemic-related support, partly offset by OT transfers in 2021.

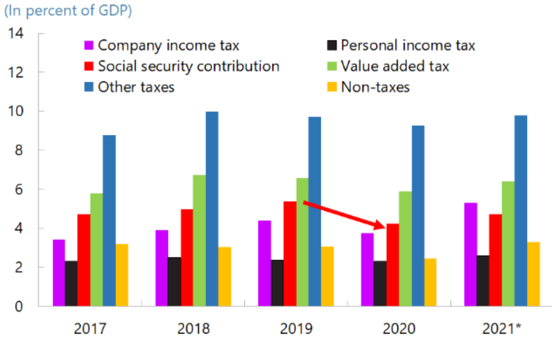
Revenue and Primary Expenditure
(In percent of GDP)



Sources: Haver Analytics; IMF Staff Estimates.
Note: The balance excludes DBM. 2021 is an estimate.

The 2020 dent in social security contributions was partly reversed as support measures expired.

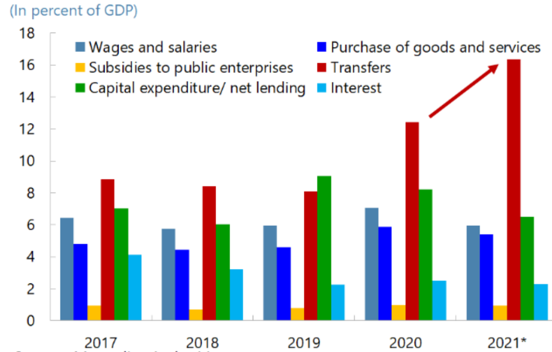
Revenue Composition
(In percent of GDP)



Sources: Mongolian Authorities.
Note: Includes one-off OT transfers in 2021. 2021 outcome is an estimate.

But COVID-related social transfers continued into 2021.

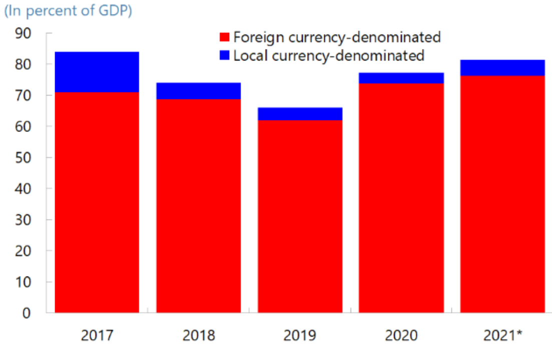
Expenditure Composition
(In percent of GDP)



Sources: Mongolian Authorities.
Note: 2021 is an estimate.

Fiscal support has increased public debt, but it remains mostly concessional.

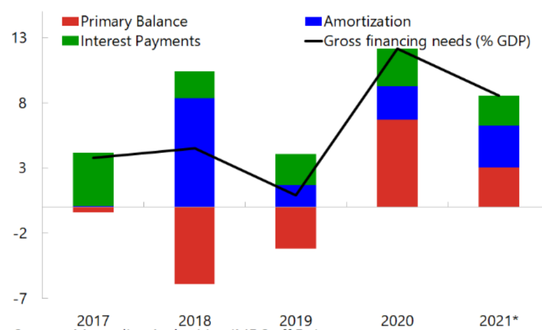
Public Debt
(In percent of GDP)



Sources: Mongolian Authorities, IMF Staff Estimates.
Note: 2021 are estimates.

Gross financing needs will remain elevated despite recent Eurobonds rollover.

Gross Financing Need
(In percent of GDP)

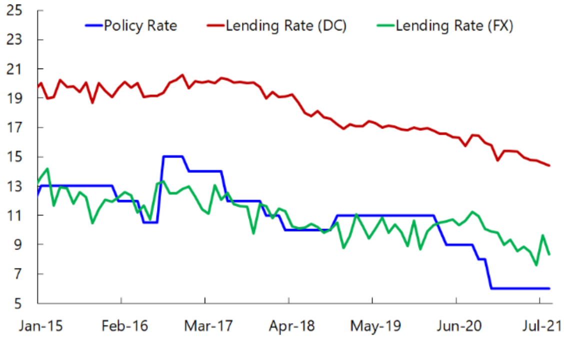


Sources: Mongolian Authorities; IMF Staff Estimates.
Note: 2021 is an estimate.

Figure 5. Mongolia: Supportive but Unconventional Monetary Policy

Monetary policy has been supportive.

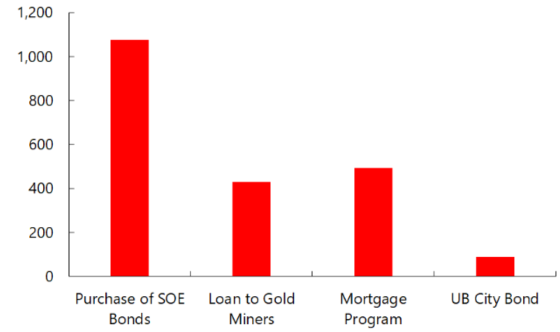
Interest Rates
(In Percent)



Sources: CEIC and Haver Analytics.

And the BOM resumed quasi-fiscal support…

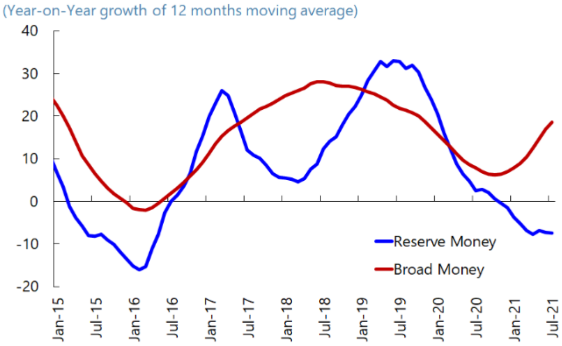
BOM's Quasi-Fiscal Operations
(In billions of togrog)



Source: The Bank of Mongolia.

…resulting in a robust recovery in broad money.

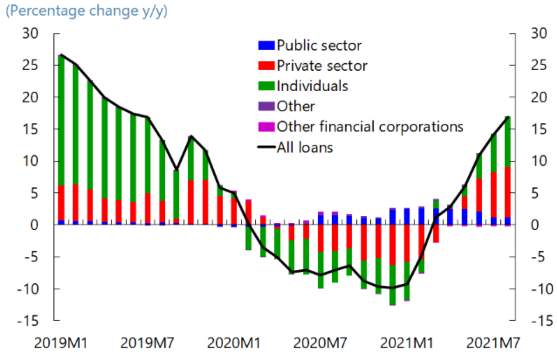
Reserve Money and Broad Money
(Year-on-Year growth of 12 months moving average)



Sources: The Bank of Mongolia, IMF Staff Calculations.

But credit growth decelerated in 2020 as the domestic activity weakened.

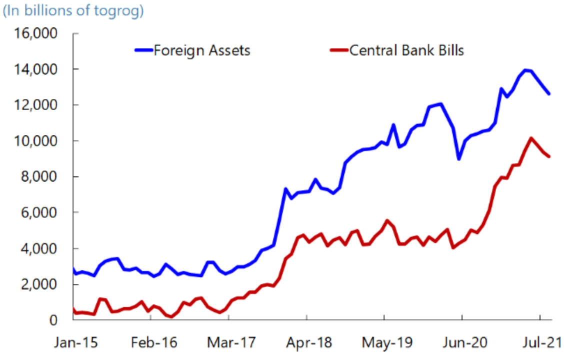
Credit Growth by Sectors
(Percentage change y/y)



Source: The Bank of Mongolia.

The BOM continues to strengthen its NFA position by intervening in FX markets to stabilize the exchange rate.

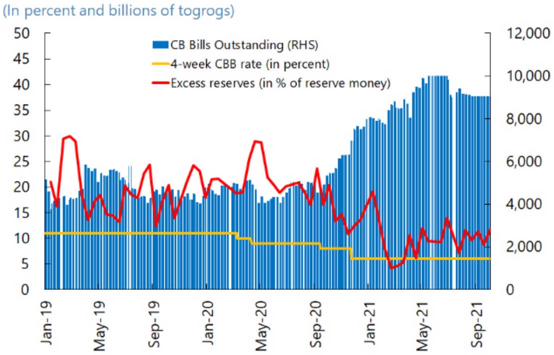
BOM Foreign Assets and Central Bank Bills
(In billions of togrog)



Source: The Bank of Mongolia.

… mopping up excess liquidity by issuing central bank bills.

Central Bank and T-Bill Rates
(In percent and billions of togrogs)

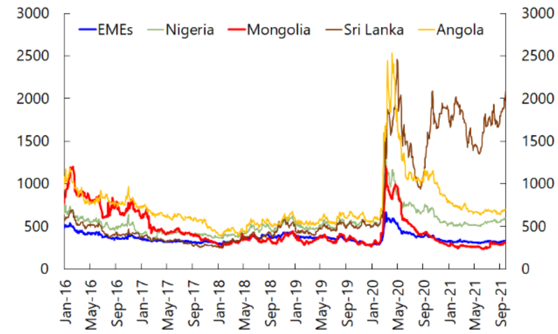


Sources: Mongolian authorities, and IMF Staff Calculations.

Figure 6. Mongolia: Contained Financial Market Pressures

After a spike in sovereign spreads, Mongolia's spreads have narrowed faster than EM peers…

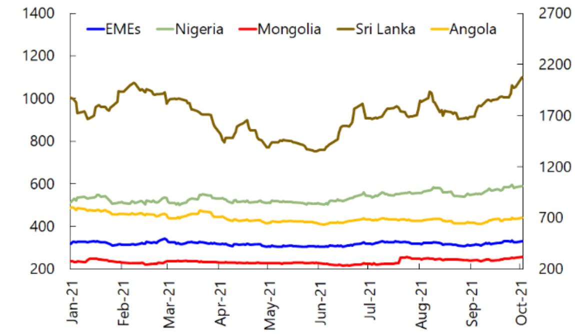
EMBI Global Sovereign Spreads
(In basis points)



Source: Bloomberg L.P.

… remained stable in recent months…

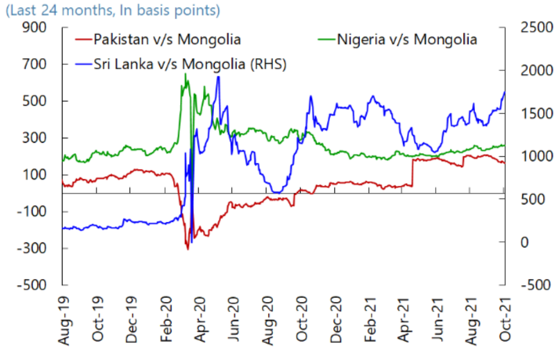
EMBI Global Sovereign Spreads
(Last 6 months, In basis points)



Source: Bloomberg L.P.

… and are now lower than other EM peers.

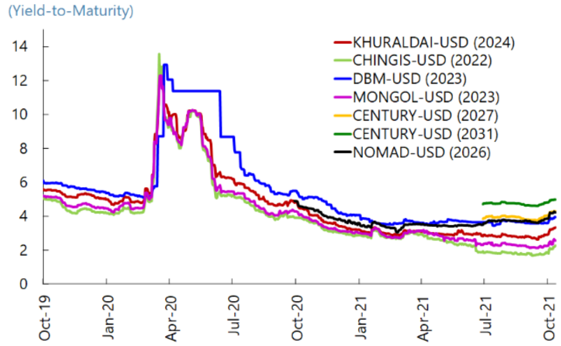
EMBI Spread Differences
(Last 24 months, In basis points)



Source: Bloomberg LP.

Mongolia's external borrowing costs is now at their lowest level since 2015.

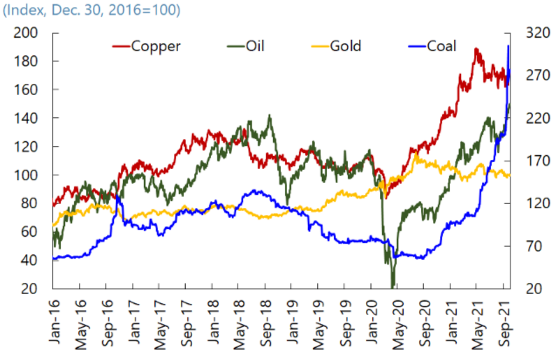
Outstanding Govt. Bonds
(Yield-to-Maturity)



Sources: Bloomberg LP

Price of Mongolia's major export commodities have risen substantially since mid-2020

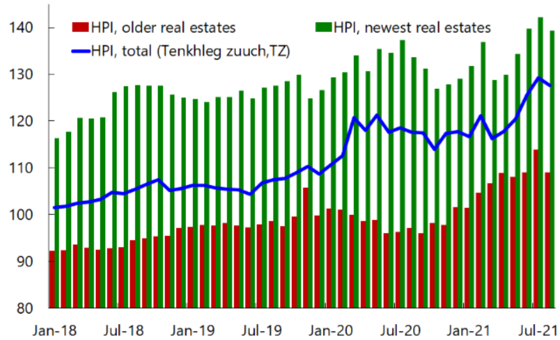
Commodity Prices: Gold, Copper , Coal and Oil
(Index, Dec. 30, 2016=100)



Source: Bloomberg L.P.

Housing prices have remained broadly stable in recent years.

House Price Index

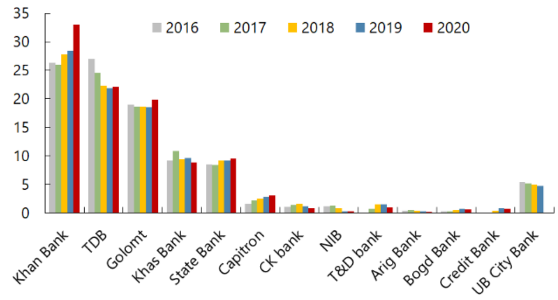


Source: Mongolian Authorities

Figure 7. Mongolia: Persistent Banking Sector Challenges, Improving Financial Inclusion

The banking system remains highly concentrated.

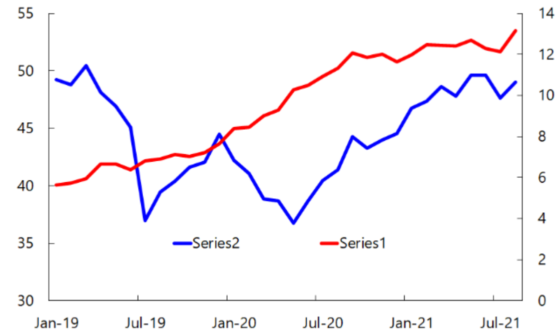
Market Share by Bank
(In Percent)



Source: IMF Financial Soundness Indicators.
Note: TDB (Trade and Development Bank); CKB (Chinggis Khan Bank); T&D Bank (Transport and Development Bank); NIB (National Investment Bank). TDB and UB City Bank merged in June 2020.

Non-performing loans are rising, though liquidity remains adequate.

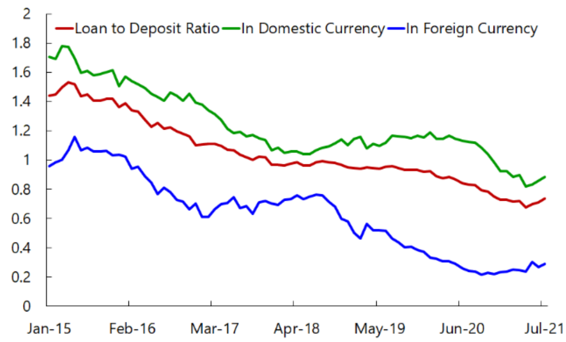
Average Liquidity Ratios and NPL Rates
(Percent)



Source: IMF Financial Soundness Indicators; IMF Staff Calculations.

Loan to deposit ratio continues to decline due to subdued credit growth and rise in deposits…

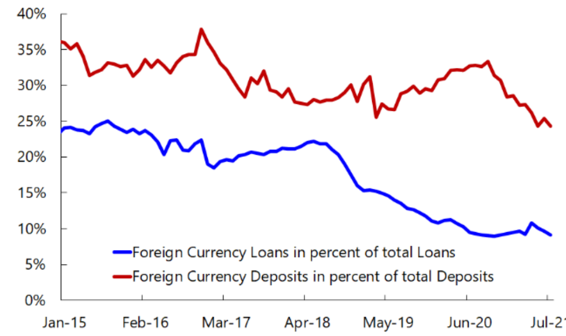
Loan to Deposit
(Ratio)



Source: IMF Staff Calculations.

…particularly due to a strong decline in the share of foreign currency loans.

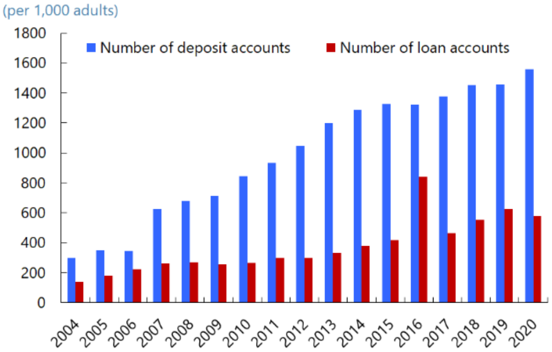
Loans and Deposits in FX
(In Percent)



Sources: CEIC and IMF Staff Calculations.

Financial inclusion has improved with rise in number of deposit accounts…

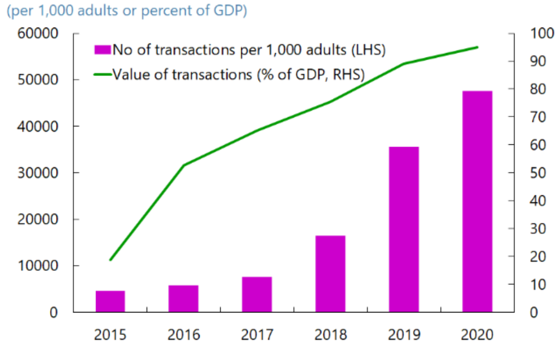
Deposit and Loan Accounts with Commercial Banks
(per 1,000 adults)



Source: IMF Financial Access Survey.

… along with rapid rise in mobile and internet banking.

Mobile and Internet Banking Transactions
(per 1,000 adults or percent of GDP)



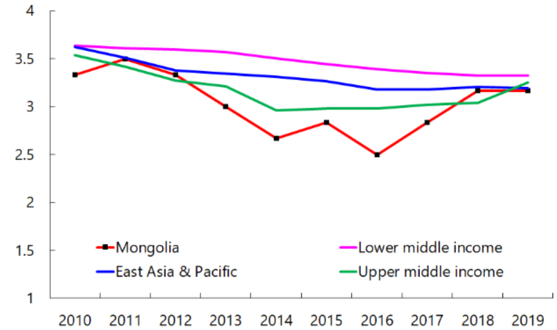
Sources: IMF Financial Access Survey.
Note: During reference period.

Figure 8. Mongolia: Ineffective Enforcement, Persistent Corruption

Macroeconomic policy management has improved…

Economic Management

(Cluster average, 1 lowest - 6 highest)

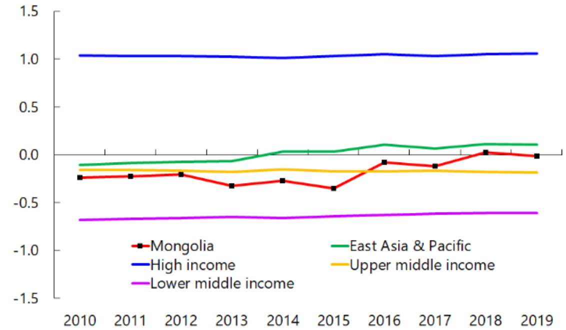


Sources: World Bank Country Policy and Institutional Assessment.

… and so has regulatory quality and legal frameworks.

Regulatory Quality

(Average Score, -2.5 weakest to 2.5 strongest)

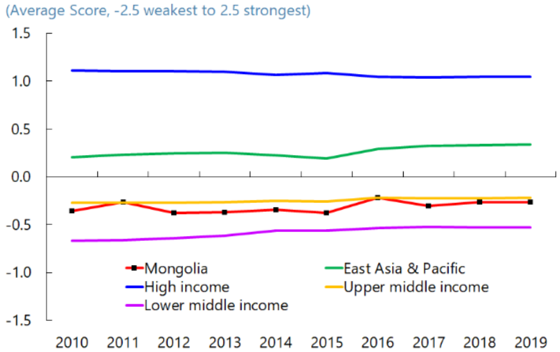


Source: Worldwide Governance Indicators.

However, effective enforcement remains weak.

Rule of Law

(Average Score, -2.5 weakest to 2.5 strongest)

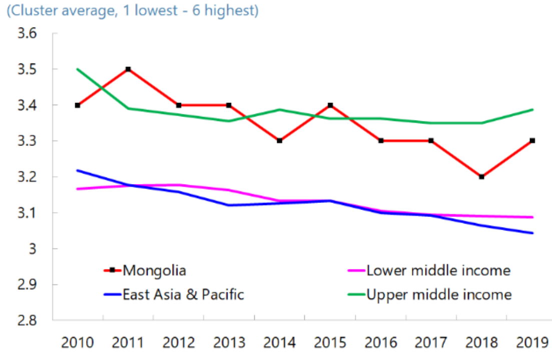


Source: Worldwide Governance Indicators.

Despite improving budget management, public sector transparency and management remains a concern.

Public Sector Management and Institutions

(Cluster average, 1 lowest - 6 highest)

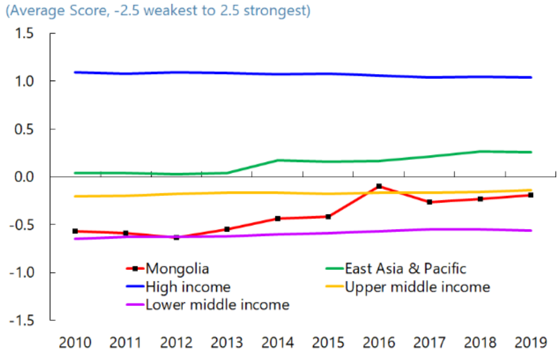


Sources: World Bank Country Policy and Institutional Assessment.

Political interference hinders the effectiveness of public services.

Government Effectiveness

(Average Score, -2.5 weakest to 2.5 strongest)

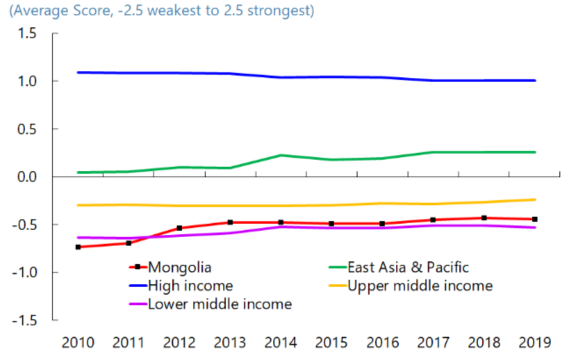


Source: Worldwide Governance Indicators.

Strengthened anti-corruption regulatory frameworks are not effectively enforced.

Control of Corruption

(Average Score, -2.5 weakest to 2.5 strongest)



Source: Worldwide Governance Indicators.

Table 1. Mongolia: Selected Economic and Financial Indicators, 2018–26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Actual				Projections			
	(In percent of GDP, unless otherwise indicated)								
National Accounts									
Nominal GDP (in USD million)	13,207	14,206	13,313	14,402	15,887	17,318	18,737	20,209	21,676
Real GDP growth (percent change)	7.7	5.6	-4.6	4.5	7.0	6.5	6.0	5.5	5.0
Domestic Demand	21.4	4.6	-10.6	12.8	9.5	6.7	5.6	6.0	5.5
Consumption	9.6	7.0	4.5	6.4	6.4	6.7	5.3	4.6	5.6
Private	11.7	5.8	2.1	3.5	10.0	7.2	4.8	4.1	5.2
Public	1.1	12.3	14.6	17.3	-5.4	4.7	7.4	6.6	7.5
Investment	52.1	0.2	-40.7	35.1	18.0	6.8	6.2	9.6	5.1
Exports of G&S	6.1	12.0	-5.3	-4.0	17.0	18.3	13.6	9.4	8.3
Imports of G&S	32.7	8.6	-15.5	12.1	18.5	15.1	10.8	9.1	8.1
Contributions to Real GDP (ppts)									
Domestic Demand	22.8	5.5	-12.8	14.1	11.4	8.3	6.9	7.4	6.8
Net Exports of G&S	-15.2	-0.1	8.2	-9.6	-4.4	-1.8	-0.9	-1.9	-1.8
Exports of G&S	3.0	5.8	-2.7	-2.0	8.0	9.4	7.8	5.7	5.3
Imports of G&S	-18.2	-5.9	10.9	-7.5	-12.3	-11.2	-8.7	-7.6	-7.0
Gross national saving	22.7	20.4	17.3	17.7	19.5	22.3	22.3	23.1	22.8
Public	8.6	9.7	-1.4	0.8	5.0	5.8	5.3	4.6	3.5
Private	14.1	10.6	18.7	16.9	14.4	16.5	17.0	18.4	19.3
Gross capital formation	39.4	35.6	22.4	30.5	32.3	31.6	31.3	32.0	31.6
Public	5.2	8.0	8.1	6.4	8.4	8.4	8.4	8.4	8.4
Private	34.2	27.6	14.3	24.1	23.9	23.2	22.9	23.6	23.2
Prices									
Consumer Prices (Avg; percent change)	6.8	7.3	3.7	6.2	7.0	6.5	6.0	6.0	6.0
Consumer Prices (EoP; percent change)	8.2	5.2	2.3	7.5	7.0	6.5	6.0	6.0	6.0
Copper prices (US$ per ton)	6530	6010	6175	9119	9060	9026	8965	8872	8834
Gold prices (US$ per ounce)	1269	1392	1770	1797	1790	1805	1846	1889	1915
Oil price (in U.S. dollars per barrel)	68.3	61.4	41.3	65.7	64.5	61.3	59.0	57.4	56.3
GDP deflator (percent change)	8.0	10.0	3.7	7.2	7.5	6.4	6.0	6.1	6.0
General government accounts									
Primary balance (IMF definition)	5.9	3.2	-6.7	-3.1	-1.1	-0.3	-0.9	-1.8	-2.7
Total revenue and grants	31.3	31.7	27.9	32.1	32.6	32.9	32.8	32.4	31.9
Primary expenditure and net lending	25.4	28.5	34.6	35.2	33.7	33.2	33.7	34.2	34.7
Interest	3.2	2.3	2.5	2.3	2.1	2.1	1.9	1.7	1.9
Overall balance (IMF definition) 1/	2.7	0.9	-9.2	-5.4	-3.2	-2.4	-2.8	-3.5	-4.6
Gross Financing Needs	4.5	0.9	12.0	8.6	6.0	8.8	8.6	5.7	11.8
General government debt 2/	74.1	66.1	77.4	81.5	76.8	72.6	69.9	68.2	68.1
Domestic	5.3	4.1	3.4	5.2	5.5	3.5	3.3	3.8	4.6
External	68.8	62.0	73.9	76.3	71.3	69.1	66.5	64.4	63.6
Monetary sector									
Broad money growth (percent change)	22.8	7.0	16.3	15.5	11.3	13.4	12.4	12.0	11.3
Reserve money growth (percent change)	24.5	5.4	-12.7	14.7	15.6	13.4	12.4	12.0	11.3
Credit growth (percent change)	23.4	4.4	-3.9	9.0	11.0	12.1	11.9	12.5	12.3
Balance of payments									
Current account balance	-16.7	-15.2	-5.1	-12.8	-12.8	-9.3	-9.0	-8.9	-8.8
Exports of goods (y/y percent change)	12.4	9.6	-2.7	12.1	17.9	14.4	8.5	5.6	4.3
Imports of goods (y/y percent change)	35.5	2.4	-13.1	31.5	13.6	5.4	7.6	3.9	3.1
Gross official reserves (in USD million) 3/	3549	4349	4534	4243	4508	4525	4719	4905	5042
(In months of imports)	4.6	7.1	5.8	4.7	4.6	4.3	4.3	4.3	4.5
Exchange rate									
Togrog per U.S. dollar (eop)	2644	2734	2850	...	...	...	...	...	...
Memorandum item									
Population in million (eop)	3.2	3.3	3.4	...	...	...	...	...	...

Sources: Mongolian authorities; and IMF staff projections.

1/ Excludes privatization receipts; includes interest financed mortgage spending from 2017 onwards.

2/ General government debt data excludes central bank's liabilities due to the PBOC swap line and SOE debt.

3/ Gross official reserves includes drawings from the PBOC swap line rolled over in 2020, and IMF SDR allocation in 2021.

Table 2a. Mongolia: Balance of Payments, 2018–24

(In millions of U.S. dollars)

	2018	2019	2020	2021	2022	2023	2024
	Actual			Projections			
	(In millions of U.S. dollars, unless otherwise indicated)						
Current account balance (including official grants)	-2,207	-2,162	-675	-1,842	-2,039	-1,619	-1,693
Trade balance	676	1,158	1,756	953	1,416	2,328	2,598
Exports	6,557	7,183	6,991	7,837	9,239	10,569	11,470
Mineral export	5,797	6,363	6,495	7,019	8,280	9,529	10,338
Non-mineral export	759	819	495	818	959	1,040	1,132
Imports	-5,881	-6,025	-5,235	-6,884	-7,822	-8,241	-8,872
Services, net	-1,978	-1,992	-1,476	-1,444	-1,962	-2,235	-2,402
Income, net	-1,228	-1,569	-1,228	-1,588	-1,762	-1,930	-2,106
Current transfers	324	241	273	237	268	218	216
General government	122	82	85	86	79	35	37
Other sectors	201	159	188	151	188	184	179
Of which: Workers remittances	154	131	144	151	152	147	142
Capital and financial account	1,757	2,487	-1,134	943	1,840	-477	1,980
Capital account	92	161	103	115	127	121	131
Financial account	1,665	2,327	-1,237	828	1,713	-598	1,849
Direct investment	2,137	2,316	1,693	2,022	2,375	1,972	1,603
Portfolio investment	61	372	-563	-276	474	517	559
Trade credits, net	-4	-83	-156	-259	-139	-273	-81
Currency and deposits, net	-11	-90	-278	-287	-137	-136	-133
Loans, net	-531	-183	-212	-475	-866	-846	-106
Other, net 1/	13	-6	-1,720	104	6	-1,831	6
Errors and omissions	-14	-224	-146	0	0	0	0
Overall balance	-464	102	-1,954	-899	-199	-2,096	286
Change in reserves 2/	541	800	186	-291	265	17	195
Financing Gap 3/	426	351	2,741	608	464	2,113	0
Fund credit	104	0	99	0	0	0	0
Donor support	322	351	916	611	490	341	0
Of which: ADB	272	267	335	258	320	279	0
Of which: WB	0	35	225	184	56	62	0
PBOC Swap renewal	0	0	1,726	0	0	1,772	0
Memorandum items:							
Current account balance (in percent of GDP)	-16.7	-15.2	-5.1	-12.8	-12.8	-9.3	-9.0
Gross official reserves (end-period) 4/	3,549	4,349	4,534	4,243	4,508	4,525	4,719
(In months of next year's imports of G&S)	4.6	7.1	5.8	4.7	4.6	4.3	4.3
Copper price (in U.S. dollars per ton)	6,530	6,010	6,175	9,119	9,060	9,026	8,965
Oil price (in U.S. dollars per barrel)	68	61	41	66	65	61	59
Gold price (in U.S. dollars per troy oz.)	1,269	1,392	1,770	1,797	1,790	1,805	1,846
Terms of trade (index, percent change)	8	6	17	10	2	-4	-1
External debt (in percent of GDP)	217	216	242	252	240	232	223
Net IIP (in percent of GDP)	-255	-252	-279	-274	-265	-259	-252
Nominal GDP (in millions of U.S. dollars)	13,207	14,206	13,313	14,402	15,887	17,318	18,737

Sources: Mongolian authorities; and IMF staff projections.

1/ Includes the IMF 2021 general allocation of SDRs of 100 percent of quota.

2/ Changes in reserves reflect valuation adjustments.

3/ Financing gap is based on donor commitments till 2023. For 2024, additional financing is included in external loans.

4/ Gross official reserves includes a rollover of PBOC swap lines in 2020, and IMF SDR allocation in 2021.

Table 2b. Mongolia: Balance of Payments, 2018–24
(In percent of GDP)

	2018	2019	2020	2021	2022	2023	2024
	Actual			Projections			
	(In percent of GDP, unless otherwise indicated)						
Current account balance (including official grants)	-16.7	-15.2	-5.1	-12.8	-12.8	-9.3	-9.0
Trade balance	5.1	8.2	13.2	6.6	8.9	13.4	13.9
Exports	49.6	50.6	52.5	54.4	58.2	61.0	61.2
Mineral export	43.9	44.8	48.8	48.7	52.1	55.0	55.2
Non-mineral export	5.8	5.8	3.7	5.7	6.0	6.0	6.0
Imports	-44.5	-42.4	-39.3	-47.8	-49.2	-47.6	-47.3
Services, net	-15.0	-14.0	-11.1	-10.0	-12.3	-12.9	-12.8
Income, net	-9.3	-11.0	-9.2	-11.0	-11.1	-11.1	-11.2
Current transfers	1.3	0.8	1.0	0.6	0.7	0.4	0.4
General government	0.9	0.6	0.6	0.6	0.5	0.2	0.2
Other sectors	0.4	0.2	0.3	0.0	0.2	0.2	0.2
Of which: Workers remittances	1.2	0.9	1.1	1.0	1.0	0.9	0.8
Capital and financial account	13.3	17.5	-8.5	6.5	11.6	-2.8	10.6
Capital account	0.7	1.1	0.8	0.8	0.8	0.7	0.7
Financial account	12.6	16.4	-9.3	5.7	10.8	-3.5	9.9
Direct investment	16.2	16.3	12.7	14.0	14.9	11.4	8.6
Portfolio investment	0.5	2.6	-4.2	-1.9	3.0	3.0	3.0
Trade credits, net	0.0	-0.6	-1.2	-1.8	-0.9	-1.6	-0.4
Currency and deposits, net	-0.1	-0.6	-2.1	-2.0	-0.9	-0.8	-0.7
Loans, net	-4.0	-1.3	-1.6	-3.3	-5.5	-4.9	-0.6
Other, net 1/	0	0	-13	1	0	-11	0
Errors and omissions	-0.1	-1.6	-1.1	0.0	0.0	0.0	0.0
Overall balance	-3.5	0.7	-14.7	-6.2	-1.3	-12.1	1.5
Change in reserves 2/	4.1	12.9	10.4	-0.7	-0.2	26.1	2.5
Financing Gap 3/	3.2	2.5	20.6	4.2	2.9	12.2	0.0
Fund credit	0.8	0.0	0.7	0.0	0.0	0.0	0.0
Donor support	2.4	2.5	6.9	4.2	3.1	2.0	0.0
Of which: ADB	2.1	1.9	2.5	1.8	2.0	1.6	0.0
Of which: WB	0.0	0.2	1.7	1.3	0.4	0.4	0.0
PBOC Swap renewal	0.0	0.0	13.0	0.0	0.0	10.2	0.0
Memorandum items:							
Current account balance (in percent of GDP)	-16.7	-15.2	-5.1	-12.8	-12.8	-9.3	-9.0
Gross official reserves (end-period) 4/	3,549	4,349	4,534	4,243	4,508	4,525	4,719
(In months of next year's imports of G&S)	4.6	7.1	5.8	4.7	4.6	4.3	4.3
Copper price (in U.S. dollars per ton)	6,530	6,010	6,175	9,119	9,060	9,026	8,965
Oil price (in U.S. dollars per barrel)	68	61	41	66	65	61	59
Gold price (in U.S. dollars per troy oz.)	1,269	1,392	1,770	1,797	1,790	1,805	1,846
Terms of trade (index, percent change)	8	6	17	10	2	-4	-1
External debt (in percent of GDP)	217	216	242	252	240	232	223
Net IIP (in percent of GDP)	-255	-252	-279	-274	-265	-259	-252
Nominal GDP (in millions of U.S. dollars)	13,207	14,206	13,313	14,402	15,887	17,318	18,737

Sources: Mongolian authorities; and IMF staff projections.
1/ Includes the IMF 2021 general allocation of SDRs of 100 percent of quota.
2/ Changes in reserves reflect valuation adjustments.
3/ The financing gap is based on donors' commitments until 2023. For 2024, additional financing is included in external loans.
4/ Gross official reserves includes a rollover of PBOC swap lines in 2020, and IMF SDR allocation in 2021.

Table 3. Mongolia: Monetary Aggregates, 2018–24

	2018	2019	2020	2021	2022	2023	2024
	Actual			Projections			
	(In billions of togrog, end of period)						
Reserve Money	4,908	5,172	4,516	5,179	5,985	6,785	7,623
Broad money	19,475	20,834	24,220	27,965	31,121	35,281	39,640
Currency	670	614	753	839	934	1,058	1,189
Deposits	18,804	20,219	23,467	27,126	30,188	34,223	38,451
Net foreign assets	-327	2,392	4,910	7,289	8,492	10,186	11,790
BOM	3,892	6,320	6,472	6,174	7,511	8,111	9,215
Other Depository Corporations	-4,219	-3,928	-1,562	1,114	981	2,075	2,575
Net domestic assets	19,802	18,442	19,310	20,676	22,629	25,095	27,850
Net Domestic credit	19,618	18,232	18,687	18,827	20,780	23,246	26,001
Other Depository Corporations	-1,170	-1,852	-1,056	-1,456	-1,856	-2,256	-2,656
Net claims on private sector	17,650	18,288	16,912	18,434	20,461	22,930	25,648
Net claims on other financial corporation	3,183	2,939	2,718	2,963	3,289	3,686	4,123
Other items, net	316	297	1,849	1,849	1,849	1,849	1,849
Memorandum items:							
Annual broad money growth	22.8	7.0	16.3	15.5	11.3	13.4	12.4
Velocity of Broad Money	1.7	1.8	1.5	1.5	1.6	1.6	1.6
Credit outstanding (Domestic credit+MBS) (In MNT bn) /1	20,382	21,272	20,436	22,275	24,724	27,707	30,992
Credit to GDP ratio	62.6	56.2	54.6	53.1	51.3	50.7	50.4
Credit growth (percent)	23.4	4.4	-3.9	9.0	11.0	12.1	11.9

Sources: Mongolian authorities; and IMF staff projections.

1/Includes mortgage-backed securities.

Table 4a. Mongolia: Summary Operations of the General Government, 2018–24
(In billions of Togrogs)

	2018	2019	2020	2021	2022	2023	2024
	Actual			Projections			
Total revenue and grants	10,185	12,000	10,445	13,466	15,741	17,997	20,151
Current revenue	10,147	11,911	10,305	13,315	15,568	17,801	19,930
Tax revenue and social security contributions 1/	9,158	10,755	9,525	12,084	14,008	16,033	17,943
Income taxes	2,086	2,556	2,266	3,315	3,380	3,966	4,464
CIT	1,277	1,661	1,402	2,228	2,130	2,549	2,872
PIT	809	895	864	1,087	1,250	1,417	1,592
Social security contributions	1,621	2,031	1,588	1,983	2,589	2,935	3,197
VAT	2,196	2,486	2,205	2,689	3,227	3,615	4,084
Excise taxes	754	863	777	870	1,001	1,135	1,275
Customs duties and export taxes	682	790	741	1,001	1,186	1,299	1,453
Other taxes	1,817	2,029	1,947	2,226	2,625	3,083	3,470
Non-tax revenue	989	1,156	780	1,230	1,560	1,768	1,986
Total expenditure and net lending 2/	9,315	11,662	13,904	15,716	17,266	19,296	21,890
Current expenditure	7,348	8,229	10,829	12,984	13,147	14,648	16,668
Wages and salaries	1,879	2,257	2,649	2,494	2,701	2,844	2,949
Purchase of goods and services	1,449	1,743	2,202	2,257	2,709	3,290	3,942
Subsidies	230	299	375	402	527	597	671
Transfers	2,746	3,068	4,664	6,865	6,221	6,779	7,923
o/w Pension	1,619	1,839	2,175	2,475	2,846	3,500	4,239
o/w Child Money	209	230	1,053	1,440	1,640	1,859	2,089
Interest payments	1,047	861	939	966	990	1,140	1,183
Capital expenditure and net lending	1,967	3,433	3,075	2,732	4,119	4,647	5,221
Capital expenditure	1,680	3,017	3,034	2,691	4,072	4,594	5,161
Domestically-financed	1,680	2,300	1,899	1,749	2,647	2,986	3,355
Foreign-financed	0	717	1,135	942	1,425	1,608	1,806
Net lending	286	416	41	41	47	54	60
Overall balance (IMF definition)	870	338	-3,459	-2,250	-1,525	-1,298	-1,739
Primary balance (IMF definition)	1,917	1,199	-2,520	-1,284	-536	-159	-556
Financing 3/	-868	-339	3,459	2,250	1,525	1,298	1,739
External	266	747	2,661	3,021	1,054	2,022	1,640
Disbursement	1,257	1,185	3,353	4,162	2,097	4,448	4,746
Amortization	-991	-438	-691	-1,141	-1,042	-2,427	-3,107
Domestic (net)	-1,135	-1,086	797	-771	471	-723	99
Government bonds (net issuance)	-1,768	-165	-263	909	471	-723	99
Other 4/	633	-921	1,060	-1,680	0	0	0
Memorandum items:							
Mineral revenue (in percent of GDP)	5.7	5.5	5.1	6.0	5.7	6.0	6.0
Non-mineral revenue (in percent of GDP)	25.5	26.2	22.8	26.1	26.9	26.9	26.8
Total expenditure (in percent of non-mineral GDP)	38.5	37.6	45.3	45.7	43.7	43.0	43.4
Non-mineral overall balance (in percent of non-mineral GDP)	0.6	-5.6	-17.5	-13.9	-10.8	-10.2	-10.8
Primary spending (change in percent)	5.2	30.6	20.0	13.8	10.4	11.5	14.0
Future Heritage Fund (in percent of GDP)	0.3	1.7	3.8	5.8	5.4	5.0	4.7
Fiscal Stability Fund (in percent of GDP) 5/	0.9	0.2	0.0	0.0	0.0	0.0	0.9
Public debt (in percent of GDP) 6/	74.1	66.1	77.4	81.5	76.8	72.6	69.9
Domestic debt (in percent of GDP)	5.3	4.1	3.4	5.2	5.5	3.5	3.3
External debt (in percent of GDP)	68.8	62.0	73.9	76.3	71.3	69.1	66.5

Sources: Mongolian authorities; and IMF staff projections.

1/ Assumes temporary anti-pandemic measures allowed to expire at end-2021 in line with draft 2022 budget.

2/ Based on draft 2022 budget which proposes gradually outsourcing around 25 percent of back office jobs, reflected as a decline in the wage bill with an equivalent increase in spending on services (per GFSM guidelines).

3/ A decision on the use of IMF 2021 SDR allocation is pending.

4/ Includes deposit buildup in government accounts (including FSF and FHF).

5/ In line with draft 2022 budget proposals, FHF balances are assumed to stay constant in nominal terms after 2021.

6/ Excludes BOM liabilities to PBOC amounting to 14 percent of GDP at end-2020, which was rolled over in 2020 and matures in 2023.

Table 4b. Mongolia: Summary Operations of the General Government, 2018–24
(In percent of GDP)

	2018	2019	2020	2021	2022	2023	2024
	Actual			Projections			
Total revenue and grants	31.3	31.7	27.9	32.1	32.6	32.9	32.8
Current revenue	31.1	31.5	27.5	31.7	32.3	32.6	32.4
Tax revenue and social security contributions 1/	28.1	28.4	25.4	28.8	29.0	29.3	29.2
Income taxes	6.4	6.8	6.1	7.9	7.0	7.3	7.3
CIT	3.9	4.4	3.7	5.3	4.4	4.7	4.7
PIT	2.5	2.4	2.3	2.6	2.6	2.6	2.6
Social security contributions	5.0	5.4	4.2	4.7	5.4	5.4	5.2
VAT	6.7	6.6	5.9	6.4	6.7	6.6	6.6
Excise taxes	2.3	2.3	2.1	2.1	2.1	2.1	2.1
Customs duties and export taxes	2.1	2.1	2.0	2.4	2.5	2.4	2.4
Other taxes	5.6	5.4	5.2	5.3	5.4	5.6	5.6
Non-tax revenue	3.0	3.1	2.1	2.9	3.2	3.2	3.2
Capital revenue and grants	0.1	0.2	0.4	0.4	0.4	0.4	0.4
Total expenditure and net lending 2/	28.6	30.8	37.1	37.5	35.8	35.3	35.6
Current expenditure	22.6	21.7	28.9	31.0	27.3	26.8	27.1
Wages and salaries	5.8	6.0	7.1	5.9	5.6	5.2	4.8
Purchase of goods and services	4.4	4.6	5.9	5.4	5.6	6.0	6.4
Subsidies	0.7	0.8	1.0	1.0	1.1	1.1	1.1
Transfers	8.4	8.1	12.5	16.4	12.9	12.4	12.9
o/w Pension	5.0	4.9	5.8	5.9	5.9	6.4	6.9
o/w Child Money	0.6	0.6	2.8	3.4	3.4	3.4	3.4
Interest payments	3.2	2.3	2.5	2.3	2.1	2.1	1.9
Capital expenditure and net lending	6.0	9.1	8.2	6.5	8.5	8.5	8.5
Capital expenditure	5.2	8.0	8.1	6.4	8.4	8.4	8.4
Domestically-financed	5.2	6.1	5.1	4.2	5.5	5.5	5.5
Foreign-financed	0.0	1.9	3.0	2.2	3.0	2.9	2.9
Net lending	0.9	1.1	0.1	0.1	0.1	0.1	0.1
Overall balance (IMF definition)	2.7	0.9	-9.2	-5.4	-3.2	-2.4	-2.8
Primary balance (IMF definition)	5.9	3.2	-6.7	-3.1	-1.1	-0.3	-0.9
Financing 3/	-2.7	-0.9	9.2	5.4	3.2	2.4	2.8
External	0.8	2.0	7.1	7.2	2.2	3.7	2.7
Disbursement	3.9	3.1	9.0	9.9	4.3	8.1	7.7
Amortization	-3.0	-1.2	-1.8	-2.7	-2.2	-4.4	-5.1
Domestic (net)	-3.5	-2.9	2.1	-1.8	1.0	-1.3	0.2
Government bonds (net issuance)	-5.4	-0.4	-0.7	2.2	1.0	-1.3	0.2
Other 4/	1.9	-2.4	2.8	-4.0	0.0	0.0	0.0
Memorandum items:							
Mineral revenue (in percent of GDP)	5.7	5.5	5.1	6.0	5.7	6.0	6.0
Non-mineral revenue (in percent of GDP)	25.5	26.2	22.8	26.1	26.9	26.9	26.8
Total expenditure (in percent of non-mineral GDP)	38.5	37.6	45.3	45.7	43.7	43.0	43.4
Non-mineral overall balance (in percent of non-mineral GDP)	0.6	-5.6	-17.5	-13.9	-10.8	-10.2	-10.8
Primary spending (change in percent)	5.2	30.6	20.0	13.8	10.4	11.5	14.0
Future Heritage Fund (in percent of GDP)	0.3	1.7	3.8	5.8	5.4	5.0	4.7
Fiscal Stability Fund (in percent of GDP) 5/	0.9	0.2	0.0	0.0	0.0	0.0	0.9
Public debt (in percent of GDP) 6/	74.1	66.1	77.4	81.5	76.8	72.6	69.9
Domestic debt (in percent of GDP)	5.3	3.4	3.4	5.2	5.5	3.5	3.3
External debt (in percent of GDP)	68.8	73.9	73.9	76.3	71.3	69.1	66.5

Sources: Mongolian authorities; and Fund staff projections.
1/ Assumes temporary anti-pandemic measures allowed to expire at end-2021 in line with draft 2022 budget.
2/ Based on draft 2022 budget which proposes gradually outsourcing around 25 percent of back office jobs, reflected as a decline in the wage bill with an equivalent increase in spending on services (per GFSM guidelines).
3/ A decision on the use of IMF 2021 SDR allocation is pending.
4/ Includes deposit buildup in government accounts (including FSF and FHF).
5/ In line with draft 2022 budget proposals, FHF balances are assumed to stay constant in nominal terms after 2021.
6/ Excludes BOM liabilities to PBOC amounting to 14 percent of GDP at end-2020, which was rolled over in 2020 and matures in 2023.

Table 5. Mongolia: Financial Stability Indicators, 2018–21

	2018	2019	2020	2021 May	2021 Jun	2021 Jul	2021 Aug
Capital (in percent)							
Risk Weighted CAR	16.6	16.6	15.4	15.0	13.9	13.7	13.8
Asset quality							
Asset Growth (percent change from start of year)	15.2	7.9	1.8	7.1	9.5	8.6	9.0
Loan Growth (Net) (percent change from start of year)	28.4	3.6	-4.6	6.1	12.0	13.7	16.4
Loan share in total assets (in percent)	52.3	50.2	47.1	46.6	48.2	49.3	50.3
Non Performing Loan (in percent)							
Past-due to gross loans	4.8	5.9	9.6	9.4	8.5	8.2	8.0
NPL + Past due to gross loans	14.6	14.0	20.3	19.4	17.9	17.6	17.2
Provision/NPLs	79.7	84.5	87.0	88.1	88.9	89.2	89.9
Provision/NPL+Past due	60.4	48.9	45.6	45.5	47.0	47.5	47.9
NPLs net of provision /Capital	4.9	6.3	7.5	6.6	6.3	6.2	5.7
NPLs+Past due net of provision /Capital	29.9	36.1	59.4	58.3	57.5	56.8	55.7
FX lending to total lending	17.1	11.9	10.1	10.8	10.9	10.1	9.8
Interest Rate (in percent)							
Average lending rate	16.6	16.8	16.6	16.2	16.0	16.0	15.9

Source: Mongolian authorities.

Table 6. Mongolia: External Financing Requirements and Sources, 2018–24
(In millions of U.S. dollars)

	2018	2019	2020	2021	Actual	2023	2024
	Actual			Projections			
Gross financing requirements	4,054	3,991	5,357	3,593	3,680	6,974	3,413
External current account deficit (excl. official transfers)	2,329	2,244	760	1,928	2,119	1,654	1,731
Amortization	1,300	927	2,183	658	1,154	4,733	2,362
o/w PBOC swap	0	0	1,726	0	0	1,837	0
Repayment of arrears	0	0	0	0	0	0	0
Other net capital outflows 1/	463	368	1,627	1,294	117	506	-966
Available financing	3,627	3,640	2,616	2,982	3,190	4,796	3,413
Grants	122	82	85	86	79	35	37
Disbursements to public sector	383	-83	259	863	249	1,890	1,458
o/w bonds	300	0	0	0	0	1,257	600
o/w loans	83	-83	259	863	249	633	858
Disbursements to private sector	985	1,325	579	10	487	899	314
Foreign direct investment	2,137	2,316	1,693	2,022	2,375	1,972	1,603
Financing need 2/	426	351	2,741	611	490	2,178	0
Financing	426	351	2,741	611	490	2,178	0
IMF	104	0	99	0	0	0	0
Other IFI	282	302	660	442	376	341	0
ADB	282	267	335	258	320	279	0
WB	0	35	225	184	56	62	0
Identified bilateral support	40	49	256	169	114	0	0
Prospective financing 3/	0	0	1,726	0	0	1,837	0

Sources: Mongolian authorities; and IMF staff projections.
1/ Includes all other net financial flows, and errors and omissions.
2/ The financing gap is based on donors commitments until 2023. For 2024, additional financing is included in external loans.
3/ Includes PBOC swap renewal in 2023.

Table 7. Mongolia: Indicators of Fund Credit, 2020–28
(In millions of SDR, unless otherwise noted)

	2020	2021	2022	2023	2024	2025	2026	2027	2028
Existing and prospective Fund arrangements									
Disbursements	72.30	...	...	...	...	...	...	...	...
Stock 1/	229.55	227.22	209.31	165.02	102.67	58.38	32.18	8.30	0.00
Obligations 2/	3.04	3.41	22.34	48.32	64.45	45.23	26.79	24.18	8.38
Principal (repayments/repurchases)	0.00	2.33	17.91	44.28	62.36	44.28	26.21	23.88	8.30
Charges and interest	3.04	1.08	4.43	4.04	2.09	0.95	0.58	0.30	0.08
Stock of existing and prospective Fund credit 1/	229.55	227.22	209.31	165.02	102.67	58.38	32.18	8.30	0.00
In percent of quota	317.50	314.27	289.50	228.24	142.01	80.75	44.51	11.48	0.00
In percent of GDP	2.38	2.19	1.83	1.33	0.77	0.40	0.21	0.05	0.00
In percent of exports of goods and services	4.15	3.53	2.80	1.95	1.12	0.61	0.32	0.08	0.00
In percent of gross usable reserves	6.99	7.43	6.47	5.09	3.05	1.67	0.89	0.20	0.00
Obligations to the Fund from existing and prospective Fund arrangements	3.04	3.41	22.34	48.32	64.45	45.23	26.79	24.18	8.38
In percent of GDP	0.03	0.03	0.20	0.39	0.48	0.31	0.17	0.15	0.05
In percent of exports of goods and services	0.05	0.05	0.30	0.57	0.71	0.47	0.27	0.24	0.08
In percent of gross usable reserves	0.09	0.11	0.69	1.49	1.91	1.29	0.74	0.58	0.19

Sources: IMF Finance Department; and IMF staff estimates and projections.
1/ End of period.
2/ Repayment schedule based on scheduled debt service obligations.

Annex I. Progress on Recommendations of the 2019 Article IV Consultation

Key Recommendations	Implementation
Fiscal Policy	
Refrain from amending the 2019 budget and save any revenue over-performance.	The authorities did not amend the budget. Most of revenue overperformance (2.6 ppt relative to the budget) was saved in 2019, given a better-than-expected primary surplus of 2.4 percent of GDP.
Target a primary surplus of at least 1 percent of GDP in 2020–24.	The primary balance recorded a deficit of 6.8 percent of GDP in 2020 due to the global pandemic.
Seek opportunities to refinance the substantial Eurobond amortizations coming due in 2021–24 period.	The authorities successfully refinanced Eurobond maturity by issuing US$600 million in 2020 and US$1 billion in 2021.
Monetary and Exchange Rate Policies	
Anchor inflation at around 5-6 percent.	Inflation moderated to 2.3 percent in 2020. The BOM lowered its inflation target to 6 (±2) percent in 2021.
Tighten monetary policy further if credit growth rises above nominal GDP growth.	The BOM loosened monetary policy to mitigate the impact of the COVID-19 pandemic. Credit growth contracted sharply due to increased risk aversion by banks, though it has turned positive since March 2021.
Boost foreign exchange reserves and increase GIR to at least 100 percent of IMF's ARA metric.	GIR was bolstered to $4.4 billion (equivalent to 103 percent of IMF's ARA metric) at end-August 2021.
Financial Sector Policy	
Complete an independent forensic audit to assist banks' recapitalization exercise and address non-compliant banks.	The 2019 independent forensic audit was completed. The BOM cancelled unqualified recapitalization measures with administrative measures in November 2019, some of which were reversed in early 2021.
Ensure that the debt-service to income (DSI) limit has no gaps in coverage by extending to all household loans and lower further the DSI limit.	The DSI has yet to be extended to NBFIs (whose system wide DSI is estimated at about 75 percent in 2021), while banks DSI limit remains at 60 percent.
Enhance consumer protection by introducing better information provisions, prohibition of usury practices and designating an adequate institution responsible for consumer complaints.	The BOM and the FRC have jointly drafted a Law on Financial Consumer Protection, in line with staff's recommendations. Following public discussions of the draft law in May 2021, the draft law will be submitted to Parliament soon.
Introduce more diversified and open shareholding structure of banks, including through IPOs and foreign bank entry.	The 2020 Banking Law Amendment requires IPOs for some banks by June 2022 and limits individual shareholder ownership up to 20 percent by end-2023.

Key Recommendations (contd.)	Implementation (contd.)
Structural Policies	
Ensure independence of the Fiscal Stability Council (FSC) to help monitor the budget process.	Strengthening the existing legal and operational framework of the FSC is underway, including regular reporting by the FRC Chairman to the Parliament Budget Standing Committee.
Strengthen the fiscal framework by revising existing outdated fiscal rules.	The authorities disagreed with staff's recommendations, arguing that any attempt to amend fiscal rules would risk weakening key parameters through political interference.
Bring public health expenditures in line with peers.	Healthcare spending increased from 2.2 percent of GDP in 2019 to 2.7 percent of GDP in 2020.
Complement the Child Money Program (CMP) with better targeted measures and expand social insurance to protect vulnerable groups.	In response to the pandemic, the CMP, food stamp and social welfare pension payments temporarily increased. There is room for better targeting.
Improve investment spending governance by (i) applying the investment guidelines to PPPs and SOE investments; (ii) enhancing fiscal risk assessments; (iii) stopping off-budgetary spending.	The authorities are preparing a draft PPP law, but little progress has been made: (1) the investment guidelines are yet to be expanded; (2) the assessment of fiscal risks on mega projects are yet to be covered; and (3) the BOM continues to be involved in quasi-fiscal activities.
Governance	
Strengthen judicial and anti-corruption institutions.	Some progress has been made, including amendment of the Law on Courts in January 2021, and the establishment of a working group to protect whistleblowers but implementation gaps remain.
Enhance disclosure/transparency around PPP/concession obligations and the allocation of mining licenses	Budget documents included information on the PPP/concession obligations, which are not comprehensive enough to cover all types of contingent liabilities
Strengthen implementation of procurement controls, including at SOEs.	Some progress has been made, including strengthening e-procurement systems and the authorities intend to upgrade the Procurement Law and initiate SOE reforms.

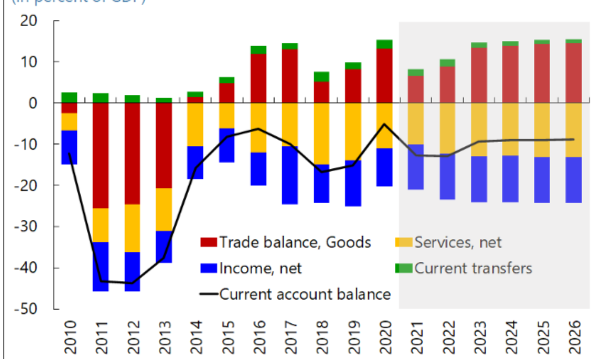
Annex II. External Sector Assessment

Mongolia's external position in 2020 was substantially weaker than implied by fundamentals and desirable policy settings. Although the current account deficit narrowed temporarily, external liabilities remained excessively high and net international reserves, below desirable levels. A more flexible exchange rate policy would be helpful as a shock absorber. Gross and net reserves should be boosted by opportunistic BOM interventions in the domestic FX market through sterilized interventions, and continued efforts to reduce external liabilities. Once economic recovery is underway, a return to fiscal consolidation, and a normalization of monetary and macro-prudential stances will remain critical to strengthen buffers and contain public sector external liabilities.

1. **Mongolia's current account deficit narrowed significantly in 2020.** After a decade of large current account deficits, driven by large persistent mining-related imports of goods of services as well as periods of credit-fueled imports of consumer durables, the 2020 current account balance improved to -5.1 percent of GDP. This reflects the combined effect of strong import compression, improving terms of trade and a boom in gold exports (including sales from gross international reserves). Nonetheless, the improvement in current account balances is expected to be temporary and current account deficits are projected to widen in 2021–22, as domestic demand and imports recovers. In the medium term, higher copper exports and lower capital imports after the completion of the OT project are expected to contribute to a gradual improvement in the overall current account deficit, which will nevertheless be large.

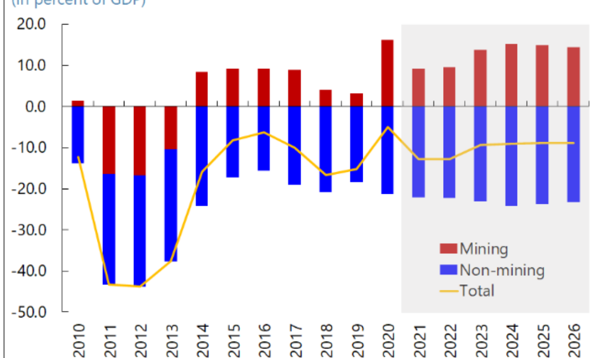
2. **Donor financing made up for the temporary decline of mining related FDI inflows.** In 2020, FDI inflows, which have been historically the main source of external financing relative to portfolio and other investment flows, declined by 30 percent, as large pandemic-related uncertainties and international travel restrictions caused investment delays. This was compensated by donor financing, which rose to US$1 billion—including US$99 million from the IMF-supported RFI. As a result, and the financial account remained in surplus. FDI inflows are

Current Account Balance
(In percent of GDP)



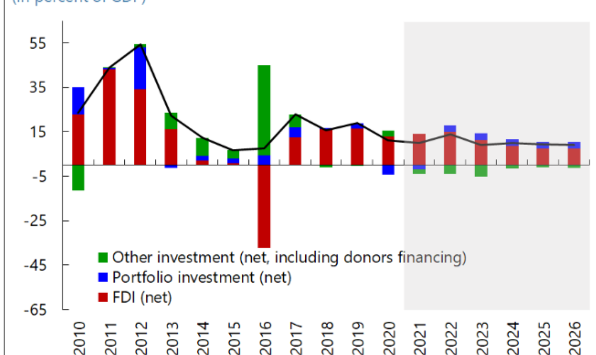
Sources: Mongolian authorities; and IMF Staff Calculations.

Current Account Balance
(In percent of GDP)



Sources: Mongolian authorities; and IMF Staff Calculations.

Financial Account Balance
(In percent of GDP)



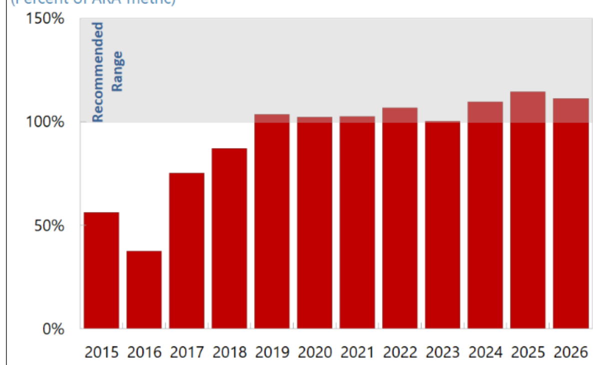
Sources: Mongolian authorities; and IMF Staff Calculations.

projected to normalize starting in 2021, growing robustly in 2021–22, as the OT project is completed.

3. **Reserve adequacy improved but remains thin**. During the first half of 2020, the combination of large BOM intervention and sharp decline in exports led to a decline of reserves by US$1 billion. However, as conditions improved since the second half of 2020, reserves increased and reached US$4.4 billion by end-August 2021 after peaking at a record US$4.9 billion in April 2021. Reserves net of BOM's FX liabilities have also improved to US$0.76 billion by end-August 2021. Nonetheless, even under the assumption that the PBOC swap is fully rolled over in 2023, reserve coverage is projected to remain at the bottom for the recommended range (Figure) while BOM's FX liabilities will remain large. In the event the PBOC swap is repaid in 2023, reserve coverage would fall below the levels recommended by the ARA metric.

Gross International Reserves

(Percent of ARA metric)

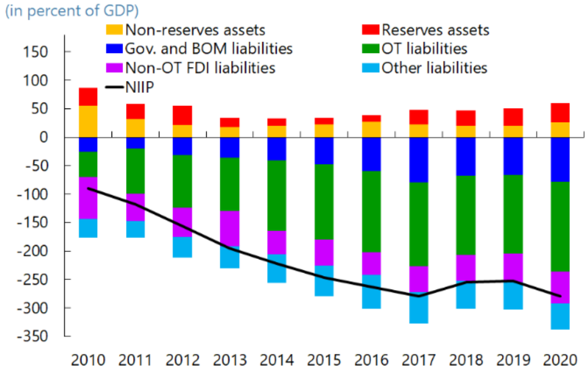


Source: IMF Staff Calculations.

4. **Mongolia's international investment position (IIP) weakened in 2020.** Mongolia IIP deteriorated during most of the last decade, due to large foreign direct investment in mining, rising public external debt and a bilateral swap arrangement with the PBOC in 2011. After a slowdown in 2018–19, owing to public deleveraging during the 2017 EFF and a temporary slowdown of mining investment, the NIIP resumed its weakening trend in 2020, as the government relied on donors' external loans to finance its large fiscal stimulus. As a result, the NIIP reached -279 percent of GDP, much weaker than any other resource rich EMEs and one of the most negative in the world as a share of GDP (Figures). IIP liabilities are largely denominated in US dollars and are mostly composed of FDI (182 percent of GDP) and external debt (156 percent of GDP). In particular, government and BOM liabilities amount to 79 percent of GDP, mainly a legacy of loose macroeconomic policies and economic crisis in the last decade.

IIP Assets and Liabilities

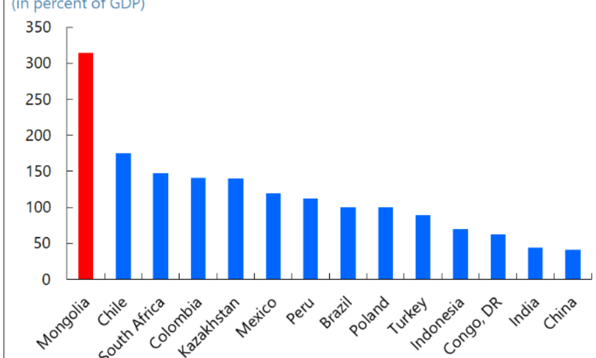
(in percent of GDP)



Sources: Mongolian authorities; and IMF Staff Calculations.

Non-Fuel Resource-Rich EMEs: IIP Liabilities, 2020

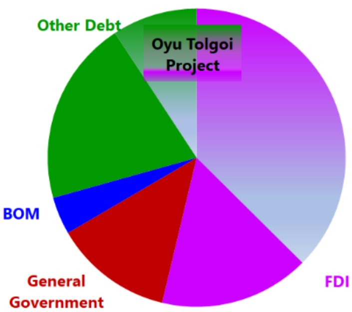
(in percent of GDP)



Sources: Mongolian authorities; World Economic Outlook; and IMF Staff Calculations.

5. The large weight of direct investment is a mitigating factor. FDI accounts for more than half of total liabilities, evenly split between debt and equity. The Oyu Tolgoi mine liabilities alone account for 70 percent of FDI liabilities and, including a large external loan, are estimated to amount about 158 percent of GDP (47 percent of total liabilities). This reflects the project's sizeable upfront capital costs. The underground project is expected to be completed by end-2022, helping to mitigate the risks arising from the very large international liabilities, as OT's external liabilities are presumed to be financed by its earnings from copper exports. Moreover, in the event of stress, there is a presumption that these liabilities will be absorbed or financed by the parent company.

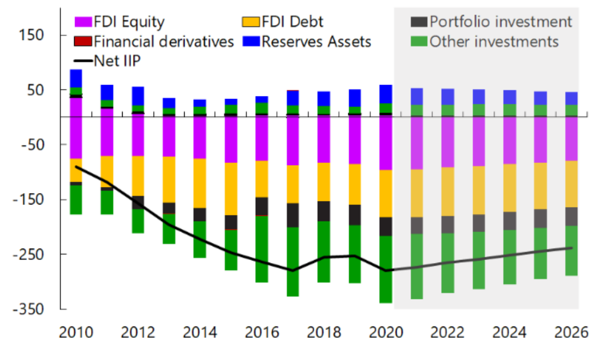
Mongolia: IIP Liabilities, 2020



Sources: Mongolian authorities; and IMF staff calculations.

6. IIP liabilities are projected to remain very large, although declining. Mongolia's NIIP is projected to improve from -279 percent of GDP in 2020 to -239 percent in 2026. This is mainly driven by a decline in FDI inflows as the OT mine is completed and a projected fiscal consolidation over 2022–23 and use of domestic FHF buffers for current spending and some use of domestic borrowing for budget financing which should help contain external public debt liabilities. In the event that the PBOC swap is rolled over, it will remain an external liability for the BOM.

IIP Assets and Liabilities
(In percent of GDP)



Sources: Mongolian authorities; and IMF Staff Calculations.

7. Mongolia's external position remains substantially weak.

- The EBA-lite current account (CA) approach estimates the CA norm at -6.8 percent of GDP. The 2020 CA is adjusted to account for the one-off impact of the pandemic on oil trade balance and tourism. In addition, a Mongolia-specific adjustor is calculated to account for a temporary surge in gold exports, which explains part of the CA improvements in 2020 and are

Mongolia: Model Estimates for 2020 (In percent of GDP)

	CA model	REER model	ES model
CA-Actual	**-5.1**		
Cyclical contributions (from model) (-)	1.3		
COVID-19 adjustor (+) 1/	-1.5		
Additional temporary/statistical factors (+)	-5.6		
Natural disasters and conflicts (-)	-0.8		
Adjusted CA	**-12.7**		
CA Norm (from model) 2/	**-6.8**		
Adjustments to the norm (+)	0.0		
Adjusted CA Norm	**-6.8**		
CA Gap	**-5.9**	**8.5**	**...**
o/w Relative policy gap	0.5		
Elasticity	-0.44		
REER Gap (in percent)	**13.3**	**-19.3**	**...**

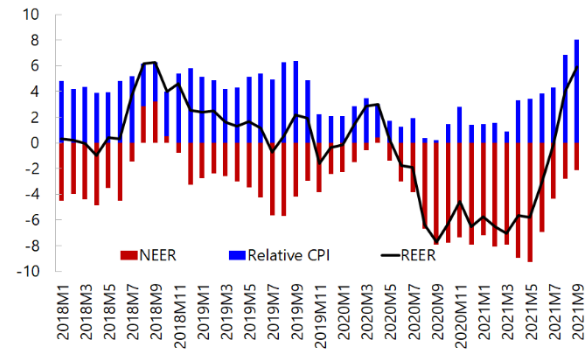
1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on oil trade balances (-0.43 percent of GDP) and on tourism (-1.08 percent of GDP).
2/ Cyclically adjusted, including multilateral consistency adjustments.

not captured in the model.[1] The CA gap is estimated at -5.9 percent of GDP, which translates into a 13.3 percent REER gap.

- The EBA-lite REER model points to a REER undervaluation of 19.3 percent. These results are largely attributable to unexplained residuals due to the sharp drop in the REER in 2016. The results of the EBA-lite REER model are inconsistent with recent developments in Mongolia's overall external position. In 2020, Mongolia's REER depreciated by 6.5 percent in 2020, as inflation softened and the MNT depreciated vis-à-vis the renminbi, in line with the strong economic recovery in China. However, the MNT/USD exchange rate, on the other hand, remained stable throughout the year, thanks in part to BOM large FX intervention in 2020Q1. Moreover, the 2020 REER depreciation was temporary: in 2021, the recent pickup in inflation has led to a REER appreciation of 9 percent (YTD, as of end-September 2021). Finally, the EBA-Lite External Sustainability (ES) approach, which calculates the external adjustment needed to stabilize the NIIP, does not point to REER misalignment since the NIIP is projected to improve in the medium term without REER adjustment.

REER and NEER

(Percentage change, yoy)



Source: IMF.

8. Overall, Mongolia's external position is assessed to be substantially weaker than implied by fundamentals and desirable policy settings. The assessment draws on Mongolia's large negative IIP position and the results from the EBA-Lite CA approach. Given Mongolia's vulnerability to external shocks, the BOM should allow greater exchange rate flexibility as a shock absorber and help improve the incentives for the private sector to properly manage exchange rate risks stemming from their external liabilities. The BOM should boost (gross and net) international reserves by opportunistically intervening in the domestic FX market through sterilized interventions. At the same time, the BOM should continue to proactively reduce its foreign liabilities by reducing reliance on off-balance sheet swaps and reducing other non-concessional liabilities. The government should reduce its external liabilities via fiscal consolidation, structural reforms to reduce fiscal pressures over the longer-term, continued improvements in external debt management and by developing the domestic debt market. To improve opportunities for domestic financing, banking sector reform should be pursued. Finally, over the medium-term, the development of hedging instruments to manage existing FX exposures is also advisable.

[1] A coefficient of 0.58 percent is applied to the temporary increase in gold exports, equal to the correlation coefficient between gold exports and the cyclically adjusted CA balance over 2010–2020.

Annex III. Risk Assessment Matrix

Source and Likelihood of Risk		Expected Impact on Mongolia	Policies to Minimize Impact
Global and Regional Risks			
Uncontrolled Covid-19 local outbreaks and subpar/volatile growth in affected countries **Global resurgence of the Covid-19 pandemic**	***High*** ***Medium***	***High***: Growth deceleration in trading partners and lower commodity prices would reduce export receipts and mining-related taxes. GDP growth would decline, fiscal balance would deteriorate along with a loss of foreign reserves and increased pressure on the exchange rate.	Strengthen health systems and adopt measures to contain the virus and allow external borders to remain safely open. Maintain exchange rate flexibility as a shock absorber, continue to opportunistically build reserves to adequate levels and prioritize fiscal consolidation to reduce public external debt, targeting support only to those affected by the pandemic. Undertake long delayed and much needed fiscal, financial and regulatory reforms to preserve investor confidence.
De-anchoring of inflation expectations in the United States leads to rising core yields and risk premia	***Medium***	***Medium:*** While external vulnerabilities have been significantly mitigated by recent rollovers of sizeable Eurobonds coming due in 2021–24, IIP and NIR remains weak and financing needs remain large. A rise in risk premia could raise funding costs and pressure external buffers.	Taking advantage of strong commodity prices, exports and FDI inflows, continue building external and domestic buffers. Reduce financing needs through fiscal consolidation and use concessional financing, if available. Develop the domestic debt market and restart issuances of government securities.
Rising commodity prices amid bouts of volatility	***Medium***	***Medium:*** Substantial improvement in external balances and buffers, faster domestic growth, and stronger fiscal balance due to robust mining related revenues.	Stronger fiscal consolidation and sustainable policies in 2022, save excess mining sector revenues/royalties in sovereign wealth funds, build GIR and lower non-concessional foreign liabilities. Tighten monetary and macroprudential policies if inflation rises. Strengthen business climate, governance, and financial sector reforms to maximize benefits from commodity price windfall.

Source and Likelihood of Risk		Expected Impact on Mongolia	Policies to Minimize Impact
		Domestic Risks	
Worsening of domestic COVID-19 outbreak	***High***	***High:*** Slower recovery, and sharp increase in public financing needs. Impact would be dire if there is a prolonged closure of the border with China, disrupting commodity exports. Financial sector stress would rise further.	Step up support for the health system and adopt measures to contain the pandemic while limiting its impact on the most vulnerable and the economy. Undertake anti-pandemic policies which can mitigate the risk of border closures. Any fiscal support should only be targeted toward those affected by the pandemic. The BoM should closely monitor growing stress in the financial system and proactively strengthen bank capital.
Intensification of financial sector vulnerabilities	***Medium***	***High:*** The undercapitalization of banks, especially in one or more systemic institutions, could be a source of instability. A surge in non-performing loans could further lower capital adequacy, affecting financial stability.	Ensure that bank recapitalization is completed quickly and is based on sound supervisory/regulatory practices. Promptly conduct an independent, reliable audit of bank balance sheets to establish accurate asset valuations and provisioning needs. Prepare contingency plan for problem banks. Ensure bank NPL resolution strategies incorporate the impact of COVID-19 on their loan books. Delay IPOs until after intensified financial sector vulnerabilities have been addressed.
Procyclical policies	***Medium***	***Medium:*** Political pressure to undertake pro-cyclical spending policies could further undermine macro-financial stability, debt sustainability and the integrity of Mongolia's institutions, while delaying reforms. Continuation of quasi-fiscal policies could jeopardize monetary policy operations. A disruptive renegotiation of the OT investment agreement could worsen the economic and external outlook.	Boost investor confidence in policy management by following the Fiscal Stability Law, undertaking critical reforms such as pension system reforms, targeted social assistance, revamped public investment management, improved insolvency framework, and strengthened SOE governance to improve public finances. The 2022 budget should focus on larger fiscal consolidation and additional fiscal support should only be targeted towards those affected by the pandemic. Discontinue quasi-fiscal operations and enhance BOM's operational independence and governance. Resolve dispute related to the OT investment agreement expeditiously and without unduly disrupting operations.
Extreme climate events	***Medium***	***Medium:*** Greater uncertainty with weather trends, higher average temperatures and weather extremes would accelerate land degradation and hurt the livestock sector, with high socio-economic costs and lower growth.	Make the agricultural sector more productive and resilient to extreme climate shocks and warmer temperatures, balance the livestock population with nature's capacity to regrow. Better pasture management to improve livestock productivity. The government should facilitate adaptation to warmer temperatures and improve resilience.

"L" =Low; "M" =Medium; "H" =High. The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex IV. Performance of Mongolia's Fiscal Framework

Since the establishment of the Fiscal Stability Law in 2010, fiscal rules have been repeatedly bypassed due to insufficient political buy-in and unexpected shocks, whereas the savings in the Fiscal Heritage Fund have been appropriately increased until end-2021. Mongolia would benefit significantly from adopting, and improving compliance with a streamlined fiscal framework and by saving additional windfall gains from higher commodity prices into their sovereign wealth funds. Adopting such policies would help build credibility in the fiscal framework and provide adequate buffers to respond to adverse shocks. Preserving the integrity of the Future Heritage Fund will also be crucial for investor confidence.

1. **The Fiscal Stability Law passed in 2010 aimed at ensuring fiscal discipline and enhancing the conduct of fiscal policy.** As part of the Fiscal Stability Law (FSL), three fiscal rules became effective in 2013. These three rules provided binding targets for (i) expenditure growth; (ii) the structural fiscal balance, and (iii) the net present value (NPV) of public debt to GDP. The FSL required budget proposals each year to comply with the numerical limits for these three rules.

2. **However, the implementation of the FSL has been poor and inadequate.**[1] There have been frequent revisions to numerical limits and the definition of fiscal rules has been altered to accommodate slippages. For example, in 2015, the definition of the debt rule was narrowed from public to general government debt, thereby excluding SOE debt, government contributions to mining, energy and railway projects, and government guarantees that are fully secured by government securities. In 2016, the debt limit was raised from 40 percent of GDP to 60 percent of GDP (in NPV terms). The expenditure rule to constrain excessive spending was not applied until 2017 due to strong political pressure to spend resource revenues. Similarly, the initial target of 2 percent of GDP for the structural fiscal balance has been met only twice since 2013 (Figure 1) and has now been pushed forward to 2025 (Figure).

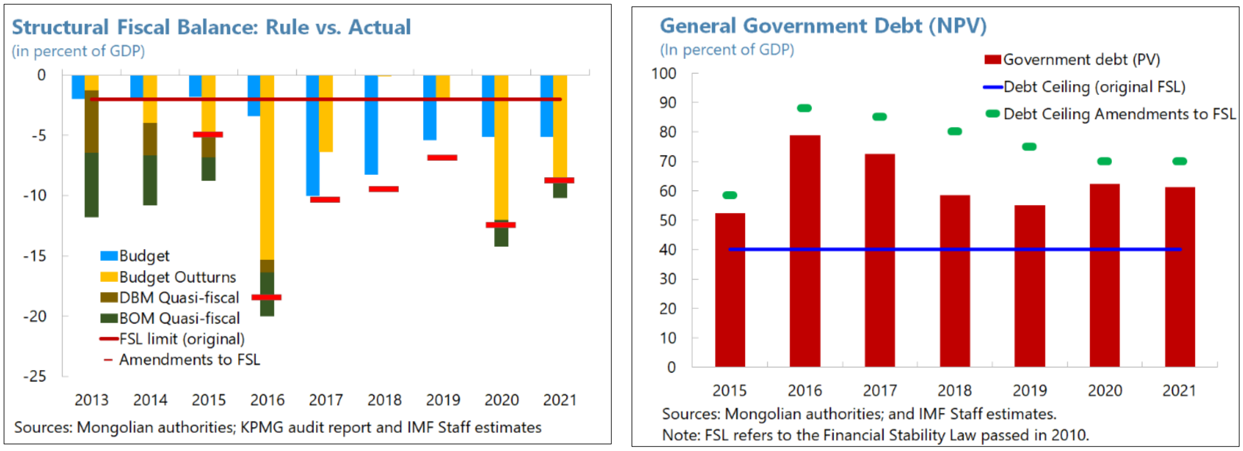
Figure 1. Changing Fiscal Rules on Structural Balance
(In percent of GDP)

	2019	2020	2021	2022	2023	2024	2025
Pre-pandemic levels	6.9	5.1	3.6	2.8	2.0	2.0	2.0
Changes made during the pandemic	6.9	-	5.1	3.6	2.8	2.0	2.0
Proposed changes	6.9	12.5	8.8	5.1	3.6	2.8	2.0

Source: Mongolia Ministry of Finance

[1] See IMF (2019b) for detailed discussion.

Figure 2. Performance of Structural Fiscal Rule and General Government Debt Ceiling



3. **Furthermore, the reliance on quasi-fiscal spending to bypass the fiscal rules has remained high.** Mongolia established the Development Bank of Mongolia (DBM), financed capital spending through promissory notes and concession, which were not properly recorded in the budget. The BOM also started financing quasi-fiscal activities. These quasi-fiscal activities by the DBM and BOM were successfully brought back on to the budget in 2017 under the EFF arrangement (Figure 2). But, as mandated in the Anti-Pandemic Law of 2020, the BOM has resumed quasi-fiscal activities in 2020−21 to support the economy during the pandemic, and these activities are likely to be extended till 2023 under the draft post-pandemic economic recovery law.

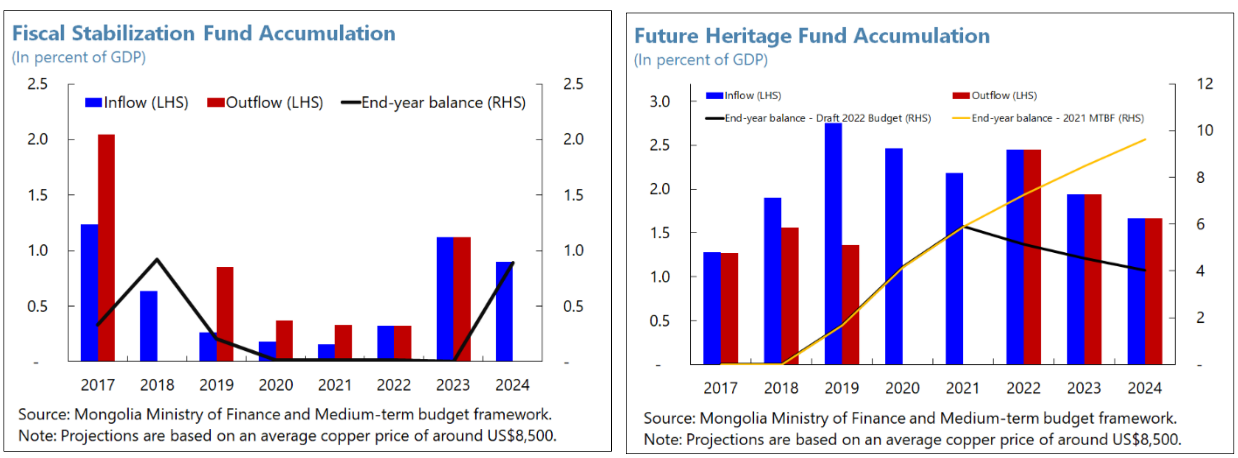
4. **Another component of Mongolia's fiscal framework are its two sovereign wealth funds created to preserve its mineral wealth**. The Fiscal Stabilization Fund (FSF) was established in 2011 following the enactment of the FSL by the Parliament. The main purpose of this fund is to insulate the budget from volatile commodity prices and provide a buffer to the budget in times of revenue shortfalls. The Future Heritage Fund (FHF) was established in 2017 to ensure a fair and equal distribution of mineral wealth across generations and to establish a stable and efficient macroeconomic management system.

5. **The government has been prioritizing the use of FSF over additional borrowing to finance its budget deficits until end-2023.** The FSF is intended to create medium and long-term stability for the general budget. Deposits to the fund comes from a combination of additional budget revenue from higher-than-projected mineral prices, structural budget surpluses, unspent balances of the government reserve fund, net income from the financial activities of the Fund itself, and any other income as designated by the parliament. The government is able to withdraw from the fund to cover the mineral revenue shortfalls. In 2017, a provision to finance the budget deficit through 2023 was added to the law, as the budget deficit rose from 5 percent of GDP in 2015 to 15.3 percent of GDP in 2016 on account of mineral revenue shortfall, higher interest expense and some one-off expenditure items. Although. this has reduced the need for additional borrowing at the time of the crisis, continuous usage of FSF even at normal times undermines the credibility of the fund and defeats its purpose.

6. Transfers to the FHF are expected to be saved for future generations. The FHF's rules dictate that the government can only spend the balance on expenses related to Fund administration and independent audit until 2030. However, a Transitional Provision was approved in 2017 under which actual savings were delayed until end-2018 and FHF revenues collected in 2017–18 were fully used to pay down debt of its successor Human Development Fund, which was terminated in 2016. Furthermore, FHF was used to temporarily fund transfers to the state budget in pre-determined amount totaling to MNT310 billion for financing expenditures that were previously financed from the Human Development Fund. Excluding these episodes, the government has continued to save in the FHF.

7. Despite the need for additional borrowing to fund COVID related fiscal measures, the government has so far continued to follow governing rules of both funds. As shown in Figure 3, government appropriately utilized savings from the FSF to partly finance its budget deficit because of the shortfalls in mineral revenue due to the external shock related to the pandemic, while continuing to accumulate in the FHF. Following the rules of these funds promotes fiscal discipline and credibility. Saving additional windfall from higher commodity prices in these funds would provide adequate buffers to respond to unexpected adverse shocks.[2]

Figure 3. Inflows and Outflows of Wealth Funds



Source: Mongolia Ministry of Finance and Medium-term budget framework.
Note: Projections are based on an average copper price of around US$8,500.

8. However, recently proposed changes may undermine the FHF. The draft 2022 budget proposes to fund a permanent expansion of untargeted social assistance instead of building savings in the FHF. If approved, this change will undermine the only pillar of the fiscal framework that has worked so far. Furthermore, there are ongoing discussions to establish a new development fund financed by dividends from the SOEs, which are currently saved in the FHF. It is critical that the integrity of the FHF be maintained and resources saved to ensure a fair distribution of mineral wealth across generations. Doing so will help and to establish a more robust and efficient and sustainable macroeconomic policy management, boost public sector buffers, and help increase system. investor confidence in Mongolia's economy.

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[2] At end-2021, total FHF and FSF assets are estimated to reach around 5.8 percent and 0 percent of GDP.

Annex V. Public Debt Sustainability Analysis

Mongolia's debt is projected to rise sharply over the long-term under current policies. Public debt (GFS basis) is expected to rise from 77½ percent of GDP in 2020 to 81½ percent of GDP in 2021. This is due to a sharp deterioration in fiscal balances during the Covid-19 crisis largely due to untargeted support. Despite some near-term improvement—due to fiscal consolidation and forgone FHF savings to finance higher social transfers—public debt is projected to remain high at about 68 percent of GDP by the end of 2026 and risks of debt distress remain elevated. Longer-term debt pressures are driven by rising pension liabilities due to higher levels of untargeted social spending, generous parameters and unfavorable demographic trends, and higher health and education expenditures to meet the government's policy goals. The debt dynamics are particularly vulnerable to developments in the economic outlook and exchange rate, and to the realization of financial sector contingent liabilities. Fundamental reforms in the pension system, social safety nets, public investment management and tax policy and administration are necessary to ensure debt sustainability.

A. Overview and Overall Assessment

1. **Mongolia's public debt is high and largely external (Table).** In 2020, external public debt (GFS basis) accounts for about 96 percent of total public debt. The bulk of external debt is to the official sector and on concessional terms. Under current policies and given the weaknesses in the financial sector, which hinders domestic debt issuance, the share of external debt in total public debt is expected to remain elevated over the medium-term. The baseline assumes a gradual increase in domestic debt financing at market rates, and that a large share of additional external debt incurred will be on less than concessional terms, but still below market rates. The debt trajectory maybe worse if new external borrowings are also contracted at market rate.

Mongolia Public Debt (GFS Basis), 2020

	In percent of GDP	In percent of Total Public Debt
Total	**77.4**	**100**
Domestic	**3.4**	**4.4**
External	**73.9**	**95.6**
Official creditors	*43.6*	*56.4*
IMF	*2.8*	*3.6*
World Bank	*5.2*	*6.7*
ADB	*14.4*	*18.7*
Other: EBRD, IFAD, EIB	*0.5*	*0.6*
Bilateral	*20.7*	*26.8*
Private Creditors	*30.3*	*39.2*

Source: Mongolian Authorities, IMF Staff Estimates.

2. **Mongolia's debt is expected to remain elevated over 2020–26.** Mongolia displayed strong fiscal discipline during 2017–19, with primary surpluses averaging 3 percent of GDP over the period. As a result of the consolidation, Mongolia's public debt (GFS basis) fell by almost 20 percentage point to 66 percent of GDP at end-2019 compared to 87.6 at end-2016. The Covid-19 crisis has partially reversed this progress. Under the baseline scenario, public debt has risen by 10 percentage points to 77½ percent of GDP in 2020 and projected to rise to about 81½ percent of GDP in 2021 due to various fiscal measures to support the economy during the pandemic. Public debt is expected to decline over 2021–26. This favorable debt dynamics is predicated on a swift rebound in economic activity starting in 2021 because of booming exports, the significant share of concessional debt, and planned fiscal consolidation, helped by Mongolia's export-led economic

recovery and the expiration of many pandemic support measures. In addition, the draft 2022 budget proposal to finance the expansion of untargeted social assistance by forgoing planned savings in the Future Heritage Fund (FHF) instead of debt issuance is expected to contain debt levels. Nevertheless, spending pressures related to accrued pension liabilities will keep debt levels high over the longer-term. Despite the declining trend, public debt is forecasted to remain elevated at about 68 percent of GDP by 2026 due to increasing accrued pension-related spending from 2023 onwards. Moreover, due to maturing Eurobonds which were recently rolled over, gross financing requirements are expected to climb to 13.5 and 11.6 percent of GDP in 2023 and 2026 respectively. The public debt coverage in the debt sustainability analysis is broader than in the macro-framework (see Section B).

3. Mongolia's risks of debt distress remains high. In addition to high levels of debt, Mongolia's narrow economic base, history of pro-cyclical policies, and high levels of foreign exchange-denominated debt and limited buffers, poses significant risks to the debt trajectory and explains the overall assessment of high risk of debt distress.

B. Coverage

4. For the debt sustainability analysis, the public debt coverage has been expanded to include the Bank of Mongolia's (BOM) external liabilities (PBOC swap) of about 14 percent of GDP in 2020 (Figure 1-5). This raises public debt to 91.3 percent of GDP at end-2020. The inclusion of the PBOC swap in public debt for the DSA is consistent with IMF policy since the PBOC swap is not part of the BOM's monetary or liquidity operations, but medium-term balance of payments support to help shore up gross reserves.[1] The inclusion of the PBOC swap line is consistent with the practice of including IMF credit in the DSA.[2] According to the IMF's assessment of Mongolia's external position, if the swap were to be settled in 2023, it would bring GIR below the IMF's ARA threshold (see Annex II).

5. The coverage of public debt comprises the general government, one state-owned bank, and the BOM's liabilities to the PBOC. The definition of public debt is comprehensive and specifically includes: (i) consolidated public debt of the general government (in local and foreign currency); (ii) government guarantees of external borrowing in foreign currency by state-owned enterprises; (iii) the external borrowings in foreign currency by the Development Bank of Mongolia, the largest state-owned bank; (iv) IMF credit; and (v) certain external liabilities of the BOM (i.e., the PBOC swap (US$1.8 billion, 14 percent of GDP) which was rolled over in July 2020 and now matures in 2023). Public debt does not include any fully collateralized public guarantees of private-sector external debt.

[1] See 2021 review of the MAC-DSA (Annex II, https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/02/03/Review-of-The-Debt-Sustainability-Framework-For-Market-Access-Countries-50060).

[2] The PBOC swap is included in the DSA from 2011 onward when the swap was initiated. The swap was gradually drawn between 2011 and 2016.

C. Assumptions

6. The baseline scenario assumes economic recovery, beginning in 2021. The assumptions are as follows:

- Real GDP growth is expected to rebound to 4½ percent in 2021 and average 6 percent in the period 2022–26 due to booming of Mongolian mineral exports. Inflation is expected to increase from its trough of 3.7 percent in 2020 to 7.2–7.5 percent in 2021–2022, and stabilize at 6.4 percent by the medium term (2023 onward).

- The external position is substantially weaker than implied by fundamentals and desirable policy settings. Current account deficits are projected to remain large, as domestic demand and imports recover. External liabilities are expected to remain high given large fiscal financing needs over the medium-term, and international reserves are assessed to be below desirable levels.

- Financing is expected to comprise concessional budget support and project loans from multilateral development banks in line with current commitments. In addition, some domestic issuance of bonds at market rates and relatively less concessional terms are assumed for new external budget support and project loans from multilateral development banks compared to current commitments. The DSA assumes that, over the forecast horizon, Mongolia's external debt will be contracted on a relatively less concessional terms with grant elements of about 25 percent.[3] Domestic debt issuance will start gradually and will remain limited owing to financial sector constraints. The average stock of domestic debt over the forecast horizon is assumed to be about 5 percent of GDP. In the event new external debt is also available at market terms, debt dynamics will worsen.

- The primary balance is projected to improve to -3.1 percent of GDP in 2021 from -6.7 percent of GDP in 2020 due to the reduction of COVID-19 fiscal support measures, increase in revenues from higher commodity prices and stronger activity and a one-off tax transfer from OT. The primary balance is expected to improve further till 2023 to a deficit of 0.3 percent of GDP as COVID-19 stimulus measures expire, and due to the continued budgetary impact of stronger growth. Over the medium term, the primary balance is expected to deteriorate gradually due to accrued pension related expenditure.

7. The favorable debt dynamics during 2021–26 is mainly shaped by the projected path of the interest rate-growth differential. The public debt-to-GDP ratio is forecasted to decline by about 17.6 percentage points between end-2021 and end-2026. In addition to the expiration of pandemic-related fiscal support and the use of the FHF to finance social assistance spending, this decline is also due to automatic debt dynamics including low effective interest rates (reflecting a still significant share of relatively concessional debt) and high economic growth. At the end of 2020, some 56½ percent of public debt was official and on relatively concessional terms, with low interest

[3] Loans with a minimum grant element of 35 percent grant are considered concessional (https://www.imf.org/external/np/pdr/conc/calculator/default.aspx).

rates and long maturities. The share of official sector debt is expected to increase to 77 percent by the end of 2026, reflecting the inability of the authorities to issue large amounts domestic debt to fill the additional financing needs. The average effective nominal interest rate of public debt is projected to decline from its 3.2 percent in 2020 to 1.7 by 2026, due to a decline in interest payment as a result of the Eurobond rollover and a declining growth in public debt.

D. Risks

8. Fund staff forecasts have simultaneously been both pessimistic and optimistic in the period 2010–19. Inflation forecasts have been pessimistic. The forecast track record shows that Fund staff has systematically overestimated inflation, with forecast errors in the 93rd percentile of all forecast errors across countries over the same period. Inversely, the primary balance forecast has been too optimistic, with actual primary deficits being much higher than projected (except in the past three years of the analysis). The pre-pandemic (2017–19) improvement in fiscal indicators suggests that the conduct of fiscal policy has become more prudent, avoiding excessive volatility and pro-cyclicality. Under the baseline scenario, the projected 3-year adjustment in the cyclically adjusted primary balance (CAPB) is in a percentile rank of 6 percent compared to the historical experience for market access countries. The CAPB 3-year average level is in a percentile rank of 74 percent.

9. The public debt and financing needs projections are particularly sensitive to shocks to growth, exchange rate, and financial sector contingent liabilities.

- *Growth shock.* Slower growth can threaten debt sustainability, given the high volatility and commodity-dependence of the Mongolian economy. If growth declined by one standard deviation in 2022 and 2023, which would slow the expected recovery from the Covid-19 crisis, the debt-to-GDP-ratio is forecast to reach 105 percent in 2023. It would also sizably increase gross financing needs in 2023 to 22 percent of GDP compared to about 13.5 percent of GDP in the baseline.

- *Exchange rate shock.* An exchange rate depreciation also poses significant risk to public debt, given that the bulk of the public debt is foreign currency denominated and the external position is judged to be weaker than implied by fundamentals. A nominal exchange rate depreciation of 33 percent in 2021 would increase debt to almost 108 percent of GDP. Gross financing needs would peak at 16 percent of GDP two years later in 2023.

- *Financial sector contingent liability shocks.* Mongolia's large banking system (assets of some 97 percent of GDP as of 2020) poses a perennial vulnerability to the debt outlook. If the Mongolian government were called on to backstop a systemic bank, fiscal costs could be considerable. To examine the effect of this scenario, the contingent liability shock assumes that: (i) one-off fiscal outlays in the order of 15 percent of banking-sector assets (14½ percent of GDP, excluding credit to the government) accrue in 2022; (ii) concomitantly, real GDP growth declines by one standard deviation (same shock as above). This shock is larger than the standard size of 10 percent of banking-sector assets because of long-standing challenges in strengthening the financial resilience of the sector. Under this shock scenario, gross financing needs could reach 17 percent of GDP in the year of the shock, raising public debt to about 106 percent of GDP in the following year.

- *Primary balance shock*. The primary balance shock assumes that the planned fiscal consolidation in the years 2022–24 is not implemented as projected. Specifically, the primary balance shock assumes that fiscal balances deteriorate by another 1 percent of GDP next year before the consolidation begins, combined with an increase in interest rates of 25bps for every 1 percent of GDP worsening in the primary balance. Relative to the baseline, the cumulative shock equals 4 percent of GDP spread evenly over the three years 2022–24 and an increase in interest rates by 60 bps in each year. Under this scenario, public debt trajectory worsens but the impact is limited with public debt reaching 84 percent of GDP over the forecast horizon.

- *Combined macro-fiscal shock*. Under a scenario with combined shocks to both GDP growth and primary balance (of the same magnitude as discussed above), public debt will peak at about 139 percent of GDP by 2023 compared to 83 percent of GDP in the baseline. The gross financing needs will also reach its peak at 28 percent of GDP in 2023 compared 13.5 percent of GDP in the baseline.

10. The fan charts (see figure 5) further illustrate Mongolia's debt vulnerabilities. Given Mongolia's elevated starting point at end-2020 and pronounced volatility of its public debt-to-GDP ratio historically, the fan charts put a significant probability on the scenario of debt remaining above the projected level at end-2020 by the end of the forecast period. If positive and negative shocks were equally likely, public debt would remain above 75 percent with a 25 percent probability. If, on the other hand, the one views downside risks associated with external vulnerabilities and delays in implementing fiscal consolidation as more likely (which results in an asymmetric fan chart that restricts positive realizations of the shocks to the exchange rate and the primary balance), public debt would stay above 75 percent with a probability of about 37 percent.

11. Mongolia's external imbalances create weaknesses in the public debt profile. External financing needs, driven by Mongolia's current account deficit, are above the upper-risk assessment benchmark. However, large current account deficits in recent years reflect one large FDI project in Mongolia's mining sector. The current account will improve over the medium term as the project is completed, and production and exports of the large mining project pick up. Public debt held by non-residents and public debt denominated in foreign currency are also above the upper-risk assessment benchmark (both at 96 percent as all public debt owed to non-residents is foreign currency denominated). In particular, Mongolia's public external debt will lead to large external amortizations in the years 2023 and 2026 due to Eurobond rollover, which may create financing pressures. Lumpy one-off amortizations aside, the risks inherent in relying on external financing are offset by the fact that most of the external debt is provided by bilateral and multilateral lenders on terms that are below-market.

E. Risk Mitigation

12. To mitigate risk, Mongolia will need fundamental reforms to put debt under a sustainable path over the medium term. This will require stronger fiscal consolidation which could be realized through parametric reforms of the pension insurance scheme, more targeted and consolidated social safety nets, improvement in public investment management, allowing greater tax progressivity and improving tax administration. The integrity of the FHF should be preserved. In addition, Mongolia will need a greater recourse to domestic financing by restarting domestic government bond issuance. This requires a comprehensive medium-term debt strategy and an Annual Borrowing Plan, and addressing the financial sector and governance weaknesses including improving compliance with streamlining the fiscal framework. Continuing to improve asset-liability management and raising the concessionality of debt can improve fiscal space and further help mitigate risks associated with the projected hump in gross financing requirements in 2023 and 2026. Adherence to a nominal medium-term debt anchor (as a percent of GDP instead of in net present value terms) can help stave off political pressures and signal the government's commitment to fiscal sustainability and better fiscal governance through greater transparency. Most emerging market economies have adopted 60 percent of GDP debt as a medium-term anchor, but a lower level—50 percent of GDP—could be considered appropriate for Mongolia given its greater reliance on external debt compared to peer economies.

13. Given Mongolia's history of boom-bust cycles, the authorities need to remain vigilant and pro-actively mitigate debt sustainability risks. Mongolia would be well advised to use the projected recovery this year to resume recent progress in building fiscal and external buffers. Larger buffers are necessary to protect Mongolia against inherent debt sustainability risks that arise from resource-dependence, significant external imbalances, and contingent liabilities. If downside risks materialize, contingency planning helps mitigate risks proactively and should explore scope for reprioritizing expenditure plans and mobilizing additional donor financing.

Figure 1. Mongolia: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(In percent of GDP, unless otherwise noted)

Debt, Economic and Market Indicators [1]

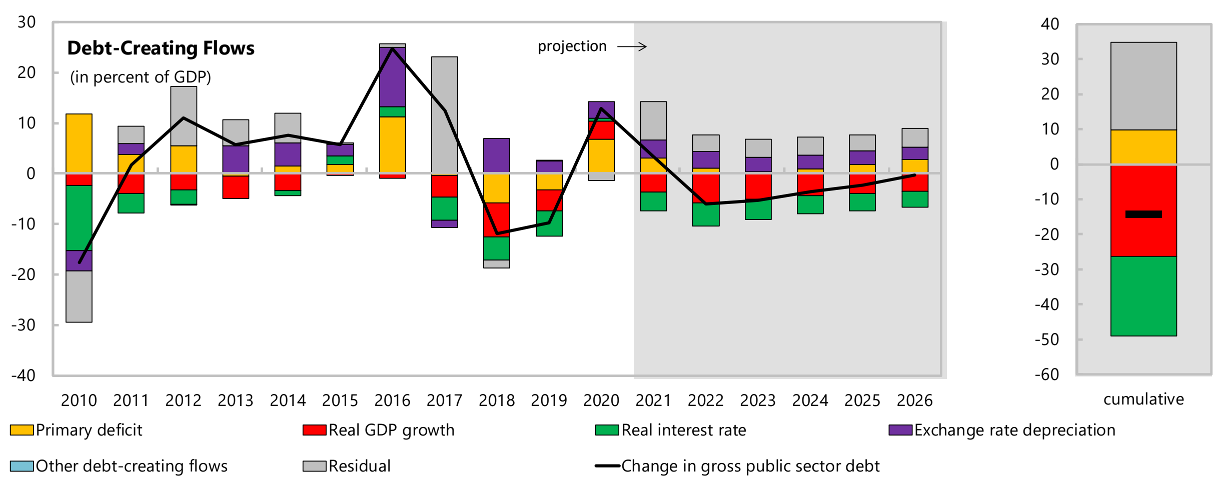
	Actual 2010-2018 [2]	Actual 2019	Actual 2020	Projections 2021	2022	2023	2024	2025	2026
Nominal gross public debt	61.4	78.5	91.3	94.6	88.5	83.2	79.6	77.3	77.0
Public gross financing needs	7.2	0.8	24.8	9.2	6.2	13.4	8.4	5.6	11.6
Real GDP growth (in percent)	8.0	5.6	-4.6	4.5	7.0	6.5	6.0	5.5	5.0
Inflation (GDP deflator, in percent)	11.2	10.0	3.7	7.2	7.5	6.4	6.0	6.1	6.0
Nominal GDP growth (in percent)	20.2	16.1	-1.0	12.0	15.0	13.4	12.4	12.0	11.3
Effective interest rate (in percent) [4]	4.0	3.0	3.2	2.9	2.3	1.7	1.6	1.5	1.6

As of October 25, 2021

Sovereign Spreads		
EMBIG (bp) 3/		280
5Y CDS (bp)		1055
Ratings	Foreign	Local
Moody's	B3	B3
S&Ps	B	B
Fitch	B	B

Contribution to Changes in Public Debt

	Actual 2010-2018	Actual 2019	Actual 2020	Projections 2021	2022	2023	2024	2025	2026	cumulative
Change in gross public sector debt	4.4	-9.8	12.9	3.2	-6.1	-5.3	-3.6	-2.4	-0.3	-14.4
Identified debt-creating flows	0.1	-9.9	14.2	-0.8	-6.1	-6.0	-4.3	-3.0	-1.5	-21.7
Primary deficit	3.2	-3.2	6.7	3.1	1.1	0.3	0.9	1.8	2.7	9.9
Primary (noninterest) revenue and grants	28.1	31.7	27.9	32.1	32.6	32.9	32.8	32.4	31.9	194.8
Primary (noninterest) expenditure	31.3	28.5	34.6	35.2	33.7	33.2	33.7	34.2	34.7	204.7
Automatic debt dynamics [5]	-3.1	-6.7	7.5	-3.9	-7.2	-6.2	-5.2	-4.8	-4.2	-31.6
Interest rate/growth differential [6]	-6.2	-9.3	4.2	-7.4	-10.4	-9.1	-8.0	-7.4	-6.7	-49.1
Of which: real interest rate	-2.9	-5.0	0.6	-3.7	-4.7	-4.1	-3.5	-3.5	-3.2	-22.8
Of which: real GDP growth	-3.3	-4.3	3.6	-3.7	-5.8	-5.1	-4.4	-3.9	-3.5	-26.3
Exchange rate depreciation [7]	3.1	2.5	3.3	…	…	…	…	…	…	…
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization/Draw-down of Deposits (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other debt creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes [8]	4.3	0.1	-1.4	7.6	3.3	3.6	3.5	3.3	3.7	24.9



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data and includes BOM's external liabilities (PBOC swap).

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

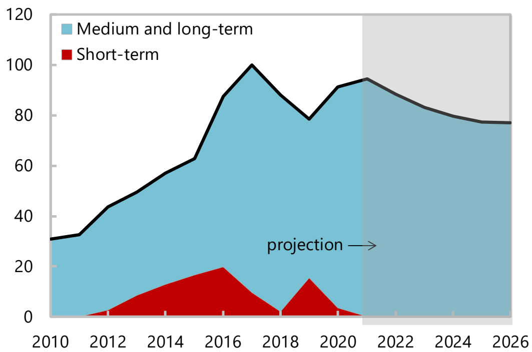
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

Figure 2. Mongolia: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

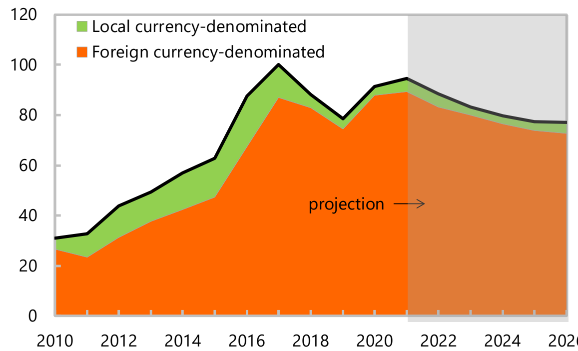
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

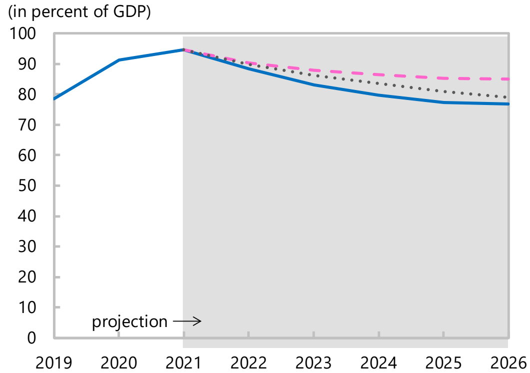


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

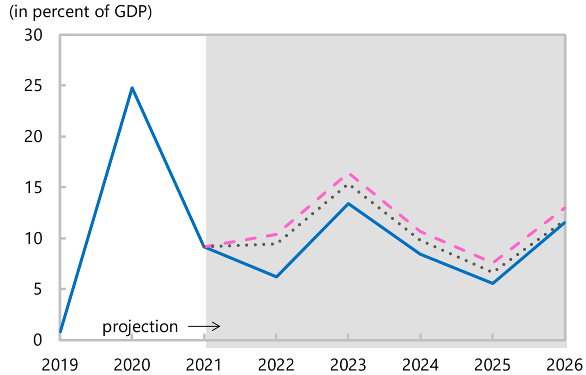
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

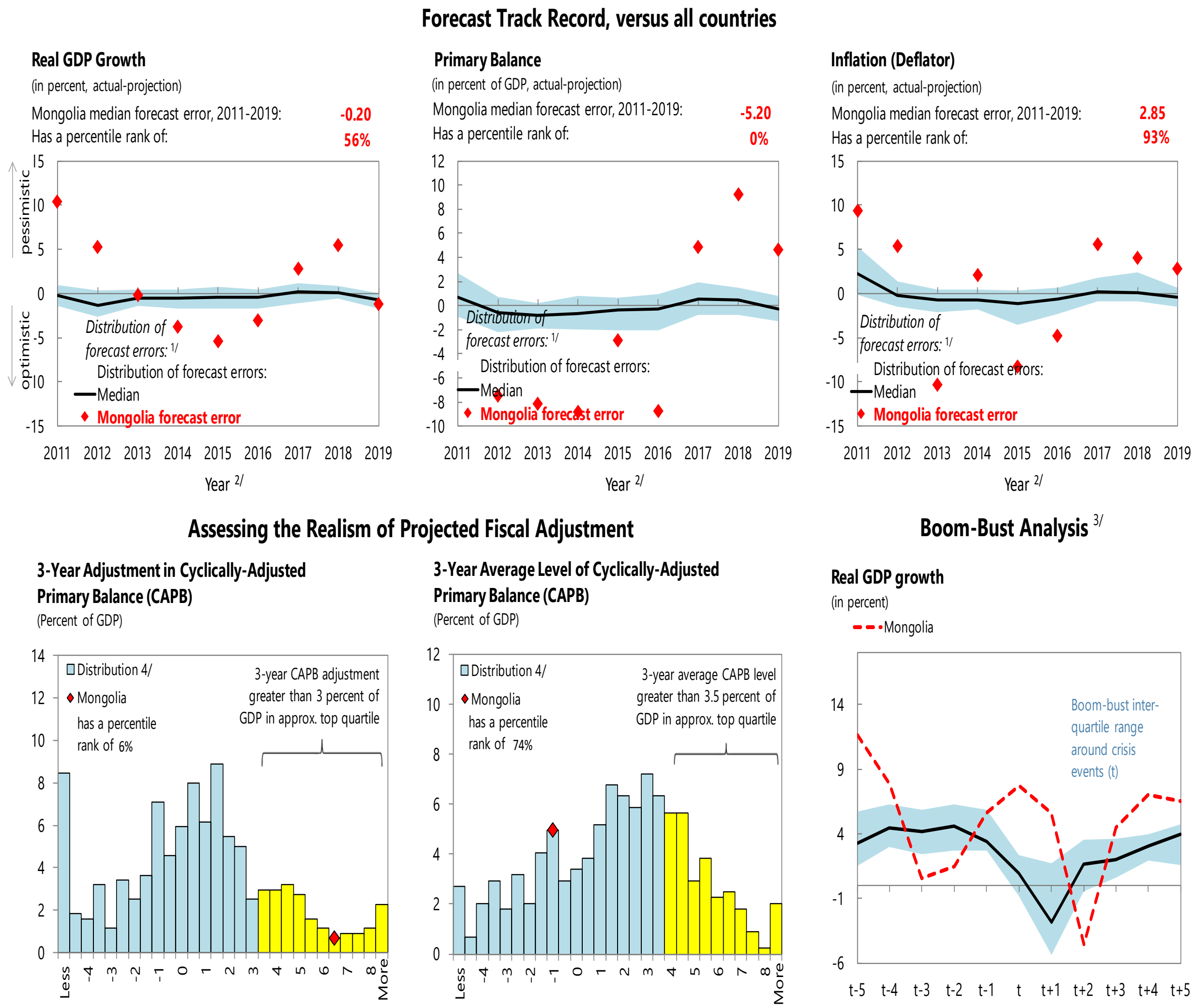
(in percent)

Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	4.5	7.0	6.5	6.0	5.5	5.0
Inflation	7.2	7.5	6.4	6.0	6.1	6.0
Primary Balance	-3.1	-1.1	-0.3	-0.9	-1.8	-2.7
Effective interest rate	2.9	2.3	1.7	1.6	1.5	1.6
Constant Primary Balance Scenario						
Real GDP growth	4.5	7.0	6.5	6.0	5.5	5.0
Inflation	7.2	7.5	6.4	6.0	6.1	6.0
Primary Balance	-3.1	-3.1	-3.1	-3.1	-3.1	-3.1
Effective interest rate	2.9	2.2	1.6	1.5	1.5	1.6

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	4.5	6.6	6.6	6.6	6.6	6.6
Inflation	7.2	7.5	6.4	6.0	6.1	6.0
Primary Balance	-3.1	-2.1	-2.1	-2.1	-2.1	-2.1
Effective interest rate	2.9	2.2	1.7	1.9	1.9	2.1

Source: IMF staff.

Figure 3. Mongolia: Public DSA – Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

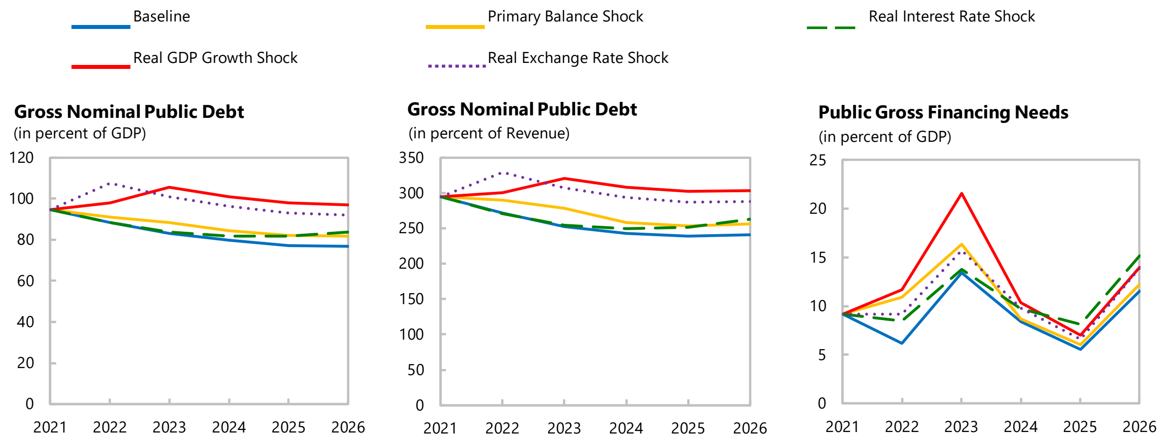
2/ Projections made in the spring WEO vintage of the preceding year.

3/ For Mongolia, t corresponds to 2015; for the distribution, t corresponds to the first year of the crisis.

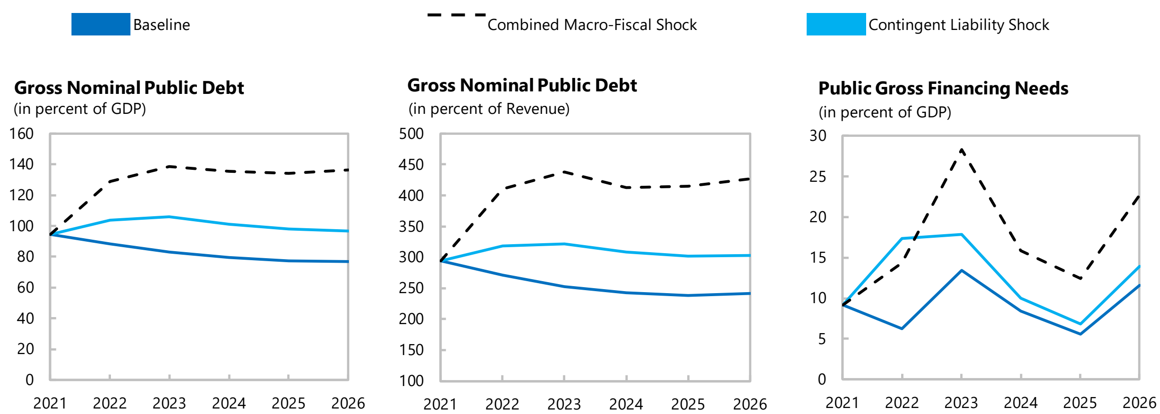
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Mongolia: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2021	2022	2023	2024	2025	2026
Primary Balance Shock						
Real GDP growth	4.5	7.0	6.5	6.0	5.5	5.0
Inflation	7.2	7.5	6.4	6.0	6.1	6.0
Primary balance	-3.1	-3.6	-2.8	-0.9	-1.8	-2.7
Effective interest rate	2.9	2.2	1.6	1.7	1.6	1.7
Real Interest Rate Shock						
Real GDP growth	4.5	7.0	6.5	6.0	5.5	5.0
Inflation	7.2	7.5	6.4	6.0	6.1	6.0
Primary balance	-3.1	-1.1	-0.3	-0.9	-1.8	-2.7
Effective interest rate	2.9	2.2	2.3	3.5	4.2	4.9
Combined Shock						
Real GDP growth	4.5	0.6	0.1	6.0	5.5	5.0
Inflation	7.2	5.9	4.9	6.0	6.1	6.0
Primary balance	-3.1	-5.0	-7.0	-0.9	-1.8	-2.7
Effective interest rate	2.9	2.8	2.4	3.9	4.6	5.2

	2021	2022	2023	2024	2025	2026
Real GDP Growth Shock						
Real GDP growth	4.5	0.6	0.1	6.0	5.5	5.0
Inflation	7.2	5.9	4.9	6.0	6.1	6.0
Primary balance	-3.1	-3.8	-5.8	-0.9	-1.8	-2.7
Effective interest rate	2.9	2.2	1.6	1.9	1.8	1.8
Real Exchange Rate Shock						
Real GDP growth	4.5	7.0	6.5	6.0	5.5	5.0
Inflation	7.2	15.7	6.4	6.0	6.1	6.0
Primary balance	-3.1	-1.1	-0.3	-0.9	-1.8	-2.7
Effective interest rate	2.9	2.8	1.5	1.5	1.4	1.5
Contingent Liability Shock						
Real GDP growth	4.5	0.6	0.1	6.0	5.5	5.0
Inflation	7.2	5.9	4.9	6.0	6.1	6.0
Primary balance	-3.1	-9.3	-0.3	-0.9	-1.8	-2.7
Effective interest rate	2.9	2.4	1.9	1.8	1.7	1.8

Source: IMF staff.

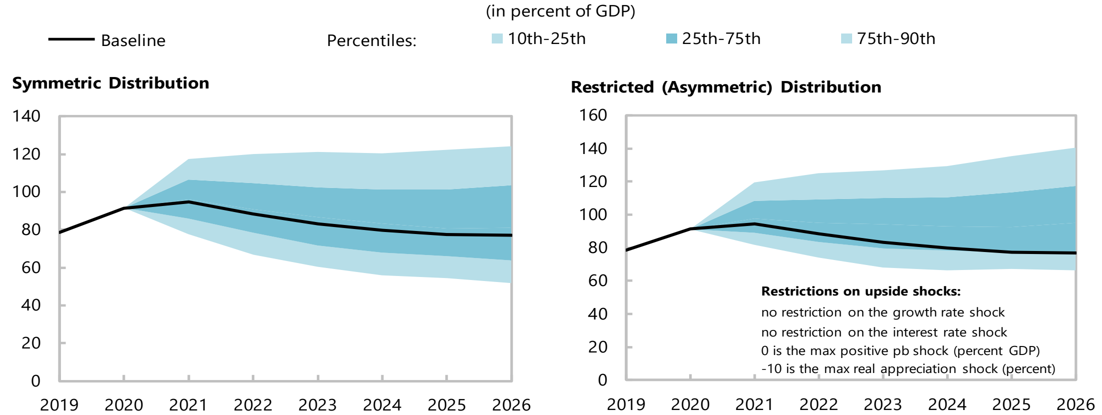
Figure 5. Mongolia: Public DSA – Risk Assessment

Heat Map - Current version

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

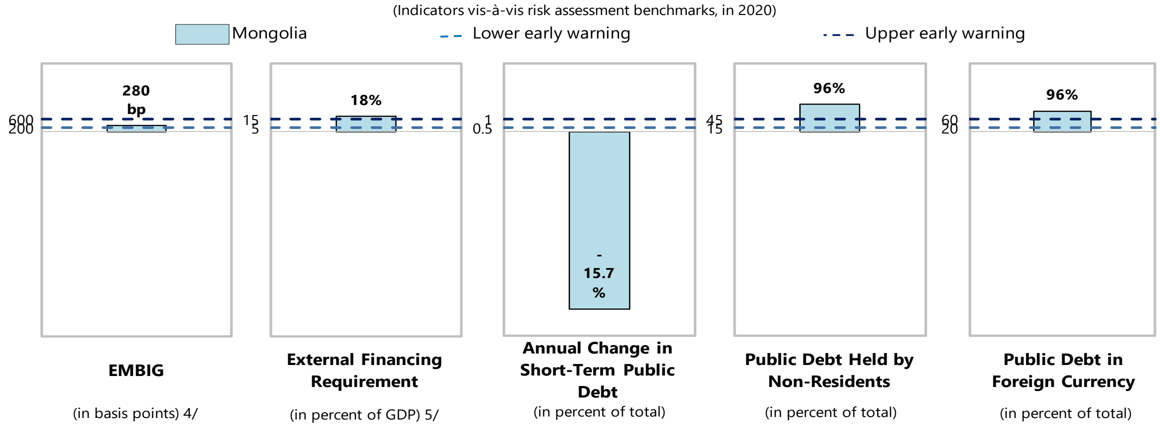
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 27-Jul-21 through 25-Oct-21.

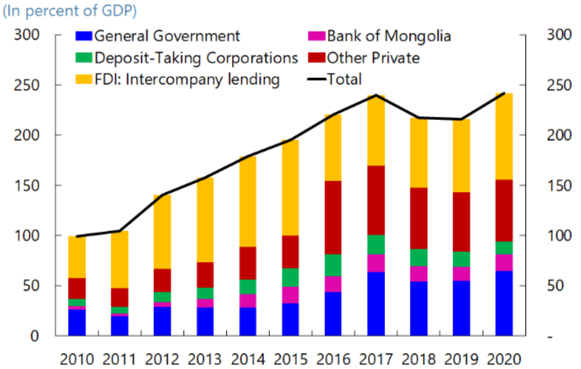
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex VI. External Debt Sustainability Analysis

Mongolia's external debt is very high, at 240 percent of GDP. It reflects the combination of large capital needs of the mining sector; loose fiscal and monetary policy in the past; and corporate borrowing. The large weight of the FDI-related borrowing and the large share of concessional external debt are mitigating factors. Nevertheless, large external debt leaves Mongolia vulnerable to external shocks to which it is highly susceptible given its heavy reliance on commodity exports, and exchange rate volatility. To lower vulnerabilities, macroeconomic policies should be tightened once the pandemic recedes, while MOF's and BOM's debt management capacity must be improved.

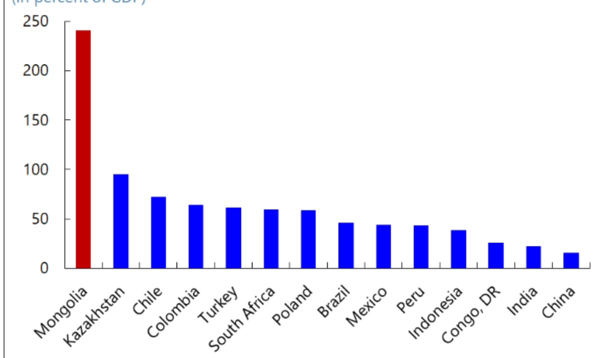
1. **Mongolia's external debt is extraordinarily high.** The external debt to GDP ratio rose five-fold since 2010 and reached 240 percent of GDP, largely surpassing other mining EMEs. Massive mining investment and excessive demand drove large current account deficits, which were financed by debt rather than equity. Furthermore, loose fiscal and monetary policies have also resulted in episodes of large exchange rate depreciation in 2013–14 and 2016–17, contributing further to the surge in external debt.

Mongolia: External Debt
(In percent of GDP)



Sources: Mongolian authorities; and IMF Staff calculations.

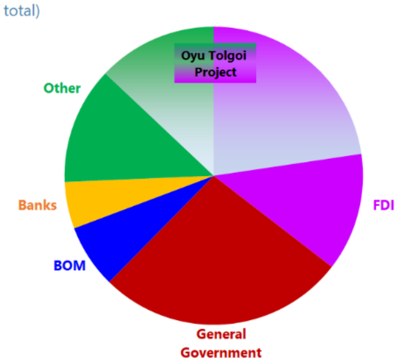
Non-Fuel Resource-Rich EMEs: External Debt, 2020
(In percent of GDP)



Sources: Mongolian authorities; World Economic Outlook; and IMF Staff calculations.

2. **Large mining companies and government are the biggest external borrowers.** FDI intercompany loans, almost entirely in the mining sector, amount to US$11.4 billion, a third of total external debt. Public debt amounts to US$10.7 billion, split between US$5.8 billion of external loans from the official sector (largely concessional), US$2.9 billion of international bonds, and a US$1.8 billion PBOC swap maturing in 2023. Banks' external leverage declined in recent years, to US$1.6 billion at end-2020. Finally, remaining debt liabilities (excluding OT) amount to US$4 billion, mainly comprising corporate sector borrowing in mining, construction, and financial activities. OT external debt liabilities are estimated to amount to US$11.5 billion at end-2020, two-third of which are

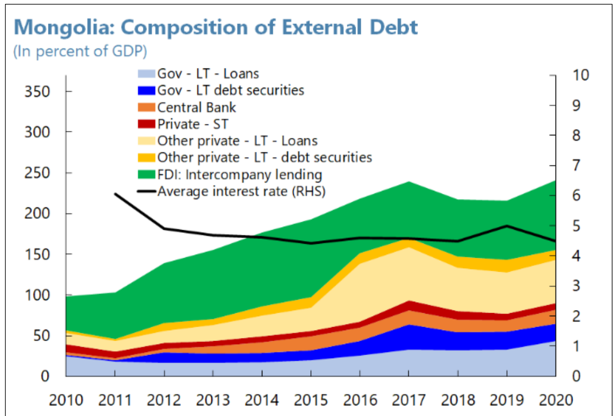
External Debt, 2020
(In percent of total)



Sources: Mongolian authorities; and IMF staff calculations.

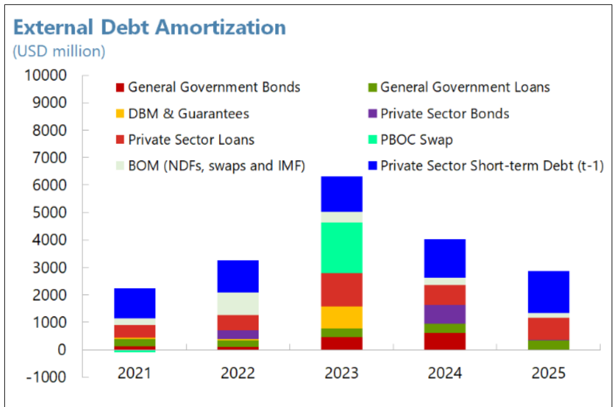
intercompany loans, and the presumption is that they can be financed by its earnings from copper exports and, in the event of stress, absorbed/financed by the parent company.

3. Mongolia's external debt is largely long term. 95 percent of external debt is of long-term maturity (more than one year), mainly loans, while short-term debt has remained small, at 8.1 percent of GDP by end-2020. Since 2010, sovereign and corporate borrowing on international markets has increased, but the stock of debt securities has remained stable, at 34 percent of GDP. In particular, the government has not issued new international bonds since 2018, other than to rollover existing bonds, while the share of concessional public external debt rose to 48 percent. The average interest rate on Mongolia external debt liabilities has been stable, hovering around 4½ percent.



Sources: Mongolian authorities; and IMF Staff calculations.

4. Mongolia's external debt is most vulnerable to external and exchange rate related shocks and rollover risks. Non-FDI amortization is expected to rise in the medium term, increasing overall rollover risk, and could lead to drains of international reserves.[1,2] While Mongolia's external debt is projected to decline in the medium term, aided by some fiscal consolidation and the completion of the OT project, it remains particularly vulnerable to current account shocks and exchange rate depreciation. A 30 percent depreciation could increase the external debt-to-GDP ratio by 130 percentage points.



Sources: Bank of Mongolia; IMF WEO data; IMF staff calculations.

5. Tighter fiscal and monetary policies once the pandemic recedes will be critical to contain current account deficits and external indebtedness. The MOF's domestic debt management capacity should be adequately resourced and staffed and many aspects of investor relations, market outreach, and coordination with the BOM needs to be significantly strengthened. Public sector external assets should be increased, including by gradually investing the Future Heritage Fund (FHF) balances abroad from 2025 onwards. Furthermore, pursuing banking reform is necessary for the development of the domestic debt market and reduce Mongolia's reliance on external creditors. Finally, strong policy management and governance, macro-financial stability, high buffers and low political risk can help reduce rollover risks.

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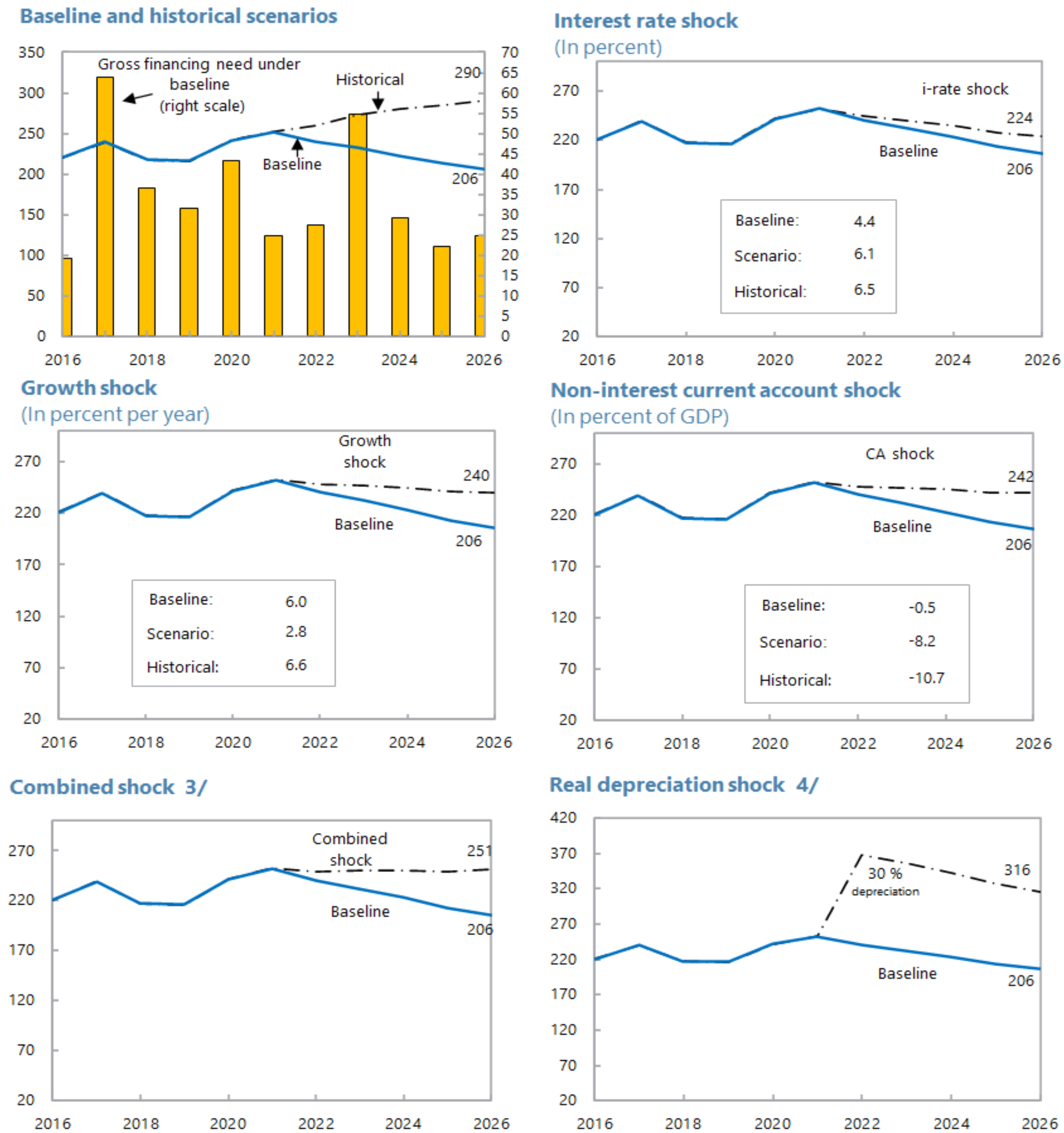
[1] The $1.8 billion PBOC swap is assumed to be rolled over when maturing in 2023.

[2] In June 2021, the government successfully rolled over US$1 billion of Eurobonds coming due in 2022–23.

Figure 1. Mongolia: External Debt Sustainability – Bound Tests 1/ 2/



Sources: International Monetary Fund, Country desk data, and IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2021.

Table 1. Mongolia: External Debt Sustainability Framework, 2016–2026
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2016	2017	2018	2019	2020			2021	2022	2023	2024	2025	2026	Debt-stabilizing non-interest current account 6/
Baseline: External debt	220.8	239.5	217.4	216.1	241.6			**252.3**	**240.1**	**232.0**	**223.0**	**213.1**	**206.0**	**-8.4**
Change in external debt	25.3	18.7	-22.0	-1.3	25.5			10.7	-12.2	-8.1	-9.0	-9.9	-7.0	
Identified external debt-creating flows (4+8+9)	13.6	7.3	-20.9	-7.1	10.3			-2.0	-8.3	-10.5	-8.1	-5.6	-4.0	
Current account deficit, excluding interest payments	-3.6	0.5	7.7	5.5	-5.0			3.1	3	0	0	0	0	
Deficit in balance of goods and services	0.0	-2.4	9.9	5.9	-2.1			3.4	3.4	-0.5	-1.0	-1.2	-1.3	
Exports	50.2	59.2	58.1	59.2	57.4			61.9	65.5	68.2	68.2	66.7	64.9	
Imports	50.3	56.8	67.9	65.1	55.3			65.4	68.9	67.6	67.1	65.5	63.6	
Net non-debt creating capital inflows (negative)	-0.9	3.5	-6.3	-7.0	-9.2			-4.7	-5.1	-5.5	-4.2	-3.2	-2.8	
Automatic debt dynamics 1/	18.0	3.3	-22.3	-5.5	24.6			-0.3	-6.0	-4.7	-3.5	-2.4	-1.3	
Contribution from nominal interest rate	9.9	9.6	9.0	9.7	10.1			9.7	10.0	9.6	9.3	9.0	8.7	
Contribution from real GDP growth	-3.0	-12.1	-16.1	-11.3	10.5			-10.0	-16.0	-14.3	-12.9	-11.4	-9.9	
Contribution from price and exchange rate changes 2/	11.2	5.8	-15.2	-4.0	4.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	11.7	11.4	-1.2	5.8	15.1			12.7	-3.9	2.3	-0.9	-4.3	-3.1	
External debt-to-exports ratio (in percent)	439.3	404.3	374.5	364.8	420.7			407.3	366.8	340.3	327.0	319.3	317.2	
Gross external financing need (in billions of US dollars) 4/	2.1	7.3	4.8	4.5	5.7			3.6	4.4	9.5	5.5	4.5	5.4	
in percent of GDP	19.2	63.8	36.6	31.4	43.2	10-Year	10-Year	24.8	27.4	54.7	29.1	22.2	24.9	
Scenario with key variables at their historical averages 5/								**252.3**	**260.1**	**272.4**	**280.3**	**284.9**	**290.3**	**-6.8**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	1.5	5.6	7.7	5.6	-4.6	6.6	6.4	4.5	7.0	6.5	6.0	5.5	5.0	
GDP deflator in US dollars (change in percent)	-5.4	-2.6	6.8	1.9	-1.8	0.4	9.8	3.5	3.1	2.4	2.1	2.2	2.2	
Nominal external interest rate (in percent)	4.8	4.5	4.3	4.8	4.4	6.5	3.6	4.4	4.4	4.4	4.4	4.4	4.4	
Growth of exports (US dollar terms, in percent)	9.1	21.3	12.8	9.7	-9.1	9.7	17.3	16.7	16.6	13.5	8.2	5.5	4.4	
Growth of imports (US dollar terms, in percent)	6.0	16.4	37.5	3.1	-20.4	11.5	39.1	27.8	16.3	7.0	7.4	5.2	4.2	
Net non-debt creating capital inflows	0.9	-3.5	6.3	7.0	9.2	5.6	5.5	4.7	5.1	5.5	4.2	3.2	2.8	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex VII. Pension Insurance Scheme Reform Proposals[1]

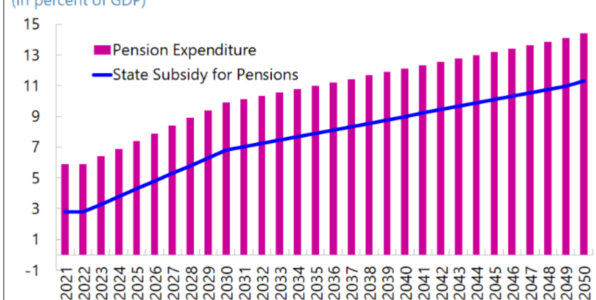
Pension reform is critical to Mongolia's fiscal sustainability. Given generous pension parameters and an ageing population, budget subsidies are likely to rise significantly over the medium term without reforms. The key recommendations are: a gradual increase in the retirement age and penalties for early retirement; higher social insurance contributions; automatic price indexation of pensions; and an extension of the wage base for pensions.

1. **Context.** Mongolia's Pension Insurance Scheme (PIS) is a contributory, pay-as-you-go defined benefit scheme. The scheme covers over 90 percent of the labor force. It is mandatory for workers with labor contracts, with a combined employer-employee contribution rate of 17 percent. Self-employed and other workers in the informal sector can participate voluntarily at a contribution rate of 13½ percent. Benefits equal about 45 percent of pensionable wage base for workers who contributed to the PIS for at least 20 years, with an accrual rate of 1.5 percent per year thereafter. During the pandemic, the government announced exemptions from social insurance contributions for qualifying workers in 2020–21 but all exemptions are expected to expire by end-2021.

2. **Fiscal costs of pensions.** Pension expenditure is projected to increase continually over the medium and long term. World Bank estimates suggest a rapid increase in the state subsidy for the PIS of about 8.4 percent of GDP between 2020 and 2050, resulting in total pension expenditures rising from about 6 percent of GDP to 14.4 percent of GDP by 2050 respectively (Figure). This is driven by the relatively low contribution rates compared to the benefits promised, the rising old age dependency ratio, and the early retirement ages.

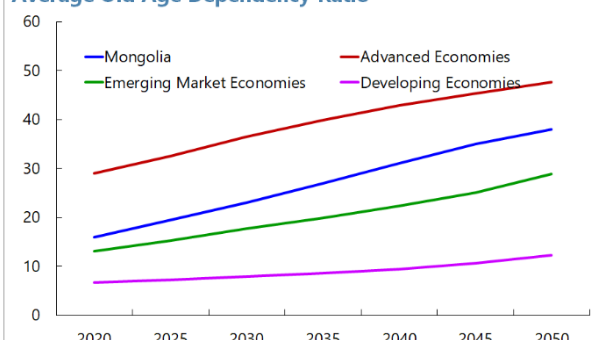
- **Mongolia's old age dependency ratio remains elevated.** The old age dependency ratio is expected to increase from its current level of 16 percent to 23 and 38 percent by 2030 and 2050 respectively due to a rapidly ageing population (Figure). The pace of ageing is faster than that of the average emerging market or developing economy.

Mongolia: Projected Pension Expenditure and Subsidy
(In percent of GDP)



Source: World Bank (2020); IMF Staff Estimates.
Note: State subsidy forecasts based on World Bank (2020). Total pension expediture equals state subsidy plus budget transfers of social security contributions.

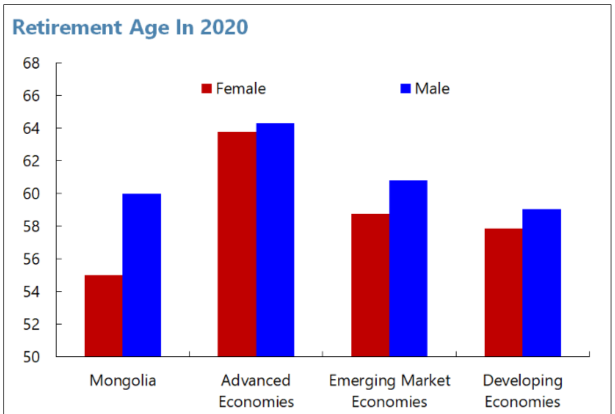
Average Old Age Dependency Ratio



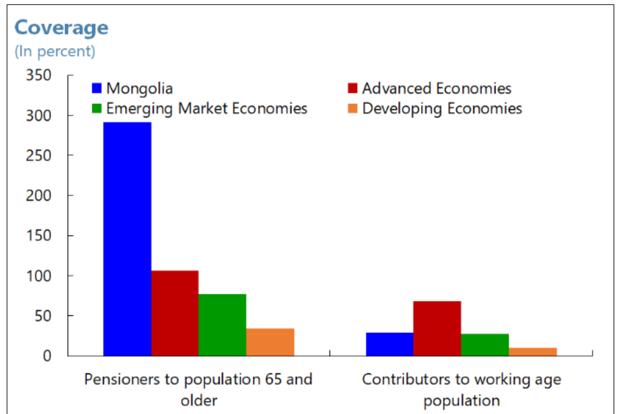
Sources: World Bank and IMF Staff Calculations.
Note: Defined as the share of population 65 and older as a ratio to the total working age population aged 15-64 years.

[1] Based on "Mongolia Pension Reform", World Bank 2020 (https://documents1.worldbank.org/curated/en/187871592809672529/pdf/Mongolia-Pension-Policy-Reform-Options.pdf). The report provides recommendations on measures to improve the long-term sustainability and adequacy of the Pension Insurance Scheme (PIS) using the Pension Reform Options Simulation Toolkit (PROST) to simulate selected parametric reforms.

- **Mongolia's pension parameters are also far more generous than comparator countries** (Figures below). In particular, the retirement age for women (55) remains below all comparators, and the male retirement age is below that of advanced economies though on par with that of the average emerging market and developing economy. Moreover, the provisions for early retirement are fairly generous, with workers in specific profession or under certain conditions, entitled to benefits as early as 10 years prior to the legal retirement age. Given the early retirement age, the coverage of pension beneficiaries (290 percent) to old age population is significantly higher than its comparators. Similarly, the coverage of active contributors to working-age population (29 percent)—though slightly higher than emerging market countries—remains very low.

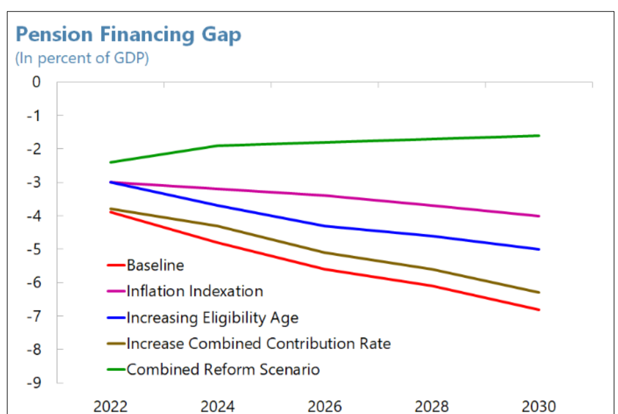


Sources: World Bank and IMF Staff Calculations.



Sources: World Bank and IMF Staff Calculations.

3. **Proposed reforms.** Any further delay in reforming the PIS will negatively affect Mongolia's fiscal sustainability and its transition to an equitable pension system. Pension reform is therefore critical to Mongolia's fiscal sustainability and to reduce the growth of pension expenditure. The following parametric reforms are modeled: (i) inflation indexation, with pensions adjusted by the CPI of the previous year; (ii) increasing the retirement age at a rate of 3 months per year until it reaches age 65 for both men and women, with actuarially fair benefit reduction for early retirement; (iii) an increase in the payroll contribution rate by 2 percent for both the mandatory and voluntary schemes and returning to a combined contribution rate of 19 percent; and (iv) wage base extension and valorization: the wage base for calculating pensions should gradually be increased from the current 7 years to a worker's lifetime wages and the wage base indexed or "valorized" according to the average growth in covered wages.



Source: World Bank Estimates (World Bank, 2020).

4. **These reforms would reduce the growth of pension expenditure while also making the PIS more equitable and benefits more predictable.** The four parametric reforms were modeled to project the impact on the amount of the budget subsidy to the PIS (Figure). Relative to the baseline, all three

reforms modeled helped bring down state pension subsidy in 2030 by varying magnitudes. Inflation-based indexation is projected to stabilize state subsidy at about 4 percent of GDP by 2030. Likewise, increasing the eligibility age stabilizes the state subsidy at about 5 percent of GDP by 2030. Increasing the contribution rate by 2 percent is projected to realize on average about 1 percent of GDP fiscal cost savings per year. Given difficulty in modelling the behavioral response to suggested wage base extension and valorization reforms, the impact on reducing fiscal costs is projected to be immaterial. When all four reforms are combined, they are projected to stabilize the required state subsidy at about 1 to 2 percent of GDP per year, every year till 2030. The combined reform scenario is designed to reflect all the three reforms enacted, according to the same parameters and transition period.

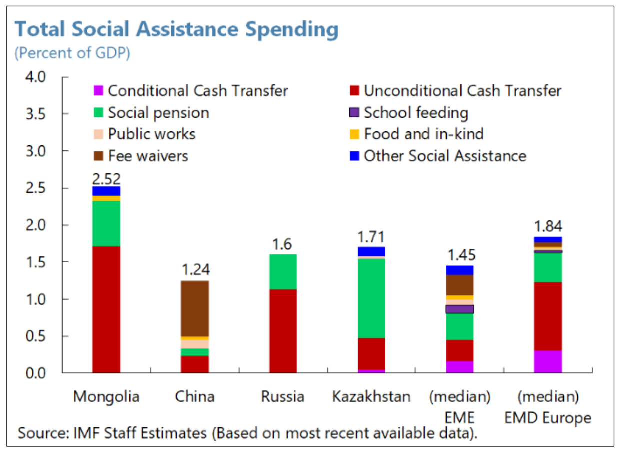
5. Other reforms.[2] Reforms are needed in the Minimum Pension which leave many workers vulnerable to poverty. The Minimum Pension should be replaced with a Tested Social Pension (TSP), which would ensure that all Mongolian retirees have a minimum level of old age income protection. However, the transition of the minimum pension to a TSP should be closely related to the indexation of benefits and is expected to have a negligible fiscal impact if the coverage of the elderly continues to make Pension Insurance largely universal. A combined program of Parametric reforms and a TSP can substantially improve the sustainability, equity and predictability of Mongolia's pension system.

[2] A Notional Defined-Contribution (NDC) scheme was found to be ill-suited for Mongolia's needs since the parametric reforms could achieve most of the results without abrupt reductions in replacement rates between cohorts. A Funded Defined-Contribution scheme was considered neither advisable nor feasible for Mongolia since it would require a commitment to additional fiscal resources for three decades.

Annex VIII. Evaluation of Mongolia's Social Safety Nets[1]

Mongolia's social safety net (social assistance) is characterized by near-universal coverage and high levels of spending, yet inadequate support for the poor. While there are many social programs to help the poor, poverty and mortality rates remain high. These inefficiencies in the social protection system could be addressed by restructuring existing social safety nets and better targeting to protect the most vulnerable. This would help reduce the level of spending on social assistant programs, while helping to address Mongolia's substantial income inequality and promote more inclusive growth. The draft 2022 budget proposal to make universal untargeted social assistance permanent is unsustainable and does not address the current challenges in the social assistance system.

1. **Mongolia social assistance spending remains high relative to comparators.** The main social program is an unconditional cash transfer program (Child Money Program) which is effective at reaching a broad segment of the population but has been insufficient in helping to improve living standards of the most vulnerable. Excluding the pandemic relief package, Mongolia had a higher level of spending on social assistance at (2½ percent of GDP in 2019) compared with other emerging market and advanced economies (Figure).



2. **Mongolia's social assistance spending is also the least targeted among comparators.** Relative to other countries, the share of unconditional cash transfer and social pension programs remains very large 69 percent and 24 percent of total social assistance spending, respectively (Figure above).

3. **Despite a high and universal coverage relative to comparators, Mongolia's social assistance to the poor is inadequate (Table next page).** When disaggregated by type of programs, Mongolia has substantially higher coverage for social assistance programs at 86 percent compared to EME (44 percent) and EMD-Europe (26 percent).[2] This means that nearly the entire population—including the rich—is covered by the social assistance system in Mongolia.

[1] This analysis is derived from the IMF-FAD Social Protection and Labor –Assessment Tool (SPL-AT).

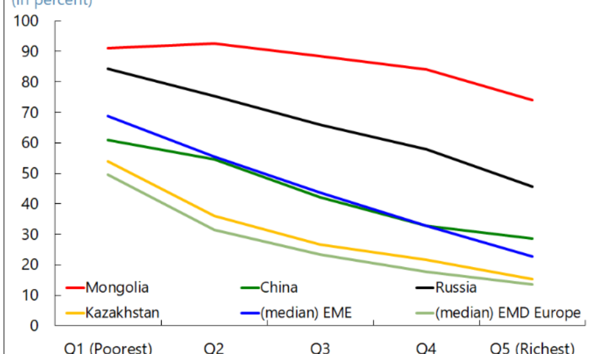
[2] Coverage is defined as the share of a population or subpopulation (e.g. quintiles) that receives a social protection benefit. The indicator is estimated by program type and by quintiles of the pre-transfer (pre-T) welfare distribution. The calculation is: (number of individuals in the population (pre-T quintile) who live in a household where at least one member receives the transfer)/(number of individuals in the population (pre-T quintile).

Mongolia and Comparators Social Assistance Indicators						
	Mongolia	Emerging Market Economies	EMD-Europe	China	Russia	Kazakhstan
Spending (% of GDP)	2.5	1.5	1.8	1.2	1.6	1.7
Coverage (%)	86	44	26	44	66	31
Adequacy (%)	4.8	8	12	2.3	7	13
Benefit incidence (Poorest)	25.8	41	46	33	30	39
Beneficiary incidence (Poorest)	21.2	30	35	28	26	35
Source: IMF Staff Estimates.						

Nevertheless,

- **The coverage gap is too narrow.** Mongolia's social assistance programs (including cash transfers) do not sufficiently differentiate across quintiles, as do its country comparators (Figure). For instance, the coverage gap between the poorest (90 percent) and richest (73 percent) is small in Mongolia (17 percent) compared to the coverage gap in EMEs (46 percent) and EMD-Europe (37 percent). This indicates that the rich are covered just as well as the poor in Mongolia, whereas other countries cover the poor at a higher rate than the rich.

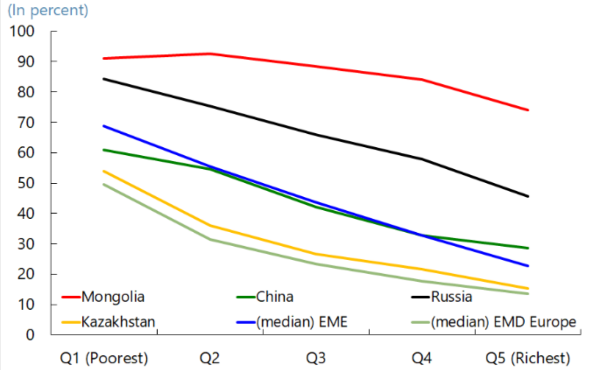
Total Social Assistance Coverage by Quintile
(In percent)



Sources: IMF Staff Estimates (Based on most recent available data).

- **Moreover, the adequacy of benefits for the poor remained substantially low.**[3] Despite having many social programs and high social spending, Mongolia's poverty (28 percent) and mortality (32 percent) rates remain one of highest in the region. Disaggregating by quintiles, the adequacy of benefits at the lowest quintile remains well below almost all country and regional comparators (i.e., for the poorest quintiles, the total transfers received as a share of the

Total Social Assistance Coverage by Quintile
(In percent)



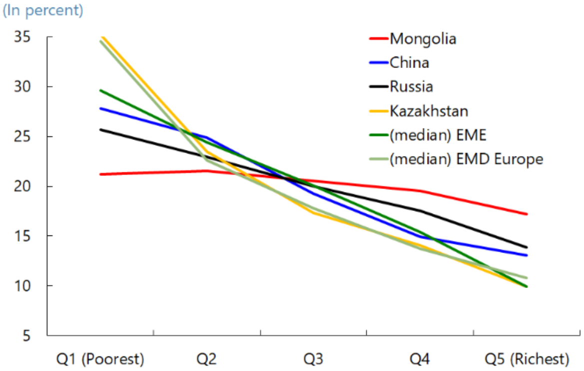
Sources: IMF Staff Estimates (Based on most recent available data).

[3] Adequacy of benefits is defined as the total transfer amount received by all beneficiaries in the population (or pre-transfer (pre-T) quintile) as a share of the total income/expenditure of beneficiaries (in that quintile). The indicator is estimated by program type and by quintiles of the pre-transfer welfare distribution. The calculation is: (Amount of transfers received (by pre-T quintile))/(Total income or expenditure of beneficiaries (in that quintile).

total spending of this group remains much lower in Mongolia (13 percent) than comparators in EMD-Europe (29 percent) and EMEs (19 percent). This suggest that the assistance received by the poor in Mongolia is largely insufficient to cover basic needs. For the richest quintiles, the adequacy of social assistance seems progressive (at 2 percent) but this could be driven mainly by higher expenditure shares of the rich rather than the transfer amounts received.

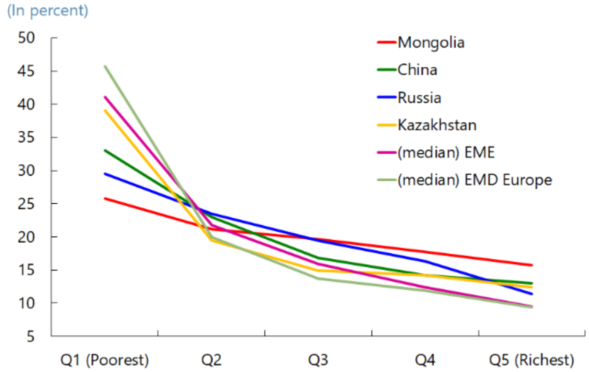
4. **Targeting remains inadequate both in terms of beneficiary and benefits incidence.**[4] Overall benefits incidence for the poorest quintiles for all social assistance is below country comparators (Figure). Similarly, beneficiary incidence for the poorest quintiles for all social assistance is more regressive than all comparator countries and regional medians. Benefits incidence for the 1st quintile (the poorest) is only 26 percent which indicate that the allocation of cash transfers seems to be universal with only about 45 percent of benefits going to Q1 and Q2. The beneficiary incidence at the 1st quintile for all social assistance is 21 percent, which is lower than the country comparators, EME and EMD-Europe medians at 30 percent and 35 percent, respectively.

Beneficiary Incidence by Quintile, All Social Assistance
(In percent)



Sources: IMF Staff Estimates (based on most recent available data).

Benefit Incidence by Quintile, All Social Assistance
(In percent)



Sources: IMF Staff Estimates (based on most recent available data).

5. **Conclusion and policy recommendations.** Mongolia spends much more on social assistance to achieve a lot less than other comparator countries. This is mainly due to a lack of effective targeting toward the poor. This raises fiscal sustainability issues in a crisis when social assistance must be expanded, as untargeted assistance can end up raising fiscal spending significantly. The draft 2022 budget proposal to make universal untargeted social assistance permanent is unsustainable and does not address the current challenges in the social assistance

[4] Beneficiary incidence is defined as the percentage of program beneficiaries in a quintile relative to the total number of beneficiaries in the population. The calculation is: (Number of individuals in each pre-T quintile who live in a household where at least one member participates in a SPL program)/(Number of individuals participating in SPL programs in the population). Benefits incidence is defined as the percentage of benefits going to each group (e.g. quintile) of the pre-transfer welfare distribution relative to the total benefits going to the population. The calculation is: (sum of all transfers received by all individuals in the pre-T quintile)/(sum of all transfers received by all individuals in the population).

system. The following recommendations would enhance Mongolia's social safety nets and help address its substantial income inequality and promote more inclusive growth:[5]

- **Improve and expand targeting.** The authorities should expand coverage but better target the Child Money Program toward the poorest 40 percent of households. Mongolia's safety nets exclude a large proportion of the poorest households and fail to reach the most vulnerable groups. Therefore, authorities should expand coverage among the poor and make efforts to target orphans, and the urban unemployed, those exposed to serious livelihood risks and those that have limited social support. Broadening the coverage while targeting supports will provide better protection for the poor within a given spending envelope and help contain fiscal costs.[6] The existing social assistance programs should be used as platforms to gradually improve the database to accurately capture all those who are vulnerable, including the newly poor, while eliminating the rich who benefit from the programs (Fiscal Monitor, April 2021). In this way, diffuse social protection spending can be made more efficient and effective and ensure fiscal sustainability during downturns when social assistance needs to be scaled-up.[7]

- **Consolidate programs**. There are numerous social transfer programs, many of which serve overlapping groups (i.e., the Child Money Program, Food Stamp Program, and social pension). These programs should be consolidated, thus generating some fiscal savings through better targeting. For instance, currently, the majority of households receiving child money are also receiving food stamps. Merging the Child Money Program and Food Stamp Program to avoid duplicating benefits among households, together with better targeting, will ensure more benefits are received by the most vulnerable in the society, while generating fiscal savings.

- **Rationalize spending.** Cutting spending to the level of at least emerging market economies will bring a fiscal savings of about 1 percent of GDP per year. With better targeting to lower the coverage of benefits across richer quintiles, higher benefit adequacy for the poor can be achieved at lower cost.

- **Broaden other existing social assistance programs**. Ensuring that coverage captures the majority of the poor and vulnerable, and that benefits are adequate, would improve the effectiveness of social assistance programs in reducing poverty and inequality. Other programs (such as, social pension, social welfare allowance, community-based welfare services, allowance for the elderly and people with disabilities etc.) could also be broadened to accommodate poorer individual and households in society (Fiscal Monitor, April 2021).

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[5] These recommendations are broadly in line with the objectives of the World Bank partnership framework for Mongolia (World Bank, 2021) which emphasizes the need to enhance efficiency and sustainability of social protection system (https://documents1.worldbank.org/curated/en/820241621966528091/pdf/Mongolia-Country-Partnership-Framework-for-the-Period-FY21-FY25.pdf).

[6] See IMF Note on Fiscal Policy responses to COVID-19. https://www.imf.org/-/media/Files/Publications/covid19-special-notes/en-special-series-on-covid-19-expenditure-policies-in-support-of-firms-and-households.ashx

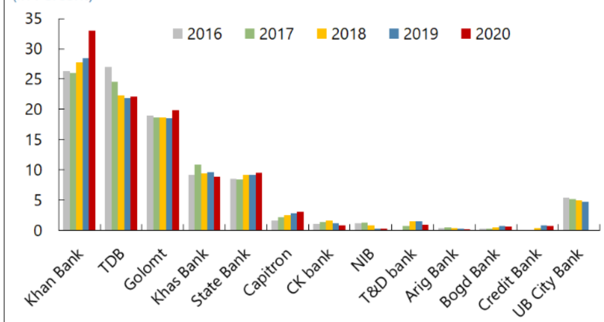
[7] Cases of how improved targeting has positively impacted the economy includes Ethiopia's productive safety nets programs which reaches about 8 million poor and chronically food insecure and the Egypt's Takaful and Karama programs which reaches about 2.25 million poor households.

Annex IX. Banking Sector Stability

A. Context

1. Mongolia's banking sector is highly concentrated. Banks comprise 93 percent of all financial sector assets, while 80 percent of banking system assets are concentrated in 5 SIFIs—Khan Bank, TDB, Golomt, Khas Bank, and State Bank[1] (Figure).

Market Share by Bank
(In Percent)



Source: IMF Financial Soundness Indicators.
Note: TDB (Trade and Development Bank); CKB (Chinggis Khan Bank); T&D Bank (Transport and Development Bank); NIB (National Investment Bank). TDB and UB City Bank merged in June 2020.

2. Prior to the pandemic, capital shortfalls were identified in some banks.

- The 2017 AQR found asset classification and provisioning deficiencies in select banks resulting in additional capital needs.[2]
- In 2019, the Bank of Mongolia (BOM) oversaw an independent forensic audit which found that most of the capital raised post-AQR was either non-compliant with BOM regulations, illicit, or fictional.
- In October 2019, BOM rejected almost all of the capital raises and instructed the banks to raise compliant capital. All banks reversed the capital raise transactions as instructed.[3]
- In December 2019, institution-specific administrative measures were placed on the banks and included restrictions on dividend payments and curtailment of certain business activities until the capital was raised.

3. Some positive measures aimed at financial stability have been reversed. In early 2020, the BOM suspended the administrative measures and accepted new capital raises—similar in nature to the increases rejected by the 2019 forensic audit—without independently validating the transactions. Efforts to ensure a well-capitalized and well-regulated banking sector have, therefore, taken a major step back.

4. As part of the GOM response to COVID-19, the BOM adopted a range of forbearance measures that have also put pressures on bank balance sheets. The measures have not been targeted to affected sectors of the population and have been extended four times, with some now

[1] State Bank is fully state-owned by the Ministry of Finance (MOF) (52.2 percent) and the Deposit Insurance Corporation of Mongolia (DICOM) (47.7 percent).

[2] This also resulted in Capital Bank being closed and placed into liquidation.

[3] Confirmed in the 2020 Audited Annual Reports.

scheduled to remain in place until end-March 2022. Although BOM requires two-tiered reporting by banks (with and without forbearance), the measures mask the true asset quality and restrict the BOM's ability to understand the full impact of the pandemic on banks, including capital needs. The measures involve:

- Delaying the regulatory period for classifying loans in three categories: Performing (extended up to 90 days past due from the previous 15 days); Special Mention (91–120 days from the previous 15–90); Non-Performing (more than 121 days past due from the previous 91).
- Suspending the classification requirement for restructured consumer and business loans.
- Postponing the repayment of subsidized mortgage loans and reducing the rate from 8 percent to 6 percent.
- Removing the negative credit history of eligible borrowers.
- Allowing banks to breach the capital safeguard buffers without regulatory penalty.
- Permitting banks to pay zero interest on current and savings accounts.
- Lowering the bank liquidity ratio from 25 percent to 20 percent. This measure was canceled at end-July 2021.

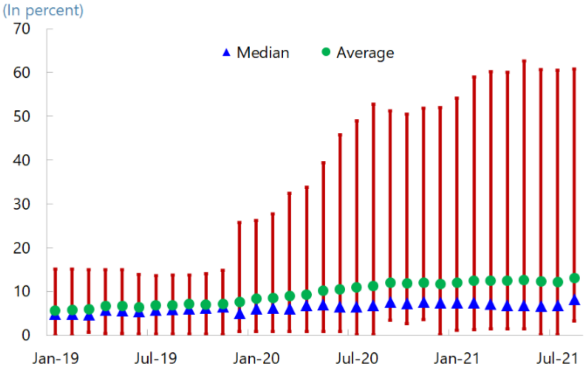
5. At the same time, the BOM is implementing policies designed to improve the stability of the banking system. The authorities have developed a multi-pronged approach to addressing capitalization and governance issues across the sector, focusing on three key elements:

- A 2017 regulation requires all banks to meet a new minimum paid-in equity capital level of MNT 100 billion (a doubling from the previous level) by end-2021. This is intended to strengthen the capital position and improve the resiliency of the small, non-SIFI banks.
- Recent amendments to the Banking Law requires SIFIs to convert their ownership structures to Joint Stock Companies and limit single shareholder ownership to a cap of 20 percent. This is intended to improve corporate governance in a sector that is currently dominated by single or small group shareholder ownership of banks.
- The 2020 Medium-Term Banking Sector Strategy requires all banks to meet the new 20 percent shareholder limit before end-2023 by tendering shares via public offer or private placement on a stock exchange approved by BOM. The strategy aims to provide banks with better access to capital over the long term, and all SIFIs are intending to list on the Mongolian Stock Exchange.

B. Bank Balance Sheet Assessment

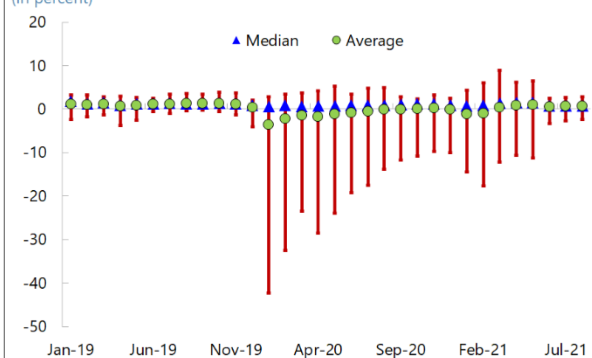
6. Baseline. Although the banking sector absorbed a COVID-related hit in 2020, indicators have turned positive in most banks (Figures below), the result of de-risking, participation in COVID relief program lending, and progress by some banks on NPL resolution. System-wide non-forborne NPLs expanded to a high of 9.3 percent in late 2020 before moderating by end-July 2021, though one small bank has had a sizable expansion of NPLs. Profitability ratios in the sector had fallen into negative territory but have recently rebounded, with all but one of the SIFIs generating positive levels in both ROA and ROE. Banks remain highly liquid, with all except the two insolvent banks remaining well above the regulatory minimum 25 percent liquidity ratio. However, as these figures stem from BOM data under forbearance reporting, the situation could be less positive.

NPL Rates in Major Banks
(In percent)



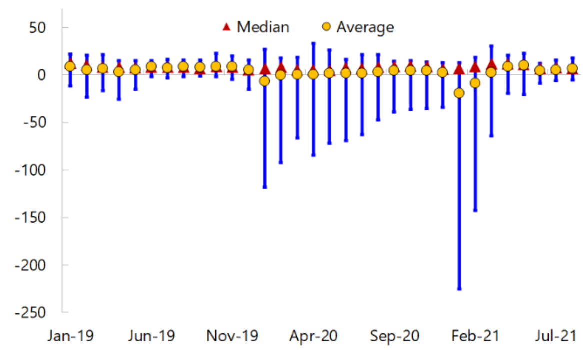
Source: FSI; IMF Staff Calculations.

ROA Rates in Major Banks
(In percent)



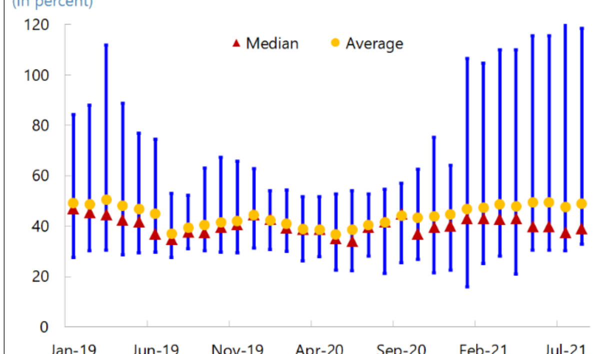
Source: FSI; IMF Staff Calculations.

ROE Rates in Major Banks
(In percent)



Source: FSI; IMF Staff Calculations.

Liquidity Ratio in Major Banks
(In percent)



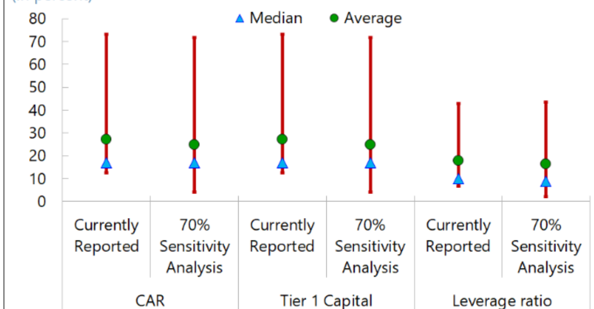
Source: FSI; IMF Staff Calculations.

7. Sensitivity analysis methodology. The results of an assessment of capital needs across the sector based on a sensitivity analysis is depicted in Table 1 below. The scenario was run starting from three separate baselines: (1) bank capital levels as accepted by BOM; (2) capital levels of banks taking BOM's number and subtracting the shortfall amounts communicated to banks by BOM in

October 2019;[4] and (3) taking the latter number and further subtracting 2020 capital raises that were deemed too similar to those identified as suspect in the 2019 forensic audit. Any loans currently under forbearance that are determined to be unlikely to be repaid will need to be adversely classified once forbearance measures are lifted, thereby further increasing NPL levels. The sensitivity analysis determines what additional capital needs will result from the provisioning for those loans at a level that will allow the banks to meet/continue to meet minimum capital requirements, if 20–30–50–70 percent of these forborne loans became NPLs in the 'Loss' category, requiring 100 percent provisioning.[5]

8. Sensitivity analysis results. Banks continue to have high levels of liquidity and most maintain regulatory compliance with capital adequacy, tier 1, and leverage ratios, even under a severe 70 percent sensitivity scenario as depicted in the fourth Figure below.[6] The results show that many banks remain solvent but also fully compliant with minimum capital requirements, thus requiring no additional capital raises. However, some banks would fall significantly below minimum capital requirements.[7]

CAR, Tier 1 Capital and Leverage Ratio
(In percent)



Sources: FSI; IMF Staff Calculations.
Note: A 70 percent worst-case scenario is standard IMF practice, given uncertainty due to pandemic (Mongolia's 2017 AQR identified NPL underestimation of 164%). Based on (reported capital)–(capital similar to those rejected earlier)–(capital raised per BOM's October 2019 instructions).

9. The capital deficiency of some banks could present a systemic stability risk should the public believe that the problems were not contained. These banks could fall well below minimum capital requirements in the sensitivity analysis and will need to raise significant additional capital. In the extreme downside, should 70 percent of forborne loans need to be provisioned, these banks would need at a minimum 1.29 percent of GDP in additional capital.

10. The potentially capital deficient banks also pose downside liquidity risks. Combined, these banks hold a significant share of system deposits with large concentrations of FX deposits. While they currently have sizable liquidity, a run on the banks could drain liquidity quickly,

[4] The amounts communicated at the time were based on the BOM's assessment that banks had not fully complied with classifying and provisioning requirements resulting from the 2017 AQR. Subtracting these amounts provides a better starting position for bank capital levels as of end-2019, though there may have been further asset deterioration from the October 2019 to the beginning of the pandemic. A new AQR will be key to filling in that data gap.

[5] Given the uncertainty of the ongoing pandemic, IMF practice is to conduct sensitivity analyses with 70 percent being the worst-case outcome. This approach is considered reasonable given the likelihood that some borrowers will remain solvent post-COVID and others can be restored to solvency with some level of restructuring. In the Mongolia context such a scenario is not viewed as extreme given that the 2017 AQR identified that banks underestimated NPLs by 164%.

[6] For purposes of the analysis, two insolvent banks have excluded as they are beyond saving.

[7] One bank falls below regulatory minima in the Baseline 1 scenario (capital levels currently accepted by BOM) but the impact is broader under the other two scenarios.

necessitating ELA from BOM including in FX,[8] and could have systemic repercussions. In addition, the banks rely heavily on wholesale funding in FX from international banks, and many of these borrowings contain covenants making them immediately callable should banks fall below minimum regulatory standards which could precipitate a liquidity crisis at the bank.

11. The GOM has exposure to the potentially capital deficient banks totaling 3.6 percent of GDP through a combination of deposits and loans from government entities to the banks. The insolvency and failure of these banks could result in a loss to the government. Many of the borrowings are unsecured and government claims occupy a low ranking in the creditor hierarchy in liquidation (ninth position), indicating a low likelihood of having the funds repaid.

C. Policy Response

Action 1. BOM should Undertake Actions Designed to Increase the Transparency of Bank Balance Sheets and Identify the Full Impact of COVID-19 Prior to Bank IPOs.

12. Forbearance measures should be transitioned from system-wide application to increasingly targeted actions and the BOM should move up the full-phase-out to end-2021. Given the expected export-led economic recovery, which started in mid-2020 and is expected to gather steam from 2021 onwards, BOM should avoid an excessive extension beyond what is needed. It should align the phase-out with the end of the Anti-Pandemic Law and the GOM's emergency measures (end-2021). Furthermore, The BOM should carefully assess the quality of bank reporting and monitor NPLs, profitability indicators, and liquidity as these will be impacted when forbearance measures begin to be phased out.

- The sensitivity analysis shows no indication that removing these measures will have an adverse impact on many banks in the system. All but a few banks should be able to reclassify loans and provision without impact on regulatory compliance. Maintaining the forbearance regime for the benefit of only select institutions is not justifiable and could compromise the BOM's larger goals (next point).
- Banks should be required to fully disclose audited financial statements—that demonstrate strong balance sheets and comply with all regulatory norms—prior to launching IPOs on the Mongolian Stock Exchange. Asset classification and provisioning consistent with IFRS-9 will be critical to generating investor confidence in bank stocks, without which the risk of failed IPOs is large.[9] The BOM is requiring all banks to submit year-end 2021 audited financial statements under IFRS-9, and expressed confidence that this deadline can be met. However, meeting this requirement will

[8] Article 20 of the Central Bank Law establishes the BOM's authority to provide ELA and the implementation framework was put out in 2008 regulations. The framework is sound, and BOM should be able to provide ELA provided the banks remain solvent and can post high quality collateral.

[9] Historically, only two banks traded on the Mongolian Stock Market—Anod Bank and Zoos Bank—and both failed in 2008, severely damaging public confidence in owning bank stocks. Increasing investor confidence will be key to making the IPO process successful.

be harder for banks that have not done so in prior years, and it could prove difficult for banks to comply in time for the IPOs.

13. Once the forbearance measures are lifted, a new, targeted AQR focused on the problem banks should be conducted. The short-term focus should be on providing a detailed and valid assessment of asset quality, loan classification and provisioning needs, and capital adjustments at these institutions as they pose systemic risk. An AQR will apply a rigorous set of valuation criteria, applying IFRS loan classification and provisioning rules through a centralized process, thereby arriving at more reliable valuations than can be achieved by bank examiners. An AQR may also identify other sources of instability, such as instances of weak risk management controls or hidden liabilities in the banks. Concurrent to this, the BOM should independently validate any additional capital raises by banks to determine if they are regulatorily complaint and not rely on legal opinions that were paid for by the banks themselves as has been done thus far.

14. In the medium term, a system wide AQR should be pursued. This will update the exercise conducted in 2017 and will serve to validate the findings of the BOM Supervision Process via its Business Plan Exercise and Bank Solvency Assessments once those are resumed. The findings can be integrated into the BOM supervisory approach as was done with the prior AQR's findings, thereby further enhancing the BOM's regulatory toolkit.

Action 2. Bank IPOs Should be Delayed to Ensure the Success of this Strategy.

15. Banks should not proceed with IPOs until they can provide accurate and transparent financial disclosures showing strong balance sheets. For all banks, this will require updating financial disclosures at the conclusion of forbearance measures and addressing any potential deterioration in balance sheet strength. For banks identified as having capital needs pre-pandemic, the disclosures will also need to be based on updated AQR findings to convey an objective assessment of balance sheet strength and the validity of stated capital levels. It may be easier for those banks that were previously determined to have sound loan classification and provisioning practices and that are rated by international ratings agencies to proceed with their IPOs as they have had higher levels of transparency. Banks that are not well capitalized and transparent in their disclosures should not be allowed to list, because a failed IPO—or one that is carried out with forbearance measures in place, masking a bank's true financial condition—could endanger IPOs by healthy banks, with potentially systemic stability implications and major reputational damage to the BOM and other regulators.

16. The BOM's timeline for banks to list on a stock exchange and reduce single shareholder ownership below a 20 percent limit should also be reexamined.[10] The proposed reform may provide the SIFIs with better long-term options for raising capital when needed and enable them to achieve better compliance with international best practices for corporate governance. The near-term focus should be on ensuring that banks are able to raise needed capital

[10] The non-SIFI banks are not subject to the listing requirement but must comply with the shareholder cap. Only one bank in the system is currently at or below the 20 percent maximum single shareholder ownership limit.

and restore regulatory compliance with minimum capital requirements for CAR, Tier 1, and the Leverage Ratio.

- BOM should avoid rushing the shareholder diversification objective as it could present an impediment to necessary capital raises by crowding the field of issuers on a stock exchange that has a low level of capitalization and no history of significantly large IPOs.[11] Given the high shareholder concentration in most of the SIFIs, achieving the 20 percent single shareholder limit by end-2023 is not realistic. The reform should be pursued but the timetable should be delayed.
- The authorities should ensure that the legal basis for the requirement is solid and that it is prepared to react to any legal challenges that are launched by banks or shareholders as some have questioned the constitutionality of the law.
- Moreover, BOM will need to carefully gauge the fitness and proprietary of any new (large) shareholders that would materialize through this process, with the risk that strawman transactions and/or 'round tripping' of capital remains undetected. There will be multiple layers to ensuring that only fit and proper persons hold an interest or management function, including as beneficial owner, in line with AML/CFT standards. The institutions involved will include the MSE, BOM, FRC, the Financial Intelligence Unit, and brokers. Despite this, BOM has acknowledged the difficulty of assessing offshore entities that may seek to invest.
- The process needs to be well managed and overseen by BOM and the FRC which has regulatory responsibility for the stock exchange.

17. The authorities should ensure that investments in banks do not contribute to instability in the non-bank sector. FRC suggested that insurance companies can invest up to MNT 180 billion from their reserve funds, an amount equal to 47 percent of their market cap. Insurers should make their own investment decisions that are based on strong risk management processes and that ensure access to liquidity in times of large payout needs, not be directed by the regulator. Any decrease in stock prices of banks could negatively impact insurance funds, thereby weakening this important sector of the financial system, and this would be further exacerbated in the event of the failure of a bank as stock investments do not enjoy a guarantee as deposits do.

Action 3. The BOM Should Focus Near-term Regulatory Efforts on Strengthening Bank Balance Sheets.

18. The BOM should adhere to the end-2021 deadline for banks to reach a new minimum paid-in equity capital level of MNT 100 billion. This doubling of the current level is well timed and will enable smaller banks to strengthen their high quality, loss-absorbing capital to better prepare them to deal with the ongoing pandemic and any future financial distress that may hit the Mongolian banking sector. Most banks have already begun implementing plans to reach the new

[11] The largest issuance to date on the Mongolian Stock Exchange was only MNT 50 billion. Market listings to raise additional capital would entail large IPOs by banks and meeting the 20 percent shareholder limit would require very large and unprecedented levels of issuance. The ratings agencies have expressed concern about the stock market's capacity to accommodate listings of this magnitude (Moody's and Fitch, 2021).

level, including through consolidation. The BOM should review these plans and ensure they meet regulatory requirements and best practices.

19. BOM should urgently conduct updated Business Plan and Solvency Assessments of banks and conduct stress tests.[12] This will provide the regulator with more granular data to assess the financial health of the banks and present an understanding of balance sheet deterioration under adverse scenarios involving a prolonged pandemic impact on the Mongolian economy. The BOM should use realistic stress criteria that cover a range of scenarios from moderately worsening to more extreme downside risks. Banks should be encouraged to provision preemptively for forborne loans (in advance of the winding down of forbearance) and can reduce provisioning should borrowers' repayment capacity recover.

20. BOM should begin addressing identified weaknesses in banks, including instructing any capital deficient bank to submit restructuring plans. The plans should focus on operational restructuring, capital restoration, and an updating of NPL strategies. The plans must be detailed and have timebound implementation targets. The BOM should review the plans, require modifications it finds to be necessary, and only then approve the plans. The BOM should closely monitor implementation and place the banks under enhanced supervisory regimes, including the installation of full-time examination teams on-site at the banks until capital compliance is achieved and long-term viability is assured.

Action 4. Timely Action is Necessary to Address Possible Capital Shortfalls Capital Deficient Banks.

21. BOM should take timely action against capital deficient banks if they are unable to raise sufficient capital to ensure regulatory compliance. While it is important for the restructuring plans to have a reasonable timeframe for implementation, BOM will need to make a determination if it becomes apparent that the plans cannot be successful. BOM should exercise its authorities under the Banking Act and take appropriate increasing regulatory measures against the banks. This should extend to requiring the replacement of bank management and suspending shareholder voting rights until capital compliance is achieved. [13]

22. The need for public solvency support cannot be excluded. The state may need to inject public funds—estimated to be at least 1.29 percent of GDP—to avoid systemic challenges and enable capital deficient banks to reach regulatory capital compliance should they be unsuccessful in raising capital on their own. However, the means of effecting such a public recapitalization need to be agreed upon by the authorities. The BOM and MOF would need to act in a coordinated fashion to ensure that public funds are utilized in a manner that guarantees the successful turnaround of the

[12] The Business Plan Review was temporarily suspended during COVID-19, and the inability to have exam teams onsite at banks has meant that the BOM is only able to perform sensitivity analyses. The BOM is working to develop a methodology for conducting more thorough stress tests, but that methodology is not yet finalized.

[13] Under Chapter 6, Subchapter 2 (Early Intervention), Article 48, BOM can require that a bank's Board of Directors replaces management. If they fail to do so, the rights of shareholders can be suspended (though the law does not specify a maximum amount of time those rights can be suspended or if it can be permanent) and BOM will exercise the votes of the board.

banks. To reduce moral hazard and ensure accountability and buy-in, public solvency support should be predicated on a change in bank management and a bail-in of existing shareholders. Appropriate provisions of the Banking Law and the 2018 Law on Ensuring Banking Sector Stability should serve as the basis for such actions and implementing regulations should be issued without delay so that the authorities are able to operationalize a public recapitalization.

23. The authorities should begin to improve the necessary regulatory foundations that could facilitate the resolution of distressed assets. There has been progress on advancing the insolvency framework and there are efforts underway to establish a specialized, independent unit within the legal system to adjudicate financial claims, such as seizure of collateral and debt collections. These reforms are essential to speed up the claims process which at present takes 4.2 years on average to resolve. A more functioning real estate market will be key to ensuring that repossessed real estate collateral can be sold in a manner that is timely and generates a reasonable sale price, and utilization of electronic trading platforms will offer efficiencies through bulk sales of distressed assets. Once these foundations are in place, the real economic value (REV) of the assets will increase, thereby allowing banks to lessen upfront loss recognition.

24. A clear communication strategy is needed. Communication with the banks and the broader public will be key to maintaining public and investor confidence. A crisis communications committee should be convened well in advance, and include key stakeholders, including BOM and MOF, to ensure that a uniform communication strategy and talking points are developed and communicated in a clear and concise manner via appropriate channels (press releases, press conferences, and other forms of outreach). The communications departments of BOM and MOF should be in regular contact to prevent any conflicting information from being released.

25. Critical role of deposit insurance. The Deposit Insurance Corporation of Mongolia (DICOM) will play a key role in resolving smaller institutions, including payout of depositors, and is authorized to contribute to the financing of Purchase and Assumption transactions. A number of important reforms have been implemented since 2019, including the DICOM's assumption of supervisory authority, hiring of additional staff that has allowed for better specialization, standardization of reporting on insured deposit accounts, and the implementation of an integrated database that is nearing completion. These achievements must be accompanied by a reduction in the political interference exerted on DICOM in the past to exceed its mandate and make payouts to uninsured depositors outside the established hierarchy of claims in liquidation. The entity must carry out its functions in a fully transparent manner consistent with its established procedures if it is to serve its role in enhancing depositor confidence. Additionally, provisions for backup funding from the government that might be required in the event of the insolvency of a SIFI must be well-defined.

Action 5. Broader Financial Sector Reforms are Needed.

26. Strengthen bank supervision with IMF support. The further strengthening of bank supervision capacity will be critical to safeguarding financial sector stability in Mongolia. The BOM has implemented the new supervisory framework designed to move the institution toward risk-based supervision, however implementation is not viewed to be fully consistent with Basel and capacity development of supervisory staff remains necessary. This is particularly in reviewing and approving of banks' NPL resolution strategies and restructuring plans which will be critical to the post-pandemic period and are within the remit of the BOM Department of Supervision. IMF proposes a reengagement of CD support to BOM to address this shortfall.

27. Regulatory reforms. A number of legislative and regulatory developments have been achieved in Mongolia since the completion of the 2019 Article IV consultation. A Law on Deposits, Loans, and Banking Transactions was adopted and amendments to the Banking Law were drafted and adopted in late 2020 with IMF input. The Central Bank Law, adopted in 1996, has been amended to include more appropriate legal protections for bank staff and to further establish the institutional integrity and independence of BOM. The insolvency and creditor rights regime are being revised, though it will be necessary to determine if the changes are in line with the advice provided by the IMF and other institutions. However, further refinements maybe needed in these and other regulations which the IMF could support through HQ-based review. In particular, it would be important to ensure that appropriate codes of corporate conduct are included and that the BOM has appropriate legal authorities to address non-compliance. The Banking Law and the Law on Deposit Insurance should be reviewed and updated to improve creditor hierarchy of claims to bring it in line with international best practices. The Parliament should refrain from passing legislation that establishes policies and timetables that supersede the authorities of the regulatory bodies.

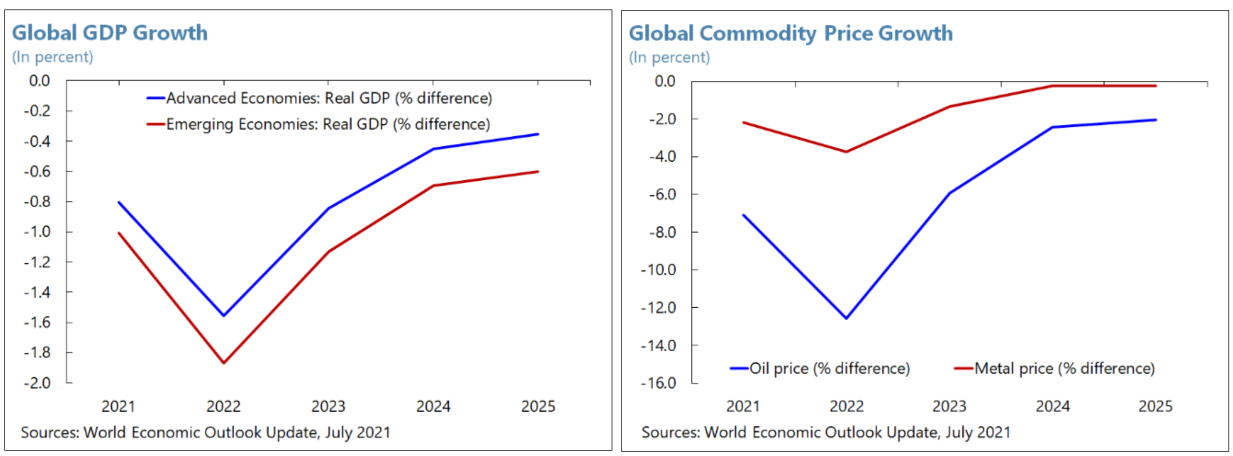
Annex X. An Illustrative Adverse Scenario[1]

Mongolia is benefitting from a surge in commodity prices that is expected to boost exports significantly in 2021 and beyond. This has led to a small improvement in Mongolia's capacity to repay the IMF recently. But given large uncertainty with the pandemic, downside risks remain high. This annex presents an illustrative adverse scenario built on a global resurgence of the pandemic and discusses Mongolia's capacity to repay under such a shock. Under such an adverse scenario, Mongolia's capacity to repay the IMF would deteriorate somewhat but would still remain adequate.

1. **Given the large uncertainty and downside risks associated with the pandemic, the illustrative adverse scenario assumes a sharp global resurgence of the pandemic.** The downside scenario is built on the basis of the scenarios recently published in the IMF's World Economic Outlook Update (July 2021) which combines analyses from epidemiological models and the IMF's G20 Model. The scenario models the global growth impact of a global resurgence of a super-contagious virus variant in late 2021 which leads to lower mobility in many advanced and emerging market economies. Under such a scenario, growth in advanced economies in 2021 and 2022 is projected to be weaker than the baseline forecast by almost 0.8 percent and 1.6 percent, respectively. Furthermore, commodity prices are projected to remain weak with oil prices declining by around 12 percent and metal prices by around 4 percent in 2022.

Global Downside Scenario

(Deviations from baseline)



2. **The global downside risk scenario has been complemented with the assumption of a worsening of the domestic COVID-19 situation in Mongolia for about 6 months starting in late-2021/early-2022.** This reflects the assumption that a global resurgence of a super-contagious virus variant can also spread domestically and worsen the still challenging COVID-19 situation in

[1] This section reports on discussions under the Post Financing Assessment (PFA) policy which was initiated for Mongolia in May 2021. For a description of the PFA policy, see Policy Paper No. 2021/026 (https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/05/19/Post-Program-Monitoring-During-The-Pandemic-460350).

Mongolia. To model the domestic economic impact of such a spread, we assume a temporary nationwide lockdown of 1 month[2] and the closure of the border with China for 4 months in late-2021/early-2022 which is more severe than the closures that took place during the 2020 wave of the pandemic. The thrust of fiscal and monetary policy responses is assumed to be the same as in the baseline and no additional fiscal or quasi-fiscal support is assumed apart from what has already been approved in the 2021 supplementary budget and the Anti-Pandemic Law.

Impact of the Adverse Scenario

3. Under such an adverse scenario, external and fiscal balances are expected to deteriorate while the banking sector could come under severe stress.

- **Growth:** Strong containment efforts, temporary domestic lockdown and lower mining exports to China would lower domestic growth by about 6 percent points in 2021−22 relative to the current baseline. Given a wider and more persistent output gap, and global price declines under the adverse scenario, inflation would be lower compared to the baseline.[3]

- **External:** A decline in global commodity prices and extended closure of the China border, although partly offset by the compression of imports, would have a negative impact on the trade balance with current account deficit projected to widen to over 20 percent of GDP in 2022. The increase in the current account deficit relative to the baseline is projected to be financed by the drawdown in the BOM's gross reserves while maintaining a stable exchange rate. This is in line with the BOM's current policy stance.

- **Fiscal:** A decline in domestic activity and the deterioration in trade would lead to lower revenues, widening the overall fiscal deficit. Sovereign yields would increase compared to the baseline—increasing debt service payments—and the refinancing of the $500 million Eurobond maturing in 2023 may need to be delayed due to tighter global financing conditions. Assuming no additional fiscal support is provided compared to the baseline, public debt (excluding BOM debt) would rise to around 90 percent of GDP by end-2022. Public debt dynamics, already difficult in the baseline scenario, would worsen significantly and be particularly vulnerable to further declines in growth and large exchange rate depreciations.

- **Financial Sector:** Lower economic activity, uncertainty in the business climate and tight FX liquidity would lead to a sharp deterioration in asset quality in the banking system putting further pressure on bank capital. Credit growth to the private sector could be expected to decline due to increased risk aversion by banks, further delaying the recovery.

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[2] Since start of the COVID-19 outbreak, there have been 4 temporary lockdowns with an average duration of 20 days and a maximum duration of 34 days whereas the border with China was closed for around 2 months in 2020.

[3] Inflation is assumed to decline by around 0.25 bps for every 1 pp decline in GDP growth, in-line with the IMF's MAC DSA template.

4. Mongolia's capacity to repay the IMF would deteriorate somewhat but would still remain adequate (Table). Under such a scenario, key indicators such as IMF debt service as a percentage of exports and gross reserves are projected to rise to 0.8 and 2.3 percent respectively, slightly higher than the baseline projections. Despite this slight deterioration in key indicators, Mongolia's capacity to repay the IMF is expected to remain adequate.

Table. Adverse Effect Scenarios, 2021-24

		2021	2022	2023	2024
	Scenario				
Real GDP	Adverse	3.0	2.2	7.0	6.0
(percentage change)	Baseline	4.5	7.0	6.5	6.0
Inflation	Adverse	6.5	6.5	6.0	6.0
(percentage change)	Baseline	7.5	7.0	6.5	6.0
Primary deficit	Adverse	-5.0	-5.2	-2.4	-2.9
(percent of GDP)	Baseline	-3.1	-1.1	-0.3	-0.9
Public debt[1]	Adverse	86.5	90.2	85.8	84.4
(percent of GDP)	Baseline	81.5	76.8	72.6	69.9
Exports	Adverse	6,836	7,383	10,091	11,112
(in US$ million)	Baseline	7,837	9,239	10,569	11,470
Imports	Adverse	6,638	7,110	7,444	8,023
(in US$ million)	Baseline	6,884	7,822	8,241	8,872
Current account	Adverse	-17.9	-20.2	-7.4	-6.1
(percent of GDP)	Baseline	-12.8	-12.8	-9.3	-9.0
Reserves	Adverse	3,943	3,608	3,607	4,092
(in US$ million)	Baseline	4,243	4,508	4,525	4,719
Obligations to the Fund from existing Fund arrangements					
In percent of exports of goods and services	Adverse	0.1	0.4	0.6	0.8
	Baseline	0.1	0.3	0.6	0.7
In percent of gross usable reserves	Adverse	0.2	0.9	2.0	2.3
	Baseline	0.2	0.7	1.6	2.0

Sources: Mongolian authorities; and IMF Staff Calculations.
[1] Excluding BOM liabilities.

INTERNATIONAL MONETARY FUND

MONGOLIA

November 3, 2021

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By Asia and Pacific Department (in collaboration with other departments)

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FUND RELATIONS

(As of September 30, 2021)

Membership Status: Joined: February 14, 1991; Article VIII

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	72.30	100.00
Fund Holdings of Currency	296.41	409.98
Reserve Position in Fund	5.44	7.52

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	118.05	100.00
Holdings	98.22	83.20

Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
Emergency Assistance[1]	72.30	100.00
Extended Arrangements	157.25	217.49

Latest Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
EFF	05/24/2017	05/23/2020	314.51	157.25
Stand-by	04/01/2009	10/01/2010	153.30	122.64
ECF [2]	09/28/2001	07/31/2005	28.49	12.21

Latest Financial Outright Loans:

Type	**Date of Commitment**	**Date Drawn**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
RFI	06/03/2020	06/05/2020	72.30	72.30

Overdue Obligations and Projected Payments to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2021	**2022**	**2023**	**2024**	**2025**
Principal	2.33	17.91	44.28	62.36	44.28
Charges/interest	1.08	4.43	4.04	2.09	0.95
Total	3.41	22.34	48.33	64.45	45.23

[1] Emergency Assistance may include ENDA, EPCA, and RFI.

[2] Formerly PRGF.

Safeguards assessment:

Safeguards assessments of the Bank of Mongolia (BOM) were conducted in 2002, 2003, 2009, and 2017. The 2017 assessment found limited progress in strengthening the safeguards and governance frameworks at the BOM. While financial accountability and transparency practices were found to be robust, other areas, such as operational and financial autonomy, collegial decision making, oversight of central bank operations and audit mechanisms, and internal audit needed to be strengthened. The BOM has taken steps to address key recommendations from the 2017 safeguards assessment. These include amending the Central Bank Law to improve the governance framework, autonomy of the BOM, and collegial decision-making, establishing an MoU with the Ministry of Finance to limit the BOM's involvement in the mortgage program, and setting up a working group to review the veracity of program monetary data. The BOM has also drafted a new charter for the Internal Audit Department and established a quarterly reporting mechanism of the function to the Supervisory Board. In line with the 2017 safeguards assessment recommendations, the 2018 amendments to the Central Bank Law further enhanced the BOM’s governance by allowing members of the Monetary Policy Committee to have a vote on policy decisions and ensuring BOM decisions on bank supervisory issues are made through the Banking Supervision Committee. The 2021 Central Bank Law amendments strengthened legal protections for supervisors. However, some important recommendations remain to be completed. Agreement on the timing and modalities for the transfer of the mortgage program from the BOM to the MOF remains to be finalized and the BOM should recognize IMF holdings of Mongolia’s currency on its balance sheet.

Exchange Arrangement:

On March 24, 2009, the BOM instituted a foreign exchange auction allowing the determination of the exchange rate mainly by market forces. The de jure exchange rate arrangement is floating, and the de facto exchange rate arrangement is stabilized. The de facto exchange rate arrangement was reclassified twice: (1) retroactively to crawl-like from floating, effective September 18, 2017, and (2) to other managed from crawl-like, effective April 11, 2018.

Mongolia accepted the obligations of Article VIII, Sections 2, 3, and 4 on February 1, 1996. Mongolia maintains two multiple currency practices (MCPs) subject to Fund jurisdiction. First, the modalities of the multi-price auction system give rise to an MCP since there is no mechanism in place that ensures that exchange rates of accepted bids at the multi-price auction do not deviate by more than 2 percent. The Executive Board approved the multi-price auction MCP until June 22, 2010 (Decision No. 14365 of June 23, 2009), and its further extension until March 15, 2012 or the next Article IV consultation whichever is earlier (Decision No. 14669 of June 23, 2010 and Decision No. 14365 of March 16, 2011). The MCP, however, could not be resolved by March 15, 2012, and will continue as long as the multi-price foreign exchange auction mechanism remains in place. Therefore, this MCP remains to be approved, and since the criteria for approval of this MCP are not in place, staff do not recommend Executive Board approval of said measure.

In addition, Mongolia has an official exchange rate (reference rate) that is mandatorily used for government transactions (as opposed to the commercial market rate). Therefore, by way of official action, the authorities have created market segmentation. While Order #699 of the BOM issued on December 3, 2010, sets forth that the reference rate is determined based on the weighted average of market rates used from 4 PM of the previous day to 4 PM of the current day, staff are of the view that this Order does not eliminate the market segmentation and the multiplicity of effective rates arising from it. Accordingly, in the absence of a mechanism to ensure that the commercial rates and the reference rate do not deviate by more than 2 percent, the way the reference rate is used in government transactions gives rise to an MCP subject to Fund approval. Since the criteria for approval of this MCP are not in place, it remains unapproved by the Executive Board.

Mongolia imposes exchange restrictions for security reasons in accordance with United Nations Security Council Resolution No. 92/757 concerning certain transactions with the Federal Republic of Yugoslavia (Serbia and Montenegro) that have been notified to the Fund under Decision 144 (11/4/94).

The BOM notes that no measures have been taken since 2019 that could give rise to exchange rate restrictions or multiple currency practices. Due to the spread of COVID-19 pandemic, the BOM implemented temporary macro-prudential measures against dollarization such as requiring the banks to notify the BOM about any investments in FX denominated securities and restricting individuals and entities from transferring foreign currency between accounts in domestic banks. The BOM indicated that these measures do not affect foreign settlements and transfers.

Article IV Consultation:

The 2019 Article IV consultation (IMF Country Report No. 19/297) was concluded by the Executive Board on September 11, 2019. Mongolia is on a 12–month cycle.

ROSC Assessments:

The following ROSC assessments have been undertaken: Data Dissemination (May 2001), Fiscal Transparency Module (November 2001), Fiscal Update (May 2005), Data Dissemination (April 2008), Monetary and Fiscal Policy Transparency (September 2008), Banking Supervision (September 2008).

Recent Financial Arrangements:

A Rapid Financing Instrument in an amount of equivalent to SDR 72.30 million (100 percent of quota) was approved on June 3, 2020.

A 36-month Extended Fund Facility in an amount of equivalent to SDR 314.5054 million (435 percent of quota) was approved on May 24, 2017. The Executive Board completed the fifth review on October 31, 2018. The program expired on May 23, 2020.

FSAP Participation:

Mongolia participates in the Financial Sector Assessment Program (FSAP). The first, second, and third FSAP missions took place in May 2007, September 2007 and November 2010 respectively. The latest report (IMF Country Report No. 11/107) was published in May 2011.

Capacity Development:

Mongolia is an intensive recipient of IMF technical assistance (TA). Since the 2019 Article IV consultation, assistance in the fiscal area focused on tax and customs administration via short-term expert visits and a resident advisor, supported by the Revenue Mobilization Thematic Fund. In the wake of the COVID-19 pandemic, the IMF provided TA to assist the Mongolian tax authorities in preparing a business continuity plan (July 2020). Given the country's elevated external public debt levels, MCM provided TA to support the authorities' external debt rollover (June 2020) and to assist the authorities in developing a framework for issuing local currency bonds and developing the domestic capital market (January 2021). Besides this, IMF TA has focused on assisting the authorities in improving and developing new macroeconomic statistical indicators: high frequency indicators (September 2019 and March 2021) and residential property price index (April 2021). IMF TA is also contributing to building capacity for debt sustainability analysis (June 2021). Since the CCAMTAC was established in February 2021, the authorities have been discussing potential TA areas with the CCAMTAC as a complement to IMF HQ-based TA.

IMF TA Missions (September 2019–2021):

- Customs administration, (FAD) August–September 2019
- High frequency economic indicators, (STA) September 2019
- Banking regulation, (MCM) September 2019
- Revenue performance analysis, (FAD) October 2019
- AML/CFT, (LEG) November 2019
- Banking regulation, (MCM) November 2019
- Macro-Fiscal modeling, (FAD) January 2020
- Banking regulation, (MCM) January–February 2020
- Medium term debt strategy and liability management operations, (MCM) June 2020 (remote mission)
- Business continuity plan for MTA, (FAD) June–September 2020 (remote mission)
- Customs diagnostic mission, (FAD) July 2020 (remote mission)
- Mongolia Customs General Authority (MCGA) strategic plan for 2021–2024, (FAD) September 2020 (remote mission)
- Domestic government bond market development mission (MCM), January–February, 2021
- High Wealth Strategy (FAD), February–April 2021 (remote STX mission)

- Tax Gap Analysis (FAD), February–April 2021 (remote STX mission)
- High frequency economic indicators, (STA) March 2021 (remote mission)
- Residential property price index, (STA) April 2021 (remote mission)
- Issuing tax guidelines (FAD), April–June 2021 (remote STX mission)
- Data and analytics (FAD), June 2021 (remote STX mission)
- Debt Dynamics Training (ICD), June–July 2021 (remote mission)
- Hidden economy strategy (FAD), August–September 2021 (remote STX mission)

Resident Representative:

Since July 2019, Mr. SeokHyun Yoon has been the resident representative based in Ulaanbaatar.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

World Bank: https://www.worldbank.org/en/country/mongolia

Asian Development Bank: https://www.adb.org/countries/mongolia/main

STATISTICAL ISSUES

(As of October 2021)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund is broadly adequate for surveillance, but some shortcomings exist in the estimation of GDP and treatment of missing observations in price indices. The priority areas for improvement are national accounts and price statistics, and also the migration of government finance statistics to a new methodology.
National Accounts: The National Statistics Office (NSO) currently publishes annual and quarterly GDP using the production and expenditure approaches. Annual supply-use tables are compiled and represent a significant quality improvement as part of Mongolia's implementation of 2008 SNA. The NSO implemented the 2015 rebasing and published the data on its website. The NSO is also working to chain-link their annual GDP series using the annual Supply Use Tables (SUTs). There is ongoing cooperation with Caucasus, Central Asia, and Mongolia Regional Capacity Development Center (CCAMTAC) to further improve the Mongolia quarterly GDP by expenditure in a mission scheduled for March 2022. A 2018 mission recommended making further use of tax data to supplement/replace survey collections; and to improve volume estimates of taxes and subsidies on products.
Price Statistics: The NSO produces a monthly consumer price index (CPI) with weights from the 2015 household survey. The index covers prices of expenditures by both urban and rural households and the data is disseminated within two weeks from the reference month. The NSO publishes a monthly producer price index (PPI) for industrial activities and a quarterly PPI for services activities. An experimental quarterly residential property price index (RPPI) is produced for Ulaanbaatar following a mix-adjustment by stratification methodology. Technical assistance to implement an enhanced index compilation methodology with improved data sources is ongoing, with the goal of disseminating an improved RPPI in 2022.
Government Finance Statistics: Currently, the concepts, classifications, and definitions used to compile sub-annual and annual fiscal statistics for the consolidated general government operations series used by Fund Staff for surveillance generally follow the guidelines of the GFSM 1986. The authorities have been working to compile time series data based on the GFSM 2014 methodology. STA has been providing technical assistance (funded by Japan) aimed at developing annual General Finance Statistics (GFS) data for 2016 onward. A June 2019 GFS TA mission compiled a financial balance sheet and integrated presentation of stock and flows for the consolidated general government sector using the accrual (IPSAS-based) accounts maintained by the Ministry of Finance. In December 2018 the authorities began reporting of public sector debt statistics (PSDS) to the World Bank for dissemination.
Monetary and Financial Statistics: The BoM reports regular monetary data using the IMF's recommended Standardized Report Forms (SRFs), covering the central bank balance sheet and other depository corporations. Mongolia's monetary and financial statistics (MFS) conform to the concepts and definitions of the *Monetary and Financial Statistics Manual and Compilation Guide*. The BOM also reports some basic data to the IMF's Financial Access Survey including mobile and internet banking and the two indicators adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (commercial bank branches per 100,000 adults and ATMs per 100,000 adults).

Financial sector surveillance: Mongolia does not currently report Financial Soundness Indicators (FSIs) to the Fund for dissemination on the Fund's external website. The BoM is quite advanced in the compilation of FSIs, but needs to finalize their action plan related to the submission of the data and metadata to the IMF for external dissemination.
External Sector Statistics: For compilation of external sector statistics (ESS), the Bank of Mongolia (BOM) follows the statistical framework of the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6). Priorities for improvement includes addressing persistent negative net errors and omissions. Mongolia participates in the IMF's Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS). Mongolia has compiled external debt statistics and the Reserves Data Template since it subscribed to the IMF's Special Data Dissemination Standard (SDDS) in 2019.
II. Data Standards and Quality
In April 2019, Mongolia graduated to the Fund's Special Data Dissemination Standard (SDDS), which sets high standards for the timeliness and periodicity of dissemination of economic and financial data.

Table 1. Mongolia: Common Indicators Required for Surveillance
(As of October 2021)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality-Methodological soundness[7]	Data Quality – Accuracy and Reliability[8]
Exchange rates	10/25/21	10/25/21	D	D	D		
International reserve assets and reserve liabilities of the Monetary Authorities[1]	08/2021	09/2021	M	M	M		
Reserve/base money	08/2021	09/2021	M	M	M	O, LO, LO, LO	O, O, O, O, LNO
Broad money	08/2021	09/2021	M	M	M		
Central bank balance sheet	08/2021	09/2021	M	M	M		
Consolidated balance sheet of the banking system	08/2021	09/2021	M	M	M		
Interest rates[2]	10/20/2021	09/20/2021	D	D	D		
Consumer price index	09/2021	10/2021	M	M	M	O, LO, O, O	LO, LO, LO, O, O
Revenue, expenditure, balance and composition of financing[3] – general government[4]	08/2021	09/2021	M	M	M	LO, LNO, LO, O	LO, O, LO, LO, LNO
Stocks of general government and general government-guaranteed debt[5]	2021Q1	06/14/21	Q	Q	Q		
External current account balance	08/2021	09/30/21	M	M	M	O, O, O, LO	LO, O, LO, LO, LO
Exports and imports of goods	08/2021	09/15/21	M	M	M		
GDP/GNI	2021Q2	08/24/21	Q	Q	Q	O, LNO, O, LO	O, LO, LO, LO, LNO
Gross external debt	2020Q4	04/08/21	Q	Q	Q		
International investment position	2021Q2	09/21/21	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, and rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), Not Available (NA).
[7] Reflects the assessment provided in the data ROSC or the Substantive Update (published in April 2008, and based on the findings of the mission that took place during September 1–28) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

MAIN DATA WEBSITES

National Statistics Office (www.1212.mn)

- National Accounts
- Consumer Price Inflation
- Agricultural and Industrial Production
- Petroleum Imports
- Electricity Production and Consumption
- Coal Production
- Retail Prices
- Employment
- Exports and Imports
- Securities Market Data

Bank of Mongolia (www.mongolbank.mn)

- Monetary Survey
- Consolidated Balance Sheet of Commercial Banks
- Distribution of Bank Credit to the Nongovernment Sector
- Net Credit to Government
- Interest Rates
- Balance of Payments
- Services and Income Accounts
- Official Reserves of the Bank of Mongolia
- Selected Indicators of Commercial Bank Foreign Exchange Operations
- Nominal and Real Exchange Rates
- Government Budget Accounts

Ministry of Finance (www.mof.gov.mn)

- Government Budgetary Operations

National Development Agency (www.nda.gov.mn)

- Long- and medium-term development strategy
- Economic and social policies
- Investment policy coordination

Financial Regulatory Commission (www.frc.mn)

- FRC decisions
- Total assets of regulated entities (insurance companies, securities and broker firms, non-bank financial institutions, savings and credit unions)
- Consolidated income statements of regulated entities (insurance companies, securities and broker firms, non-bank financial institutions, savings and credit unions)

Statement by Chang Huh, Executive Director for Mongolia,
Gantsogt Khurelbaatar, Senior Advisor to Executive Director, and
Jinhyuk Yoo, Advisor to Executive Director
November 19, 2021

The Mongolian authorities wish to convey their appreciation to Ms. Banerji and her team for the candid and constructive discussions during the Article IV mission.

The authorities responded proactively to containing the spread of the virus including closing borders and providing unprecedented support measures to save the lives and livelihoods of the Mongolian people. The pandemic crisis inevitably caused a deep economic contraction in 2020 and substantial scarring effects are expected over the medium term. Without policy support, however, there would have been more adverse impacts on the economy and the poverty situation.

Despite high uncertainty surrounding the course of the pandemic, the Mongolian government adopted a national long-term vision, Mongolia Vision 2050, that aims to transform the country by fighting poverty, creating a greener economy, improving the education system and gender equality for enhanced job access, and redefining the social strategy in a more citizen-centered way. Continuing reform efforts, together with the swift pandemic response, have contributed to favorable external financing conditions. After a spike in sovereign spreads early in the pandemic, Mongolia's spreads have narrowed faster than those other emerging market peers and Eurobonds were successfully rolled over. External borrowing costs are now at their lowest level since 2015. Going forward, the Mongolian authorities aim to ensure an inclusive recovery and to continue to pursue necessary structural reforms, while preserving macroeconomic stability as well as debt sustainability.

Economic outlook

The economy is recovering strongly after the recession in 2020 with growth projected to be around 4.5 percent in 2021 and around 5 percent over the medium term. The completion of the construction of railway lines to mining sites, and the successful renegotiation and start of the underground exploration of Oyu Tolgoi mine are expected to improve growth prospects further from 2022 onwards.

Covid-19 cases remained high throughout 2021 despite the strong vaccination campaign. However, cases have started to drop recently. As nearly 95 percent of the population is fully vaccinated, and the country has started administering the third dose of vaccines, domestic economic activity is expected to begin to slowly recover.

Mainly due to higher global commodity prices, the economic outlook is positive, but the authorities are treating the positive outlook with caution. Since Mongolia's economy is closely tied to China, possible economic volatilities in China may significantly impact the economy, especially in the mining sector. For example, the recent closure of the main border points due to a covid-19 outbreak in the bordering areas of China highlights the risks related to Mongolian commodity exports and imports of goods. Moreover, prolonged disruption in trade with major trading partners could seriously hurt the export sector and deteriorate the supply of food and goods.

Fiscal policy

The budget for 2022 envisages policies to support the recovery by increasing capital investment to strengthen export sector productivity and maintaining adequate welfare support to the vulnerable while rationalizing expenditure. The primary budget deficit is expected to be 3.1 percent of GDP for 2021, and to further decrease to 1.1 percent for 2022. The continued fiscal adjustment is planned through 2026 so as to firmly put debt on a downward path from 81.5 percent of GDP in 2021 to 68.1 percent in 2026, which amounts to a reduction of about 13 percentage points.

Given pandemic instigated risks are still high, and the subdued and slow revival of domestic economic activity, the authorities believe that deeper fiscal consolidation at this moment could hurt the recovery and the livelihoods of vulnerable people. Once the recovery is on a firm footing, the authorities plan to undertake fiscal consolidation and explore options to set the appropriate and much lower target level of the public debt.

The current crisis clearly showed a need for reforms in many areas of government finances. Thus, fundamental fiscal reforms to rationalize expenditure are being planned. For example, the pension law is currently being discussed in the Parliament to reform the pension insurance scheme, improve the pension fund's economic viability, and reduce the dependence on budget transfers. The authorities also plan to pursue a number of other significant reforms, such as introducing result-based financing of public entities, civil service reforms, freezing of new hires except in priority sectors, improving SOEs governance, and exploring liquidation and privatization of non-strategic SOEs through the stock market, to name a few.

The child money program proved to be very efficient and effective in providing financial support to households during the covid-19 pandemic. A number of surveys showed that the program helped the vulnerable and assisted most of the population avoid poverty and maintain adequate living standards. Considering that pandemic risks remain and that a reliable and up-to-date database on the household income does not exist, the authorities have chosen to provide an assistance to children without discrimination. For this, the authorities are planning to introduce savings accounts for cash transfers rather than cash handouts, which could help build savings for children’s futures. Going forward, when the ongoing crisis is over and dependable data is available, the authorities will seek to better target the social assistance programs.

Monetary and external policies

Inflation was subdued during the covid-19 pandemic, but there has been a sign of inflationary pressures since June of this year. In addition, recent border closures and the global disruptions in the shipment of goods increased supply-side inflationary pressures and may result in double-digit inflation later this year. If inflationary pressures persist, the Bank of Mongolia stands ready to undertake policy measures to curb inflation.

External financial support, including the Fund’s RFI and an SDR allocation as well as subdued import activity, helped to increase the gross foreign reserves to 4.2 billion USD, equivalent to 5 months of supply at the end of October this year. Going forward, the authorities are committed to a floating exchange rate regime to accommodate adverse external shocks and maintaining an adequate level of foreign reserves. The Bank of Mongolia is keenly aware that the current level of reserves is not adequate and will take necessary measures to attain additional buffers.

Financial sector policy

An inefficient banking sector has been the root cause of financial instability and the low level of financial inclusion for many years. The lack of competition, weak supervision, and the concentration of banking sector ownership gave rise to an unhealthy banking sector. Deep banking sector reforms have been the Fund's main recommendation for the past decade, and the previous Fund program stalled in 2019 because of inaction reforming the banking sector. After years of setbacks, the Parliament finally approved the banking sector reform package in 2021 to make banks public, improve transparency, and restrict the ownership of individuals and their related parties to no more than 20 percent of shares.

The banking sector reform will proceed gradually through 2024. In the first phase, the initial public offerings of 10 percent of shares of banks through the stock market are planned for June 2022. The authorities are keenly aware of the risks related to this significant reform that staff point out. Hence, they will carefully assess the result of the first phase of the reforms and based on this analysis will make necessary changes to the banking sector reform strategy, if needed. The authorities are fully committed to delivering this historic reform and are of the view that any delay to reforms could jeopardize the reform momentum and leave unresolved the root cause of financial instability and underdevelopment of the financial market.