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# Impact of fiscal consolidation on the Mongolian economy

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## Key messages

- The impact of fiscal consolidation measures is closely tied to international commodity prices.
- These measures should be implemented while international commodity prices are high.
- Mongolia's reliance on the mining sector means government measures are needed to protect the economy from uncertainties in the commodity markets.

## Background

To avoid an economic crisis, the Mongolian government reached an Extended Fund Facility (EFF) agreement with the International Monetary Fund (IMF).

Under this agreement, the government will receive USD 5.5 billion but will also cut its expenditures and increase taxes (known as fiscal consolidation) with the aim of achieving debt sustainability and stable growth.

According to the IMF, the overall budget deficit will fall to 1.5% of GDP by 2022, down from 11.3% of GDP in 2014, if the Mongolian government stays committed to the fiscal consolidation.

A team of local researchers examined how decreased government expenditure (spending, transfers to households and capital expenditure) is likely to impact the Mongolian economy under different economic conditions.

### Why was Mongolia on the brink of an economic crisis?

Mongolia's economy is highly dependent on the mining sector, which represents around 94% of exports and contributes over 20% of government revenue. The economy thrived during the 2010-2013 commodity boom but growth has slowed significantly since 2013. The Mongolian government's efforts to mitigate the effects of the global slowdown in mining through higher budget deficits resulted in unsustainable public debt.

## The analysis

The research team used a static Computable General Equilibrium (CGE) model calibrated to a 2014 Mongolian Social Accounting Matrix (SAM) to simulate three scenarios.

**Baseline scenario:** The budget deficit decreases 72.4% from 2014 to 2022, to reflect the IMF's projection, and the world prices of copper and coal remain at their 2014 values.

**Pessimistic scenario:** The budget deficit decreases 72.4%, as above, but the copper price decreases 29% (reflecting its lowest price between 2000 and 2016) and the coal price decreases 13.4% (reflecting its lowest price between 2010 and 2016) in comparison to their 2014 values.

**Optimistic scenario:** Compared to their 2014 values, the price of copper increases 29% (reflecting its 2011 price) and the price of coal increases 76% (reflecting its expected 2017 price). The budget deficit decreases 72.4%, as above.

## Key findings

**The impact on the economy of fiscal consolidation varies depending on the world prices of Mongolia's export commodities.** As government revenue changes in the optimistic and pessimistic scenarios, government expenditure adjusts differently to the baseline scenario to decrease the budget deficit to the target level.

### Baseline scenario

**Fiscal consolidation has a negative impact on many macroeconomic indicators.** To decrease the budget deficit to the target level, the government should reduce its spending on goods and services by 25.8% (3.7% decrease/year over eight years), reduces transfers to households by 24% (3.4% decrease/year) and reduces its capital expenditure by 18.6% (2.5% decrease/year) in this scenario.

As the government is the main user of education, health, public administration and sewerage, demand falls and so does production and employment in these sectors. At the same time, total investment increases which has a compensatory effect on employment. The net effect on employment is a decrease of 6.4% and household income, consumption, and savings decrease by 4.1%. Real GDP also falls by 1.9% in the baseline scenario.

### Pessimistic scenario

As export commodity prices are low, **the negative impacts of fiscal consolidation are much worse for the economy** than in the baseline scenario.

Production decreases in almost all sectors. Production decreases the most in the sectors that are highly dependent on government spending. GDP falls by 7.9%. Because tax revenue decreases by 19.7% in this scenario, government spending, transfers to households and government capital expenditure fall by 47.4%, 44.6% and 18.6%, respectively, to decrease the budget deficit to the target level.

### Optimistic scenario

Given the high international prices for coal and copper, fiscal consolidation can be much softer. **The impacts of the positive price shocks are more than offset the negative impacts of fiscal consolidation** and GDP increases by 3.9%.

In this scenario, as government revenue increases by 20.6%, government capital expenditure remains at its 2014 value while spending on goods and services and transfers to households should decrease by 9.6% and 9%, respectively, to achieve the target budget deficit.

**To reduce the budget deficit to the target level without changing total government expenditures from their 2014 values, the international prices for coal and copper would need to increase a further 8.6%.**

## Conclusions and implications for policy

**The results of this analysis indicate that the impacts of fiscal consolidation on Mongolia's economy are closely tied to international commodity prices.** To offset the negative impacts of fiscal consolidation, **the policy should be implemented when commodity prices are high.**

As Mongolia cannot influence global commodity prices and due to the country's reliance on the mining sector, **government measures are needed to protect the economy from uncertainties in the commodity markets**. Managing the country's Fiscal Stability Fund effectively and maintaining low public debt may provide some protection. However, further simulations are needed to define which measures would be most effective.

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