Policy Brief

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Assessing threats to Mongolia's economic recovery

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Key messages

- **Increasing government spending or stopping the mine expansion will put Mongolia's fragile economic stability at risk**
- **Either action, for which there is political pressure, is likely to slow GDP growth, increase public debt and increase the government's budget deficit**

Mongolia's fiscal recovery remains precarious

Low commodity prices and a sharp decline in foreign direct investment (FDI) in Mongolia saw the country's growth slow to 1% in 2016. High government expenditure coupled with reduced government revenue led to huge public debt (87.6% of GDP) and a significant budget deficit (17% of GDP) the same year. Furthermore, the central bank's resistance to devaluing the domestic currency left official reserves depleted.

Facing unimaginable economic and currency crises, the Mongolian government initiated and reached an extended fund facility (EFF) agreement with the International Monetary Fund (IMF) in May 2017. Under this agreement, the government cut non-essential expenditures and increased taxes (fiscal consolidation) aiming to achieve debt sustainability and stable economic growth.

A combination of the EFF program, persistent high commodity prices and FDI in the Oyu Tolgoi mine has swiftly redressed the fiscal structural balance, with a surplus of 2% of GDP in the second quarter of 2018.

However, this fiscal improvement may be temporary. Political pressure to increase government expenditure, unexpected delays to the Oyu Tolgoi mine expansion, and potential commodity price shocks still pose threats to Mongolia's economic recovery.

A team of local PEP researchers sought to assess the economic impacts of these risks.

The analysis

The research team used a dynamic Computable General Equilibrium (CGE) model to simulate the evolution of the Mongolian economy over 10 years under a "business as usual" scenario and under possible three risk scenarios. The model was calibrated to the 2014 Mongolian Social Accounting Matrix.

Business-as-usual (BAU) scenario illustrates what is likely to happen until 2025. It nearly replicates the IMF's projections in the fourth review under the EFF arrangement.

Scenario 1: Expansionary fiscal policy due to political cycles

- Current expenditure, capital expenditure and transfers to the private sector all increase by 15-20% from 2021, compared to the BAU.
- Simulates expected potential increased budget expenditure related to the upcoming 2020 Parliamentary election that will coincide with the end of the EFF program.

Scenario 2: Oyu Tolgoi underground mine development is terminated

- Absence of the planned FDI inflow (about 5.9 trillion MNT in the BAU scenario) to finance construction from 2019-2021
- Mine production remains at the 2018 level for the whole simulation period
- Political uncertainty suggests the mine development project may not continue as planned.

Scenario 3: Negative shock to the coal sector

- World export prices of coal and coke decrease by 10% in 2019-2020 and stay at their 2020 levels thereafter.
- In response, coal and coke exports are down by 20% from their BAU levels from 2019.

Key findings

BAU scenario

- **Real GDP grows significantly** by 5-6%, on average, each year
  - Reaches 38 trillion MNT (expressed in 2016 prices) by 2025
  - Helped by FDI in the mining sector and stable commodity prices that promote investment and increase mining sector production
- **The real wage increases** while unemployment remains stable (around 6.5%)
  - Thanks to stable economic growth
- **Government budget deficit eradicated** from 17% of GDP in 2016 to -0.1% in 2025 and **public debt steadily diminishes**
  - Due to fiscal consolidation and economic growth

Scenario 1 compared to the BAU scenario

- Expansionary fiscal policy has a negative impact on many macroeconomic indicators despite promoting household and government consumption.
- **Inhibits total investment, expands the budget deficit and leads to a higher public debt**.
  - **Real GDP and investment decrease** by 0.2%-1.3% and 7%-8%, respectively
  - **Budget deficit increases** up to around 5.3% of GDP.
  - **The debt-to-GDP ratio increases** to around 70% by 2025 (23 percentage points higher)

Scenario 2 compared to the BAU scenario

The absence of the Oyu Tolgoi underground mine development has a negative impact on the economy and budget conditions.

- **Real GDP decreases** by 7-8% in 2023-25
- **Total investment decreases** by 13-34% from 2019
- **The budget deficit to GDP ratio reaches 5.7%** (5.8 percentage points higher than BAU),
- **The debt-to-GDP ratio reaches 73.2% by 2025** (25.5 percentage points higher).

The negative shock effects are much bigger in 2023-25 than the previous years because the withdrawal of FDI is combined with the decrease in metal ore production (Oyu Tolgoi copper production).

Scenario 3 compared to the BAU scenario

The decrease in world price of coal and coke combined with decreases in production in these sectors have a negative impact on the macroeconomic indicators except real public consumption.

- **Real public consumption increases** due to lower prices while other indicators decrease by 4-15% in 2019-25.
  - Sectors such as construction, livestock, trade and transportation decline most.
- **Real GDP decreases** by around 6%
- **Total investment decreases** by around 13-14% from 2019
- **The budget deficit to GDP ratio reaches 2.9%** (3 percentage points higher)
- **The debt-to-GDP ratio reaches 66.6% by 2025** (18.9 percentage points higher)

Conclusions and implications for policy

Should any of the scenarios simulated by the team occur, Mongolia's current economic recovery would be put in jeopardy. As well as negative effects on GDP, all scenarios will also create a significant burden of debt that the government will have to urgently address. The worst case scenario is that these negative shocks occur simultaneously.

The government should be aware that acquiescing to political pressures to increase spending and/or stop the mine expansion will put Mongolia's fragile economic stability at risk.

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