MONGOLA ECONOMIC UPDATE

Macroeconomic Stability and Credit Growth

January 2020
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MONGOLIA – GOVERNMENT FISCAL YEAR
January 1 – December 31

Currency Equivalents
(Exchange Rate Effective as of December 31, 2019)

Currency Unit = Tugrug (MNT)
US$1.00 = MNT 2734.33

ABBREVIATIONS

AMC Asset Management Company
AQR Asset Quality Review
BoM Bank of Mongolia
CIT Corporate Income Tax
EMDEs Emerging Market and Developing Economies
FATF Financial Action Task Force
FDI Foreign Direct Investment
FX Foreign Exchange
GDP Gross Domestic Product
H1 First half of year
H2 Second half of year
LLP Loan Loss Provisioning
MNT Mongolian Tugrug
MoF Ministry of Finance
NEER Nominal Effective Exchange Rate
NPLs Nonperforming loans
NSO National Statistics Office
OT Oyu Tolgoi
PBOC People’s Bank of China
PIT Personal Income Tax
Q1 First quarter of the year
Q3 Third quarter of the year
Q4 Fourth quarter of the year
REER Real Effective Exchange Rate
VAT Value-Added Tax
y/y Year-over-year
EXECUTIVE SUMMARY

While Mongolia’s economy is starting to slow from its brisk pace of recent years, the medium-term growth outlook remains firmly positive. The strong economic recovery since 2017 has been underpinned by impressive fiscal outcomes, better coordination of macroeconomic policy, favorable global commodity prices, and strong recovery in private investment. Real GDP growth strengthened to 7.2 percent in 2018 from 5.3 percent in 2017. Following the gradual decline in commodity prices combined with a reduction in the quality of key mineral exports, growth moderated to 6.3 percent in the first nine months of 2019 and is expected to slow to 5.8 percent for the year as a whole.

Medium-term growth prospects remain positive (averaging 5.6 percent in 2020–21), largely supported by robust growth in private consumption and continued steady investment in mining and manufacturing. This forecast is predicated on the government’s continued commitment to fiscal consolidation to contain public debt in the medium term by improving revenue mobilization and controlling public spending.

There are significant downside risks to the growth outlook emanating from heightened uncertainties in the global and domestic environments. Domestically, risks are related to the possible relaxation of the government’s commitment to reforms on the eve of the general elections in 2020, thereby affecting market sentiment and the flow of foreign direct investment. Although the authorities have maintained fiscal discipline and tight credit policies, the recent decisions to roll back the increase in the social security contribution rates and to write off pension-backed loans, are seen as notable setback to progress on economic reforms. The lack of such commitment has been responsible for exacerbating fiscal and financial vulnerabilities in past elections.

Globally, uncertainty surrounding the impact of the recent trade deal between China and the United States of America, especially China’s energy imports from non-US sources, poses considerable risk to our base case outlook. In addition, given the strong economic linkages between China and Mongolia, our growth outlook is likely to be adversely affected if the novel coronavirus outbreak is not quickly contained. Weather-related shocks (e.g., drought/flooding, harsh winter) and resumption of non-trade barriers at the border with China could affect Mongolia’s coal exports.

Mongolia’s policy buffers, while stronger than prior to the last downturn in 2016, are not yet sufficient to fully mitigate the potential impact of negative shocks. The banking sector remains fragile and the failure to complete the banking recapitalization program could delay official financial support. Given that Mongolia remains on the gray list of the Financial Action Task Force (FATF), limited progress on anti-money laundering issues would pose additional risks.

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1 The deal signed in January 2020 includes Chinese commitments for the purchase of U.S.A energy exports. It is not clear whether this would affect Chinese energy imports from other sources. This could affect growth prospects for Mongolia negatively. At the same time, a renewed flare up of international trade tensions could depress global growth and exert downward pressure on commodity prices.

2 The FATF is an independent inter-governmental body, which develops and promotes policies to protect the Global Financial System from terror funding and money laundering activities. Mongolia was put in the FATF’s gray list on October 18th, 2019 following limited progress on addressing anti-money laundering issues. Incidentally, ING group recently decided to exit Mongolia and stop serving as foreign currency clearing agent for the Mongolian banks. Moreover, with slow progress on FATF issues, there is risk that an already limited corresponding relation with banks in advanced economies is likely to be further eroded with adverse effects on trade and investment.
Strengthening fiscal buffers through continued fiscal consolidation and building up reserves by limiting excessive foreign exchange interventions should remain two important near-term policy priorities of the government. In addition, improving the business environment and strengthening financial sector stability, especially with regard to credit policy and soundness of the banking sector, will contribute to greater macroeconomic stability, job creation, and poverty reduction. The accelerated progress on the U.S.A-Mongolia trade agreement following the July 2019 visit of the Mongolian president to the U.S.A. could also contribute positively to the outlook.
I. PERFORMANCE AND PROSPECTS
A. Recent Economic Developments

A1. Real sector: Economic growth is slowing as mining production moderates

Having maintained a brisk pace of growth since early 2017, the Mongolian economy showed signs of gradual deceleration in the second half of 2019. Real gross domestic product (GDP) growth decelerated to 6.3 percent year-on-year (y/y) in the first nine months of 2019 from 7.3 percent in the first half (H1) of the year. With lower gold and copper grades in Oyu Tolgoi’s (OT’s) production, mining sector output contracted by 1.4 percent (y/y) in the third quarter after an average growth of 13 percent in the first two quarters. In addition, the closure of OT’s copper concentrator factory for maintenance in September also contributed to the slowdown in growth. However, coal production and exports volumes have remained robust despite gradually declining prices. Growth in the non-mining sector slowed down to 6 percent over the first nine months of 2019, from 8.1 percent in the same period of 2018.

On the demand side, investment continued to grow rapidly (24.5 percent, y/y) in the first nine months of 2019, mainly driven by strong foreign direct investment (FDI) inflows (US$1.3 billion) (figures I.1 and I.2). Private consumption growth remained strong as well (7.3 percent during January–September 2019 from 6.4 percent a year ago) amid improved labor market conditions and increased wages.

Investment remains the largest contributor to growth. Gross capital formation expanded by 24.5 percent in the first three quarters of 2019—a deceleration from 35.7 percent a year ago. FDI remained robust during January–September 2019 (close to 10 percent of GDP) despite a slight decline from 11 percent in the first nine months of 2018. Mongolia’s economic growth remains heavily dependent on investment, which is largely funded by volatile FDI flows. In addition, public sector investment grew by 57 percent (y/y) during January–September 2019, reflecting increased budget investment in schools and hospitals and improved customs capacity (including laboratories, border checkpoints, and control and management centers). Moreover, accelerated progress toward completion of investment projects that have been under implementation for several years also helped explain these developments in public investment.
Final consumption grew rapidly in the first nine months of 2019 supported by robust growth in household income and increased government spending. Final consumption grew by 7.7 percent (y/y), relative to 5.8 percent in the same period in 2018, owing to a surge in government consumption—fueled by increased wages of public sector employees—and sustained expansion of private consumption (7.3 percent from 6.4 percent) (figure I.3). Meanwhile, real household income continued to grow rapidly (8.6 percent, y/y) in September 2019 (figure I.4). Negative net exports has slightly narrowed compared to a year ago due to an improved trade balance in 2019.

Mineral production remained robust in 2019, though the pace of expansion moderated. The performance of the coal sector—which accounts for 48.2 percent of total mineral exports—remained robust in 2019, mainly driven by strong demand from China and high contractual prices (figure I.5). Meanwhile, iron ore production was up by 37.3 percent in the same period following a sharp increase in prices. However, copper production weakened, especially in the second half of the year—a contraction of 3.7 percent (y/y) in 2019—reflecting the lower quality of copper from OT and declining prices in global markets. Moreover, despite rising gold prices, gold production fell by 21 percent in 2019, which can be mainly attributed to the government’s decision to raise the gold royalty in March 2019.

Sources: NSO; World Bank staff estimates.

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1. Rising public wages and recovery in income from livestock activities have supported household income growth.
2. In 2018, coal production and export grew by 6.2 percent and 8.6 percent, respectively, to reach historically high levels (that is, 50 million tons and 36 million tons, respectively).
3. The OT management indicated that copper production contracted by 8 percent in 2019. The gold production also contracted by 15.2 percent in 2019. The contraction in copper and gold production is expected to continue in 2020, mainly due to lower grade ore. The shutdown of the concentration factory of the OT mine for maintenance reasons in September also contributed to a weaker performance. In 2021, higher grade ore and a significant increase in gold production are expected.
4. On March 3, 2019, the Parliament ended the subsidy on gold sales to the Bank of Mongolia (BoM). As a result, the royalty tax on gold sales increased from 2.5 percent to 5 percent.
Non-mining output growth has decelerated but remains robust, supported by the services sector. Non-mining GDP grew by 6 percent (y/y) in the first nine months of 2019, slightly below the 8.1 percent achieved during the same period last year (figure I.6). Agriculture sector growth accelerated to 4.1 percent during January–September 2019, from 2.1 percent in the previous year, reflecting relatively favorable weather conditions, lower loss of livestock, and strong survival rates. The services sector, mostly the transportation and trade sectors, continue to post robust growth (above 6 percent) owing to their strong links with the mining sector. The construction sector has also recovered, growing by 4.7 percent (y/y) in the same period from 0.3 percent in the first three quarters of 2018. The latter is explained by the continued development of OT’s underground project, increased government capital expenditures, and recovery in residential buildings with increased funding to the government’s housing mortgage program since April 2019. Manufacturing production decelerated to 2.3 percent (y/y) in the same period, from 10.1 percent in 2018, mainly due to a slowdown in food and textile productions, which both account for nearly 70 percent of the manufacturing production.

A2. Inflation has decelerated in recent months, reflecting the impact of slowing credit growth

National Consumer Price Index inflation has fallen sharply in recent months. Declining meat prices, decelerating credit growth, and some base effects from the previous year were the main factors for the declining inflation rate, including in Ulaanbaatar (figure I.7). Food inflation moderated to 8.3 percent (y/y) in December 2019 from 19 percent in September following a seasonal decline in meat prices. Mainly reflecting the implementation of a series of macroprudential measures by

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7 Transportation services accelerated to 15.1 percent (y/y) in Q3 2019, from 8 percent in the first half of 2019. Traditionally, transportation activities tend to accelerate in the third quarter of the year, mainly due to acceleration of activities in the construction and services sectors under favorable weather conditions.

8 A slowdown in the food industry has mainly been explained by a moderation in meat processing compared to the peak of 2018 due to the government’s efforts to limit meat exports somewhat following the rapid increase in the retail price of meat in the domestic market during most of 2019. Moreover, China imposed several standards requirements on imports of meat products from Mongolia, which also contributed to a moderation in meat exports.

9 In September 2019, inflation (9 percent, y/y) was mainly driven by meat prices (over 40 percent, y/y) following accelerated meat exports.
the Bank of Mongolia (BoM), credit growth slowed to below 5 percent (y/y) in December from a peak of 26.5 percent in December 2018. On the supply side, the impact of the government’s ban on transportation and use of raw coal to improve Ulaanbaatar’s air quality, which triggered a massive hike in hardwood fuel inflation last year, dissipated in 2019. The price of hardwood fuel (coal and wood) declined by 8.1 percent (y/y) in December 2019 relative to its peak of 65 percent (y/y) in December 2018. This follows the introduction of subsidized/affordable refined coal briquettes to accompany the ban as well as some base effects. In addition, retail fuel prices also declined, by 1.9 percent (y/y) in December compared to 24.6 percent increase in the same period last year.

The core inflation rate has also moderated following a sharp deceleration in credit growth. Supported by a combination of factors such as strong domestic demand, pass through of fuel and food prices, and exchange rate depreciation, the core inflation—defined as the change in prices of consumer items excluding meat, milk, and vegetables—was a key driver of high inflation in 2018. However, it has moderated considerably this year. A robust recovery in private consumption (6.6 percent, y/y) and high credit growth (26 percent) weighed on core inflation in 2018. However, after reaching 8.6 percent in September 2019, core inflation moderated to 4.2 percent in December 2019, reflecting the impact of credit growth deceleration (figure I.8).

**A3. The labor market: A strong recovery but limited progress on reducing the gender wage gap and poverty**

Labor market conditions continued to improve in 2018, with the unemployment rate steadily declining. Largely driven by an expansion of employment in the industrial sector, the national unemployment rate fell to 7.8 percent in 2018, down from 8.8 percent in 2017 and 10 percent in 2016 (figure I.9). The mining, manufacturing, and construction sectors were the largest contributors to employment growth in 2018, as the number of people employed increased by over 20,000 between 2017 and 2018. The services sector also added nearly 17,000 jobs during this period. However, despite an increasing share of employment in the industrial sector, the majority of the employed population remains engaged in low-end services and agriculture.

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10 This policy went into effect in May 2019.
The structural transformation of the economy has continued, though both agriculture and services have lost labor to the industrial sector. The employment share of agriculture declined over the past three years from 34 percent in 2016 to 26 percent in Q3 2019. (figure I.10) The employment share of the industrial sector, including mining, manufacturing, and construction, has been on the rise over the same period, reaching nearly 23 percent in Q3 2019 from 11 percent in 2016. The services sector, including wholesale and retail businesses, absorbed many workers during 2012–16 who migrated from agriculture-related activities, with its job share rising to 58 percent from 48 percent. However, the share of the services sector declined during 2018–19, reflecting a shift to the industrial sector from services, following a strong performance of the mining sector. The employment share of the mining sector increased to about 5 percent in Q3 2019 from 3.7 percent in 2016, reflecting increased activities in the mining sector over the past two years. In total, around 15,000 new jobs were created in mining, an increase of 36 percent.

Despite improved labor market conditions, the gender wage gap remains wide and the female labor force participation rate is at a historic low. In 2018, the nominal monthly average wage and salary was MNT 903,000 for women and MNT 1,100,000 for men—a 22 percent gender wage gap. This gap is partly explained by the fact that many women are employed in informal or low-end service activities, while an increasing number of men have obtained jobs in better-paid sectors (such as mining, manufacturing, and construction). Indeed, the male labor force participation rate reached a historically high level (69.5 percent) in 2018, while female labor force participation, which has consistently declined since 2006, hit a historically low level (53.4 percent) in 2018 (figure I.11). To reduce gender disparities in Mongolia’s labor market, a recent qualitative study suggested a package of policy reforms including promoting a mandatory gender nondiscrimination policy in hiring, ensuring access to finance and training for female-operated micro-businesses, and expanding the quantity and quality of early childcare services (Schmillen and Weimann-Sandig 2018).
After years of stagnation, public sector wages have increased. The authorities have steadily increased public sector wages since late 2018 (an 8 percent increase in both Q4 2018 and January 2019) to help address wage stagnation that began in 2012. The real average wage of the public and private sector grew sharply—by 33 percent—during 2010–12 (figure I.12). Wages in the private sector rose by another 32 percent during 2013–18, while the public employees saw their real wages contract by about 5 percent during the same period. However, as of September 2019, public employees have seen a 10 percent real wage growth (y/y) following two sequential wage increases by the government.

Poverty has declined in rural areas but remained unchanged in urban areas, resulting in little progress in lowering the national poverty rate. Based on the 2018 Household Socio-Economic Survey (HSES), the 2018 national poverty headcount rate was estimated at 28.4 percent, representing a 1.2 percentage point reduction from 2016. During the same period, the rural poverty rate declined by 4.1 percentage points, while the urban poverty rate was not statistically different from 2016 (figure I.13). While the incidence of poverty remains high in rural areas, with two-thirds of the total population of Mongolia living in urban cities, poverty has become more concentrated in urban areas. The share of the poor population in urban areas increased from 56.3 percent in 2012 to 63.5 percent in 2018, with more than 40 percent living in Ulaanbaatar in 2018.

A4. Fiscal developments: Impressive performance continued in 2019

With three consecutive years of primary budget surplus, government debt has been steadily declining since 2016. The fiscal balance has improved significantly, from a deficit of 15.3 percent of GDP in 2016 to a surplus of 2.6 percent of GDP in 2018 and 1.4 percent in 2019 (figure I.14). This remarkable fiscal turnaround is explained by massive revenue overperformance (strong performance in the mining sector and considerable revenue mobilization efforts by the government through improved tax administration), and a commitment to spending control (for example,

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11 Development Bank of Mongolia spending is excluded from the fiscal balance for 2016–19. It is monitored separately.
streamlining of the wage bill through a hiring freeze, and rationalization of underperforming capital spending). In contrast to the practices prior to 2017, the government has avoided any budget amendments in 2018 and 2019 keeping spending in check, (see box I.1 for more details). Substantial improvements in the primary balance and use of the fiscal surplus to buy back expensive domestic debt resulted in a sharp reduction in government debt between 2016 and 2019 (figure I.15). Declining interest payments reflecting falling government debt and improved terms contributed to the fiscal consolidation in recent years.

In 2019, the fiscal balance was in surplus for the second consecutive year amid revenue overperformance. The budget execution of 2019 recorded a surplus mainly due to robust revenue performance, although the under-execution of the capital budget (capex) also continued. The overall balance reached a surplus of 1.4 percent of GDP in 2019 following a surplus of 2.6 percent in 2018. The primary balance also exhibited a surplus of 3.7 percent of GDP after 5.8 percent in 2018. Revenue exceeded targets by over MNT 721 billion (6.4 percent relative to target) in 2019. Strong revenue collection in 2019 was supported by a broad-based revenue stream (corporate income tax [CIT], including thanks to robust mining exports, personal income tax [PIT], and value-added tax [VAT]), and more than compensated a surge in current budget spending after two years of tight spending controls.

The Parliament approved a slightly expansionary 2020 budget while committing to reduce public debt further. The approved 2020 budget assumes that government revenue will grow by

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**Figure I.14. Fiscal balance (percent of GDP) has improved in recent years...**

<table>
<thead>
<tr>
<th>Year</th>
<th>Overall Balance</th>
<th>Revenue</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>-4.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>-9.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>-9.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>-10.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>-5.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>-3.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>-2.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>-1.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2019e</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Figure I.15. ...resulting in steady fall in government debt (percent of GDP) since 2017**

<table>
<thead>
<tr>
<th>Year</th>
<th>Overall Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>43</td>
</tr>
<tr>
<td>2013</td>
<td>49</td>
</tr>
<tr>
<td>2014</td>
<td>58</td>
</tr>
<tr>
<td>2015</td>
<td>60</td>
</tr>
<tr>
<td>2016</td>
<td>88</td>
</tr>
<tr>
<td>2017</td>
<td>85</td>
</tr>
<tr>
<td>2018</td>
<td>73</td>
</tr>
<tr>
<td>2019e</td>
<td>68</td>
</tr>
</tbody>
</table>

*Source: MoF; World Bank staff estimates.*

*Note: LHS = left-hand side; RHS = right-hand side.*

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12 Improved value-added tax (VAT) administration through digital technologies, increased social security contributions, and increased excise taxes on alcohol and tobacco were key drivers of growth in non-mineral revenues.

13 With technical assistance from the World Bank, the Minister of Finance issued Order #295 in December 2018 approving regulation of and methodologies on evaluation, prioritization, and selection of publicly financed projects. The approved methodology is expected to help the government assess its public investment projects to be financed by state budget investment. The new regulation will be used starting with the 2020 budget.

14 However, after no wage increases for five years, the government sequentially increased public wages starting in late 2018, as a response to pressing labor union demands.

15 Interest payments quadrupled from about 1 percent of GDP in 2012 to over 4 percent in 2017 due to a sharp rise in government or government guaranteed debt. However, implementation since mid-2017 of the government’s debt strategy, which emphasized repaying expensive domestic debt, replacing short-term external commercial loans by concessional borrowing, resulted in a gradual decline in interest payments. Consequently, the gap between the primary budget deficit and the overall budget deficit has been narrowing.
16.6 percent (reaching 31.7 percent of GDP), mainly through improved CIT collection and better VAT collection due to upgraded facilities at the customs/border posts (figure I.16). As explained below, these revenue projections may be overoptimistic in light of recent developments. On the spending side, the 2020 budget projects an increase of 19.7 percent (reaching 34.1 percent of GDP) relative to the 2019 planned budget (figure I.17). The major sources of the spending increase are social welfare and pensions (inflation adjustment- and pension fund-related expenses including implementation of the legal amendments introduced in 2017 but postponed in the 2019 budget), capital expenditures (mainly ongoing investment projects), the wage bill, and spending on goods and services (including the cost of the election and air pollution reduction). Public debt is expected to decline further (for more details on the 2020 budget, see boxes I.2 and I.3).

The revisions of the tax law approved by the Parliament in March 2019, became effective in January 2020. It aims to broaden the tax base through simplification of filing and rationalizing the number of taxes paid by Small and Medium Enterprises (SMEs).
Box I.1. A surge in recurrent spending is explained by growth in the pension and wage bill

The 2020 budget exhibits a substantial increase in the recurrent spending relative to capital expenditure. The primary drivers of recurrent spending increases are pension/welfare-related expenditures including the implementation of the 2017 amendments to the pension insurance legislation (32 percent of the total increase), the wage bill (23 percent), and spending on reducing air pollution, environmental protection, elections and Olympic games (13 percent) (figure I.18). Specifically, the implementation of the 2017 legal changes would increase the spending on pensions and welfare by about 0.3 percent of GDP (figure I.19).17

The revenue mobilization plan in the 2020 approved budget may be overoptimistic. While assumptions on commodity prices are broadly consistent with the projections of international institutions including the International Monetary Fund (IMF) and the World Bank, assumptions on export volumes appear to be overly optimistic. In particular, the revenue estimates assume that coal exports will reach 42 million tons this year, a 14.7 percent increase over the 2019 outturn of about 36.5 million tons. The latter is likely to be optimistic given weak prospects in the coal market and the expected growth slowdown in China.

The authorities may also have over-estimated the impact of the new tax law package on revenues. The approved budget proposes to collect MNT 1.8 trillion for the CIT (an almost 50 percent increase over the 2019 budget) through simplified and digitalized tax collection despite falling commodity prices. In the first 11 months of 2019, over 50 percent of total CIT collection came from mining companies. In addition, the approved 2020 budget expects to collect MNT 2.4 trillion in social security contributions, a substantial increase over MNT 1.7 trillion in 2019, largely due to a 1 percent increase in the contribution rate agreed under the IMF Extended Fund Facility program. However, recently the president vetoed the last phase of this gradual increase in the contribution rate to the social insurance program, which had been approved by Parliament in December 2019. An immediate impact of the veto would be that revenue collection for 2020 will decline by about 0.4 percentage points of GDP. The authorities recently indicated that this

17 The 2017 legal changes include (i) reducing the age for eligibility for pension insurance benefits by five years for herders; (ii) calculating each year of herders’ contributory service as 1.5 years instead of one year; (iii) introducing a second round of service buy-back options for herders and the self-employed following the first buy-back in 2012; (iv) awarding 1.5 service years for retiring mothers per child; and (v) guaranteeing social insurance premiums for mothers looking after a child under three years of age, financed by employers and the Social Insurance Fund. The service buy-back for herders and self-employed accounts for 90 percent of increase in Pension Insurance Fund expenditure.
increase in contribution rate will be implemented in 2021 instead of 2020. Moreover, there are proposals by members of Parliament to revise the VAT Law, which could be a threat to the fiscal gains of the last three years (see box I.2).

Box I.2. Proposed amendments to the VAT are likely to be detrimental to revenue mobilization

Two draft amendments to the VAT law aimed to decrease the value-added tax (VAT) statutory rate and increase refunds were recently introduced in the parliament. Specifically, the proposals intend to reduce the statutory rate from 10 percent to 5 percent and increase the refund on VAT paid to consumers for requesting vendors of a certified bill of purchase to 70 percent from the current 20 percent (of the VAT paid). Moreover, the proposal includes increasing the ceiling of total VAT refunds into total VAT revenue to 40 percent from 30 percent. Lawmakers argue that the proposed changes will alleviate the tax burden on the registered taxpayers but also ensure further contraction of the shadow economy and thus broaden the tax base. They also argue that VAT collection is at risk in the medium to long term since the number of VAT payers has risen at a slower rate since the amendment of the VAT law in 2015. But there are several weaknesses in the proposed changes.

A reduction of the VAT statutory rate could have a significant immediate adverse effect on VAT revenue collection. In January 2007, the VAT statutory rate (introduced in 1998) was reduced from 15 percent to 10 percent. This resulted in a drop in the VAT revenue estimated at 0.7 percentage point of GDP between 2006 and 2007. Mongolia’s VAT statutory tax rate is already low compared to its peer countries (figure I.20). The current 10 percent statutory rate is also below the average applied rate in neighboring countries, including China (a five-tier VAT structure of 3 percent, 5 percent, 6 percent, 10 percent, and 16 percent), Kazakhstan (12 percent), and Russia (a differentiated structure with 10 percent applied on basic foodstuffs, medicines, children’s stuffs, and 20 percent on any other goods). In addition, the low tax burden in Mongolia is further evidenced in the 2020 Doing Business report, as total tax and contribution rate (percent of commercial profits) stands at 25.7 percent, compared to 33.6 percent for East Asia and Pacific and 39.9 for OECD high income countries.

A more generous VAT refund system could further erode Mongolia’s VAT revenue mobilization. The rollout of the VAT system supported by internet-based electronic receipt system (e-barimt), resulted in a substantial increase in the number of registered business entities. It also led to an expansion of the tax base as domestic VAT revenue increased by twofold to MNT 1.1 trillion in 2019 from about MNT 500 billion in 2015 (figure I.21). However, Mongolia’s VAT refunds have also increased substantially during the same period. Specifically, the 20 percent VAT refund to individuals has accelerated, while refunds to corporates have been declining (figure I.22).
The VAT system needs reform, but not the reforms currently under discussion. First, the statutory tax rates are too low not too high. Second, the authorities should integrate the e-barimt system with customs declaration database and other tax information for ease of paying tax and filing tax return. Third, e-barimt system security and sustainability issues should be addressed by introducing ISO standards. Fourth, the e-barimt system should be made more accessible and convenient to end-users. Fifth, the tax authorities should focus on business entities that evade the e-barimt system altogether or fail to print out e-barimt to end-users. Moreover, the refund framework should be revised, following a detailed assessment of the costs and benefits of the current system. Particularly, the 20 percent VAT refund on final consumers is an income transfer. It would be useful to estimate the amount and determine if it makes sense both from a revenue and a policy standpoint. In short, the main VAT priority is to continue the rollout of the electronic receipt system and gradually reduce the refund.

Source: Summarized and updated by the authors based on World Bank (2018).

Note: a. There are three types of refunds that are operated under the current VAT system: (i) normal VAT refunds through the input tax credit; (ii) up to a 20 percent VAT refund to consumers who upload e-receipts of the VAT including purchases from registered VAT payers; and (iii) the lottery (applicable to all regardless of VAT payer) for all e-receipts.

Box I.3. Summary of the 2020 budget

The 2020 budget assumes (a) real economic growth of 8 percent in 2019 and 6 percent in 2020, (b) strong demand for coal and relatively lower production of copper concentrate, and (c) that tax reforms are fully implemented from 2020. It also assumes that inflation will be contained at 8 percent in 2020 as part of the monetary policy guidelines. Under the macroeconomic assumptions, the 2020 budget provides the revenue projections and corresponding expenditure plans shown in table I.1.
### Table I.1. Summary of the 2020 approved budget

<table>
<thead>
<tr>
<th></th>
<th>2019 Budget Plan</th>
<th>2020 Approved Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Billion MNT % of GDP</td>
<td>Billion MNT % of GDP</td>
</tr>
<tr>
<td>A. Total revenue &amp; grants</td>
<td>11,067 31.3</td>
<td>12,900 31.7</td>
</tr>
<tr>
<td>B. Total structural revenue &amp; grants</td>
<td>9,676 27.4</td>
<td>11,798 29.0</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>8,586 24.3</td>
<td>10,656 26.2</td>
</tr>
<tr>
<td>Non-tax revenue</td>
<td>1,091 3.1</td>
<td>1,142 2.8</td>
</tr>
<tr>
<td>C. Total expenditure &amp; net lending</td>
<td>11,589 32.8</td>
<td>13,873 34.1</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>8,217 23.3</td>
<td>10,019 24.6</td>
</tr>
<tr>
<td>Wage bill</td>
<td>2,215 6.3</td>
<td>2,628 6.5</td>
</tr>
<tr>
<td>Goods and services</td>
<td>1,732 4.9</td>
<td>2,158 5.3</td>
</tr>
<tr>
<td>Interest payments</td>
<td>865.6 2.4</td>
<td>960 2.4</td>
</tr>
<tr>
<td>Subsidies</td>
<td>252 0.7</td>
<td>375 0.9</td>
</tr>
<tr>
<td>Transfers</td>
<td>3,152 8.9</td>
<td>3,899 9.6</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>3,244 9.2</td>
<td>3,806 9.4</td>
</tr>
<tr>
<td>Domestic investment</td>
<td>2,300 6.5</td>
<td>2,890 7.1</td>
</tr>
<tr>
<td>Externally funded investment</td>
<td>944 2.7</td>
<td>916 2.3</td>
</tr>
<tr>
<td>D. Structural balance: B–C</td>
<td>(1,913) -5.4</td>
<td>(2,075) -5.1</td>
</tr>
<tr>
<td>E. Overall balance: A–C</td>
<td>(522) -1.5</td>
<td>(973) -2.4</td>
</tr>
<tr>
<td>F. Stability and Heritage Funds: E–D</td>
<td>1,391 3.9</td>
<td>1,102 2.7</td>
</tr>
</tbody>
</table>

**Key highlights of the 2020 budget include the following:**

- The budget is moderately expansionary. Primary spending (total expenditure net of interest payments) will increase by 1.4 percentage points of GDP in 2020. In the 2019 budget, primary spending rose by 5 percentage points relative to 2018.
- Revenue projections, especially corporate income tax collection, are unrealistically high, given the slowdown in the economy and in commodity prices. The government has argued that the impact of tax reforms (simplification and digitalization) supports their revenue projections.
- The substantial increase in recurrent spending is largely explained by an 8 percent increase in wages and pensions. This will feed through to social insurance, and social welfare benefits to create future spending commitments.
- Capital spending is projected to reach 9.4 percent of GDP, a slight rise from 2019, mostly to complete existing projects.
- The approved budget also includes the provision of MNT 125 billion (US$46 million) for fiscal stabilization funds and MNT 977 billion (US$361 million) for the Future Heritage Fund.

**Sources:** MoF; 2020 budget document; World Bank staff calculations.

### A5. The balance-of-payments situation has improved, but external buffers remain weak

**Balance-of-payments pressures moderated in 2019 due to robust FDI inflows and import deceleration.** The current account deficit decreased to US$1.7 billion in 2019 from US$2.2 billion in 2018. This mainly reflects trade balance improvements following the robust growth of exports (8.7 percent, y/y, in 2019) and a sharp deceleration of import growth (from a peak of 45.5 percent, y/y, in May 2018 to 4.3 percent in 2019). Relatively high commodity prices (especially for coal and iron ore) and stronger external demand contributed to the robust export performance. Meanwhile, the impact of the macroprudential measures to contain credit growth to households (effective
January 2019) and slowing demand from the manufacturing sector explain the sharp deceleration of imports (figure I.23). The current account deficit has remained fully financed by FDI, with net inflows closing the year at US$2.11 billion, virtually unchanged from 2018. In addition, portfolio investment increased to US$368 million in the same period, primarily reflecting the international bond issue of the Mongolia Mortgage Corporation in January 2019.\(^{18}\) As a result, the balance-of-payments turned around from a deficit of US$141 million in 2018, to a surplus of US$453 million in 2019 (figure I.24).

Figure I.23. Macroprudential measures have significantly contained growth of imports

Figure I.24. The balance-of-payments situation has improved in 2019

Gross international reserves further strengthened in 2019, mainly reflecting easing balance-of-payments pressures (figure I.25). In 2018, reserve accumulation was the result of a bond issue (not sovereign guaranteed) by the Development Bank of Mongolia (US$500 million) in October, and historically large amount of Bank of Mongolia gold purchases (about US$800 million) from individuals and companies. In 2019, gross international reserves further expanded to US$4.3 billion (about seven months of imports), supported by an improved trade balance, the international bond issue of the Mongolian Mortgage Corporation, and official sector support from development partners.

18 In January 2019, the Mongolian Mortgage Corporation issued a US$300 million non-sovereign guaranteed bond at a rate of 9.75 percent with a three-year maturity.
Increased foreign exchange interventions in 2019 led to a real appreciation of the tugrug against the U.S. dollar and the Chinese renminbi (RMB).

In nominal terms, the tugrug depreciated by 3.4 percent against the U.S. dollar and by 2.1 percent against the Chinese RMB in 2019, compared to depreciation of 9 percent and 3.4 percent, respectively, in 2018. The Bank of Mongolia is estimated to have sold US$2.86 billion to defend the tugrug in 2019, up from US$1.5 billion for 2018 (box I.4).19 Pressure on the exchange rate was moderate during the first half of the year but accelerated thereafter, partly reflecting general U.S. dollar strength against the currencies of Mongolia’s peers and neighbors (figure I.26) and partly explained by some market panic prompted by the gray listing of Mongolia by the Financial Action Task Force (FATF). Meanwhile, with Mongolia’s inflation higher than that of major trading partners (China and Russia), the real effective exchange rate appreciated by 5 percent in 2018 and 3.7 percent in the first 10 months of 2019, which may have affected the export competitiveness of the non-mining sector (figure I.27).20

19 During this period (July–August), Chile’s currency depreciated by 5 percent, Russia’s by 4.1 percent, and China’s by 3 percent.

20 According to Gan-Ochir and Munkhbayar (2019), the real exchange rate was undervalued for the period 2000-03 and 2007-08, and there is a sign that the underestimation of the domestic real exchange rate started to occur in the end of 2018.
Box I.4. Exchange rate development and FX intervention in Mongolia

The Bank of Mongolia (BoM), the country’s central bank, has been intervening in the foreign exchange market to stabilize the tugrug in response to recent market reaction to the gray listing by the Financial Action Task Force (FATF). Since April 2018, the exchange rate has come back under depreciation pressure, facilitated by an easy credit policy. The tugrug depreciated by 10.5 percent between March 2018 and March 2019, sliding back to MNT 2,644 per U.S. dollar. Between April and September 2019, the exchange rate was relatively stable amid strong export performance, robust FDI, and slowing import growth despite a strong U.S. dollar. However, the tugrug depreciated sharply in early October with the announcement of Mongolia’s inclusion on the gray list by the FATF. As the exchange rate approached MNT 2,700 per U.S. dollar, the BoM increased its foreign exchange (FX) intervention. In Q4 2019, BoM intervened to the tune of US$1 billion, a historical high (figure I.28).

In addition, the BoM recently raised FX reserve requirements to ease depreciation pressure on the tugrug. On December 20, 2019, the Monetary Policy Committee maintained the central bank’s policy rate at 11 percent amid moderate inflation and a slowing global economy. The BoM argued that in the context of high FX holdings, the interest rate channel of monetary transmission is impaired. Hence, to discourage FX demand, the BoM further increased the reserve requirement ratio on FX deposits to 15 percent from 12 percent. High provisioning for FX loans, on the other hand, has led to a sharp decline in their share in total credit since September 2018 (figure I.29).

Given limited reserves, the BoM will not be able to sustain recent levels of intervention in the FX market. If market participants anticipate this, the mere fact of intervention may prompt additional FX demand, as prospective buyers expect future devaluation, rendering intervention less effective. A policy to discourage dollarization would need to be based on gradually moving towards a more flexible exchange rate, so that depositors and lenders know they face a two-sided bet.
A6. Monetary policy: Monetary conditions have gradually tightened, but risks to financial sector sustainability remain high

Monetary policy stance has improved since late 2018, lowering the risks to the balance of payments. Monetary policy was tightened in late 2018 and the BoM reaffirmed its commitment to a more flexible exchange rate. This followed a credit boom in 2018, when domestic credit grew at 26.5 percent in 2018, fueling rising imports and growing external imbalances. The sharp rise of credit reflected a series of factors including the lagged response to lower policy rates, improved market sentiment, and an apparent exuberance following the findings of the Asset Quality Review, with a lower-than-expected capital shortfall. Monetary authorities’ response to the surge in imports and credit growth included a series of macroprudential measures aimed at limiting the debt-to-income ratio of individual borrowers from as high as 100 percent to 60 percent, reducing the maturity on non-mortgage household loans, and raising the risk rating on unhedged foreign currency borrowing. In addition, the BoM raised the policy rate by 100 basis points to 11 percent in November 2018.21 As a result of these efforts, credit growth moderated to less than 5 percent (y/y) at the end of 2019 (figure I.30 and figure I.31).

Interest rates have been on a downward trend. Interbank rates have closely tracked changes in the BoM’s policy rate, declining substantially between mid-2016 and end 2018 and increasing moderately since then (figure 1.32). Weighted average lending rates of new domestic currency loans fell to 17 percent in 2019 from about 17.2 percent in 2018 and 19 percent in 2017. Domestic currency deposit rates—which were stable at around 13 percent on average during most of 2017— fell to 12 percent in 2018 and to 10.5 percent in 2019 (figure I.33).22

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21 Although introduced in late 2018, the effectiveness date of the above macroprudential measures was January 2019. Banks massively front-loaded loan issuances in the last quarter of 2018 to take advantage of the delayed effectiveness of the measures. The debt service to income, set at 60 percent, remains higher than the international standards.

22 Nearly flat deposit rates reflect strong competition among banks for large deposits concentrated in the hands of a few depositors.
Macroeconomic Stability and Credit Growth

**Figure I.32. Interbank rates have increased moderately in tandem with the policy rate...**

Interbank market rates and BoM policy rate (%)

**Figure I.33. Average lending rates have gradually declined amid relatively robust funding conditions**

Weighted average lending and deposit rates (domestic currency, %)

Source: BoM.

**Money supply (M2) growth has decelerated in line with slowing credit.** Broad money increased by 7 percent in 2019, down from 23 percent in 2018 (figure 1.34). On the asset side, credit to the public sector declined, while net foreign assets became a main driver of money supply growth. Meanwhile credit to the non-bank private sector decelerated. On the liability side, money supply was mainly driven by the growth of local currency deposits, which averaged nearly 25 percent in 2018 and 13 percent during 2019 (figure I.35).

Source: BoM; World Bank staff estimates.
The quality of bank assets remains weak

The quality of banking sector assets remains weak, with a high level of nonperforming loans. Between 2014 and 2018, NPLs in the banking sector more than doubled and, by official accounts, have remained above 10.1 percent in 2019 (figure I.36). Private sector loans have accounted for the bulk of bad loans despite the strong economic recovery in the past two years. The persistently high level of NPLs suggests that underlying capital shortfalls identified during the Asset Quality Review (AQR) remain, raising the urgency of completing the bank recapitalization program. Ensuring that the banks are fully capitalized will be crucial to restore confidence in the financial sector. More recently, there have been calls to create an asset management company (AMC) to address Mongolia’s nonperforming loan issues, which may not be appropriate given lingering structural weaknesses in the banking sector (box I.5).

Box I.5. Asset Management Company – An effective solution to the banking sector problems?

Mongolia is considering creating an Asset Management Company (AMC) to address structural problems in the banking sector, including the rise in nonperforming loans. Estimating the size of Mongolian NPLs is not easy; estimates vary from the official figure of 10.1 percent in December 2019 to two to three times the number cited by several local experts. A draft resolution was recently introduced in Parliament to establish the AMC. Since AMCs are costly to establish and operate, their expected benefits need to be carefully assessed and the preconditions for successful establishment of an AMC need to be in place. Mongolia can draw on international experience to design its AMC.

A recent study on a toolkit for public AMCs, building on nine case studies from around the world, found that a successful AMC requires certain preconditions. These include (a) a commitment to comprehensive reform of the banking sector; (b) a systemic problem and public funds at risk; (c) a solid diagnostic and critical mass of impaired assets; (d) a tradition of institutional independence and public accountability; and (e) a robust legal framework for bank resolution, debt recovery, and creditors’ rights.

Mongolia seems to be far from the above-mentioned requirements. In terms of institutional independence and public accountability, recent experience of management involving the government has not been successful (for example, the Development Bank of Mongolia, Mongolian Mortgage Corporation). There is also a need to improve the regulatory capacity and institutional independence of the prudential supervisor in assessing banks’ business models, their sustainability and asset quality, and the performance of its regulatory and supervisory function. Moreover, the risk exists of abusing AMCs as an instrument to liquidate NPLs at preferential pricing for politically well-connected debtors and investors.

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23 There is considerable debate surrounding the correct size of NPLs, ranging from the official figure of 10.1 percent to several multiples of it cited by local experts (box I.5).
Another key factor for a successful AMC is a robust legal framework for bank resolution, debt recovery, and creditors’ rights. In Mongolia, although significant progress was achieved through the IMF’s Extended Fund Facility program in building banking laws and regulations in line with international standards and improving the capacity of banking supervisors, serious shortcomings remain, particularly in the implementation of the new framework and the political independence of the BoM.

In addition, an AMC is a remedial solution that should always be accompanied by measures to prevent a buildup of future NPLs. In that respect, the prudential supervisor in Mongolia still faces substantial capacity limitations. Addressing more structural issues of the banking sector should be a priority. These include a highly concentrated banking sector (the “too big to fail” problem), concentrated lending to few economic sectors (concentrated lending portfolios pose risks to asset quality, profitability, and stability of banks), and weak internal capacity to assess emerging risks, sound lending practices, NPL valuation, and collateral valuations.

Source: Summarized and adapted from “Public Asset Management Companies: A Toolkit” (World Bank 2016).

Note: a. World Bank 2016; b. Establishing an AMC is not warranted unless weaknesses in the financial system are systemic and threaten to put public funds at risk. The public AMC’s role is to limit the ultimate cost to the public sector of resolving financial sector weaknesses, by recovering proceeds from assets that have lost value temporarily.

Available liquidity indicators suggest that the banking system as a whole remains liquid (figure I.37). According to BOM, the system-wide capital adequacy ratio is currently above the minimum threshold of 12 percent. But a forensic audit of the recapitalization process suggests raised doubts over the quality of bank capital, suggesting several systemic banks remain severely undercapitalized. Bank reserves stood at about 27 percent of total deposits in December 2019, above the 10.5 percent reserve requirement ratio. Meanwhile, the ratio of liquid assets—including bank reserves, central bank bills, and government bonds—to total bank liabilities was 37.2 percent in December 2019, above the minimum threshold of 25 percent imposed by the central bank.

Figure I.37. Banking system appears liquid

<table>
<thead>
<tr>
<th>10%</th>
<th>15%</th>
<th>20%</th>
<th>25%</th>
<th>30%</th>
<th>35%</th>
<th>40%</th>
</tr>
</thead>
<tbody>
<tr>
<td>0:10</td>
<td>5:19</td>
<td>10:29</td>
<td>15:39</td>
<td>20:49</td>
<td>25:59</td>
<td>30:69</td>
</tr>
</tbody>
</table>

Bank Reserves/Deposits (%)
Liquid Assets/Total Assets(%)

Figure I.38. Rising currency mismatch in the banking system

<table>
<thead>
<tr>
<th>10%</th>
<th>15%</th>
<th>20%</th>
<th>25%</th>
<th>30%</th>
<th>35%</th>
<th>40%</th>
</tr>
</thead>
<tbody>
<tr>
<td>0:10</td>
<td>5:19</td>
<td>10:29</td>
<td>15:39</td>
<td>20:49</td>
<td>25:59</td>
<td>30:69</td>
</tr>
</tbody>
</table>

FX deposits/total deposits
FX loans/total loans

Sources: BoM; World Bank staff estimates
The banking system remains exposed to a high risk of currency mismatch (figure I.38). The size of the foreign liabilities of the banking system is more than twice the size of foreign assets, exposing the banks to high currency mismatch risks. However, credit risks associated with exchange rate fluctuation have significantly declined, as foreign currency loans accounted for 12.6 percent of total loans at the end of 2019, but a significant portion of foreign currency loans were likely provided to unhedged borrowers. This substantial decline in FX loans is mainly attributed to macroprudential measures by the monetary authorities (high provisioning for FX loans), especially since September 2018 when the measure was introduced.

**B. Outlook and Risks**

With the global economy slowing and commodity prices falling, growth in Mongolia is likely to decelerate as well albeit remaining at par with its main regional peers (box I.7). Supported by a stable macroeconomic environment, robust domestic demand, large inflows of foreign direct investment, and relatively robust commodity exports, economic growth is projected to be around 5.8 percent in 2019 (revised downward from our initial projections of 6.9 percent). This revision is explained by the recent fall in copper prices, lower gold content of OT’s copper production, and falling coal production, especially during November–December 2019. Average growth over the medium term (2020–22) is expected to be around 5.6 percent, mainly supported by the mining sector, especially with imminent developments of the Tavan Tolgoi mining project, and the remaining export potential of Oyu Tolgoi phase 1, despite a delay in phase 2. Buoyed by its links with mining, the services sector is also expected to enjoy robust growth (table I.2).

Monetary policy is expected remain relatively tight, given persistent inflation and external sector pressures. Inflation is likely to be within the central bank’s target mainly due to moderating domestic demand, despite the immediate and lagged impact of oil and food prices (mainly meat prices) and exchange rate depreciation. Moreover, increasing public wages and relatively higher fiscal spending in 2019–20 compared to the previous two years could generate inflationary pressures. Our base case is built on the continued commitment of the monetary authorities to price stability keeping inflation within the central bank’s target, which would eventually help lower inflation expectations. Interventions in the foreign exchange market are expected to be limited to smoothing excessive volatility, allowing more flexibility in exchange rate movements, and rebuilding international reserves.

The 2020 budget and the medium-term fiscal framework are broadly consistent with fiscal consolidation and the debt reduction objective. The 2020–22 Medium-Term Fiscal Framework projects an overall budget surplus of about 1 percent of GDP by 2022.24 We estimate the fiscal deficit (using the World Bank/IMF definition) more conservatively (given less optimistic revenue projections) to average around 0.3 percent of GDP during 2020–22. Financial support from donors is expected to continue to contribute to the fiscal consolidation process. Concessional budget support loans from multilateral and bilateral donors would allow expensive domestic debt to be replaced. Interest payments, reflecting projected concessional financing, are forecast to decline to about 1.5 percent of GDP during 2020–22 from

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24 According to the Fiscal Stability Law, the structural budget balance is defined as the difference between structural revenue (that is, total government revenue minus transfers to the Fiscal Stabilization Fund and the Future Heritage Fund) and total government spending (excluding projects financed by Development Bank of Mongolia). Meanwhile, the IMF and World Bank monitor the overall fiscal balance, including on the revenue side, proceeds to the saving funds.
Macroeconomic Stability and Credit Growth

2.3 percent of GDP in 2019, 3.2 percent in 2018, and 4.1 percent in 2017.\textsuperscript{25}

**Government debt is projected to fall further, supported by real GDP growth and a primary surplus** (figure I.39). Assuming fiscal consolidation is sustained – and any revenue shortfalls are compensated by additional spending restraint – the government debt to GDP ratio should continue to decline to around 60 percent of GDP, falling below the target set in the Economic Recovery Program. Compared with its peers, Mongolia’s debt ratio remains elevated, however.

**Figure I.39. Government debt-to-GDP ratio is projected to fall further but remains higher than many selected peers**

![Graph showing government debt-to-GDP ratio over time for various countries including Chile, Kazakhstan, Russia, Malaysia, Peru, Philippines, Mongolia, China, and selecion peers.](image)

**Figure I.40. The government is expected to pay a higher amount of debt due on external bonds during 2021–24**

<table>
<thead>
<tr>
<th>Year</th>
<th>(US$ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2021</td>
<td>500.0</td>
</tr>
<tr>
<td>2022</td>
<td>1,000.0</td>
</tr>
<tr>
<td>2023</td>
<td>800.0</td>
</tr>
<tr>
<td>2024</td>
<td>600.0</td>
</tr>
<tr>
<td>Total</td>
<td>2,900.0</td>
</tr>
</tbody>
</table>

Sources: IMF (Fiscal Monitor, October 2019); World Bank staff estimates.

Despite significant progress in lowering public sector debt, pressures on the balance of payments are likely to continue in the medium term. Although the current account deficit is expected to gradually narrow in 2020–22, an expected slowdown in commodity prices and a relatively large deficit in the services and income accounts will likely keep the current account in the red in the coming years. Unless further external financing is timely and successfully mobilized, a higher current account deficit could easily translate into a deficit in the balance of payments. Fortunately, no large external debt repayments are due on the public sector side until 2021, except the renewal of the People’s Bank of China (PBOC) swap line with the BoM.\textsuperscript{26} However, a total of US$2.9 billion in sovereign external debt is due in 2021-24 (figure I.40). In addition, delayed implementation of ongoing reforms could affect Mongolia’s sovereign ratings and reduce the odds of refinancing under favorable conditions.

\textsuperscript{25} One key feature of the government’s debt management strategy is to substitute expensive domestic debt with concessional borrowing and foreign debt obtained through refinancing on preferential terms, resulting in a considerable decline in interest payments in 2017–18.

\textsuperscript{26} Expected public debt repayments during 2020–24 include the following: PBoC swap line (US$1.7 billion, due in June 2020), Mazaalai Bond (US$500 million, due in 2021), Gerege Bond (US$800 million, due in November 2022), Chinggis Bond (US$1 billion, due in December 2022), Samurai Bond (US$268 million, due in May 2023), and Khuraldai Bond (US$600 million, due in March 2024).
Table I.2. Key macroeconomic indicators

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019f</th>
<th>2020f</th>
<th>2021f</th>
<th>2022f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, at constant market prices</td>
<td>1.4</td>
<td>5.4</td>
<td>6.8</td>
<td>5.8</td>
<td>5.3</td>
<td>5.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Private Consumption</td>
<td>-2.2</td>
<td>5.3</td>
<td>6.2</td>
<td>6.3</td>
<td>6.2</td>
<td>6.3</td>
<td>6.4</td>
</tr>
<tr>
<td>Government Consumption</td>
<td>10.6</td>
<td>-1.8</td>
<td>0.5</td>
<td>14.0</td>
<td>13.2</td>
<td>4.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Gross Fixed Capital Formation</td>
<td>0.5</td>
<td>35.6</td>
<td>22.4</td>
<td>16.0</td>
<td>11.0</td>
<td>8.7</td>
<td>9.3</td>
</tr>
<tr>
<td>Exports, Goods and Services</td>
<td>13.8</td>
<td>14.8</td>
<td>13.4</td>
<td>4.6</td>
<td>0.6</td>
<td>4.4</td>
<td>6.5</td>
</tr>
<tr>
<td>Imports, Goods and Services</td>
<td>12.7</td>
<td>24.8</td>
<td>20.8</td>
<td>7.1</td>
<td>4.0</td>
<td>5.9</td>
<td>7.7</td>
</tr>
<tr>
<td>Real GDP growth, at constant factor prices</td>
<td>1.2</td>
<td>5.3</td>
<td>7.2</td>
<td>5.8</td>
<td>5.3</td>
<td>5.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Agriculture</td>
<td>6.2</td>
<td>1.8</td>
<td>4.5</td>
<td>4.5</td>
<td>4.4</td>
<td>4.4</td>
<td>5.0</td>
</tr>
<tr>
<td>Industry (incl mining)</td>
<td>-0.4</td>
<td>0.7</td>
<td>7.4</td>
<td>3.4</td>
<td>3.1</td>
<td>5.6</td>
<td>5.5</td>
</tr>
<tr>
<td>Services</td>
<td>1.1</td>
<td>7.7</td>
<td>5.0</td>
<td>6.8</td>
<td>6.2</td>
<td>6.0</td>
<td>6.7</td>
</tr>
<tr>
<td>Inflation (CPI, end-period)</td>
<td>0.9</td>
<td>6.4</td>
<td>8.1</td>
<td>5.2</td>
<td>6.2</td>
<td>7.0</td>
<td>7.3</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td>-6.3</td>
<td>-10.2</td>
<td>-16.9</td>
<td>-12.5</td>
<td>-11.9</td>
<td>-10.9</td>
<td>-9.8</td>
</tr>
<tr>
<td>Financial and Capital account (% of GDP)</td>
<td>7.6</td>
<td>23.4</td>
<td>16.7</td>
<td>17.4</td>
<td>12.1</td>
<td>11.0</td>
<td>7.4</td>
</tr>
<tr>
<td>Net Foreign Direct Investment (% of GDP)</td>
<td>1.1</td>
<td>12.7</td>
<td>16.4</td>
<td>15.4</td>
<td>13.1</td>
<td>12.1</td>
<td>8.8</td>
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<tr>
<td>Fiscal Balance (% of GDP)**</td>
<td>-15.3</td>
<td>-3.8</td>
<td>2.6</td>
<td>1.4</td>
<td>-1.9</td>
<td>-0.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Primary Balance (% of GDP)</td>
<td>-10.1</td>
<td>-1.3</td>
<td>5.8</td>
<td>3.7</td>
<td>0.3</td>
<td>1.9</td>
<td>2.7</td>
</tr>
<tr>
<td>Debt (% of GDP)***</td>
<td>87.6</td>
<td>84.7</td>
<td>73.3</td>
<td>68.2</td>
<td>65.2</td>
<td>60.0</td>
<td>57.9</td>
</tr>
</tbody>
</table>

* In 2016, Net FDI number excluded the transactions of OT-2 project financing in May-June, 2016.
** DBM spending is excluded from fiscal balance and monitored separately.
*** General government debt data excludes SOE’s debt and central bank’s liability from PBOC swap line.

**Risks**

The economic outlook, while positive, is subject to considerable political and macroeconomic risks. The major risks from domestic and external sources include (a) political uncertainty due to the 2020 election, (b) the potential impact of the U.S.A.-China trade deal on the demand for Mongolia’s key export commodities (particularly copper and coal), (c) climate shocks (drought/flooding, harsh winter), (d) renewal of bottlenecks at the border with China, (e) limited progress on recapitalization of the banking sector, (f) impact of the recent inclusion of Mongolia in the “gray listing” of the Financial Action Task Force, and – most recently - (g) the impact of the coronavirus epidemic. In the short run, pre-election fiscal spending increases (due to an accelerated capital budget execution in Q4 2019 and a relatively less stringent 2020 budget), a decline in confidence following Mongolia’s recent “gray listing,” and concerns over the banking sector, could increase the demand for U.S. dollars and put pressure on limited international reserves. In addition, the government’s decision to write off pension-backed loans is a threat to recent fiscal gains (box I.6). Over the medium term, political uncertainty and its impact on economic management, the large external financing requirements during 2020–24, and potential negative external trade shocks present the highest risks. Moreover, given strong trade and investment links with China, additional downside risk to economic outlook would depend on the magnitude and duration of the impact of coronavirus outbreak in China. Some possible transmission channels to the Mongolian economy could be through a decline in commodity prices and demand, and a slowdown in activities such as tourism and meat processing following the closing of key border posts with China. Some signs of pressures recently observed on food prices may be fueled by panic related to the perceived risk of the coronavirus epidemic spreading to Mongolia. On the positive side, progress on the U.S.A-Mongolia trade agreement following the July 2019 visit of the Mongolian president to the U.S.A could help support investor confidence.
Box I.6. The macro-fiscal implications of writing off loans of pensioners

The National Security Council recently announced the decision to write off pension-backed loans. The Council argued that its decision aims to improve the inclusiveness in sharing the proceeds of the country’s natural resources as indicated in one of key amendments to the constitution, approved in December 2019. In January 2020, the Parliament passed two laws describing the pension loans forgiveness and its implementation strategy. According to the approved laws, pension loans up to MNT 6 million (about US$2200) will be written off. In addition, pensioners with no pension-backed loans will be eligible to receive securities equivalent to MNT 1 million (US$365) which can be liquidated starting from May 2021. Regarding the funding scheme, Erdenes Mongol LLC (a state-owned enterprise) is expected to issue a MNT 900 billion bond (US$330 million) collateralizing future proceeds from one of its mines (Salkhit silver mine). The bond would be swapped for the outstanding pension loans with the commercial banks. The banks can make repurchase agreements (usually called repos) with the central bank, and any potential loss incurred by the central bank in relation to this bond is expected to be compensated by the government. While the goal of increasing inclusion in Mongolia is laudable, the proposed write-off has several drawbacks.

Central bank financing of any public sector losses incurred in the above transaction can be viewed as a resumption of quasi-fiscal activities, against the principles of the central bank law. According to the newly approved law on the one-time paying off of pension-backed loans by the State (Clauses 5.4 and 5.7), the central bank can buy including through open market operations, the corporate bond issued by Erdenes Mongol to write-off the pension loans. This could contravene the principles of the central bank law on quasi fiscal activities and the spirit of the commitments made under the Economic Recovery Program. The quasi-fiscal costs of fully monetizing the bond issue could be up to 2.5 percent of GDP.

The implementation of the above scheme would pose substantial risks to the fiscal gains of the past two years. Since the government is liable to compensate for any loss by the central bank incurred on the bond, it adds to the government’s contingent liability. Moreover, borrowing against future mining revenues is also ill-advised, given the volatile nature of commodity prices. In case of a loss in the value of the bond in 2020, it would most likely create a burden on the budget for 2021, and the fiscal gains of 2018 and 2019 could be eroded.

Note: a. A five-year bond of MNT 900 billion with a 6 percent annual coupon rate would be guaranteed by the Development Bank of Mongolia. The weighted average interest rate or return on outstanding pension loans is 17 percent, and the central bank’s policy rate is 11 percent as of end-2019. In addition, the approved law indicates that to reduce the above interest rate differential, the government can deposit at subsidized rates its social insurance fund reserves in commercial banks with pension loan assets. b. Repurchase agreements (repos) are instruments used by the central bank to address commercial bank short-term liquidity issues. The maximum maturity in Mongolia is 12 weeks.

Significant vulnerabilities remain. The most important vulnerabilities pertain to the path for GDP growth, as well as fiscal and monetary policy management and the impact on the exchange rate. Slower economic growth or a higher real exchange rate depreciation could push the debt-to-GDP-ratio back above 80 percent in the medium term. Mongolia’s net international investment position remains weak, primarily reflecting limited foreign assets at the central bank (gross foreign exchange reserves are only 25 percent of GDP) and very high external debt (which has risen to 240 percent of GDP from just 40 percent in the last 10 years). Moreover, Mongolia faces substantial external debt repayments amounting to US$14.3 billion during 2020–24, of which 34 percent is public sector debt including a US$1.8 billion swap line from China coming due in 2020. The conditions under which these debts can be rolled over are critical to the country’s balance-of-payments outlook and long-term debt sustainability.
Box I.7. Global and regional outlook and risks

Global growth in 2019 has been downgraded to 2.4 percent, 0.2 percentage points below previous forecasts, reflecting continued weakness in global trade and investment. Growth is projected to gradually rise to 2.5 percent by 2020 as investment and trade gradually recover. These estimates pre-date the coronavirus outbreak, the impact of which has not yet been fully assessed.

Global economic conditions are expected to improve marginally over a longer forecast horizon, with the global growth rate projected to increase to 2.6 percent in 2021 and to 2.7 percent in 2022. After slowing to 1.4 percent in 2020, growth in advanced economies is projected to improve slightly to 1.5 percent in both 2021 and 2022. Growth in emerging market and developing economies (EMDEs) is expected to recover over the next two years. This projection is predicated on a rebound in several large EMDEs, some of which are emerging from deep recessions or sharp slowdowns but remain fragile.

Global economic conditions are expected to remain challenging over the forecast period. A further escalation of trade tensions involving major economies could lead to a sharp increase in trade barriers and weigh on confidence and investment. Global financing conditions are expected to remain volatile, even if generally more supportive. This reflects the fact that major central banks have provided accommodation in response to softening economic prospects. However, EMDEs with low credit ratings have not benefited from the global decline in borrowing costs. Portfolio outflows resumed in the second half of last year. A rising share of EMDE currencies are at their lowest level against the U.S. dollar in a decade.
Financial market volatility will continue to have the strongest impact on countries with high vulnerabilities, weak growth prospects, and elevated policy uncertainty. Oil prices averaged US$60 per barrel in 2019, a 12 percent decline from 2018 and 9 percentage points below previous projections, with production cuts by the Organization of the Petroleum Exporting Countries (OPEC) and its partners. Oil prices are expected to decline slightly to an average of US$59 per barrel in 2020–21, with high uncertainty around the outlook (figure I.42). Prices for most base metals weakened in the second half of 2019, primarily reflecting weaker global growth and elevated trade tensions. Despite subdued industrial commodity demand, metals prices are expected to decline further in 2020. Agricultural prices declined in the second half of 2019 on improved weather conditions and elevated stock levels for grains. Agricultural prices are expected to stabilize in 2020, with risks to the forecast broadly balanced.

Growth in the region is projected to slow from an estimated 5.8 percent in 2019 to 5.7 percent in 2020, and to moderate further to 5.6 percent in 2021–22 (figure I.43). Easier financing conditions and fiscal policy support will partly mitigate the negative impact of ongoing trade tensions and associated policy uncertainty. In China, growth is expected to slow gradually, from an estimated 6.1 percent in 2019, to 5.9 percent in 2020, and to 5.7 percent by 2022. In the rest of the region, growth is expected to slightly recover to 4.9 percent in 2020 and firm further to 5 percent in 2021–22. Downside risks to regional growth have intensified. They include a contraction in global trade due to a further escalation of trade tensions; a sharper-than-expected slowdown in major economies; and a sudden reversal of capital flows due to an abrupt deterioration in financing conditions, investor sentiment, or geopolitical relations. An upside risk to the forecast is the possibility of a de-escalation of trade tensions between the United States and China, which would likely boost regional trade.

Risks to the outlook. Global growth, which weakened to an estimated 2.4 percent in 2019, is projected to edge up to 2.5 percent this year, following an expected recovery of trade and investment. However, risks to the global outlook are firmly on the downside. Rising trade barriers and protracted policy uncertainty could further weigh on global activity. Amid financial sector vulnerabilities, major economies could slow more than expected. EMDEs remain at risk of financial stress, especially those with elevated debt, while some EMDE regions could be affected by geopolitical tensions, social unrest, large swings in commodity prices, or increasingly volatile weather patterns. On the upside, progress in the resolution of ongoing trade tensions could mitigate global policy uncertainty and bolster activity.


Note: a. This box was prepared by Ekaterine Vashakmadze, Senior Country Economist, World Bank.
II. UNDERSTANDING MONGOLIA’S BANKING SECTOR
CREDIT DEVELOPMENT

Private sector credit growth in Mongolia has recently moderated. But the rapid credit expansion in the past several years and the slow progress on bank recapitalization process call for heightened vigilance. While monetary policy tightening since late 2018 has helped to contain credit growth, further macroprudential measures can be effective to preempt emerging risks. Mongolia will benefit from ongoing efforts to strengthen financial supervision and its macroprudential framework, and to bolster its crisis management and resolution frameworks.

A. Context

The importance of the banking sector has increased over the past decade. Total assets in the banking sector reached 97 percent of GDP in 2019 compared to 56 percent in 2008. Mongolia’s financial sector is highly dominated by the banking system (close to 90 percent as of H1 2019), and consequently, loans from commercial banks are the main financing source for both individuals and businesses. The banking sector consists of 14 banks (now 13 banks with one bank in the resolution process since April 2019) with 1,413 branches and 1 development bank. Total outstanding loans in the banking sector are equivalent to 56.3 percent of GDP in 2019. Meanwhile, total deposits and current accounts (individuals and companies) represent 51 percent of GDP.

In the last decade, Mongolia experienced rapid growth of the banking sector. This was driven by growing incomes from mining resource rents, which generated a greater domestic source of funding and created opportunities for financial intermediation and deepening. Mongolia consequently ranks well in terms of financial sector development among comparable countries in the region (figure II.1).

Mongolia faces structural characteristics that challenge its financial sector development and integrity. These challenges interact with money laundering risks. The Mongolian banking sector is highly concentrated in five large banks, which as of Q3 2019 together held around 87 percent of total banking assets. There are six systemically important banks and seven small banks. The deposit base is narrow and concentrated among a few large clients.

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27 The total financial sector (banks – 88 percent, NBFI’s – 1.4 percent, stock market – 6.6 percent, and insurance market – about 1 percent) accounted for 122 percent of GDP in H1 2019.

28 A bank that holds over 5 percent of the banking system assets for the past 6 months is considered a systemically important bank.
The loan portfolio remains concentrated in five sectors that have strong links with the mining sector. Loan portfolios in these economic sectors account for about half of total loans, while household loans including mortgage, consumption, and salary loans constitute the remaining half. Reflecting a sharp economic downturn in 2015-16, banking sector NPLs rose from less than 3 percent before 2014, to about 9 percent in 2016 and to more than 10 percent in 2018. Despite the subsequent economic recovery, NPLs have remained persistently high, raising questions over the underlying health of the sector. In January 2018, as part of the IMF’s Extended Fund Facility program, third-party auditors completed an Asset Quality Review of the banking sector on behalf of the BoM, which revealed some serious weaknesses in the current supervision practice and raised some red flags.

B. Recent developments in bank credit

B1. Current status of banking sector credit

The credit-to-GDP ratio is lower than the average for upper middle-income countries suggesting some financial deepening potential. The credit-to-GDP ratio averaged over 70 percent in 2016–17, which is comparable to that of the lower-and middle-income groups (64 percent). It is lower than the average in upper middle-income countries but high relative to some of its regional peers (Indonesia, Kazakhstan, and Myanmar) (figure II.2).

The total credit-to-GDP ratio has increased significantly in the past 15 years, driven by consumer loans (figure II.3). The average credit-to-GDP ratio increased from around 30 percent in 2006 to about 40 percent in 2007–12. Then it jumped significantly in 2013 and hovered around 60 percent, reflecting the subsidized housing mortgage program of the BoM. By 2019, individual loans accounted for about 58 percent of total loans, while corporate loans accounted for 42 percent, their respective shares reversed relative to the period before 2013. As housing mortgage loan growth started to decelerate since early 2017, non-mortgage individual loans (especially salary loans) were a key driver of the high growth of individual loans in 2017–18.

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29 Total credit is defined as the credit extended by banking institutions to both firms and households, and the outstanding amount of mortgage credit of the Mongolian Mortgage Corporation.
Mongolia also stands out with high credit growth (figure II.4). Credit growth averaged around 22 percent during 2009–18 compared to 12.1 percent in its peer countries. Moreover, high credit growth was accompanied by weak lending standards, which resulted in excessive leverage (individuals and corporates) asset price bubbles (due to rapid growth of mortgage loans in 2013–15), and relatively high inflation.

Underlying strong average credit growth have been several sharp credit cycles, most recently during the second half of 2018. Mongolia has experienced several episodes of rapid credit expansion in the past, including episodes in 2005–08, 2010–11, and 2013–14 (figure II.5). The recent rapid credit expansion was channeled mainly to individuals (figure II.6). Over the past decade, bank credit in Mongolia has usually been a key driver of domestically financed private investment (total domestic investment excluding government investment) (figure II.7). In 2018, bank credit to the economy grew annually by about 26.5 percent in nominal terms and 15.4 percent in real terms.
A tightening of monetary and credit policies brought the most recent credit boom to a halt in 2019 (figures II.8 and II.9). The BoM’s response to the surge in imports and credit growth in 2018 included a series of macroprudential measures aimed at limiting the debt-to-income ratio, reducing the maturity of non-mortgage household loans, and raising the risk weights on unhedged foreign exchange borrowing. In addition, the BoM adopted a tightening bias in November 2018 as it raised its policy rate by 100 basis points to 11 percent. Partly in response to these policy actions, credit growth to individuals and the private sector fell from its recent peak of 35 percent and 17 percent, respectively, in December 2018, to 4 percent and 6 percent, respectively, in December 2019. Given persistent external pressures, monetary and credit policies will likely need to remain tight.
NPLs are concentrated in the corporate sector, reflecting weak lending standards during previous credit expansions and suggesting underlying financial sector vulnerabilities (figure II.10). The NPL ratio of the corporate sector reached 19 percent, its highest level, during the 2008–09 global financial crisis. But in December 2019, the NPL ratio of the corporate sector approached 18 percent again. Corporate sector NPLs are mainly concentrated in a few risky sectors such as mining, manufacturing, construction, and trade, which are highly vulnerable to a volatile mining sector. By contrast, the NPL ratio of the household sector has been stable at around 3.5 percent over the past four years.

Loan loss provisioning (LLP) remains low for many key sectors. The mining, construction, trade, and real estate sectors account for over 80 percent of total NPLs, but LLP of these sectors ranged between 71 and 76 percent as of December 2019. However, manufacturing sector LLP stood at 83 percent. Meanwhile, pension loans have exhibited LLP equaling or exceeding 100 percent (figure II.11).

Figure II.10. Provisioning remains below average for many key sectors

<table>
<thead>
<tr>
<th>Sector</th>
<th>LLP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate loans</td>
<td>79%</td>
</tr>
<tr>
<td>Other</td>
<td>70%</td>
</tr>
<tr>
<td>Trade</td>
<td>70%</td>
</tr>
<tr>
<td>Real estate</td>
<td>71%</td>
</tr>
<tr>
<td>Mining</td>
<td>75%</td>
</tr>
<tr>
<td>Construction</td>
<td>76%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>83%</td>
</tr>
</tbody>
</table>

Source: BoM.

Figure II.11. Provision of individual loans increased

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>LLP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total loans</td>
<td>82%</td>
</tr>
<tr>
<td>Salary loans</td>
<td>74%</td>
</tr>
<tr>
<td>Consumption loans</td>
<td>75%</td>
</tr>
<tr>
<td>SMEs</td>
<td>85%</td>
</tr>
<tr>
<td>Mortgage</td>
<td>86%</td>
</tr>
<tr>
<td>Pension loans</td>
<td>131%</td>
</tr>
</tbody>
</table>

Source: BoM.

B2. Main drivers of credit development

Bank deposits, GDP growth, and commodity prices were the key drivers of credit growth. A recent empirical assessment by the BoM and the World Bank used a Vector Autoregression model based on quarterly data spanning 2000–18 to define factors that affect private sector credit growth. It found that commodity prices and economic growth were the strongest contributing factors to private credit growth, reflecting the cyclical characteristic of credit growth. However, the BoM also actively supporting faster credit growth by engaging in quasi-fiscal activities, many of which have since been withdrawn. In this regard, credit growth and macroeconomic shocks

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30 The provision coverage ratio is used to determine how banks are protected from possible losses on nonperforming credits.

31 NPLs for pension loans have been relatively low, which causes high LLPs.

32 To define the main drivers of credit development in Mongolia, a Vector Autoregression model was employed using quarterly data between Q1 2000 and Q4 2018. The endogenous variables included real GDP; real deposits; real credit; the nonperforming loan ratio; the interbank market rate; the nominal effective exchange rate; and the exogenous variable, the export price index. The main results, including the impulse response functions and variance decomposition, are shown in the annex.
have been closely intertwined, often feeding on each other to amplify the boom and bust cycles in Mongolia.

**B3. Growing importance of non-bank financial institutions**

Risks from volatile credit growth in Mongolia are further complicated by the growing importance of non-bank financial institutions (NBFIs) (figure II.12). While banks are the main providers of private credit, loans by NBFIs increased as a share of GDP from 1.2 percent in 2010 to about 3.7 percent in September 2019 (loans increased by almost 13 times, from about MNT 100 billion to about MNT 1.3 trillion during this period). While this sector is too small to constitute a systemic risk, vulnerabilities of NBFIs should be closely monitored and addressed, as NBFIs largely serve the riskier part of the population.33 Particularly, following the macroprudential measures by the BoM since mid-2018, credit (especially individual loans) may have gradually migrated to the less regulated non-banking sectors, including NBFIs. Thus, regulation and supervision of the NBFIs need to be strengthened and, if possible, coverage of macroprudential limits should be expanded to NBFIs.

**C. Sectoral allocation**

**C 1. Household sector**

Individual credit is dominated by mortgage loans and overdrafts. With the housing mortgage program, mortgage loans have risen sharply since 2013 (figure II.13). The share of outstanding mortgage loans in total household credit reached 51.5 percent in 2016 before moderating to 38 percent in 2019. Salary loans have become a key driver of individual loans (26 percent of individual loans in 2019) (figure II.14). Pension and other consumption loans have also picked up since late 2016. Consequently, the average household debt-to-income ratio was estimated at over 90 percent at the end of 2018, up from 39 percent in 2012, reflecting a substantial increase in household loans. However, with macroprudential measures, the growth of individual loans has sharply decelerated since early 2019. Meanwhile, loans to household small businesses or small and microenterprises decreased substantially over 2010–17, as most banks opted to extend consumption loans (mainly salary), given a higher return and limited risk. However, with macroprudential measures on consumption loans, small and microenterprise loans have recently increased again.

33 NBFIs provide loans to the segment of the population that does not meet bank requirements or requirements for small and medium-sized enterprise loans. Hence, they usually issue vehicle loans, leases, and business loans.
Macroeconomic Stability and Credit Growth

Figure II.13. A large part of outstanding individual credit is for mortgage and salary loans

<table>
<thead>
<tr>
<th>Composition of outstanding individual loans (in percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Others</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>2008</td>
</tr>
<tr>
<td>2009</td>
</tr>
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<td>2010</td>
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<td>2011</td>
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<td>2017</td>
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<td>2018</td>
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<td>2019</td>
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</tbody>
</table>

Source: BoM.

Figure II.14. Salary loans have been a key driver of individual credit growth since 2016

<table>
<thead>
<tr>
<th>Contribution to annual growth of individual loans (in percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage incl RMBS</td>
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<tr>
<td></td>
</tr>
<tr>
<td>2012</td>
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<tr>
<td>2013</td>
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<td>2014</td>
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<td>2015</td>
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<tr>
<td>2018</td>
</tr>
<tr>
<td>2019</td>
</tr>
</tbody>
</table>

Source: BoM.

Note: RMBS = residential mortgage-backed securities; SMEs = small and microenterprises.

C2. Private sector

Corporate credit has increased sharply since mid-2018 amid an economic recovery and the BoM’s efforts to contain individual loans. However, sectors with a higher share of GDP receive a smaller share of credit (figures II.15 and II.16). Corporate credit growth to the trade and mining sectors accelerated (16.2 and 20.2 percent, respectively) in 2019. Although accounting for a total of 44 percent of GDP in 2018, the mining, agriculture, and manufacturing sectors held about 35 percent of total corporate credit in 2019. The trade (wholesale/retail) and construction sectors held 43 percent of total credit while accounting for only 13 percent of GDP.

Figure II.15. Corporate credit is concentrated in the mining and mining-related sectors

<table>
<thead>
<tr>
<th>Composition of outstanding corporate loans, by sector (in percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>2002</td>
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<td>2003</td>
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<td>2017</td>
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<tr>
<td>2018</td>
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<tr>
<td>2019</td>
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</tbody>
</table>

Source: BoM.

Figure II.16. Corporate credit growth has been dominated by trade and mining activities since early 2018

<table>
<thead>
<tr>
<th>Contribution to annual growth of corporate loans, by sectors (in percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining</td>
</tr>
<tr>
<td>2015Q1</td>
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<tr>
<td>2015Q2</td>
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<tr>
<td>2015Q3</td>
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<tr>
<td>2015Q4</td>
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<tr>
<td>2016Q1</td>
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<tr>
<td>2016Q2</td>
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<td>2016Q3</td>
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<td>2016Q4</td>
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<td>2017Q1</td>
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<td>2017Q3</td>
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<td>2017Q4</td>
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<tr>
<td>2018Q1</td>
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<td>2018Q2</td>
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<td>2018Q3</td>
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<td>2018Q4</td>
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<tr>
<td>2019Q1</td>
</tr>
<tr>
<td>2019Q2</td>
</tr>
<tr>
<td>2019Q3</td>
</tr>
<tr>
<td>2019Q4</td>
</tr>
</tbody>
</table>

Source: BoM.

Persistent tugrug depreciation and implementation of macroprudential measures have led to a sharp reduction in foreign currency lending. In fact, with the economic difficulties during 2013–16, the tugrug depreciated significantly, resulting in substantial losses for unhedged borrowers. Accordingly, the credit dollarization has constantly declined since 2009 except for a brief period in 2017-18 (figure II.17). The share of total foreign currency loans dropped to 9.5 percent at the end of 2019, from 33 percent in 2013.
Credit dollarization has been declining for both corporate and individual borrowers (figure II.18). Almost all individual loans (99 percent as of the end of 2019) were issued in the local currency, reflecting the fact that mortgage and salary loans dominated individual loans. Meanwhile, about 21 percent of corporate loans were denominated in foreign currency as of December 2019, substantially down from about 40 percent in Q3 2016. This reflects the persistent depreciating trend of the tugrug and macroprudential measures introduced since September 2018 (for example, greater risk weights for foreign exchange loans).

### C3. Credit concentration

Another characteristic of credit in Mongolia is its concentration in a limited number of firms. The majority of total credit in the banking system went to only a few large companies. Only 13 percent of total corporate borrowers acquired more than 80 percent of the total outstanding corporate loans (figure II.19). Basically, corporate loans are heavily concentrated in a few large companies, which indicates serious risk of exposure to a limited number of borrowers.

Moreover, a significant majority of individual borrowers have taken more than half of the total individual loans. Over 90 percent of the total household borrowers have acquired credit up to MNT 20 million (about US$7,500), representing about 60 percent of the total outstanding individual loans. In contrast, only 10 percent of the individual borrowers own about 40 percent of the loans (figure II.19).

Also, only a minority of individuals own more than half of bank individual deposits, pointing to banks’ dependence on a few large depositors. In fact, on average, only 1 percent of household depositors holds deposits exceeding MNT 20 million (US$7,500). This exposes banks to the risk of sudden shifts in their deposit base (figure II.19).  

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34 An additional risk for high concentration in the banking sector is related party lending whereby bank owners are also the biggest borrowers and the biggest depositors. In fact, amendment of the banking law in January 2018 indicates that a related party’s loan should not exceed 5 percent of the bank’s own capital and total loans to a related party and to his/her related parties in total should not exceed 20 percent of the bank’s own capital.
Figure II.19. Loan and deposit concentration by allocation and client

Over 80 percent of total credit in the banking system went to only a few large companies...

Corporate loans by loan size

- Above MNT 1 bn: 84%
- Up to MNT 1 bn: 16%

Structure of corporate borrowers, categorized by the size of their loans

- Above MNT 1 bn: 13%
- Up to MNT 1 bn: 87%

Over 90 percent of individual borrowers were only eligible for small loans (up to MNT 20 million or about US$7,500) from the banks...

Individual loans by loan size

- Above MNT 100 mn: 16%
- MNT 50-100 mn: 7%
- MNT 20-50 mn: 19%
- Up to MNT 20 mn: 58%

Structure of individual borrowers, categorized by the size of their loans

- Above MNT 100 mn: 0%
- MNT 20-50 mn: 5%
- MNT 50-100 mn: 5%
- Up to MNT 20 mn: 94%

Only 1 percent of depositors each hold deposits over MNT 20 million (US$7,500), reflecting an unequal distribution of bank deposits...

Household sector: Size of deposits

- Above MNT 20 mn: 62%
- Up to MNT 20 mn: 38%

Household sector: Number of depositors

- Above MNT 20 mn: 1%
- Up to MNT 20 mn: 99%

Sources: BoM; World Bank staff estimates.
Note: bn = billion; mn = million.
D. Credit cycle and business cycle

Adequate credit management is crucial to economic growth as credit and GDP growth rates are generally closely correlated in Mongolia (figure II.20 and box II.1). Credit development in Mongolia was largely driven by economic recoveries at the end of 2005, the beginning of 2010, and 2017. In 2011, however, a greater inflow of FDI was a key factor. Since 2013, the government subsidized mortgage program fueled credit growth. More recently, non-mortgage consumer loans were the key driver of credit growth (box II.1). Overall, financial cycles seem to be more persistent, with a larger amplitude compared to business cycles. This is consistent with the literature regarding other emerging and developing countries, which shows a strong co-movement between business and credit cycles (figure II.21).

Box II.1. Credit booms in Mongolia

Fluctuations in commodity prices and capital flows have driven three credit booms since early 2000. The government decided to grant mining licenses for several large coal and copper deposits including Oyu Tolgoi (OT) and Tavan Tolgoi (TT) after the 2009 global financial crisis. These factors resulted in a surge in FDI, particularly to the mining sector.

High domestic demand triggered by high copper prices and public sector salaries drove the credit boom in 2008. Favorable global copper prices during 2004–08 not only increased export revenue but also supported raising public sector wages through a higher tax income. Consequently, the private sector raised its wages. With rising wages, households expanded their consumption and acquired greater salary loans, which resulted in a significant rise in domestic purchases that later boosted domestic investment and output. Thus, the private sector’s demand for credit also increased.

Substantial quasi-fiscal activities of the government resulted in a credit boom in 2014. Unlike the previous credit boom in 2008, Mongolia faced negative external shocks in 2014, on both the trade and financial sides of the balance of payments. Since the second half of 2013, global commodity prices started to decline due to the slowdown in Chinese demand, coinciding with a significant drop of FDI in the mining sector. As a result of these negative shocks, net foreign assets shrunk by 12 percent in 2013.
To mitigate the negative impacts of those shocks and support the economy, the authorities decided to loosen the monetary and fiscal stance. For instance, the monetary policy rate was decreased by 75 basis points in January and by 100 basis points in both April and June of 2013. In addition, under an unconventional monetary policy framework, the BoM implemented “The Pricing Stabilization Program,” with two subprograms: the “Affordable Housing Finance Program,” and the “Price Stabilization Program by removing the supply chain constraints.” Meanwhile, the government issued Chinggis Bonds worth US$1.5 billion at the end of 2012. As a result, M2 increased by 91 percent in 2014. Thus, macroeconomic policies played a main role in the credit cycle of 2014-16.

During 2017-18, excessive liquidity in the banking system and repayment of government domestic bonds created room for renewed household credit expansion. Commodity prices started to increase in the second half of 2016 after almost four years of continuous decline. Higher commodity prices and increasing export volumes supported tax revenues. Moreover, the IMF’s Extended Fund Facility program improved national credibility among foreign investors and gradually attracted FDI. With its commitments to the IMF, the government reduced its expenditures and repaid the domestic bonds with the financial resources from the IMF and other organizations. The excessive liquidity from the bond repayment caused the domestic banks to increase their credit, particularly to the household sector since the end of 2017.

E. Policy recommendations

The following findings emerge from the special topic of this Mongolia Economic Update: (a) credit growth has been excessive and volatile, (b) credit policy was procyclical, (c) household and corporate debt are high, (d) funding and loans are highly concentrated, (e) level of provisioning and savings are low, (f) unconventional credit policies are common, (g) fiscal dominance is observed, and (h) credit allocation and the diversification agenda are not matched.

The significant swings in real economic conditions complicate monetary and financial policies. Large FDI inflows and high commodity prices combined with an accommodative monetary policy and lax supervision have contributed to rapid credit expansion. A significant share of bank lending is channeled to the mining and mining-related sectors (including construction, trade, and real estate) and to individual loans (mainly pension and salary loans). Credit development is highly affected by external shocks, including commodity prices and foreign direct investments through macro-financial links. The rapid credit growth has fueled a sustained rise in real estate prices and imports, leading to the buildup of substantial credit and liquidity risk in the banking system. Ensuring price stability and smoothing out the credit cycle under these conditions is challenging. Coupling traditional monetary policy with appropriate macroprudential policy is therefore warranted.

To address these challenges, the authorities will need a combination of structural and macroeconomic policy tools. To curb excessive and volatile credit growth, monetary policy will need to be carefully calibrated and supported with adequate macroprudential measures. The recent stance of the BoM has helped limit financial sector risks and vulnerabilities and in light

Fiscal dominance is an economic condition that occurs when a country has a large government debt and deficit such that monetary policy targets keep the government from bankruptcy, as opposed to economic targets such as inflation, growth, and employment. Over the period of study, we noticed that risks of fiscal dominance or pressure on a central bank to take actions that are not in line with the inflation objective appear high. For instance, government domestic borrowing in the period of 2013-16 affected credit dynamics which crowded out the private sector to some extent.
of continuing external vulnerabilities should be continued, whilst focusing on keeping inflation close to the BoM’s target. Fiscal policy also will have an important role to play in complementing monetary and macroprudential measures to smooth out excessive economic volatility. Over the medium term, Mongolia may benefit from designing a more holistic macroprudential framework. On the structural side, upgrading prudential standards in line Basel III requirements is a priority, to strengthen the BoM’s surveillance framework, together with steps to strengthen the regulator’s capacity and political independence. Moreover, in light of persistent NPLs and the identified capital shortfalls, completing the bank recapitalization program as foreseen under the ERP will be critical to strengthen financial sector resilience.

Table II.1. Mongolia: Managing credit growth volatility - some policy options

<table>
<thead>
<tr>
<th>Policy Areas</th>
<th>Policy Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>MACROECONOMIC POLICIES</td>
<td></td>
</tr>
<tr>
<td>Monetary Policy</td>
<td>Set policy rate is at the appropriate level to stem credit growth volatility while maintaining price stability</td>
</tr>
<tr>
<td>Fiscal Policy</td>
<td>Implement countercyclical fiscal policies to mitigate boom and bust cycle</td>
</tr>
<tr>
<td>PRUDENTIAL POLICIES</td>
<td></td>
</tr>
<tr>
<td>Banking and NBFIs</td>
<td>Complete implementation of adequate requirements of Basel II and III to meet the appropriate capital requirements</td>
</tr>
<tr>
<td>Regulation, Supervision, and Resolution</td>
<td>Enhance the relevant regulations and supervision of NBFIs in line with commercial banks</td>
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<tr>
<td></td>
<td>Improve a framework to monitor and measure links among financial institutions (banks and NBFIs)</td>
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<td></td>
<td>Strengthen the monitoring of corporate loans given the high level of NPLs in the private sector, and develop appropriate macroprudential and supervision tools</td>
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<td></td>
<td>Diversify credit portfolio by reviewing sector concentration</td>
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<td>Utilize micro level data including the credit information bureau in macroprudential analysis and streghten top-down stress testing</td>
</tr>
<tr>
<td>Crisis Preparation and Management Framework</td>
<td>Strengthen the financial system oversight framework including Financial Stability Committee by addressing priority risks and improving existing crisis prevention system and procedures</td>
</tr>
</tbody>
</table>

Note: NBFIs = non-bank financial institutions.
Annex: Estimating the drivers of bank credit in Mongolia

To define the main drivers of credit in Mongolia in the short and medium term, a Vector Autoregressive (VAR) model with 2 lags is estimated on quarterly data between Q1 2000 and Q4 2018.\textsuperscript{36} The VAR consists of endogenous variables that include real gross domestic product (GDP), real deposits, real credit, the nonperforming loan ratio, the interbank interest rate, the nominal effective exchange rate, and an exogenous variable of the export price index. The estimation results reveal that total credit increases due to higher export prices, GDP, total deposits, and the nominal effective exchange rate (appreciation of the domestic exchange rate), while it decreases following a hike in the policy rate and increases in nonperforming loans (NPLs) (figure A.1).

Figure A.1. Impulse response of total credit to selected shocks

<table>
<thead>
<tr>
<th>Response to export price index</th>
<th>Response to GDP</th>
<th>Response to total deposit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Response to NEER</td>
<td>Response to policy rate</td>
<td>Response to NPLs</td>
</tr>
</tbody>
</table>

Sources: BoM and World Bank staff calculations.
Note: Dotted lines are asymptotic 1 standard deviation confidence bands; NEER = nominal effective exchange rate; NPLs = nonperforming loans.

Variance decomposition shows that credit in Mongolia is mainly explained by fluctuations in deposits (figure A.2). For instance, total deposits explain 70.9 percent of the fluctuations in total credit. This is consistent with the fact that about 90 percent of the financial market consists of the banking sector, and deposit rates in Mongolian banks are relatively high (around 12 to 18 percent) and inflexible due to a high concentration of deposits in the hands of only a few depositors. In the short term, bank credit seems highly sensitive to the volatility of commodity prices, which explains the 6.6 percentage point variations in the past. As the economy is highly dependent on the mineral sector, bank credit is strongly caused by commodity prices.

\textsuperscript{36} Lag length criteria show different results; some criteria select 1 lag, some criteria select 2 lags, and some criteria select 3 lags. A lag of 2 was chosen following the empirical studies conducted on Mongolian data.
For instance, it was estimated that a 1 percentage point positive shock in the export price index could boost bank credit by up to 2.4 percent within three quarters, explaining 12 percent, on average, of the variations of total credit.

The variance decomposition analysis suggested that real GDP shock explains about 10 percent of the credit fluctuations. For instance, a 1 percentage point positive shock in real GDP could expand bank credit by around 0.4 percent after one quarter shock observed, sustaining the effect in the medium term.

Monetary policy also played a critical role for bank credit development. The policy rate shock explained about 3.4 percent of the variations in total credit.

The NPLs and exchange rate fluctuations are also important factors for bank credit. It is found that a 1 percentage point increase in the NPL ratio decreases bank credit by up to 1.5 percent in the short term, while the nominal exchange rate shock explained 3.4 percent of the historical variations of bank credit.
REFERENCES


