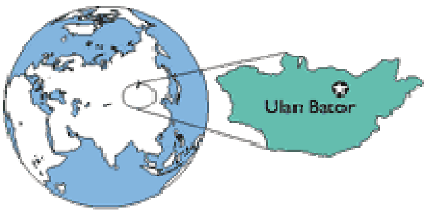
COUNTRY REVIEW

Mongolia



6 April 2011

ANALYST: Dr. Manfred Stamer

EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest risk.

COUNTRY PROFILE

Capital city:	Ulan Bator (Ulaanbaatar)
GDP:	USD 4,203 mn (2009e)
Population:	2.71 mn (2009e)
GDP per capita:	USD 1,551 (2009e)
Currency:	Togrog / tugrik (MNT)
Form of state:	Parliamentary democracy
Head of government:	Prime minister Sukhbaatar BATBOLD (since October 2009)
Next elections:	Legislative: June 2012 / Presidential: May 2013

Politics has at times been turbulent since Mongolia turned to democracy in the early 1990s. The ex-Communist Mongolian People's Party (MPP), which now regards itself as social democratic, won a solid majority in the last parliamentary election in June 2008, gaining 46 of 76 seats, but the results were challenged by the opposition Democratic Party (DP), leading to weeks of uncertainty and violent street clashes and the first imposition of a state of emergency in the country. Political stability returned in late August 2008, when the two sides agreed to form a coalition government, with the DP as the junior partner, but the political scene is likely to remain volatile at least until the next general election, due in June 2012. The structural reform process is expected to remain slow. The outlook for social stability in Mongolia is also uncertain owing to social discontent over the distribution of mineral wealth while the poverty rate remains high, with 36% of the populace living below the internationally accepted "poverty line".

Mongolia's international relations are mostly good, in particular with its major aid donors (US, Japan) and main trading partners: China, which is its major export market (79%) and in 2009 also became the main import market (36%) ahead of Russia (31%), on which Mongolia is reliant for energy imports.

The economy depends heavily on agriculture (accounting for 21% of GDP) and mining (22%), while manufacturing contributes just 6% to GDP. Raw commodities account for over 90% of exports, with copper and gold alone representing about 70%. The economy is particularly vulnerable to severe weather and to fluctuations in world prices for mineral and agricultural products. That exposure became acute following the steep fall in commodity prices in H2 2008 in the wake of the global economic crisis. Both the fiscal and current account balance shifted from solid surpluses in the previous years to large deficits of 4.9% and 14.0% of GDP, respectively, in 2008. In early 2009, the economy was on the brink of collapse: the fiscal deficit could not be financed anymore; foreign exchange (FX) reserves had plunged to just USD0.5bn; the MNT/USD exchange rate had fallen by more than 30% yr/yr; and a systemic banking crisis was looming as the central bank of Mongolia had to assume control of two of the five largest banks (Anod Bank and Zoos Bank).

An 18-month Stand-By Arrangement (SBA) with the IMF was agreed in April 2009, the successful completion of which has stabilised the economy in the meantime, though substantial risks have remained. Real GDP growth slipped from an average annual 8.7% in 2003-2008 to -1.3% in 2009, but rebounded to an estimated 6% in 2010. A further acceleration in 2011-2012 is likely thanks to higher commodity prices and new mining projects.

Mongolia has a history of pro-cyclical macroeconomic policies and, following the completion of the SBA with the IMF, a return to this risky policy strategy appears likely. The 2011 budget implies a 7% of GDP increase in spending—inconsistent with a Fiscal Responsibility Law adopted in 2010, according to the IMF—that will shift the 2010 fiscal surplus (1.2% of GDP, including grants) back into a deficit of 3-4% of GDP in 2011. Moreover, the fiscal loosening will fuel inflation which has already surged from just 1.8% at end-2009 to 14.3% at end-2010 on the back of rising food prices. Monetary policy is not appropriate as the policy interest rate (currently 11%) has not been increased in line with inflationary pressures. As a result, domestic credit growth has soared again to 35% yr/yr in January 2011, fuelling import growth and the widening of the current account deficit from 9% of GDP in 2009 to 15.2% in 2010. However, the MNT/USD exchange rate has recovered and stabilised, to date.

Data on total public debt, which is largely external, is ambiguous, ranging between 45% and 60% of GDP in 2009 according to different sources. However, external public debt-service will be low in the next few years because most of the debt was contracted on concessional terms and is long-term in structure. Private non-guaranteed external debt is reportedly very low at about USD100mn. FX reserves have recovered to about USD2.2bn at end-2010 (covering over four months of imports).

The banking sector has not yet been restructured and remains weak, reflected in a high level of non-performing loans, dubious asset quality and deteriorating profitability. The restructuring cost is estimated at about 6.5% of GDP.

Overall, macro-economic risk remains high, especially external liquidity risk. Mongolia's heavy reliance on foreign aid to finance its large fiscal and current account deficits will be maintained.

The structural business environment is below average. Areas of particular weakness include the still high government participation in the economy, an opaque regulatory framework, a weak rule of law, perceptions of widespread corruption and the underdeveloped financial sector.

Dr. Manfred Stamer **Hamburg: +49 (0)40 8834 3607**