

Mongolia's Debt Crisis and Impact of the IMF Program: Results from a Model of the Mongolian Economy

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KEY MESSAGES

- Mongolia's debt crisis was caused by a combination of wildly over-optimistic revenue projections based on unrealistic expectations of mineral sector revenue growth, off-budget spending and a plethora of small infrastructure projects with questionable economic development benefits.
- The IMF program, while harsh, may help stabilize or even shrink public debt levels, preventing a banking crisis. Full implementation of the program is expected to lead to:
 - A 1 percentage point drop in GDP growth in 2018 relative to the baseline scenario, with growth likely to recover by 2019 and stabilize going forward.
 - Forty-seven thousand fewer jobs by 2021—a decrease of more than 3 percent—relative to the baseline scenario, predominantly in the public sector.
 - The debt-to-GDP ratio falling from 90 percent to almost 50 percent in the long run.
- However, a mere 15 percent drop in mineral prices makes the debt situation worse than today, even with the implementation of the IMF program. This high degree of risk calls for additional debt repayment or supplementary measures.

THE CHALLENGE

The Mongolian economy is going through difficult times. The economy has stagnated in recent years after a short economic expansion. This expansion—driven largely by a debt-financed public spending spree starting in 2011 and extra-budgetary programs financed by the central bank and Development Bank of Mongolia (DBM)—was based on unrealistic expectations of imminently high revenue growth from the mineral sector. Revenue projections from some big mining projects, notably for the Oyu Tolgoi copper-gold deposit and Tavan Tolgoi coal deposit, have proven wildly over-optimistic.

Mongolia's public debt-to-GDP ratio is nearly 90 percent, leading to some of the highest interest rates paid by any government in the world. Service payments on public debt alone were greater than MNT 1 trillion in 2016, more than the government spent on healthcare for the whole country. This year, service payments will likely exceed both health and education budgets. The government is essentially transferring

money to foreign financial institutions and domestic bank shareholders at the expense of greater social spending and public investment. As interest rates continue to rise, the government will have to continue borrowing just to service its debt.

Unsustainably high debt levels do not just matter for government expenditures. They also threaten investor confidence in the economy, lowering growth rates and employment. High debt levels are also unfair to future generations, as they are the ones who will have to repay it one day.

INTERNATIONAL BAILOUT PACKAGE

The Mongolian government recently announced a USD 5.5 billion bailout agreement with the International Monetary Fund (IMF) and other development partners, including the World Bank, the Asian Development Bank and the governments of Japan and South Korea. The Mongolian government has also signed an extension of its central bank swap agreement—essentially a line of credit—with China's central bank.

In return, Mongolia approved a limited and revenue-focused set of reforms. Budget amendments passed in April included increases in personal income tax rates, increases in fuel, alcohol and tobacco taxes, and a public service wage freeze.

In some sense, an agreement with the IMF was necessary. The DBM, a state-owned bank deeply in the red and guaranteed by the government, refinanced USD 580 million in loans from mainly foreign creditors in March. Without an IMF agreement, it was likely that the government would have defaulted on this or the next public sector repayment, which is due in January 2018. Such an event would have cut Mongolia off from international lending and could have precipitated a banking crisis.

Are the reforms tied to the bailout right for Mongolia? Will they turn Mongolia around, setting up the country for long-term growth and prosperity?

THE MACRO-FISCAL MODEL OF MONGOLIA (MMM)— BASELINE SCENARIO

The Natural Resource Governance Institute (NRGI) has recently developed a model comprised of three main sections: a macroeconomic model, a model of mineral sector revenues and a fiscal section, which covers public debt dynamics, among other variables.

The model provides key calculations estimating the relationships among aggregate variables such as consumption, investment, economic output, the interest rate, and domestic and international prices. These estimates are based on a theoretically consistent framework and calibrated using observations of Mongolia's economy between 2000 and 2015.

The mineral sector is modelled from the bottom up. It uses simplified project-level financial models of the country's six largest mines (Oyu Tolgoi, Erdenet, Tsagaan Suvarga, Gatsuert, Erdeness Tavan Tolgoi and Energy Resource), which are then aggregated alongside a linear projection of the remainder of the mineral sector.

The fiscal section provides detailed projections across the main tax and expenditure categories, as well as most important fiscal aggregates, such as various measures of the deficit and debt. The model assesses the country's debt sustainability outlook and the compliance with Mongolia's fiscal rules.

Our current baseline incorporates the originally approved 2017 budget and latest economic developments until Q1 2017. In brief, if current trends continue, we expect debt-to-GDP to remain at current elevated levels until 2030 and grow beyond that period, leading to continued high interest payments to foreign creditors and increasing the risk of sovereign default. Annual GDP growth averages approximately 4 percent in the long run.

IMF PROGRAM IMPACT ON GROWTH, JOBS AND DEBT SUSTAINABILITY

The IMF program calls for three major sets of policy changes:

Excise taxes

- The government will cancel its reduction in fuel excise taxes.
- Excise taxes on alcohol and tobacco will increase by 10 percentage points in 2018 and by another 5 percentage points each in 2019 and in 2020.
- Import duties on tobacco and cigarettes will increase from 5 percent to 30 percent in 2017.
- Excise taxes on older cars are increasing. In addition, excise taxes on hybrid cars and cars with LPG engines are increasing from 0 percent to 50 percent of tax imposed on cars with petrol and diesel engines. This measure may be reversed due to public outcry.

Social security and personal income taxes

- The personal income tax (PIT) rate is changing from a flat rate of 10 percent to progressive rates of 15, 20 and 25 percent. The income brackets are MNT 18, 30 and 42 million a year.
- The lowest income tax bracket is increasing from MNT 84,000 per year to 120,000 in 2018, 160,000 in 2019, 200,000 in 2020 and 240,000 in 2021.
- The social security contribution (SSC) rate is currently 10 percent for employees and 11 percent for employers. These rates are increasing to 11 and 12 percent in 2018, 11.5 and 12.5 percent in 2019 and 12.5 and 13.5 percent in 2020.

Government wage bill

- The government will freeze employee salaries in 2017-18.
- The government will reduce the number of employees over time. In doing so, it will not hire anyone to replace retirees of the public administration and state special services. It will hire one person for every two retirees from the public service sectors such as education, health and defense in 2018-21.

The IMF program also includes non-fiscal elements, such as reform of medical procurement; establishment of an independent fiscal council; review of the banking sector, potentially followed by restructuring or recapitalization of weak banks; and ending the central bank practice of financing off-budget programs (such as the mortgage loan program). These are not analyzed in our model.

IMPACT OF THE IMF PROGRAM

The result of full implementation of the program is expected to lead to a 1 percentage point drop in GDP growth in 2018 relative to the baseline scenario. However, growth is likely to recover by 2019 and stabilize going forward (see Figure 1).

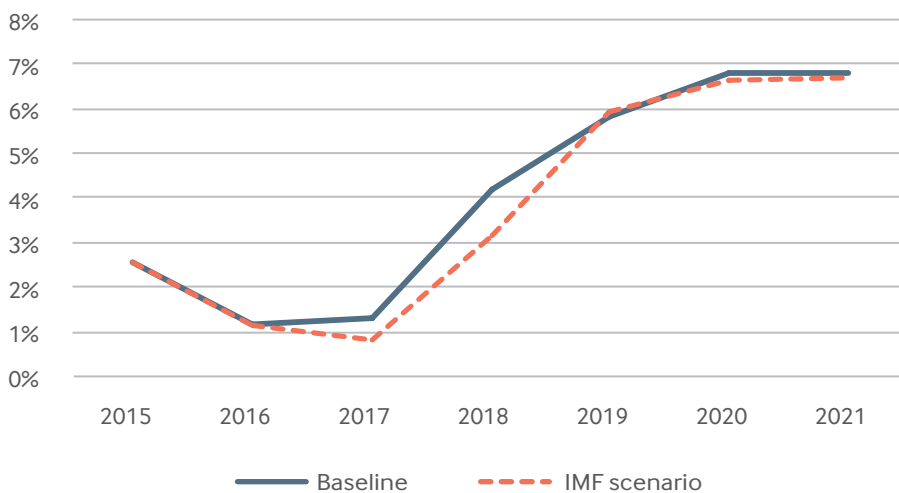


Figure 1. GDP growth rate (%) projections

Full implementation of the program is expected to lead to 47,000 fewer jobs by 2021—a decrease of more than 3 percent—relative to the baseline scenario (see Figure 2). The reduction of jobs is predominantly in the public sector.

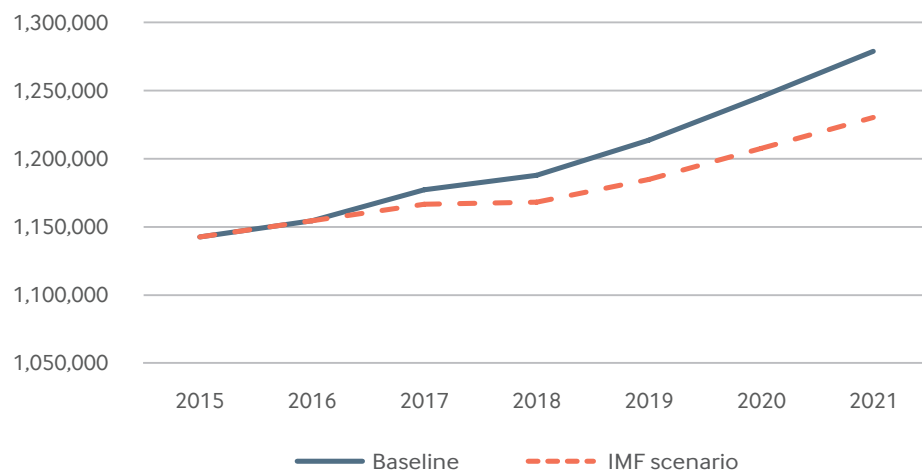


Figure 2. Employment projections

The debt-to-GDP ratio in the IMF scenario falls to almost 50 percent in the long-run (see Figure 3). This is because of the decrease in the budget deficits holds the stock of debt at a relatively constant level. As the economy grows this results in a falling debt-to-GDP ratio.

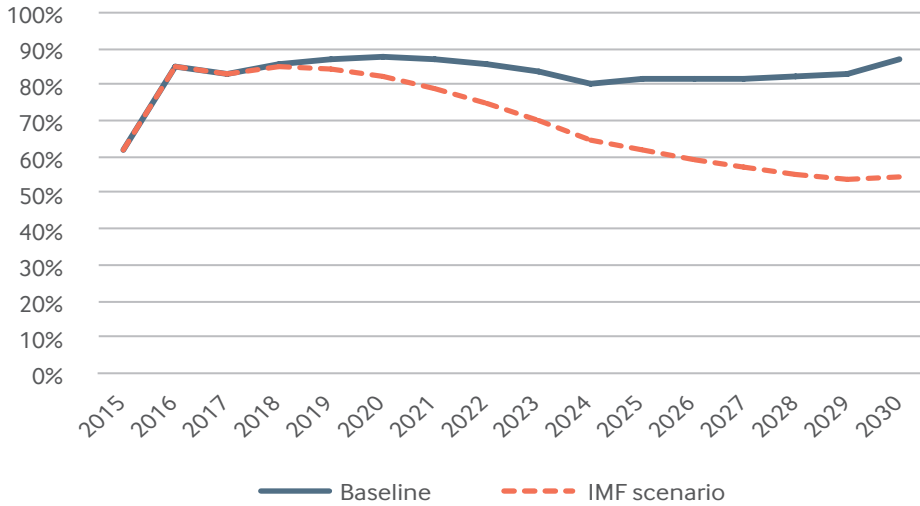


Figure 3. Debt-to-GDP ratio projection

We also modelled the risk of lower mineral prices. A mere 15 percent drop in commodity prices makes the debt situation worse compared to the baseline scenario, even with implementation of the IMF measures (see Figure 4). Therefore, Mongolian policymakers should not be content with the IMF program. They must be very prudent in approving annual budgets and pay down as much public debt as possible if mineral prices remain where they are today or even if they increase.

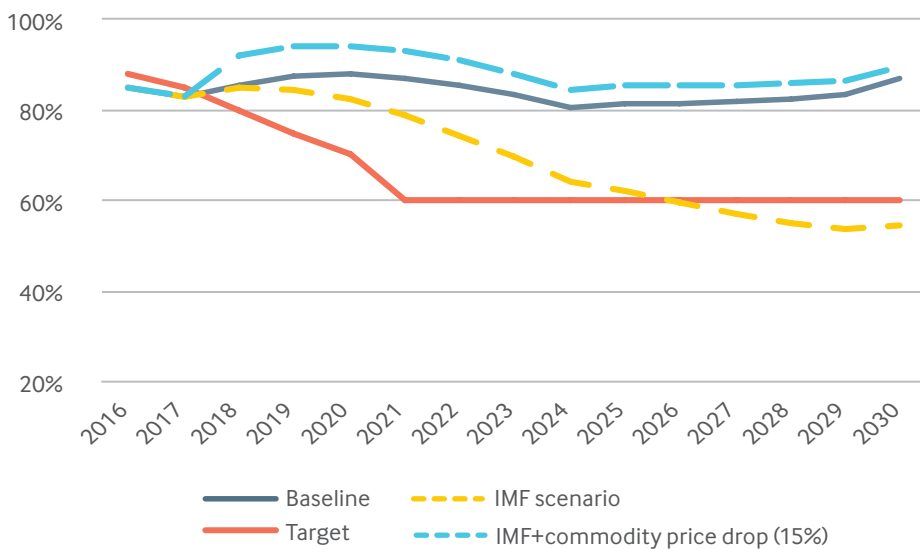


Figure 4. Debt-to-GDP ratio projection under different scenarios

CONCLUSIONS AND RECOMMENDATIONS

- While full implementation of the IMF program is expected to restore debt sustainability and confidence in the sovereign debt of Mongolia—thereby averting default and a banking crisis—these benefits are vulnerable to an unexpected drop in mineral prices.
- Achieving debt sustainability requires full implementation of the IMF program, at a minimum. While the fiscal council should encourage compliance in the long-run, it is up to the government and State Great Hural to enforce the agreement today.
- Over-optimistic revenue projections and off-budget spending, especially by the DBM, enabled government to overspend. Independent budget projections and bringing all spending on-budget, as has been done, can help control government spending.
- The government of Mongolia and State Great Hural may wish to consider reprioritization of government spending in the next budget. Some significant cuts have been made to program and infrastructure spending in 2017, but certain areas of lavish government spending remain—especially on a plethora of politically motivated local infrastructure projects. Cuts to these projects and spending according to a new national development plan may be the key to re-establishing fiscal sustainability.

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