



*Bank of Mongolia*



**BANK OF MONGOLIA**

**INFLATION REPORT**

**2015**

**DECEMBER**

# **Inflation Report**

(December 2015)

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## I. EXECUTIVE SUMMARY

During the first 9 months of this year, US and Euro economies recovered, while growth in China slowed and the downturn of the Russian economy continued. The Chinese economy slowdown reached to 6.9 at the end of the Quarter 3 of 2015, which was slightly higher than projected. Although growth in the service sector intensified, growth of the industrial sector declined due to poor performance of the construction sector, hence imposing decelerating effects on economic growth. As for Russia, drop off in real income caused by unemployment and inflation lead to a decline in the domestic demand. However, in the reporting period, the industrial sector's downswing put on the brakes and a deceleration in economic slowdown was observed. Growth intensified for the last 4 months in the Euro region and for the last 2 quarters in the USA.

The terms of trade continued to deteriorate further in our country due to decreasing export prices and increasing import prices in Q3. Although supply remained constant, weaker demand entailed a slight drop in world prices of all exporting commodities, which are significantly lower level than that of the previous year. MNT to USD exchange rate depreciated by 2 percent in the reporting quarter of 2015, which indicates relatively stable movement. Trade-weighted real effective exchange rate depreciated due to the deterioration of terms of trade and the depreciation of nominal exchange rate.

As for the expected economic growth of the main trading partners, it is expected to remain lower than the average level of the last 10 years within the coming 2 year, which slightly brings down the previous forecasts. Although it is anticipated that growth in Euro zone will stabilize and Russian economy would recover from its downfall, growth in the Chinese economy will continue to decline, which soothes Mongolia's external demand. Given that oil prices remain stable in the coming months and import prices stay unchanged as previously forecasted, prices of main export commodities will continue on their downward trend, and terms of trade will slightly improve as a result of the base period effect.

Growth of the Mongolian economy has been decelerating consecutively for the last 4 quarters, reaching 1.8 percent at the end of the 2015 Q3 and is lower than the potential production level. During the last 2 years, gross domestic production has remained lower than its potential level, meaning the production gap is negative. The mining sector made the biggest contribution of 2.8 percentage points to the economic growth. In contrast, non-mining sector growth contracted by 1.2 percentage points during the last 2 quarters.

In the reporting period, investment continued to contract and export growth decelerated, causing to decline overall growth for the most part. However, a positive contribution was made by the growth in household consumption and contraction in imports, hence leading to the positive net exports. A delay in the commencement of mining new projects due to continued decline in commodity prices, has been bringing down investment in the mining sector. As for the non-mining sector, investment has been also declining as a result of the continued reduction in the banks' new first 9 months, which signifies a y-o-y decline of USD 516.3 million or 98.1 percentage points. This is equal to 0.1 percent of GDP. Banks' lending over the last 5 quarters and contraction in investment financed by the Central Budget and Development Bank of Mongolia.

Housing prices continued to slump over the last 2 quarters, bringing the annual growth at -7.8 percent. Demand for housing purchases is unlikely to recover due to the bank lending contraction and decrease in household real income. Moreover, as of the first 3 quarters of 2015, new mortgage loans declined by 20.5 percent y-o-y. There was no decline in oversupply in housing sector, which can be illustrated by the constant number of unsold apartments also causes the consecutive fall in the housing prices. Labor market conditions deteriorated since the previous quarter. According to the Employment Force Survey, the number of employed population declined in 2015Q3, and the number of registered unemployment increased. Compared to the same quarter of the preceding year, unemployment rate in Ulaanbaatar city rose by 1.8 percentage points, y-o-y, reaching 5.4 percent. Continued contraction in investment over the last 7 quarters has entailed a decrease in labor demand, and is becoming the basis for a downfall projection in employment in the upcoming months.

Annual inflation at national level stood at 4.9 percent at the end of 2015Q3, and at 3.9 percent in Ulaanbaatar city, which are 8.1 and 9.7 percentage points lower than that of the same quarter of last year and 2.4 and 3.2 percentage points lower than that of the previous quarter, respectively. In Q3, all prices except administrative prices contributed to a decline in annual inflation. Due to a high meat supply and a sudden drop in meat prices,

in Q3 food prices fell by 1.3 percentage points to a negative level for the first time since 2011. However, prices of all other goods and services declined by 1.9 percentage points, which was mostly driven by a poor demand along with a high growth rate in the base period. Although core inflation fell in the first 9 months, it still remains at higher than headline inflation level.

Mongolia's economic growth is expected to slow down considerably in 2015, with no further significant improvements projected in 2016, and to remain below the potential output level. Owing to the factors such as higher-than-expected mining growth in Q3 along with consideration of decline in copper ore content being expected from the Oyu Tolgoi production, economic growth for 2016 is being projected downwards from the previous forecast. Poor domestic demand also causes a contraction in non-mining sectors growth of which is expected to be in a negative term in year 2015. Especially sectors like trade, construction, transportation and services are projected to shrivel as a result of declining investment and import. The main driver for growth in 2015 remains the mining sector, with significant contributions from the Oyu Tolgoi mine, though its growth has slowed down slightly. Economic growth is expected to recover slightly in 2016 with the commencement of Oyu Tolgoi underground mine development, although it will still remain below the long-term average. Annual inflation is forecasted to be on the decline until the end of 2016, followed by an increase in 2017. Inflation is being forecasted downwards from the previous forecast due to a fall in domestic demand as well as a drop in meat prices resulting from unexpected supply shocks and its outlook in the coming quarters. The outlook in the coming quarters including unemployment level rising slowly due to decline in investment and labor cost not increasing due to non-rising level of nominal wage will provide the basis for continuous decrease in core inflation. Supply-driven food inflationary pressures is expected to fall and headline inflation is expected to be on a declining trend.

Aside from China's economic growth decelerating, all other external economic risks are comparatively small. Risk from declining Chinese growth is to persevere, entailing decreasing demand for commodities, which may affect economic forecasts through changes in the terms of trade, external demand and the exchange rate.

Investment is the main source of uncertainty for the domestic economy forecast. No improvement in credit ratings and the high risk premium contribute to increased costs for drawing funds in the international financial market. In the upcoming year, uncertainties related to the investment of Phase 2 production of the Oyu Tolgoi mine will raise further uncertainties in the mining sector. According to the reports of business owners' behavior survey, there is no tendency of recovery in private investment in the near term, making it uncertain when non-mining sector investment will recover. There is still lingering risk of changes in the non-mining sector investment forecast depending on whether budget investment is allocated according to the approved budget. Meat prices may differ from expectations due to harsh weather conditions.

Monetary Policy Committee of the Bank of Mongolia reached a decision during its meeting in January 2015 to raise the policy rate by 1 percentage point, while deciding to leave it unchanged during its April and June meetings. According to the newly released data from recent months on domestic and external economic conditions, it can be observed that export growth decelerated, while investment continued on its downward trend and household real income declined. Economic growth continued to slow, falling below its long-term average in 2015. Decline in domestic and external financing, and a persevering high interest rate all illustrate private investment to decline further in the near term. As a result, increasing unemployment and slow wage growth would cause a decline in non-food inflation. Although, the commencement of Phase 2 production of the Oyu Tolgoi project would ease the depreciation pressure on tugrug exchange rate, this effect is to be offset by a decline in export revenue.

## II. ECONOMIC OUTLOOK

### II.1 External assumptions of the forecast<sup>1</sup>

*While expected growth in China remains unchanged compared to the previous forecast, growth in Russia and the prices of the exporting commodities have been revised down substantially.*

#### *External demand<sup>2</sup>*

Compared to the previous forecast, prediction for external demand growth has been lowered by 0.09 percentage points due to slow economic growth in China, the U.S and Euro area remain broadly unchanged, and however, Russia's economy will shrink steeply by 3.6 percent, basis, for y-o-y this year. External demand growth remains weak within two years.

Particularly, the forecast for Russia's economic growth in 2015 has been lowered to -3.6 percent, from -3.3 percent, as a renewed slide in the oil price and extending EU's sanctions until March 2016 will lead to expectations of a deeper slump in Russia. Although IMF expects China's economy to grow by 6.8 percent y-o-y in 2015, we reiterate our forecast of China's economic growth at 6.9 percent in light of PBOC's monetary policy easing in October and the government's increased support in stabilizing growth.

The U.S economy is showing signs of improving momentum, and is projected to rise by 2.4 percent y-o-y, led by consumer and housing activity. Moreover, the GDP in the Euro zone is projected to increase by 1.47 percent y-o-y, reflecting looser monetary conditions and improvement in industrial production, retail sales and exports.

#### *Foreign interest rate*

The Fed decided to keep its policy rate at their record low level on September 2015 citing the external factors, led by a slowdown in China's economy and it's shaking financial market. Despite this, the continuously improving situation in the domestic economy and the labor market suggests that the Fed would raise the interest rate from an extremely low level at its next meeting on December 2015.

Analysts expect that the Fed rate would be increasing by 0.2 percentage points in each quarter until 2018.

Chart II.1.1

Change in external demand, in percentage

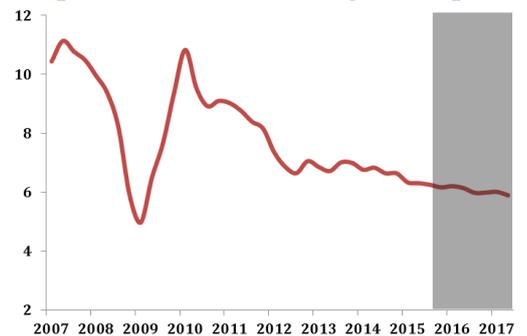
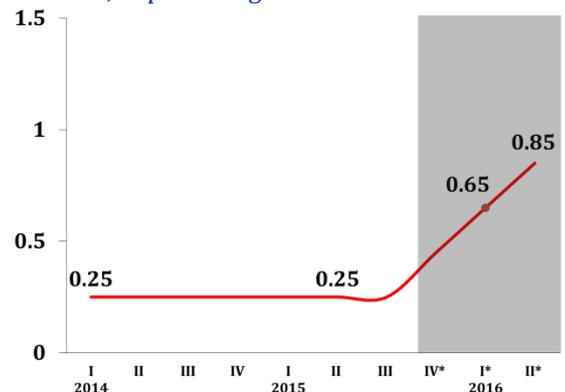


Chart II.1.2

Fed rate, in percentage



<sup>1</sup> Trading partner economies' growth and inflation forecasts are included in the external analysis. Source: Roubini Global Economics, EIU, Bloomberg, IMF-WEO.

<sup>2</sup> External demand is calculated by the weighted average of the main trading partners' economic growth.

### *Terms of trade*

Terms of trade is likely to weaken over the forecast horizon due to declining export commodity prices compared with the previous forecasts. Over the last quarter of 2015, continuously declining export commodity prices led to weakening terms of trade. However, it will improve in 2016, driven by weak oil prices and gradually increasing export commodity prices.

In terms of the forecasts for export commodity prices, gold is suffering from the prospect of Fed rate hikes and associated USD strength, even though gold consumption is expected to have risen in 2015 due to increasing gold demand in India and China. Reflecting this, we have lowered the average gold price forecast for 2015 and 2016 by USD 32 and USD 46 per ounce, respectively. The average copper price forecast for 2015 and 2016 has been lowered by USD 357 and USD 385 per ton, respectively. This is due to the combination of a strong USD and a slowdown in the Chinese industrial sector. Coal prices will remain on a downward trend through 2015 and 2016, driven by low demand for imports from China. Hence, the average coal price forecast for 2015 and 2016 has been lowered by USD 9 and USD 11 per ton, respectively.

In terms of the forecasts of import prices, experts do not expect crude oil prices to bounce back to pre-2014 levels, as the oil market remains exceptionally well supplied. In line with this trend, the average crude oil price forecast for 2015 and 2016 has been lowered by USD 11 and USD 9 per barrel, respectively.

## II.2 Forecast and uncertainties

### *Economic growth*

Domestic economy forecast is based on the assumptions that domestic fuel prices would not be affected by world oil price as a consequence of taxes and nominal exchange rate; and MNT nominal exchange rate is driven by not only the market condition, but also by the central bank interventions.

Economic growth projection in 2016 is revised downward from the level estimated in the previous quarter. Downward revision in the projection is driven by two factors. Firstly, an unprecedented increase in mining sector in the third quarter drove down 2016-2017 growth projections through this base period effect. Secondly,

Chart II.1.3

Terms of trade, export and import price change

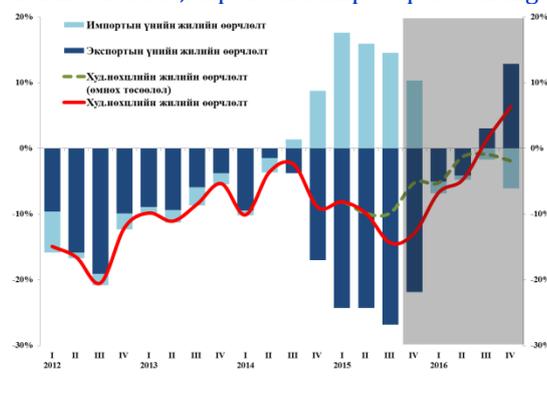


Chart II.2.1

Quarterly GDP growth forecast

copper production calculation method has changed for 2016<sup>3</sup>.

Accumulated over four quarters, economic growth is expected to decline even further to 2 percent. In 2015, investment contraction and decline in export growth are the main contributors to sluggish growth. However, unchanged household consumption growth, shrinking imports and expanding net exports supported economic growth. Contraction in investment, decline in domestic demand and imports have negatively affected the service industry, which may result in negative growth in the non-mining sector in 2015. Accounting for its major contribution to economic growth, the mining sector growth including Oyu Tolgoi is expected to decline in 2015 though.

Given Oyu Tolgoi phase II development, economic growth is expected to remain positive in 2016 to reach its potential level in 2017.



	2014	2015	2016	2017
ДНБ-ий өсөлт	7.8	2.1	0.4-2.4	4.8-5.8
Инфляци, ХҮИ	11.6	1.0	0.4-2.4	6.1-7.1

### *Inflation*

Annual inflation rate is expected to decline until the late 2016 and likely to escalate in 2017. Food and non-food prices both contributed to the diminished level of inflation forecast compared to the previous outlook.

Meat supply has increased from the expectations of severe winter resulting in decline in food price forecast over the next couple of quarters. Effect of declining meat prices on annual inflation is likely to proceed in the first half of 2016. Forecast for economic growth in 2016 is declined, consequently conditioning to lower demand-pull inflation pressure and non-food inflation forecasts.

In the reporting period, annual inflation would fall considerably from the expectation and likely to reach around 1 percent in the end of 2015. Domestic inflation pressures are expected to be low. Given the humble investment, unemployment is expected to increase gradually and increase is not anticipated. As a result of these factors, labor costs and demand-pull inflations will not increase in the domestic market and fall in non-food inflation is likely to proceed.

Administered goods and oil prices are expected to be relatively stable considering the approved budget and current government policies. Food inflation forecasts are based on an assumption that minor increases in meat prices will be observed in spring.

Expected drop in world food prices in 2016 founds stable outlook for non-tradable inflation, if MNT exchange rate remains

Chart II.2.2

Inflation forecast



<sup>3</sup> For 2016, decrease in gold deposits in Oyu Tolgoi ore concentration is incorporated in the calculation.

relatively stable.

Shrinking investment, imports, economic growth and employment are contributing to the preliminary conditions of a decline in household income. Accumulated effects of these factors are contributing to decreasing non-food inflation.

Both food and non-food inflation escalation in 2017 are expected to be brought mainly by the base effects.

### *Forecast uncertainties*

Forecasts are always subject to a considerable degree of uncertainty. This uncertainty can be illustrated roughly by the width of confidence intervals around the forecasts based on historical forecast errors. In part, the uncertainty relates to the assumptions that underlie the forecasts. Accordingly, the following uncertainties related to macroeconomic policy and other domestic or international factors may affect our forecasts:

1. The outlook for growth and trade in China is the biggest key source of uncertainty. Chinese economic growth uncertainty has important implications for our export commodity prices, particularly copper, coal, iron ore and crude oil, as well as the forecasts for the terms of trade.
2. Interruptions in the supply of goods can have significant pressure on inflation. The weather-related risks, unprecedented increase in prices of administered goods, or other types of supply-pull inflation can alter the trajectory.
3. Domestically, key sources of uncertainty continue to be the outlook for investment. Mongolia's sovereign rate is unlikely to improve making the foreign investment and credit sources expensive. Mining investment is likely to increase as Oyu Tolgoi underground development is launched.
4. Revivals in non-mining investments remain uncertain and business surveys are not indicating much revival. Non-mining investment trajectory is also subject to change considering feasible changes in approved budget investment, and further bonds issuing by commercial banks and the development bank of Mongolia.
5. Parliament election in next year could also be the source of uncertainty.
6. If budget revenue fails to reach its plan next year, budget deficit could further expand leading to lesser public investment.

## III. CURRENT ECONOMIC DEVELOPMENTS

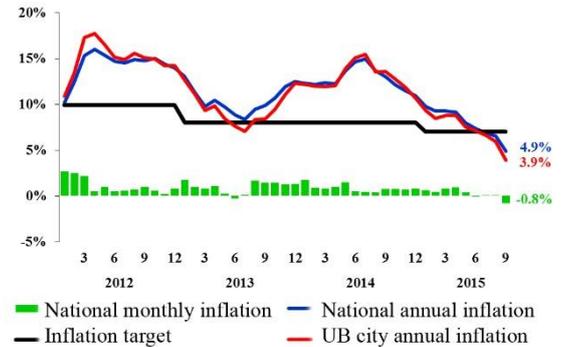
### III.1 Inflation

#### III.1.1 Inflation target, performance

It has been stated in the Monetary Policy Guideline 2015 that annual inflation rate, as measured by the consumer price index, will not exceed 7 percent by the end of 2015. At the end of 2015Q3, the annual inflation rate reached 4.9 percent; 2.4 percentage point lower than the previous quarter and below the target level of 7 percent by 2.1 percentage point (Chart III.1.1.1).

Chart III.1.1.1

Inflation has rapidly declined in 2015Q3 and reached low levels...

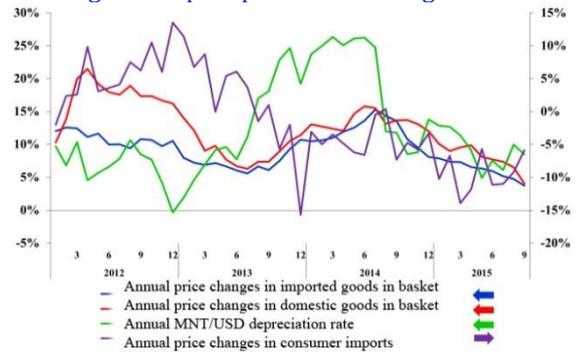


Source: NSO

The rapid decline in inflation rate has been affected by: 1) reduction in demand side pressure on inflation due to weakening domestic demand, 2) increase in supply of meat as prices of meat declined considerably, 3) gradual decrease in import prices included in the basket of consumer goods as the pace of tugrug depreciation has been slowing since the second half of 2014 (Chart III.1.1.2), 4) the tightening of monetary policy by raising the policy rate by 1 percentage point in January 2015 and reducing the monetary stimulus provided via unconventional measures.

Chart III.1.1.2

The pace of tugrug depreciation is slowing and import price is declining...

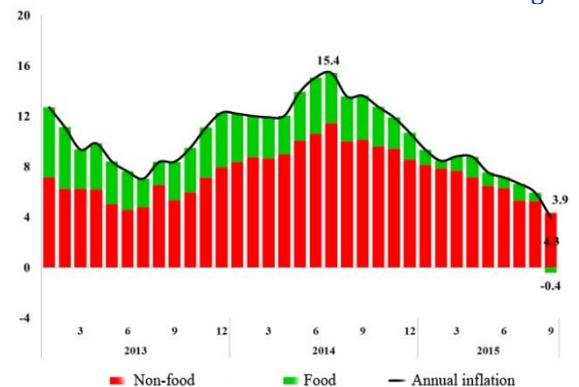


Source: NSO, BoM

The contribution of food price inflation has turned negative for the first time since 2011; a decline of 1.3 percentage point from the previous quarter. It was mainly caused by a rapid decline in meat prices owing to its increased supply. The contribution of non-food price inflation decreased by 1.9 percentage point due to the higher growth in the base year and weaker domestic demand. Inflation is expected to decline further as demand and supply driven pressures are low in the coming months (Chart III.1.1.3).

Chart III.1.1.3

Food and non-food inflation are both declining...



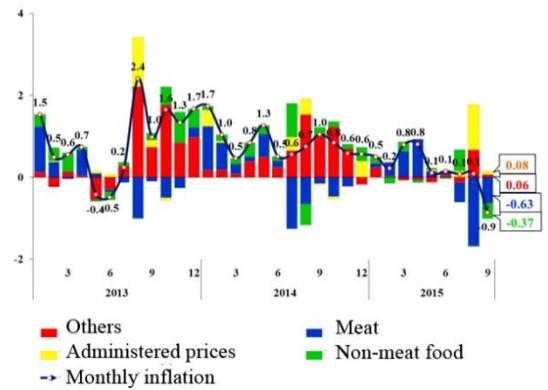
Source: NSO, BoM

### III.1.2 Inflation and its components

Consumer prices in Ulaanbaatar have increased by 1.3 percent q-o-q on average in the first 2 quarters of 2015 while it has declined by 0.7 percent q-o-q in Q3. The monthly inflation rate was -0.23 percent on average in Q3; 1.08 percentage point lower than in 2014 and 0.66 percentage point lower than in the first half of 2015. Prices of other goods and services (illustrated in red in chart III.1.2.1) remained relatively stable in the first 9 months of 2015. Administrated prices increased by 12.3 percent q-o-q in Q3, mainly due to the rise of 4.2 percent q-o-q in household electricity prices in July 2015, 32.5 percent q-o-q in tuition fees at public universities in August 2015 and 8.9 percent q-o-q in the prices of household hot water in Q3. Prices of meat products fell at a higher pace at 21.0 percent q-o-q (Chart III.1.2.1).

Chart III.1.2.1

Inflation reached -0.7 percent in 2015Q3...<sup>5</sup>

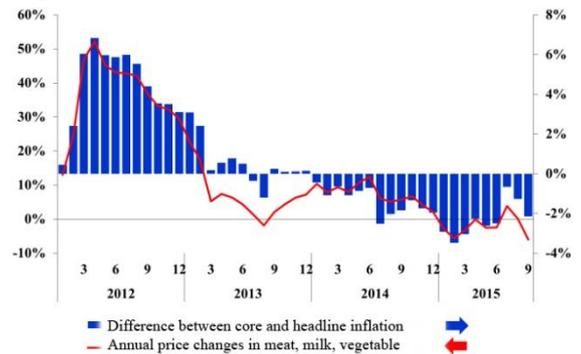


Source: NSO, BoM

Annual inflation reached 3.9 percent by the end of 2015Q3 which is 9.7 percentage points lower y-o-y and 1.7 percentage points lower q-o-q. The core inflation<sup>4</sup> stood at 6.1 percent by the end of 2015Q3; 9.4 percentage points lower q-o-q. Though price growth has been slowing down throughout the past year, the core inflation still remains at higher levels than headline inflation. In July 2015, the difference between core and headline inflation fell to 0.7 percentage points, its lowest level in more than 16 months, supported by the gradual increase in meat prices, which were previously declining in the first half of 2015. However, the difference has once again increased, affected by the rapid decline in meat prices in August and September 2015. The average prices of meat, milk and vegetable which are excluded from core inflation followed its seasonal pattern and declined by 9.7 and 6.4 percent respectively in August and September 2015. (Chart III.1.2.2)

Chart III.1.2.2

The difference between core and headline inflation has increased in August and September...<sup>6</sup>



Source: NSO, BoM

<sup>4</sup> 37 types of tradable and non-tradable goods are excluded from the basket of consumer goods.

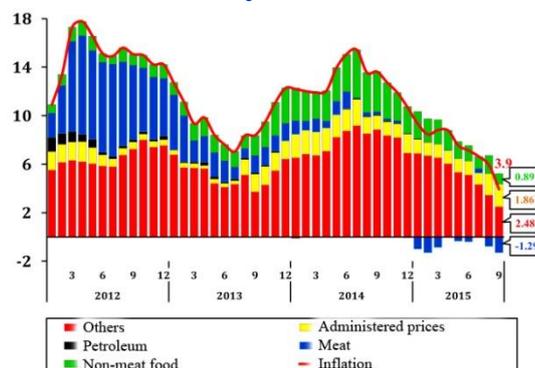
<sup>5</sup> Monthly inflation in Ulaanbaatar has been considered.

<sup>6</sup> Annual inflation in Ulaanbaatar has been considered.

By looking at the components of annual inflation rate in Ulaanbaatar, the increase in meat prices, food prices excluding meat, administrated prices and other goods<sup>7</sup> (illustrated in red in the chart) prices contributed -0.58, 1.13, 1.54 and 3.41 percentage points on average to total inflation in 2015Q3, respectively. Compared to 2015Q2, the impact of administrated prices on total inflation increased by 0.41 percentage point, while the impact of meat prices, food prices excluding meat and other goods declined by 0.35, 0.31 and 2.07 percentage point, respectively (Chart III.1.2.3).

Chart III.1.2.3

Declining meat prices positively affected inflation rate in 2015Q3 ...<sup>7</sup>

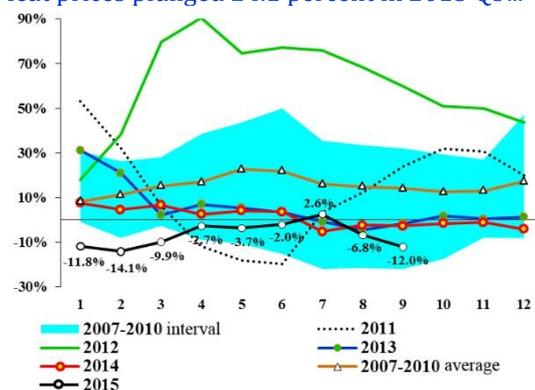


Source: NSO, BoM

The annual growth of meat prices excluding July 2015, has been negative for the 14 months. In 2015Q3, the annual growth of meat prices was at -5.4 percent on average; 2 percentage points higher than the first half average of 2015, while 6.4 percentage points lower than the 2014 average. Besides seasonal pattern, the expectations of heavy snowfall in the winter months negatively affected meat prices, which plunged by 24.1 percentage points in 2015Q3 (Chart III.1.2.4).

Chart III.1.2.4

Meat prices plunged 24.1 percent in 2015 Q3...



Эх сурвалж: NSO, BoM

<sup>7</sup> Contribution to annual inflation in Ulaanbaatar has been considered.

## III.2 Demand, supply

### III.2.1 Domestic demand

Total demand grew 1.8 percent y-o-y in 2015Q3 and 2.6 percent y-o-y in the first 3 quarters of 2015. Private consumption and foreign trade have contributed positively to economic growth, while investment and government consumption had a negative contribution.

#### Consumption

**Household:** Household expenditure growth, which was 4.8 percent y-o-y in Q2, slowed down to 4.3 percent y-o-y in Q3. In real terms, private consumption grew at 8.4 percent y-o-y in Q3 and contributed 4.6 percentage points to GDP growth. The intuition for private consumption real growth being higher than its nominal growth was due to the decline of 3.7 percent y-o-y in the corresponding general price deflator. Within the consumer basket used to measure inflation, prices of meat and milk products declined considerably in Q3.

In an environment of slowing economic growth, declining business activities and lower household income, households are financing their expenditure needs through credit. Though total loan is on the decline, consumption loan grew 8 percent y-o-y. Moreover, household income decreased by 7.2 percent y-o-y mainly due to a decline in wages and income from private businesses (Chart II.2.1.2).

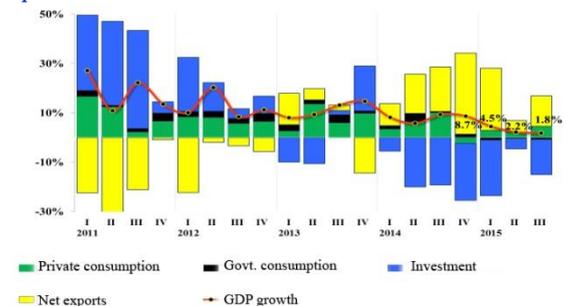
The decline in household income led to a fall in average household expenditure. Specifically, annual growth of average household expenditure in nominal terms has begun weakening since 2014Q4 and contracted by 2.1 percent y-o-y in 2015Q3. By deflating it with consumer price index, household expenditure in real terms has been contracting for the past 2 consecutive quarters. The majority of contraction was explained by a decline in non-food expenditures which is a common occurrence observed during economic contraction period (Chart II.2.1.3).

**Government:** The Government had to take measures to cut down on expenditures due to budget revenue collection not meeting its planned amount. Specifically, a second amendment to the 2015 budget was approved on Oct 30<sup>th</sup> which reduced budget spending by MNT 584.1 billion.

As of 2015Q3, government expenditure decreased by 7.7 percent y-o-y and contributed 0.8 percentage points to the economic slowdown. Budget revenue shortage is mainly driven by economic slowdown which results in lower tax revenues imposed on domestic and imported goods and services. There are risks of continued decline in budget revenue collection, which necessitates a further reduction in budget expenditure. In turn, it will negatively affect economic growth.

Chart III.2.1.1

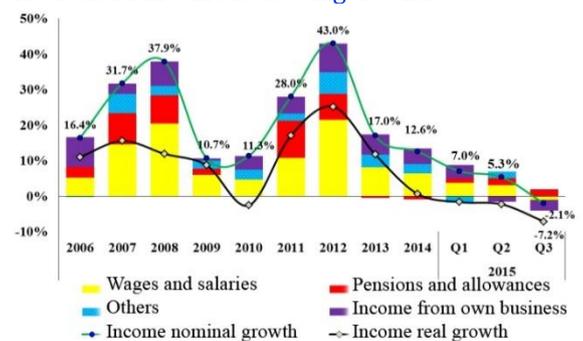
Growth is slowing down... Net export contributed significantly to economic growth in the last 7 quarters...



Source: NSO

Chart III.2.1.2

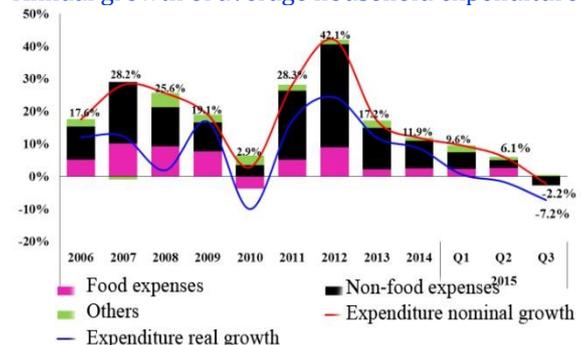
Household income is slowing down...



Source: NSO

Chart III.2.1.3

Annual growth of average household expenditure



Source: NSO

## Budget

According to the budget performance in the first 10 months in 2015, total equilibrated budget revenue collection was 95.1 percent (MNT 4569.3 billion), total expenditure incurred was 87.1 percent of its planned amount (MNT 5484.6 billion) and total equilibrated deficit stood at MNT 915.3 billion.

## Investment

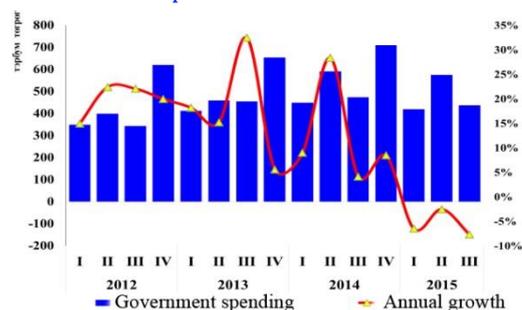
Both foreign and domestic investment contributed negatively to economic growth for the last 7 quarters. However, it led to narrowing savings and investment gap in an environment of declining foreign and domestic financing. A narrowing savings and investment gap is causing the current account deficit to shrink and the tugrug depreciation pressures to soften.

Total investment (capital formation) fell by 35.9 percent y-o-y in Q3 and led to a 14.2 percentage point decline in economic growth. A rapid fall in foreign direct investment and a fall in investment by domestic entities mainly contributed to lower gross fixed capital formation. Since the sudden drop in foreign direct investment, financing by the BoM and the Development Bank projects were the main sources of private investment. In Q3, there was no significant rise in investment by the Development Bank. Moreover, the BoM has been exiting from its financing programs by transferring its obligations to the Development Bank. These led to declining investment.

Changes in stock, which contributed positively to the total capital formation in Q2, had negative effects in Q3. It was mainly due to a reduction in gold reserves and its contribution. Economic uncertainties are causing downward pressures on private investment.

Chart III.2.1.4

Government expenditure



Source: NSO

Table III.2.1.1

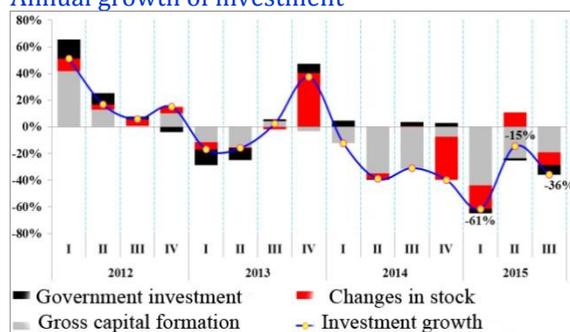
Fiscal revenue is on the decline

billions togrog	2013	2014	2014.X	2015.X
Stabilization fund	47	-78	48	2.3
Equilibrated revenue	5881	6223	4850	4569
Expenditure	6178	7031	5129	5485
Equilibrated balance	-297	-808	-278	-915
Nominal GDP	19118	21884		
(as share of GDP)				
Stabilization fund	0.2%	-0.4%		
Equilibrated revenue	30.8%	28.4%		
Expenditure	32.3%	32.1%		
Equilibrated balance	-1.6%	-3.7%		

Source: Ministry of Finance

Chart III.2.1.5

Annual growth of investment



Source: NSO

## ***BOX: Factors contributed to the recent Sovereign rate downgrade***

Mongolian sovereign credit rating plays an important role in providing incentives for investment and facilitating internal and external economic balance. International credit rating agencies are downgrading the Mongolian sovereign credit rating.

Moody's has downgraded our credit rating from B1 to B2 in July 2014 and stated the outlook to be negative. It was mainly due to rapidly declining foreign reserves, increasing external debt pressures, expansionary macroeconomic policies and resulting banking sector and balance of payments issues. Though Moody's has kept our credit rating in November 2015, it still considered the outlook to be negative due to several factors including, economic growth slowdown, credit quality, fiscal deficit, low levels of foreign reserves and private and public external debt.

Moreover, Fitch has downgraded our rating from B+ to B. Factors such as expected economic slowdown in 2015-2017 and foreign reserve pressures, its expected downward trend, government debt pressures, its expected increase, issues arising from its refinancing and decline in the quality of bank assets were taken into consideration for the downgrade. However, a successful proceeding of Oyu Tolgoi underground mine development is critical for economic growth outlook, and governance indicators and structural indicators such as the savings and investment ratio could positively affect credit ratings. Furthermore, factors such as a decline in Central bank quasi-fiscal expenditure and the savings dollarization not exceeding 29 percent could contribute to a reduced amount of risks to the external financial position, though not fully eliminating them.

S&P agency has downgraded our credit rating from B+ to B in November 2015, while upgrading the economic outlook from negative to stable at the same time.

<b>Fitch</b>				<b>Moody's</b>			
<b>Date</b>	<b>Foreign currency</b>	<b>Domestic currency</b>	<b>Outlook</b>	<b>Date</b>	<b>Foreign currency</b>	<b>Domestic currency</b>	<b>Outlook</b>
24/11/2015	<b>B</b>	<b>B</b>	stable	7/17/2014	<b>B2</b>	<b>B2</b>	<b>negative</b>
23/11/2010	B+	B+	stable	6/10/2009	B1	B1	<b>negative</b>
11/10/2009	B	B	stable	2/5/2009	B1	B1	-
1/19/2009	<b>B</b>	<b>B</b>	<b>negative</b>	10/3/2005	B1	B1	stable
7/18/2005	B+	B+	stable				

<b>S&amp;P</b>			
<b>Date</b>	<b>Foreign currency</b>	<b>Domestic currency</b>	<b>Outlook</b>
11/3/2015	<b>B</b>	<b>B</b>	stable
4/29/2014	<b>B+</b>	<b>B+</b>	stable
12/13/2007	BB-	BB-	stable
12/22/2006	B+	B+	positive
12/23/1999	B	B	stable

Fitch agency has considered the outlook to be stable mainly due to several positive factors, including macroeconomic policies aimed at improving economic stability and ensuring targeted budget performance that promotes government debt stability. On the other hand, a decline in external liquidity (or ability to enter the international capital market), systemic financial market issues and Oyu Tolgoi mine development discontinuation were some of the negative factors are taken into account.

## Net export

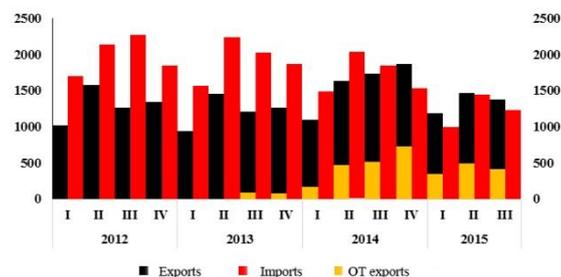
Net export remains the largest contributor to economic growth. As of 2015Q3, though exports of goods and services shrank in y-o-y terms, net exports exhibited growth due to even rapidly shrinking imports. Specifically, exports of goods and services decreased by 20.4 percent y-o-y in Q3, owing to the lower demand for commodities in international markets and a decline in their prices. Imports of goods and services decreased by 31.2 percent y-o-y in Q3 due to weakening economic activities, fall in investment and slowing down of consumption. As such, net exports was in surplus of USD114.8 million in Q3. It contributed 12.3 percentage points to economic growth in Q3.

A fall in prices of coal and oil contributed significantly to export decline in nominal terms in 2015Q3. By looking at imports components, reduced investment and consumer imports were main contributors to the decline of USD 575.1 million in imports of goods and services. Specifically, consumer imports fell by 19.2 percent y-o-y while imports of investment goods declined by 34.3 percent y-o-y. Imports are expected to remain subdued due to shrinking total demand.

A depreciation of domestic currency could improve the competitiveness of domestic products and lead to a fall in imports. A ratio of imports to GDP in terms is illustrated in Chart II.2.1.8. A nominal depreciation of tugrug since 2012 is coincident with a decline in imports to GDP ratio. As such, it shows that imports contribution to the overall economy has been decreasing while consumption of domestically produced goods and services has been on an upward trend.

Chart III.2.1.6

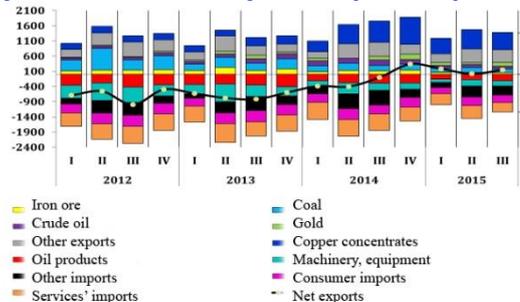
Exports and imports of goods and services are declining.



Source: BoM

Chart II.2.1.7

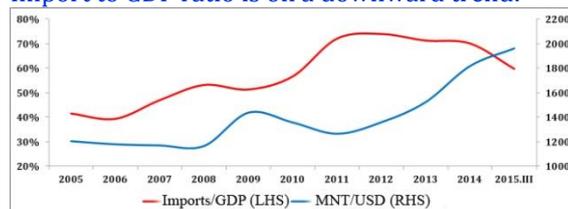
Net exports of goods and services have remained positive in the last 4 quarters. (nominal)



Source: BoM

Chart II.2.1.8

Import to GDP ratio is on a downward trend.



Source: BoM

### III.2.2. Supply

Gross domestic product grew 2.5 percent y-o-y during the first 3 quarters of 2015. Thus economic growth, which was 2.1 percent in Q2, slowed further down to 1.8 percent in Q3. Non-mining sector contracted by 1.2 percent for the last 2 consecutive quarters (Chart III.2.2.1). Nominal GDP grew by 4.1 percent y-o-y to reach MNT 16.8 billion.

The largest contribution to economic growth came from the mining sector of around 2.8 percentage points. Other services and agriculture sectors were among the largest contributors, each contributing 2.6 and 1.3 percentage points, respectively. Manufacturing, power and water supply, and information sectors in total contributed about 0.2 percentage points to overall growth. However, contraction in net tax on products, construction, and transportation and trade sectors accounted for 2.1, 1.4, 0.8 and 0.7 percentage point reduction in economic growth respectively.

The mining sector grew by 11.8 percent y-o-y in Q3, mainly owing to the 20-30 percent increase in each of copper, gold, crude oil and coal production volumes. Out of which, Oyu Tolgoi production grew more than 50 percent y-o-y in Q3. Production of iron ore is, however, still on the decline due to a commodity price slump in international markets.

Activities of other service sectors expanded further by 14.8 percent y-o-y in Q3. The largest contributor was the education sector.

Agriculture sector growth remained strong at 10.4 percent y-o-y in Q3. It was mainly driven by livestock production. A total of 19 million baby livestock was added to the herd nationwide in 2015. A total of 56.3 million livestock (8.3 percent y-o-y) is expected to be head-counted by the end of 2015, while around 14 million is expected to be slaughtered for consumption.<sup>8</sup> Regarding crop production, a total of 215.7 thousand tons of cereals (out of which, 203.9 thousand tons of wheat) was harvested in 2015 which is a contraction of about 58 percent y-o-y.

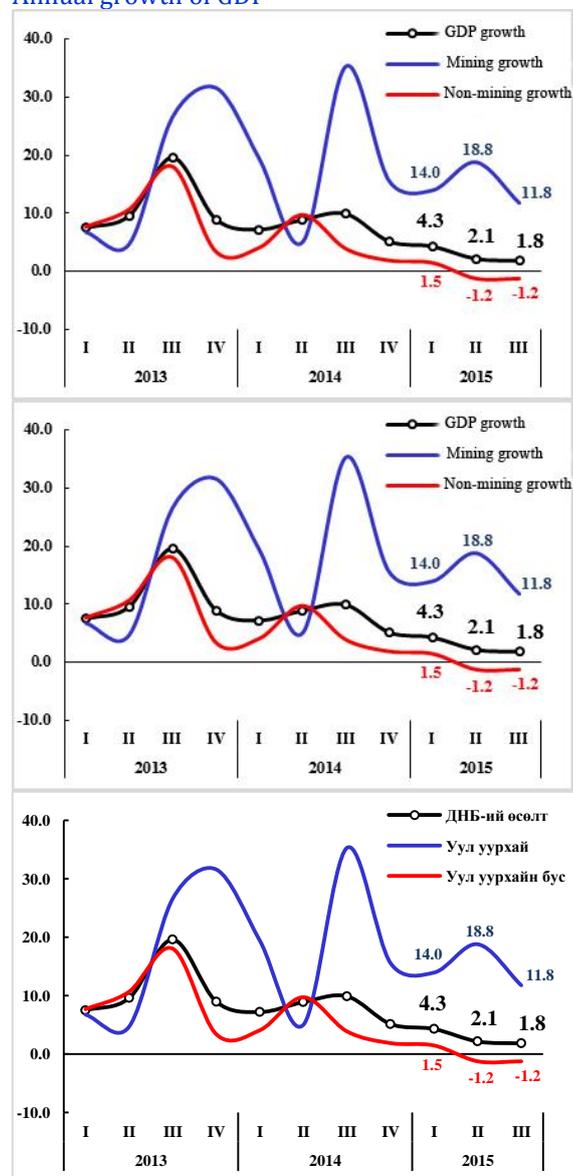
As the economy slows down, trade turnover, imports as well as transport services are on a downward trend. Specifically, though trade sales improved slightly from the previous quarter, it still contracted 4.4 percent y-o-y while transportation sector indicators worsened by 14.1 percent y-o-y.

Moreover, tax revenue on products in real terms have been declining for the past 8 quarters and reached -20.7 percent y-o-y in Q3, mainly owing to the decrease in value added tax imposed on imported goods and customs duties.

Construction activity continued to shrink and was recorded at -24.1 percent y-o-y in Q3. Residential buildings and general engineering construction activities were the main contributors for such

Chart III.2.2.1

Annual growth of GDP



Source: NSO

Table III.2.2.1

Annual and quarterly growth of production sectors /in order of contribution to 2015Q3 growth /

<sup>8</sup> Plan by Ministry of Food and Agriculture

weakening activity.

	2015Q2	2015Q3	
	YoY %	YoY %	QoQ %*
<b>Real GDP growth</b>	<b>2.1</b>	<b>1.8</b>	<b>1.8</b>
Mining	18.8	11.8	11.8
Other services	2.3	14.8	13.6
Agriculture	9.4	10.4	-2.0
Telecommunications	0.2	10.0	8.1
Manufacturing	1.4	-0.1	1.9
Electricity, water supply	1.4	-2.6	-0.3
Trade	-7.6	-4.4	5.2
Transportation	-9.3	-14.1	0.0
Construction	-2.9	-24.1	-26.0
Net tax on products	-14.3	-20.7	-13.9

\* seasonally adjusted

Table III.2.2.2

Production of major mining commodities

		2015Q2	2015Q3
		YoY%	YoY%
Coal	mln.tons	6.2	5.2
		-14%	34%
Erdenes Tavan tolgoi		1.0	1.3
		-38%	99%
Copper concentrates	thous.tons	336.0	353.8
		34%	32%
Oyu Tolgoi		215.5	210.3
		54%	57%
Gold	tons	2.7	6.3
		40%	33%
Iron ore	mln.tons	1.5	2.5
		-45%	-32%
Crude oil	mln.bar	2.0	2.5
		10%	22%

Source: NSO, Company plan

III.2.3 Potential output, output gap

Potential output<sup>9</sup> growth picked up since 2010 and potential growth rate had exceeded 10 percent since 2011. Such high growth was maintained during 2012-2013 due to several major factors including, Oyu Tolgoi production, quasi-fiscal expenditures by the Development Bank as well as conventional and unconventional expansionary measures by the BoM. However since 2014, potential output growth has been on a rapidly declining trend and it is considered to be around 3 percent as of 2015Q3 (Chart III.2.3.1)

Chart III.2.3.1

Growth of potential output

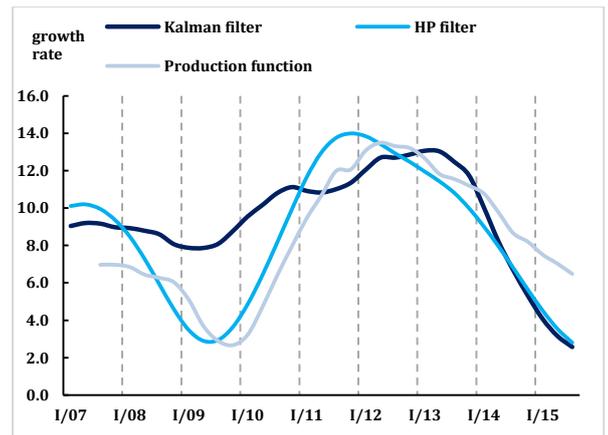


During the period of 2011-2013, it is considered that total production exceeded its potential level and there was positive output gap<sup>10</sup> mainly due to non-mining sector production. Following that, total domestic production was below its potential level and therefore, negative output gap persisted during the past 2 years. Non-mining production began to contribute negatively to the

<sup>9</sup> 1) Pure statistical HP filter, 2) production function approach which takes into account each factors of production and 3) multivariate Kalman filter which makes use of macroeconomic indicators and their correlations are used.

<sup>10</sup> Computed by Kalman filter.

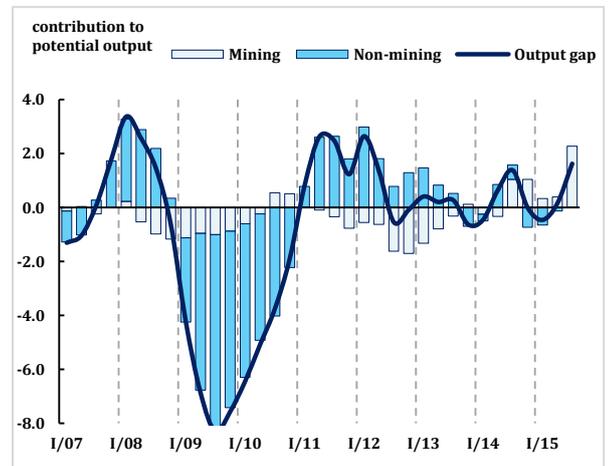
total output gap since the end of 2013. On the other hand, mining production has been exceeding its potential level since the second half of 2014. As of 2015Q3, further expansion of mining activities led to narrowing output gap to a relatively smaller amount of around -0.2 percent of potential output (Chart III.2.3.2).



Source: Estimation

Chart III.2.3.2

Output gap / mining and non-mining/



Source: Estimation

### III.3 The labor market

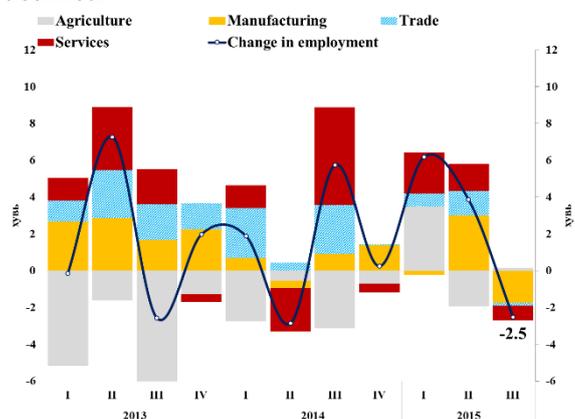
#### III.3.1 Employment and unemployment

The easing in employment in trade and industry sectors due to a slower growth in economic activity have resulted the decline in the labor demand.

In 2015 Q3, employment decreased by 2.5 percent y-o-y, reaching 1,119,703. This was fostered mainly by a weak employment in major sectors, such as manufacturing, transportation, financial activities etc., except for service and agricultural sectors. In particular, employment in the construction sector decreased by 9.3 percent (8577 people), employment in the mining sector by 15.6 percent (6499 people), employment in the information and communication sector by 34.5 percent (6731 people) and employment in the financial and insurance sector by 19 percent (5050 people), respectively.

Chart III.3.1.1

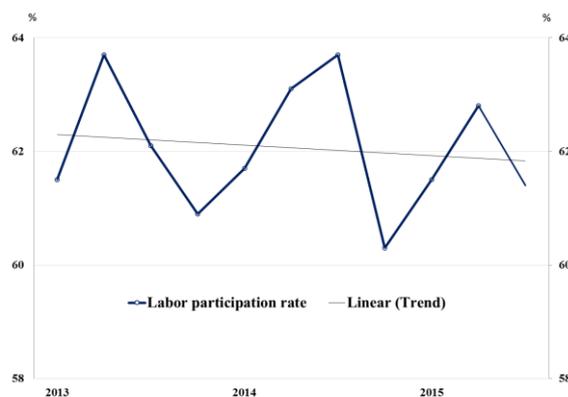
Employment and the labor force participation have declined..



Examining the employment status, the number of self-employed and paid employees decreased compared with the previous quarter, whereas the number of unpaid family workers increased.

The labor force participation rate has been declining with the downward sloped trend in last three years. In 2015 Q3, the labor force participation rate fell by 2.3 percentage points y-o-y and by 1.4 percentage points q-on-q due to declining employment in the major sectors. The labor force participation rate in Ulaanbaatar was at 53.4 percent, 2.7 percentage points lower than in the previous quarter.

Despite this, the unemployment rate remained unchanged at 6.3 percent compared with the previous year. However, the number of newly registered unemployed people increased by 8.9 percent over the previous month as of October 2015, according to the Ministry of Labor.



Source: NSO

Table III.3.1.1

Labor market indicators

Year	2012	2013	2014Q3	2014	2015Q3
Employment (thous.people)	1018	1038	1149	1041	1120
<i>y-o-y growth</i>	-0.8%	2.0%	5.7%	0.2%	-2.5%
Agriculture	318	305	319	322	321
Manufacturing	182	205	240	224	220
Trade	137	152	172	174	170
Services	381	377	418	384	409
Unemployed (thous.people)	87.8	87.2	78.1	87.0	75.7
<i>y-o-y growth</i>	13.4%	-0.6%	-12.8%	-0.3%	-3.1%
Labor participation rate, %	61.6	60.9	63.7	60.3	61.4
<i>annual change</i>	-2.6	-0.7	1.6	-0.6	-2.3
Unemployment rate, %	7.9	7.8	6.4	7.7	6.3
<i>annual change</i>	0.9	-0.1	-1.2	-0.1	-0.1

Source: NSO

## III.4 Money and financial markets

### III.4.1 Money and credit indicators

Money and credit growth has been slowing down for the last 6 to 7 quarters. M2 money has declined by 1.4 percent y-o-y and outstanding loan rate declined by 5.3 percent y-o-y in 2015Q3.

During the last 8 months, the money supply has shrunk due to diminishing net foreign assets from the reduced capital inflow.

In line with the external imbalances, there is a weak domestic economy with shrinking money demand and supply. This could be observed from sluggish growth in net domestic assets.

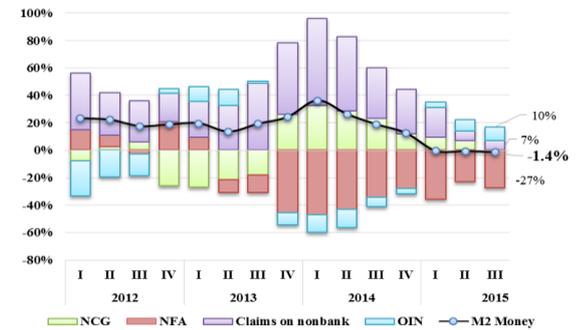
The current decline in currency outside banks and M1 money are indicators of weakening business activity in alignment with the money demand. These indicators have consistently declined y-o-y for the last 6 quarters.

The above mentioned shrinking monetary indicators are the result of depleting liquid assets in the banking system. An increase in foreign currency deposits supported the money supply while all other components affected negatively on the supply as in the previous 2 quarters. Foreign currency deposits have increased as a consequence of depreciation in the exchange rate and increase in foreign currency deposits by the Development Bank of Mongolia (DBM).

Current accounts owned by individuals and entities have declined for the past 6 quarters, local currency deposits have declined for 2 quarters, and foreign currency current accounts have declined over the last 3 quarters.

Chart III.4.1.1

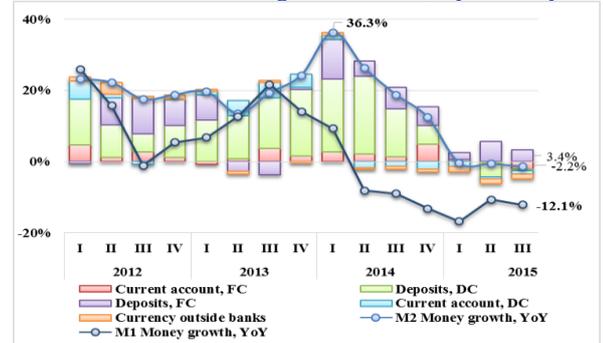
Contributions to Y-o-Y growth of M2, by assets



Source: BoM

Chart III.4.1.2

Contributions to Y-o-Y growth of M2, by liability



Source: BoM

Table III.4.1.3

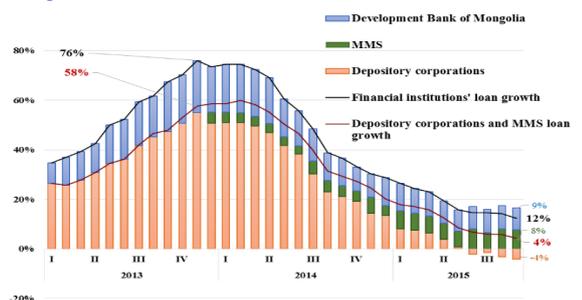
Money supply: asset and liability

In billion tugrugs	2014	2015Q1	2015Q2	2015Q3
Net foreign assets	-1702	-3048	-2999	-3742
Net domestic assets	12338	12957	13040	13676
Money supply /M2/	10636	9908	10041	9935
M1 Money	1817	1440	1664	1614
Currency outside banks	499	391	431	407
Current account, DC	1317	1049	1234	1206
Quasi money	8819	8469	8377	8321
Deposits, DC	5410	5188	5293	5183
Deposits, FC	1970	2191	2019	2095
Current account, FC	1439	1090	1065	1043

Source: BoM

Chart III.4.1.4

Financial institutions' credit growth, by compositions



Source: BoM

Annual credit growth has decelerated over the last 7 consecutive quarters. Financial institutions' credit growth fell from 76 to 12 percent, and depository institutions (*banks + deposit and loan corporations + Mongolian Mortgage Corporation*<sup>11</sup>) credit growth fell from 58 to 4 percent<sup>12</sup>.

The outstanding loans from financial institutions in 2015Q3 are MNT 17.8 trillion and out of this amount, 67 percent represents depository institutions, 23 percent represents the DBM and the remaining 10 percent represents credit provided by the MMC.

In 2015Q3, credit provided by the DBM has increased by 50 percent, leading to a 9 percentage point increase in credit by financial institutions. The amount of total outstanding loans has increased by 8 percentage points as a result of a 3.4 fold increase in loan securitization by MMC, while it declined by 4 percentage points due to a 5 percent decrease in depository corporations' loans.

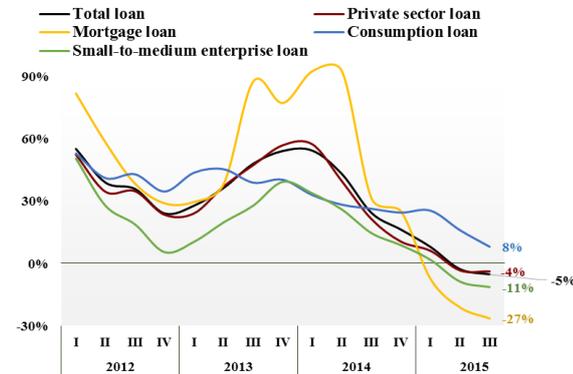
The loan outstanding (private entities, SME loans and mortgage loans) excluding consumer loans has fallen from the previous year. While consumer loan growth has slowed, it shows an 8 percent recovery from last year.

Productions in economic sectors show a contraction, thus resulting a slowed credit growth and a deterioration in the credit quality. For instance, the credit growth in the manufacturing sector has shown a contraction in the last 2 quarters reaching 3 percent. The growth in other sectors also slowed over the last 5 to 7 quarters with a decline in the last quarter. Manufacturing loans, excluding the DBM loans dropped by 17 percent y-o-y over the last quarter.

Depository institutions' non-performing loans to total loans ratio has increased by 2 percentage points in 2015Q22015Q3, hitting 7 percent, while overdue loans to total loans ratio increased by 5 percentage points hitting 7 percent since the beginning of the year. The quality of mining sector loans and foreign currency denominated loans is showing signs of rapid deterioration.

Chart III.4.1.5

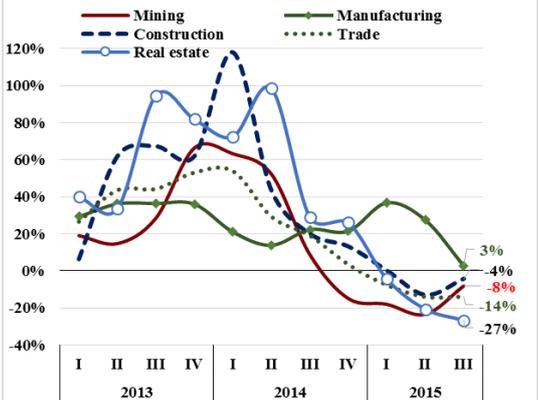
Depository corporations' annual credit growth, by sectors



Source: BoM

Chart III.4.1.6

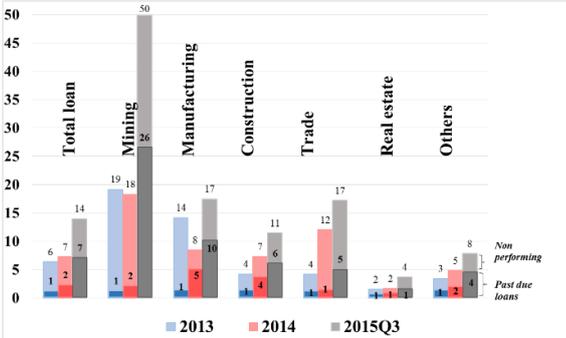
Depository corporations' annual credit growth, by economic industries



Source: BoM

Chart III.4.1.7

Depository corporations' non-performing and past due loans, by percentages



Source: BoM

<sup>11</sup> Mongolian Mortgage Corporations (MMC) loan is comprised of securitized 8 percent mortgage loans.

<sup>12</sup> It considers the depository corporations' loan in the previous reports.

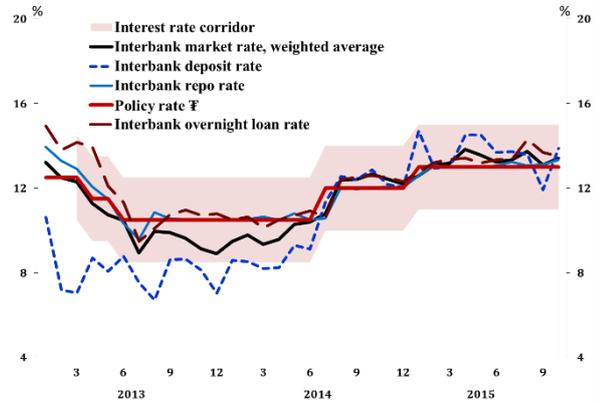
### III.4.2 Interest rate

The presence of a liquidity shortage can be observed from increasing lending rates, deposit rates, and interbank market rates.

The Monetary Policy Committee raised the policy rate by 1 percentage point to 13.0 percent in 2015Q1, which has remained unchanged since. Interbank market rates in 2015 have been close to the policy rate, but in the upper band of the interest rate corridor. For instance, in October, CBB transaction rates on the secondary market, including repo financing, overnight, and interbank deposit rates stood at 0.3 to 0.9 percentage points above the policy rate. In order to keep the interbank rate on target level, the Bank of Mongolia supplied MNT 38.6 billion through its standing facilities and reduced the outstanding central bank bills (CBB) amount by MNT 472.0 billion in 2015Q3.

Chart III.4.2.1

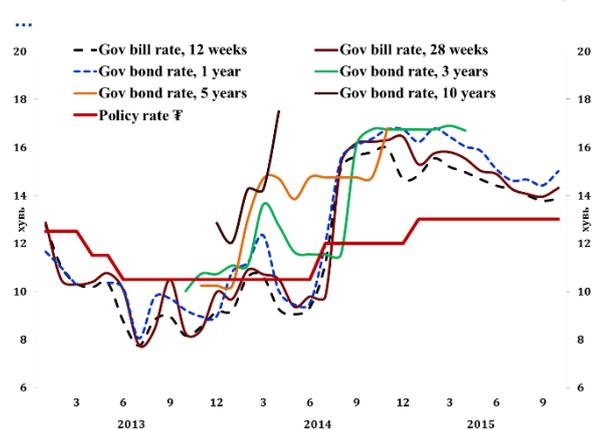
Interbank market rates are higher than the policy rate



Source: BoM

Chart III.4.2.2

Short-term Government bond rates are declining

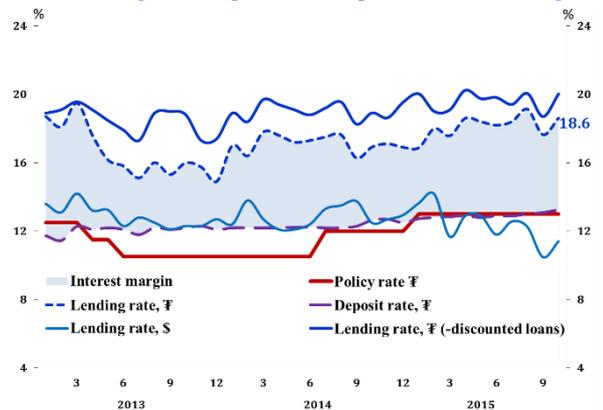


Source: BoM

The short-term government bond (GB) rate on the secondary market has consistently declined from the beginning of 2015 to reach 13.8<sup>13</sup> percent at the end of 2015Q3.

Chart III.4.2.3

The lending and deposit rate spread remains high



Increasing lending and deposit rates imply shrinking MNT supply in the economy. In 2015Q3, the MNT lending rate rose by 0.4 percentage points, the MNT deposit rate by 0.8 percentage points, and the interest margin reached 4.6 percent which represents 0.6 percentage points increase y-o-y. Increasing MNT lending rates reflect a contraction in economic growth, increasing credit risks, a contraction in discounted rate loans provided by the Bank of Mongolia and the DBM, and persistent deficits in the balance of payments.

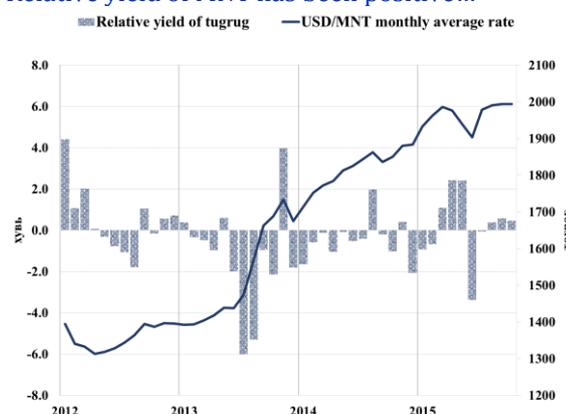
<sup>13</sup> 12 week (3 months) government bond rate

In the reporting period, foreign currency deposits showed a 22 percent increase in the amount and 0.9 percentage point increase in the rate. However, foreign currency denominated loans declined by 3.8 percent in amount and 3.3 percent in the rate. This is partly due to a decrease in demand for such loans as the exchange rate risks expand.

The relative yield of MNT has been positive for the last 3 months, mainly in response to increased MNT deposit rate and the stable exchange rate.

Chart III.4.2.4

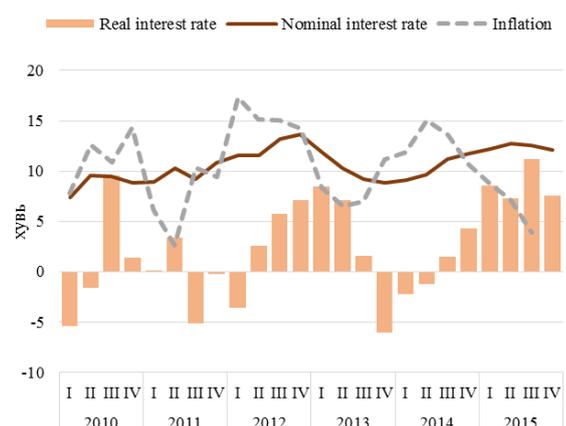
Relative yield of MNT has been positive...



Source: BoM, estimation

Chart III.4.2.5

Real interest rate has been high...



Source: BoM, estimation

Chart II.4.2.5 shows the real interest rate derived as a difference between the CCB rate and inflation expectations. Throughout this year, the nominal interest rate has consistently increased in line with faster-declining inflation expectations and these factors led to the increase in the real interest rate.

### III.4.3 Exchange rate

The MNT/USD exchange rate has been stable over the 3<sup>rd</sup> quarter of 2015 /Chart III.4.3.1/. For instance, the quarterly average MNT/USD rate has depreciated by 1.8 percent reaching MNT 1988. The DBM and quasi-fiscal expenditures have declined over the year in line with diminishing bank loans and total demand. in the economy. As a consequence, demand for imports and USD declined.

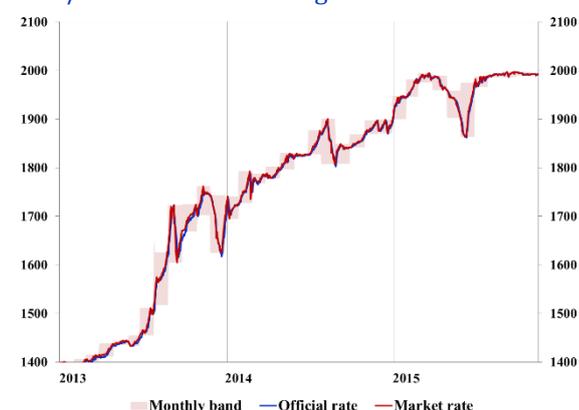
The balance of payment deficit declined from the previous year, reducing the depreciation pressure on MNT. In the first 9 months of 2015, the current account deficit<sup>14</sup> reached USD -412.7 million, which is a USD 1 billion reduction y-o-y. However, on the supply side, financial accounts had the surplus of USD 264.7 million as direct and portfolio investments increased. This has contributed to an increase in foreign currency supply. In net terms, the balance of payment deficit in 2015Q3 stood at USD 172.4 million, which reduced the pressure on the MNT rate to depreciate compared to last year.

A positive relative yield of MNT contributed to a decline in demand for USD. USD deposits are on the rise, but the Bank of Mongolia left its policy rate unchanged. As a result, the MNT yield has been positive. For instance, along with the policy rate, short-term GB risk-free interest rate (13.9 percent) is higher than the MNT deposit rate (by 0.6 percentage points) and USD deposit rates (by 7.4 percentage points); consequently, restricting MNT deposits conversion to USD deposits. In terms of an investment portfolio, the expected return from a long position in foreign currency based on the exchange rate expectations is unlikely to be higher than the MNT risk-free return.

In 2015Q3, the nominal effective exchange rate (NEER) appreciated by 0.2 percent and relative price declined by 1.1 percent; as a result, the real effective exchange rate showed a depreciation of 0.9 percent over the previous quarter. The effects of the RUB depreciation on the exchange rate is declining and is expected to be muted at the end of the year.

Chart III.4.3.1

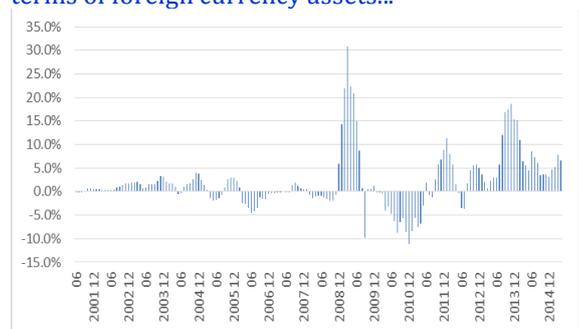
MNT/USD nominal exchange rate



Source: BoM

Chart III.4.3.2

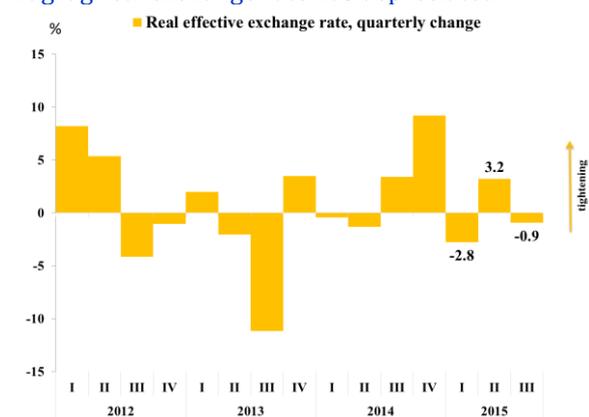
Expected returns from currency depreciation in terms of foreign currency assets...



Source: BoM, estimation

Chart III.4.3.3

Tugrug real exchange rate has depreciated...



Source: BoM

<sup>14</sup> Preliminary estimates of 3<sup>rd</sup> quarter of 2015

### III.4.4 Real estate market

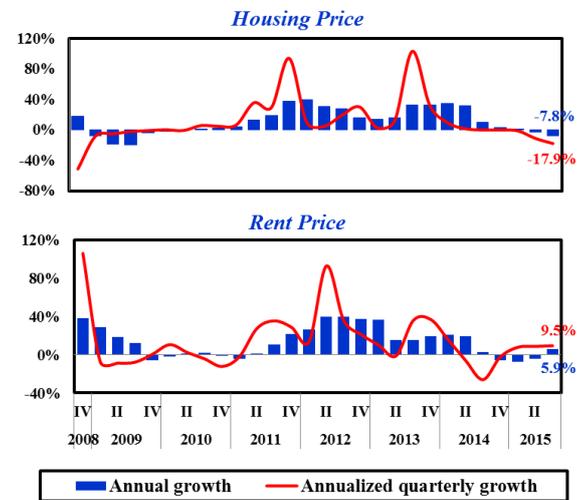
The house price index estimated by the National Statistical Office in 2015Q3 declined by 7.8 percent y-o-y and showed a 4.8 percent decline from the previous quarter. The house price index estimated by “Tenkhleg Zuuch” LLC is also in the negative territory with a decline of 10.5 percent in 2015Q3. For instance, prices of old apartments declined by 13.1 percent and prices of new houses by 4.8 percent. The rental price in 2015Q3 has declined by 5.9 percent y-o-y and showed a 2.3 percent decline from the previous quarter (Chart III.4.4.1).

In order to observe the future trend in house prices and rental prices, annualized quarterly and annual growths<sup>15</sup> are compared in the chart. By this estimation, if annualized quarterly growth is higher than the annual growth, a price is expected to increase in the near-term and vice versa. In the short run, house prices are expected to decline further as observed from the estimations for 2015Q3 (Chart III.4.4.1).

From 2013Q3, housing demand has increased in line with the implementation of “Mortgage loan program with 8 percent interest rate”. The effects of the program have been muted from the 2014Q3; as a result, demand for housing decreased and house price declined gradually. in last 5 quarters. The rent price has been declining along with the house price, but has shown recovery from the 2015Q2 and 2015Q3 y-o-y. House price showing faster growth than the rent price indicates the existence of a housing bubble. In the last 2 years, the house price growth rate exceeded rent price growth; however, 2015Q3 the opposite trend was observed. (Chart III.4.4.2)

Chart III.4.4.1

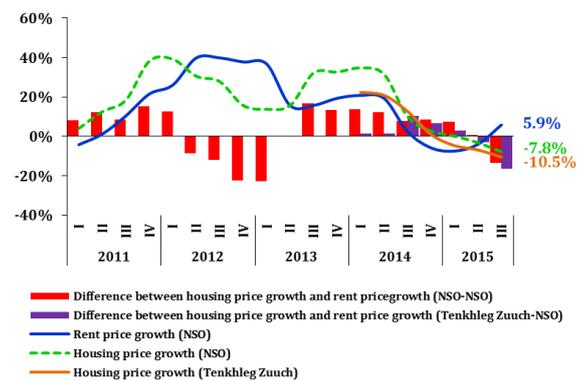
Rent prices are increasing while house prices are falling...



Source: NSO, estimation

Chart III.4.4.2

Rent price growth has exceeded the housing prices growth



Source: NSO, estimation

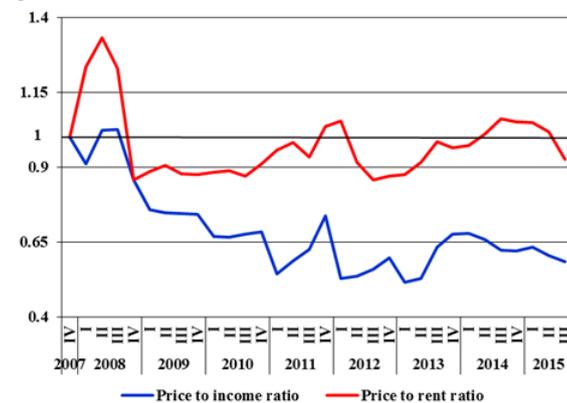
Chart III.4.4.3

<sup>15</sup> Annual growth =  $p/p(-4)-1$ . Quarterly growth in annual terms =  $(p/p(-1))^4-1$ . (p = price, rent index)

Stock market capitalization and market activities contracted due to a deteriorating economic outlook and declining market value of the companies. Stock market indicators, which have been decreasing continuously since September 2014, was quite volatile in 2015Q2 and 2015Q3. The Top-20 index and market capitalization increased significantly in June 2015 and has since been on a downward trend. At the end of 2015Q3, the average indicator of TOP-20 was 13210.2, with a decline of 10.9 percent from the beginning of the year and 9.5 percent over the previous quarter. But market capitalization of MNT 1.3 trillion as of September 2015 is estimated to have decreased by 10.6 percent from the beginning of the year and by 8.4 percent over the previous quarter. Moreover, the balance of payments statistics shows that foreign investors' assets allocated at the Mongolian Stock Exchange decreased by USD 4 million in the first 3 quarters of this year. It is one of the reasons in contracting stock market activity and the capitalization. For instance, in the first 9 months of 2015, the number of transactions conducted was MNT 7 billion, which indicates a 58 percent drop from the previous year (Chart III.4.4.4).

The Mongolian Mortgage Corporation (MMC) organized the 6<sup>th</sup> securitization operation of the 8 percent interest rate mortgage loans, and the BoM purchased these securities. The MMC securitized a portfolio of 261.7 billion mortgage securities through a special purpose company "MMC assets-6" in 2015Q3, or to be exact, on August 5, 2015. The 90 percent of the securities of 8 percent interest rate mortgage loans issued by the MMC. are purchased by BOM. For instance, with 6 securitization operations MNT 1.88 trillion of loans were transferred to MMC, of which securities worth of MNT 1.69 trillion was purchased by the Bank of Mongolia. Bond repayment of the mortgage loans is paid in accordance with the repayment schedule and the outstanding loan amount is MNT 1.57 trillion as of October 2015.

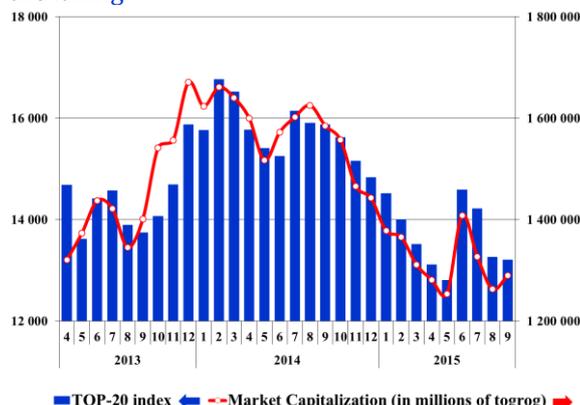
### House prices are declining in the recent quarters...



Source: NSO, estimation

Chart III.4.4.4

### Stock market capitalization and TOP-20 index are falling...



Source: Mongolian Stock Market

Table III.4.4.1

### MNT 0.26 trillion of mortgage loans are securitized by the MMC in 2015Q3...

	Issued date	Volume (in millions of togrog)
1	December 16, 2013	322 901.700
2	June 25, 2014	222 051.700
3	October 21, 2014	324 595.800
4	January 14, 2015	452 278.100
5	May 20, 2015	294 343.300
6	August 5, 2015	261 699.200
	<b>Нийт</b>	<b>1 877 869.800</b>

Source: MMC

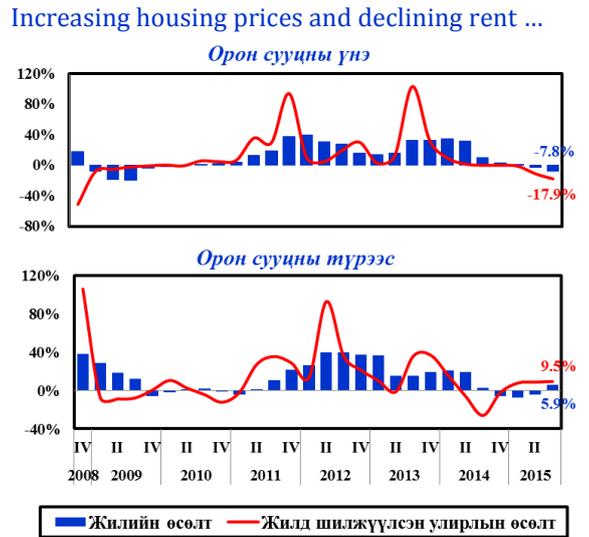
### III.4.4 Real estate market

The Housing price index estimated by the National Statistical Office in 2015Q3 declined by 7.8 percent year on year and showed a 4.8 percent decline from the previous quarter. The housing price index estimated by “Tenkhleg Zuuch” company is also expected to decline by 10.5 percent in Q3. For instance, prices of old houses declined by 13.1 percent and prices of new houses by 4.8 percent. Housing price index in the third quarter of 2015 has declined by 5.9 percent year on year and showed a 2.3 percent decline from the previous quarter (Chart III.4.4.1).

In order to observe the future trend in house prices and rent, annual growth and quarterly growths<sup>16</sup> in terms of years are compared in chart. By this estimation, if quarterly growth in terms of years is higher than the annual growth, growth is expected to increase in the near term and vice versa. In the near term, housing prices are expected to decline further as observed from the estimations for 2015Q3 (Chart III.4.4.1).

From 2013Q3, housing demand has increased in line with the implementation of “8 percent interest rate mortgage loan program”. Effects of the program have been muted from the 2014Q3; as a result, demand for housing decreased and prices for housing also declined gradually. Housing rent has been declining along with the housing prices but has shown recovery from the Q2 and Q3 year on year. Housing prices showing faster growth than the rent prices indicates the existence of a housing bubble. In the last 2 years, housing price growth rate exceeded rent price growth; however, in 2015Q3 the opposite trend was observed. (Chart III.4.4.2)

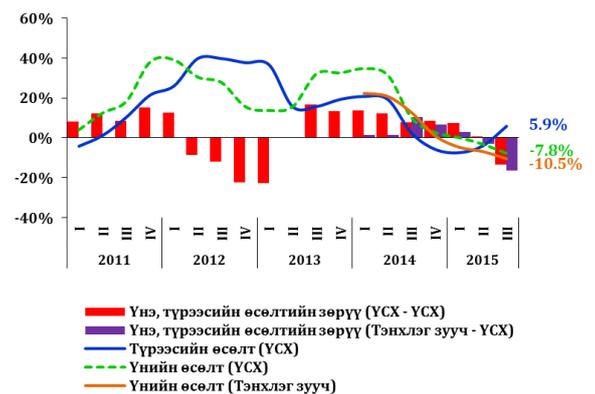
Chart III.4.4.1



Source: NSO, estimation

Chart III.4.4.2

Rent price growth has exceeded the housing prices growth



Source: NSO, estimation

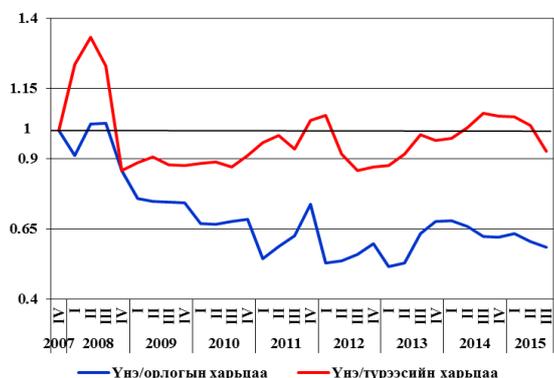
<sup>16</sup> Annual growth =  $p/p(-4)-1$ . Quarterly growth in annual terms =  $(p/p(-1))^4-1$ . (p = price, rent index)

Stock market capitalization and market activities contracted due to a deteriorating economic outlook and declining market value of companies. Stock market indicators, which have been decreasing continuously since September 2014, was quite volatile in 2015Q2 and Q3. The Top-20 index and market capitalization increased significantly in June 2015 and has since been on a downward trend. At the end of Q3, the TOP-20 average indicator is 13210.2, which indicates a decline of 10.9 percent since the beginning of the year and 9.5 percent over the previous quarter. But market capitalization of 1.3 trillion as of September, 2015 is estimated to have decreased 10.6 percent since the beginning of the year and 8.4 percent over the previous quarter. Moreover, the balance of payments statistics shows that foreign investors' assets allocated at the Mongolian Stock Exchange decreased by USD 4 million during the first 3 quarters of this year. For instance, in the first 9 months of 2015, the number of transactions conducted was 7 billion which indicates a 58 percent drop from the previous year (Chart III.4.4.4).

The Mongolian Mortgage Corporation (MMC) organized the 6<sup>th</sup> securitization operation of the 8 percent interest rate mortgage loans among banks, and the BoM purchased these securities. The MMC securitized portfolio of 261.7 billion mortgage securities through a special purpose company "MMC assets-6" in Q3, or to be exact, on August 5, 2015. BOM purchased 90 percent of the 8 percent interest rate mortgage loans securities issued by the MMC. For instance, as a result of 6 securitization operations MNT 1.88 trillion of loans were transferred to MMC, of which securities worth of MNT 1.69 trillion were purchased by the Bank of Mongolia. Bond repayment of the mortgage loans are paid in accordance with the repayment schedule and the outstanding loan amount is MNT 1.57 trillion as of October 2015.

Chart III.4.4.3

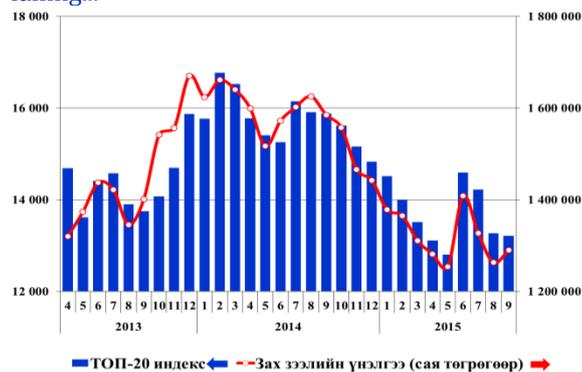
Housing prices are declining in the recent quarters....



Source: NSO, estimation

Chart III.4.4.4

Stock market rates and TOP-20 index are falling...



Source: Mongolian Stock Market

Chart III.4.4.1

MNT 0.26 trillion of mortgage loans are securitized by the MMC in 2015Q3...

	Үнэт цаас гаргасан огноо	Хэмжээ (сая төгрөг)
1	2013 оны 12 сарын 16	322 901.700
2	2014 оны 6 сарын 25	222 051.700
3	2014 оны 10 сарын 21	324 595.800
4	2015 оны 1 сарын 14	452 278.100
5	2015 оны 5 сарын 20	294 343.300
6	2015 оны 8 сарын 5	261 699.200
	<b>НИЙТ</b>	<b>1 877 869.800</b>

Source: MMC

## III.5 Balance of payments

The current account deficit decreased by 77 percent y-o-y and amounted to USD 78.3 million at the end of 2015Q3. The capital and financial account balance which amounted to a surplus of USD 683.2 million in 2014Q3, reached a deficit of USD 48.7 million in 2015Q3. As such, the total balance of payments was in deficit of USD 255.7 million. Net errors and omissions amounted to USD -128.7 million.

### III.5.1 Current account

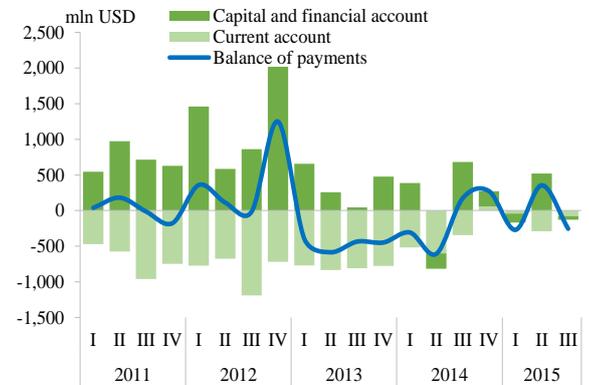
A decline in the services component contributed significantly to the decrease in the current account deficit. Specifically, foreign trade of goods was in surplus of USD 240.4 million in Q3, around the same level as 2014Q3, while the foreign trade of services was in deficit of USD 125.6 million USD, an improvement of USD 218.4 million y-o-y.

In Q3, exports contracted by 24 percent y-o-y, corresponding to an amount of USD 370.7 million, while imports declined by 29 percent y-o-y, corresponding to an amount of USD 371.3 million. Thus, the foreign trade balance was approximately at the same level as 2014Q3. Specifically, due to lower commodity prices, there was a decline of 19 percent y-o-y, equal to USD 129.8 million in copper exports and 46 percent y-o-y, equal to USD 83.3 million in crude oil exports. Due to weakening external demand and lower commodity prices, there was a contraction of 33 percent y-o-y, equal to USD 61.9 million in coal exports and 53 percent y-o-y, equal to USD 56.3 million in iron ore exports. Though the prices of gold sold by companies to the BoM declined, exported value rose by 3 percent y-o-y, equal to USD 4.0 million.

On the other hand, total imports of goods declined mainly due to the economic slowdown, continued currency depreciation, diminished investment inflow, and oil price decline. Consumer imports contracted by 19 percent y-o-y, equal to USD 63.0 million, while imports of investment goods declined by 34 percent y-o-y, around USD 213.8 million. Oil imports contracted by 37 percent y-o-y, equal to USD 120.3 million and imports of manufacturing goods decreased by 20 percent, around USD 32.5 million.

Chart III.5.1.1

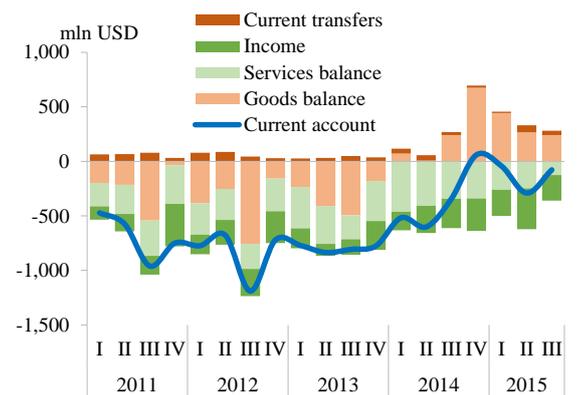
### Balance of Payments



Source: BoM

Chart III.5.1.2

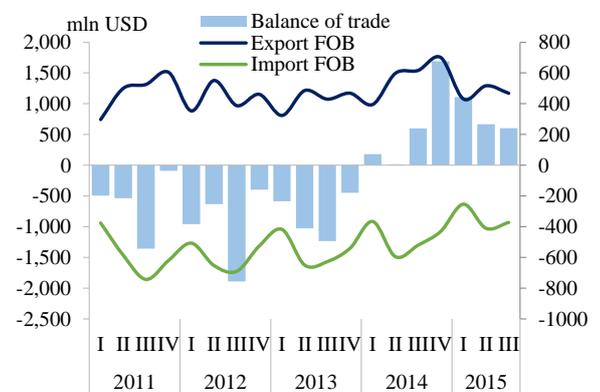
### Current account



Source: BoM

Chart III.5.1.3

### Foreign trade of goods



Source: BoM

Chart III.5.1.4

Income from a foreign trade of services rose by 7 percent y-o-y, equal to USD 14.6 million, while the corresponding expenditure contracted by 37 percent y-o-y, by around USD 203.8 million. These led to the contraction of services account deficit by around USD 218.4 million. This was mainly explained by the decline in transport expenditures of USD 45.6 million in net terms in relation to the contraction of imported goods, decline in other types of business expenditures including business management advisory services received by large mining corporations by USD 95.5 million in net terms as well as a decline in citizens' expenditure for travelling abroad by USD 55.7 million in net terms.

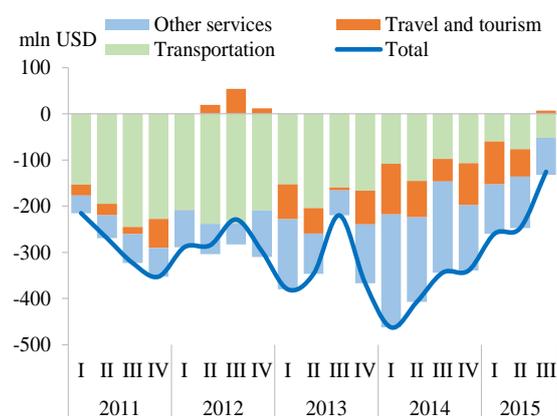
A total of credit by the Mongolian government, private entities and citizens from non-resident lenders, debt instruments, interest payments on deposits and savings and dividend payments decreased by 9 percent y-o-y, around USD 20.7 million in Q3. Thus, income account deficit contracted by 13 percent y-o-y and amounted to USD 234.7 million in Q3. On the other hand, current transfer account surplus increased by 46 percent y-o-y and reached USD 41.7 million.

### III.5.2 Capital and financial account

Capital account surplus grew 28 percent y-o-y and reached USD 33.7 million in 2015Q3.

However, the financial account was in deficit of USD 82.4 million in Q3, a deterioration of USD 739.4 million when compared to the surplus of USD 657.0 million in 2014Q3. Out of which, foreign direct investment declined by USD 197.5 million in net terms, portfolio investment declined by USD 312.9 million and other investment declined by USD 227.5 million (Chart III.5.2.1).

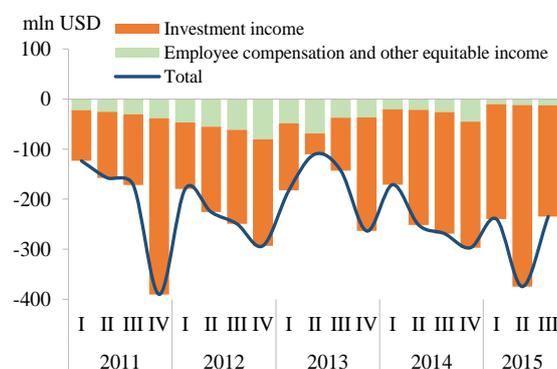
Foreign trade of services



Source: BoM

Chart III.5.1.5

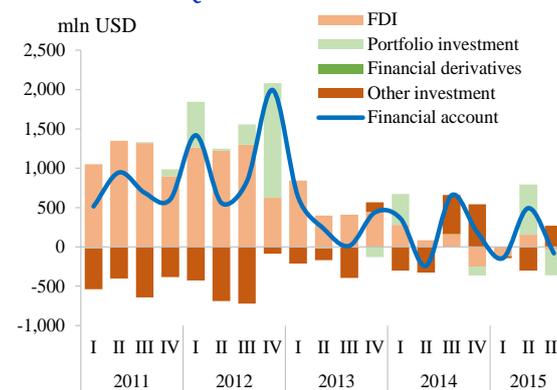
Income account



Source: BoM

Chart III.5.2.1

Financial account in deficit of USD 82.4 million due to TDBM bond repayment of USD 300 million in 2015Q3...

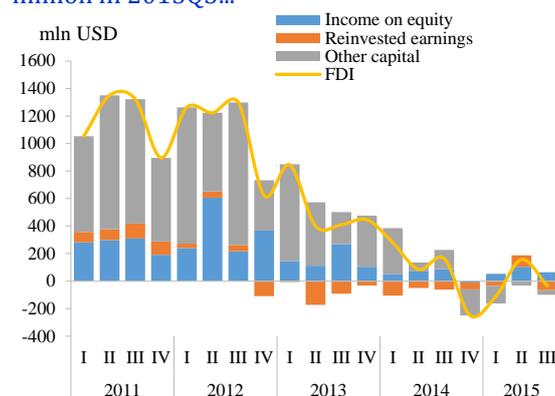


Source: BoM

Chart III.5.2.2

**Foreign direct investment** amounted to USD -34.2 million, a rapid decline from a net inflow of USD 163.3 million in 2014Q3. This is mainly due to large corporations settling their debts with the foreign investors, incurring operational losses and declining new investment. However, in the first 9 months of 2015, Mongolia's foreign direct investment was in a net inflow of USD 10.1 million (Chart III.5.2.2).

Foreign direct investment amounts to USD -34.2 million in 2015Q3...

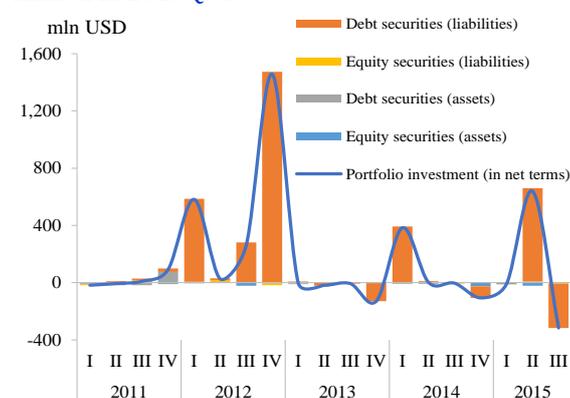


Source: BoM

Chart III.5.2.3

With regards to **portfolio investment**, it was in deficit of USD 316.4 million in net terms due to the Trade and Development Bank of Mongolia bond repayment of USD 300 million in September 2015 and lack of significant inflow financing (Chart III.5.2.3).

Portfolio investment in deficit of USD 316.4 million in 2015Q3...

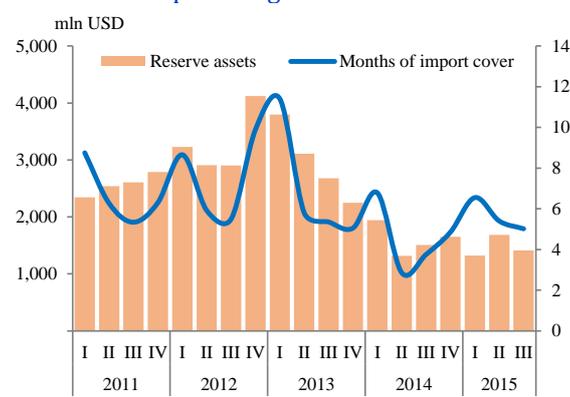


Source: BoM

Chart III.5.2.4

**Other investment** account surplus decreased by 46 percent y-o-y and amounted to USD 268.6 million in 2015Q3. Out of which, cash and current account increased by USD 239.7 million in net terms while loan utilization decreased by USD 340.6 million in net terms.

Total foreign reserves amounts to USD 1.4 billion by the end of 2015Q3 which is 5 months of retained imports of goods...



Source: BoM

As such, the balance of payments was in deficit of USD 255.7 million and **total foreign reserves** declined by 14 percent year to date, 6 percent y-o-y and reached USD 1,412.8 million. Such amount is sufficient for 5.0 months of retained imports of goods payable in foreign currency measured as the average of last 3

Chart III.5.3.1

months (Chart III.5.2.4).

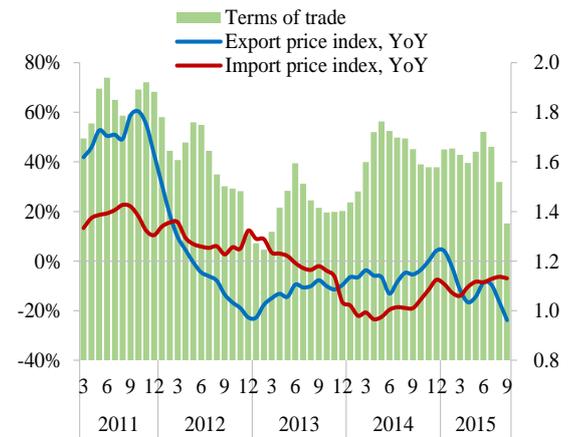
### III.5.3 Terms of trade

Terms of trade deteriorated by 21 percent y-o-y by the end of 2015Q3. Such decline was primarily contributed by the decline of 30 percent y-o-y in the export price index and 12 percent y-o-y in the import price index.

A decrease of 41 percent in the prices of copper concentrates, 52 percent in the prices of crude oil and 39 percent in the prices of iron ore contributed significantly to the export price index decline.

On the other hands, a decrease of 36 percent in the prices of oil products, 15 percent in the prices of manufactured goods and 6 percent in the prices of consumer products led to the decline in import price index.

Terms of trade



Source: BoM

## III.6 External environment

*In 2015 Q3, the situation in the U.S and the Euro zone remained broadly positive, while decelerating momentum in China and a declining trend in Russia needed close monitoring. Domestic demand in the Euro zone is gaining momentum, supported by low oil prices, euro weakness and loosening monetary policy. However, low oil prices negatively affected Russia's economy reducing domestic demand and increasing inflation. The U.S economy is growing at a moderate pace, benefited from consumer and housing activity, solid job growth, rising income gains, and cheaper gasoline prices.*

*Commodity prices are falling due to the strengthening of the USD, contraction in China's industrial sector and continued crude oil supply growth from OPEC (including Iran and Iraq).*

### III.6.1 Trading partner economies

#### China

In 2015Q3, GDP growth in China was recorded at 6.9 percent y-o-y, its slowest pace since the global financial crisis, but it still fared better than market expectations of 6.8 percent. This was mainly due to the acceleration in retail sales growth by 10.9 percent y-o-y and the service sector growth by 8.6 percent y-o-y. The resilient growth of retail sales and the services sector indicates China's efforts to shift its economy from export-driven to consumption-driven powered by its own internal growth. Property investment rose only by 2.6 percent and 2 percent y-o-y in 2015Q3 and October 2015, respectively (4.6 percent in 2015Q2), while export volume decreased by 8.8 percent y-o-y and business sentiment is waning as a slowdown in manufacturing activity continues. Reflecting this, China's economy continues to face downward pressure stemming from the industrial sector.

The People's Bank of China cut its interest rate by 25 basis points, lowered the reserve requirement ratio for large banks by 50 basis points and removed the ceiling for deposit rates in October 2015

Chart III.6.1.1

China's economic growth, y-o-y, in percentage



to support economic growth and guide inflation to a targeted level.

## Russia

In 2015Q3, the Russian economy contracted by 4.1 percent y-o-y. The ruble has depreciated by 48 percent since the beginning of 2015 and the inflation rate remained at 15.7 percent, thus causing retail sales to contract by 9.5 percent y-o-y and industrial production to shrink by 4 percent y-o-y each month.

The pace of contraction in the manufacturing sector tends to slow due to the slight increase in manufacturing PMI index to 50.2. On the other hand, the service sector growth continues to slow as domestic demand weakens, reflected by a decrease in real income of 4.3 percent y-o-y and in real wages of 9.7 percent y-o-y as of September 2015.

The Central Bank of Russia decided to keep its interest rate unchanged at 11 percent. The markets were slightly surprised by the CBR's announcement that it will start lowering rates if inflation slows to below 7 percent, as expected. While monetary policy remains tight, it is estimated that the Russian economy will recover slightly by 0.7 percent in 2016 owing to increasing tax revenues from oil and gas.

## The United States

The U.S economy expanded an annualized 3.9 percent in 2015Q2 and 2.1 percent in 2015Q3, according to the latest estimates. Personal consumption, the biggest contributor to growth, increased less than anticipated, 0.6 percentage points lower than in the previous quarter. Fixed asset investment expanded by 3.4 percent, 1.8 percentage points lower than in the previous quarter.

Conditions in the labor market continued to improve. In October, the unemployment rate persisted at 5 percent, the lowest since 2008, the labor market participation rate remained unchanged at 62.4 percent, and total nonfarm payroll employment increased by 271,000. Housing prices continued to stay strong. Compared to last year, housing prices rose by more than 5 percent each month since the beginning of this year and peaked in July at 5.8 percent. Given the positive developments in labor and housing markets, the U.S economy seems to have expanded at a healthy level.

The Fed decided to keep the interest rate in September citing the global economic slowdown, led by slowing in China's economy. Despite this, the continuously improving situation in the economy and labor market suggests that the Fed will raise the interest rate from a very low level at its next meeting in December 2015.

Chart III.6.1.2

Russia's economic growth, y-o-y, in percentage

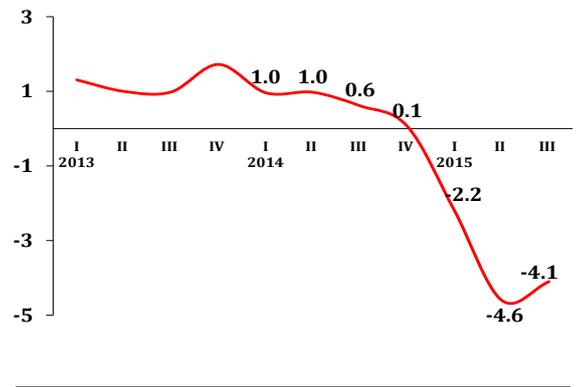
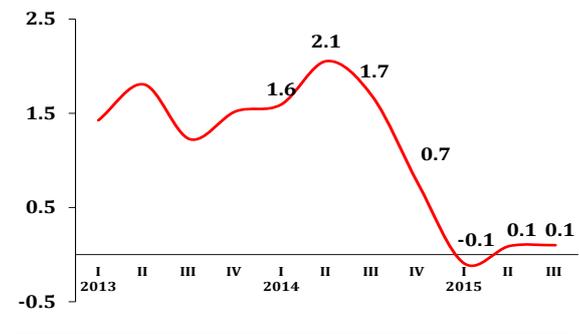


Chart III.6.1.3

Annual inflation rate in the U.S



## Euro zone

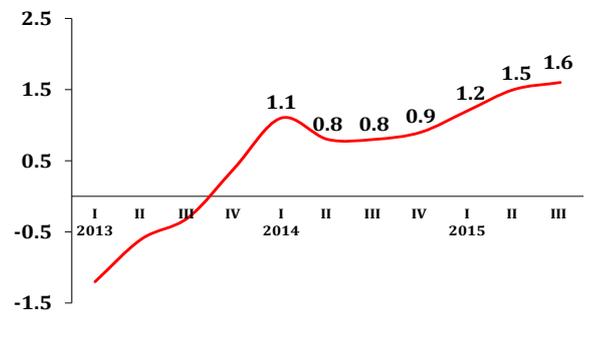
Despite the recent crisis of Greece, the Euro zone economy continues its gradual recovery. According to the latest estimate, the Euro zone economy expanded at 1.2 percent, 1.5 percent and 1.6 percent y-o-y in 2015 Q1, Q2, and Q3, respectively. In September, retail sales performed significantly well, with a yearly growth rate of 2.9 percent y-o-y, supported by strengthening domestic demand stemming from low oil prices and monetary policy easing. Also, a weaker euro helped boost exports of goods and supported the economic growth.

Labor market conditions have generally improved. The unemployment rate was at 11.1 percent in 2015Q2, and 10.8 percent in September. Some improvements in PMI indicators were visible as well. The manufacturing PMI rose to 52.3, after reaching 52.1 in September, while the services PMI rose to 54.1 from 53.7 in October.

The European Central Bank increased bond purchases to USD 70.3 billion from October with the purpose of promoting economic growth and guiding inflation to a targeted level.

Chart III.6.1.4

Euro zone's economic growth, y-o-y, in percentage



### III.6.2 Prices of exporting commodities of Mongolia

**Copper:** In August, copper prices dropped rapidly to USD 5127.0 when compared to the price of USD 6056.0 as of 2015 Q2. **Copper:** In October, copper prices fell to USD 5,216.0 per ton on average, weighed down by lower than expected industrial production numbers out of China. Moreover, the Chinese stock market crash, weakening industrial activity and the combination of strong USD and yuan depreciation heavily weighed on copper prices. Copper prices were slightly lifted after Glencore announced production cuts by 400,000 tons in Congo and Zambia over the coming 18 months.

**Gold:** In October, gold prices increased to USD 1,159.0 per ounce on average, from the price of USD 1124 in 2015 Q3. Gold prices have been trading down as financial market expectations for a Fed rate hike, even though gold demand is expected to increase.

**Thermal coal:** Thermal coal prices, which were recorded at USD 66.1, USD 59.0 and USD 52.0 per ton by the end of 2014, in 2015 Q2 and 2015 Q3 respectively, sharply fell to USD 48.0 in October. This is due to China's environmental policies slowing down the growth of coal consumption. For instance, in the first nine months of 2015, total thermal coal imports declined to 9.2 million tons from 14.3 million tons in the same months of 2014.

**Coking coal:** In October, coking coal prices fell to USD 89.0 per ton, down from USD 109.5 in 2015Q2 and USD 93.0 in Q3. Reflecting this, the prices of coking coal in Australia declined to USD 95.6, down from USD 115.0 in 2015Q2 and USD 98.0 in Q3. China's coking coal imports dropped to 36.4 million tons in the first nine months of 2015, from 44.4 million tons as of the same months of 2014, and are expected to decline substantially this year.

**Crude oil:** In October, Brent crude oil prices dropped to USD 48.0 per barrel, down from USD 64.0 in May. The combination of continued supply growth from OPEC and Iran and persistently high output in the US suggests that global crude oil markets will remain well supplied during most of next year.



BANK OF MONGOLIA