THE BANK
OF MONGOLIA

INFLATION REPORT

2018
DEC

CONTENTS

MONETARY POLICY STRATEGY, DECISION

Monetary policy strategy

According to the Law on Central Bank, the **main objective of the Bank of Mongolia is to stabilize togrog.** Within this objective, in the medium run the Bank of Mongolia implements monetary policy to stabilize annual inflation rate measured by consumer price index around its target rate set in the Monetary Policy Guideline. By stabilizing inflation at a low rate, the Bank intends to safeguard the real income and asset of households, facilitate an environment conducive to banking and financial system stability and promote investments and sustainable economic growth in the long run. Thus, based on international best practice, monetary policy strategy of the Bank of Mongolia is gradually switching to inflation targeting framework.

In carrying out its monetary policy, the Central Bank alters the policy rate in response to changes in aggregate demand, to stabilize inflation by influencing market interest rate and consequently aggregate output, asset prices, expectations, exchange rate, and domestic demand. Coupled with the policy rate, in the international case it is common to apply macroprudential policy measures such as setting adequacy ratios for the banking sector as a whole to cool down overheating credit market, to curb overcrowding of financial products in certain sectors and to limit financial dollarization.

Successful implementation of the inflation targeting strategy of monetary policy depends on the Central Bank's ability to sustain market confidence and manage its expectations effectively. To this end, the Bank of Mongolia publishes Inflation Report each quarter to inform the public on the performance and forecasts of macroeconomic indicators, inflation, near term economic outlook and factors that influence overall economic outlook such as external environment, financial sector, aggregate demand, aggregate supply, employment, prices, and costs. Informing the public on monetary policy decisions consistent with the Central Bank's target and inflation forecasts, and on the decision makers' rationale, serves the purpose of facilitating the Central Bank transparency, building public confidence in the Central Bank, thus supporting the Central Bank's policy objective to stabilize inflation around its medium-term target by managing the market's expectations.

Monetary policy decision (November and December 2018)

During its unscheduled meeting held on November 27, 2018, the Monetary Policy Committee **decided to raise the policy rate by 1 percentage points to 11 percent and to initiate issuance of a 28 week Central Bank Bills starting December 2018.** On December 14, 2018 during its scheduled meeting the Monetary Policy Committee decided **to keep the policy rate unchanged at 11 percent.** /Detailed information is provided in monetary policy statements./

EXECUTIVE SUMMARY

Since the last report was published, no significant changes were observed in the external environment, yet uncertainties and risks regarding export transportation and the US-China trade tensions are accumulating. In case of domestic environment, near-term forecast of inflation is revised up and the 2019 Budget for Government of Mongolia is approved at a level beyond previous expectations.

Due to supply-side factors, inflation accelerated in the past months. In the reporting period, prices of food items and administered services were lower than previously expected. Although demand pull inflation is increasing gradually, supply driven factors accelerated in the past months. For instance, in November monthly inflation increased sharply to 2.25 percent, mainly due to rising prices of meat, gasoline and solid fuel driven by supply factors. Monetary Policy Committee's decision to increase the policy rate to 11 percent in November, was consistent with the objective to stabilize inflation around 8 percent during 2018-2020, a target set in the Monetary Policy Guideline by the Parliament. In the upcoming months, although headline inflation is likely to exceed 8 percent mainly due to price changes of meat, solid fuel and gasoline, objective to stabilize inflation remains intact.

Investments are increasing and the economic recovery continues to gain momentum. Following major construction projects in the mining sector investments grew steadily, production accelerated in non-mining sectors and economic growth has picked up. In the reporting quarter, revenue generated through customs duty exceeded previous expectations owing to increased road transportation of cargo and imports. Such upside development was one of the main factors leading to economic growth beyond previous projections in the third quarter. However, overall economic growth projections for 2018 is revised down this quarter, as the transportation of coal exports is disrupted in the fourth quarter and oil exports decreased, which are expected to weigh down on growth in the mining sector. For 2019-2020 however, projection of growth in non-mining sector is revised up slightly, as we expect the expansion of current and capital spending by the government to support demand. Although domestic economy remains active, disruption of coal transportation and disagreement between major global economies regarding geopolitical and trade issues are likely to weigh down on the economy.

Fiscal stance is expected to loosen and growth of business credit is likely to recover further. In line with the policy to ensure government debt-sustainability in the medium to longer run, budget expenditure on goods and services were cut significantly in the past year. Yet starting this year such expenditures are likely to expand and thus loosen fiscal stance. Economic recovery and fiscal and monetary policy actions are supporting growth of business credits starting the second quarter of 2018. In particular, credits issued in MNT are increasing rapidly and credit dollarization has been declining in the past several quarters. The stock market remains relatively stable.

External environment poses risk on domestic economy, through channels of export prices and external demand. Outlook for external demand is weakened from previous quarter and a further weakening trend is unchanged. Although Chinese economy is supported by sustainable growth in domestic consumption, its growth projections are lowered mainly due to trade war issue raised by the USA and high level of debt issued by the Chinese government, which are likely to strain its growth in the future. Russian economic outlook is also weakened, on the back of tight fiscal policy, lower price of oil, depreciation of its exchange rate, tax reform and the likelihood of tighter sanction from the USA. Since growth decelerated in its main trading partners, the Euro area economic outlook is also revised down. Unsustainable improvements in its labor markets and the trade war issues are expected to weigh on its growth.

Although the outlook of terms of trade is improved from previous quarter, it remains on a declining trend for the upcoming years. In the reporting quarter, prices of copper and gold declined constantly and thus price of exports weakened beyond previous expectations. However, falling oil prices pushed import prices below our previous assumptions and thus the terms of trade improved. For the upcoming period, no change is expected in oil prices, while forecasts of coal and copper prices improved, leading to improvement in terms of trade.

On the back of lower export prices, exports revenue is declining and thus leading to lower surplus in the goods and services balance and greater deficit in balance of payments. Another factor leading to greater deficit in balance of payments is, persistently high level of import payments which are supported by increased domestic demand and rising investments. In the reporting quarter, deficit in balance of payments has widened, tension between global economies on trade issues are building and risk-free benchmark interest rate at the global financial market is increased, thus resulted in depreciation of MNT against USD. Economic sanctions set by the USA on other economies and trade dispute with China are likely to affect our external demand negatively and to push the price of exports down and the price of imports up. At the same time, its policy on interest rate is encouraging capital outflow from emerging economies and thus poses risk of lower growth. In addition, any change in our capacity to transport coal exports would have strong implications on our export revenue, balance of payments and thus exchange rate.

I. INFLATION

In the Monetary Policy Guideline for 2018, the Bank of Mongolia set forth a goal to stabilize inflation around 8 percent during 2018-2020. As of November 2018, headline inflation reached 8.1 percent nationwide and 9.3 percent in Ulaanbaatar, while core inflation reached 8.9 percent.

In the third quarter of 2018, inflation was at 7.0 percent on average, which is 0.2 percentage points lower than previously forecasted. Such difference can be explained by falling prices of meat and vegetables beyond previous estimations. In the previous report, some hikes were expected in prices of certain services based on qualitative information. Yet, it did not materialize in the reporting quarter, thus partially explains the difference in forecasted and actual inflation. For instance, tuition fees for public and private universities and colleges did not increase as much as expected, while the planned hike in certain administered prices were postponed to January, 2019[1].

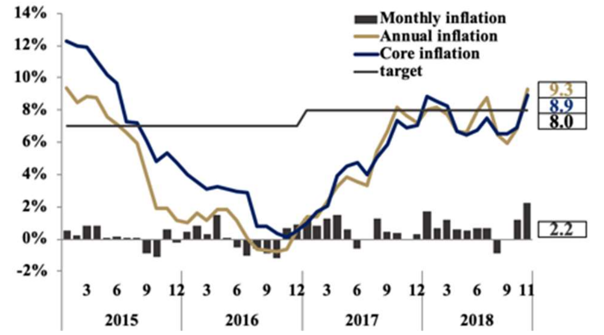
Core inflation, which excludes prices of 41 items that fluctuate significantly depending on weather conditions and seasonal factors such as meat, milk, and vegetables, has been declining steadily year-to-date and stabilized around 7 percent in the second and third quarter of 2018. In the last quarter, core inflation is expected to fluctuate around 8 percent.

In November 2018, monthly headline inflation spiked to 2.25 percent, which can be attributed to higher price of clothing items and restaurant meals. Of annual headline inflation in Ulaanbaatar, 5 percentage points or 53.8 percent, can be explained by rising prices of meat, gasoline and solid fuel. (Figure I.3). Price of meat increased in October and November, due to domestic and external factors. For instance, during these months, exports of mutton and goat meat, increased by 264 percent and 169 percent year-over-year[2], respectively. Domestically, butchering and meat processing activities were delayed this year, as the weather conditions remained warmer than usual. In November, price of gasoline increased by 4 percent from October, while price of solid fuel increased by 14 percent.

Following such supply driven factors, inflation increased sharply in November, thus exceeded

Figure I.1

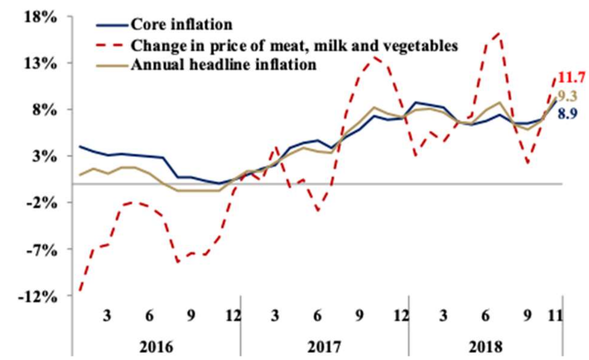
Inflation



Source: NSO

Figure I.2

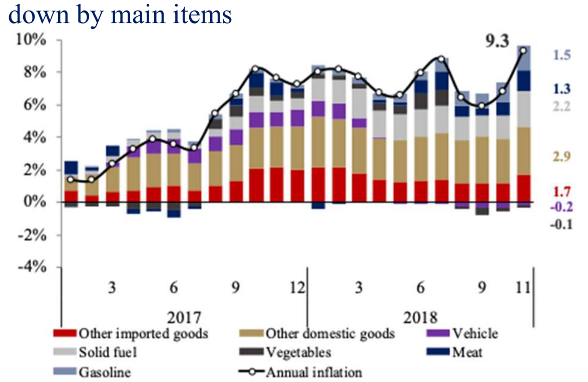
Headline and core inflation



Source: NSO, Bank of Mongolia

Figure I.3

Headline annual inflation in Ulaanbaatar, broken down by main items



Source: NSO, Bank of Mongolia

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[1] A proposal to raise price of electricity by 10.4 percent and price of hot water by 10 percent starting January 2019, was made to the government. College tuition fees were expected to increase by 15 percent, however it increased by 8 percent.

[2] Source: Foreign trade statistics from the Electronic database of Customs Office
http://www.customs.gov.mn/statistics/index.php?module=users&cmd=info_st

previous expectations. However, in 2019 inflation is forecasted to decline and fluctuate close to the previous forecast.

Although, inflation is forecasted to be around its target rate at the end of 2018, rising wages and fiscal expenditure are expected to support domestic demand and thus inflation is expected to pick up during 2019-2020. Supply related factor, on the other hand, is not expected to accelerate and price of food items are forecasted to decline in 2019, assuming weather conditions do not deviate from its historic trend. As for 2020, since food prices at the global market are projected to increase and public sector wage is expected to rise, prices of food items are projected to pick up.

From the supply side, one-time effect of certain items (gasoline and solid fuel) that contributed 5.0 percentage points of headline inflation, is expected to persist till the end of 2018 and fade starting 2019. Supported by rising public sector wages, government expenditure and investments, demand related inflation pressure is expected to push price of non-food items up in 2019, before weakening in 2020.

Uncertainties regarding inflation forecast:

- Potential shortage or oversupply of goods and services have significant implications on inflation forecasts. For instance, depending on weather conditions, supply of meat and vegetables may fluctuate, leading to price fluctuations. Similarly, potential change in administered prices (price of gasoline) may lead to a change in inflation forecast.
- Rising wages and government expenditure may result in greater demand pressure, thus push inflation beyond its current forecast.
- Although the price of oil at the global market has been declining in the past 2 months, upside risks are not fully eliminated. Rising global prices of oil are likely to create cost driven pressure on domestic prices of oil. The agreement between OPEC and non-OPEC countries to cut oil production, unresolved issue of the US export sanction on Iranian oil, expectation of lower oil production in Venezuela and limited deposit in OPEC countries, are likely to disrupt global supply of oil.

Table I.1

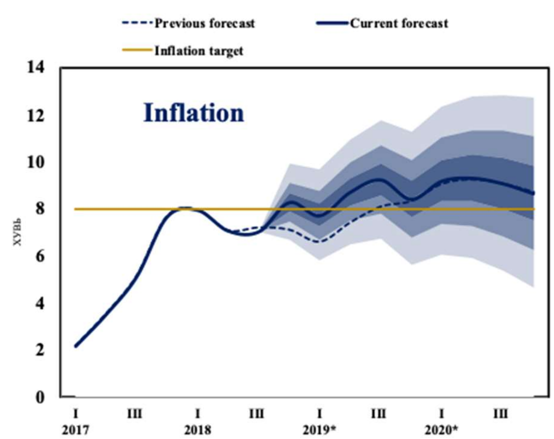
Change in inflation outlook

Assumptions of near term forecast on inflation	
Previous forecast 2018Q3-2019Q2	**Current forecast 2018Q4-2019Q3**
Price of vegetables	**Forecast decreased**
Price declined beyond previous forecasts thus is to reduce headline inflation at the end of the year.	Price declined beyond previous forecasts, thus support lower headline inflation at the end of the year.
Price of meat	**Forecast increased**
Price of meat is expected to decline following its seasonal trend, thus its contribution to headline inflation is likely to decline	Price of meat to increase following its seasonal trend
Administered prices	**Forecast decreased**
Tuition fee to increase by 15 percent in August and price of electricity and heat to increase in September	Planned increase in prices of electricity and heat is postponed to January, 2019
Price of gasoline	**Forecast increased**
Domestic price of gasoline to increase following rising price of oil and transition to winter fuel.	Domestic price of gasoline increased following change in oil prices and transition to winter fuel in October. Hence, price of gasoline is expected to remain stable at its current level
Price of domestic goods	**Forecast increased**
During 2018Q3-Q4, price of solid fuel to increase less rapidly compared to previous year, and to remain stable during 2019Q1-Q2	Price of solid fuel increased in October and November. It is expected to remain stable in the first 2 quarters of 2019.

Source: Expert's judgment

Figure I.4

Inflation forecast



Source: Bank of Mongolia

Table I.2

Inflation forecast[‡]

	2017	2018*	2019*
	actual	*forecast*	
Inflation, CPI[†]	7.7	7.9 – 8.7	7.6 – 9.2

[‡] 30 percent confidence interval

[†] Average inflation in the fourth quarter of each year.

Source: Bank of Mongolia

Box 1: Core inflation

For a central bank with monetary policy objectives to stabilize and reduce inflation fluctuations, it is crucial to accurately estimate the medium-term trend of inflation, namely the core inflation. Since central bank monetary policy is aimed at stabilizing inflation in the medium to longer-term, policy decisions are based on the medium-term trend of inflation. On the other hand, since monetary policy has lagged impact on aggregate demand, it is implausible to take monetary policy actions in response to short term fluctuations in inflation caused by short-lived one-off factors. For instance, weaker than usual harvest could lead to sudden hike in price of vegetables and thus supply related pressure on headline inflation. However, since such event is one-time only and less likely to be repeated in the following years, supply related pressure would be short-lived and thus would not affect the inflation trend. If monetary policy stance is tightened in response to such short-lived fluctuations, aggregate demand would be squeezed in the medium term and pose risk of lower employment and inflation relative to its longer-term trend.

Depending on economic condition, peculiarity of consumption behavior, and other factors, central banks employ variety of methods to estimate the core inflation. For instance, some central banks i) remove certain items from consumer basket permanently, while others ii) remove only the items with most fluctuations in each reporting period.

Figure I.5 Core and headline inflation

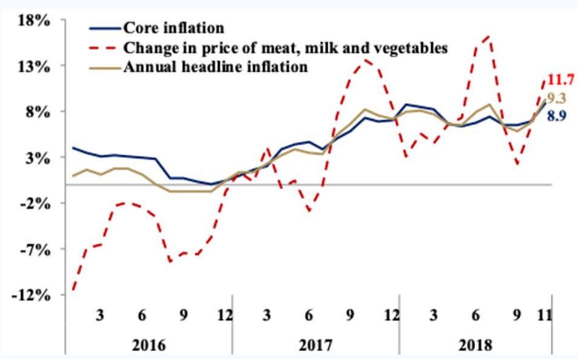
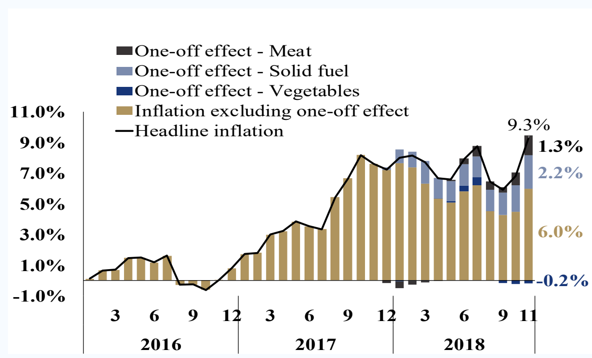


Figure I.6 One-off effect



In case of Mongolia, weather conditions often result in shortage of agricultural products such as meat, milk and vegetables, thus leading to short term price fluctuations. Hence, core inflation is estimated by removing 41 items with similar pattern, from the consumer basket. (Figure Ш.1).

Average price of meat had declined by 12 percent and 9.9 percent in 2015 and 2016, respectively, leading to headline inflation lower than its trend and the economy faced deflation in the second half of 2016. However, starting mid-2017 price of meat and dairy picked up gradually and price of vegetables shot up due to weaker harvest. Through its baseline effect such supply driven change in prices squeezed the headline inflation in the second half of 2018 and resulted in short-term fluctuations. Headline inflation declined by 2.9 percentage points during July and September of 2018 reaching 5.9 percent, while jumped back to 6.8 percent in October. Core inflation, on the other hand, remained relatively stable from early 2018 and is fluctuating between 6.4-7.5 percent in the last 6 months.

Although it is laborious to define and estimate core inflation accurately, as it is a crucial input for monetary policy decision making process, further research is needed in this field.

II. ECONOMIC GROWTH

Economic growth reached 6.4 percent in the first 3 quarters of 2018. It is mainly supported by several factors such as continued investment to large-scale development in the mining sector, relatively loose stance of monetary policy which supported economic activities and gradual expansion of credit that facilitated growth of domestic investment and demand.

Expansion of gross capital formation and accumulation of inventories made the greatest contribution to growth of aggregate demand, while contribution of household consumption was relatively low. Moreover, foreign trade deficit continues to be contractionary on aggregate demand (Figure II.1).

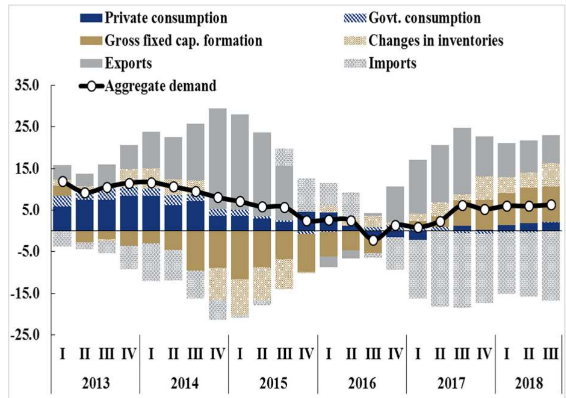
On the supply side, non-mining sectors and revenues from taxation levied on goods were the main drivers of economic activity, while mining and construction activities contributed negatively. Nevertheless, growth of aggregate supply in the third quarter of 2018 exceeded previous forecast. It was mainly supported by growth of production in agriculture, transportation and other services' sectors as well as tax revenue levied on goods and services. Specifically, crop production exceeded previous expectations, thus the agriculture sector contributed 0.8 percentage point to growth of aggregate supply (Figure II.2).

In the reporting quarter, demand for mineral products remained at a comparatively high level, leading to greater export revenue. However, imports related to investment and consumption expanded at the same time, leading to contraction in net exports year-over-year. Upside of such increase in imports is that tax revenue generated from foreign trade boosted economic growth by 2.5 percentage points. Despite growing imports, sales of fuel products which take up a significant portion of overall trade slowed down. Thus, the trade sector growth fell short of expectations and contributed a mere 0.3 percentage points to economic growth.

In the reporting quarter, investments expanded by 33.5 percent year-over-year in real terms and thus contributed 11.0 percentage points to growth of aggregate demand. Capital inflow through FDI increased following development for the Oyu Tolgoi second phase and other mining companies expanded their investments. Increased investments led to higher gross fixed capital formation in machineries,

Figure II.1

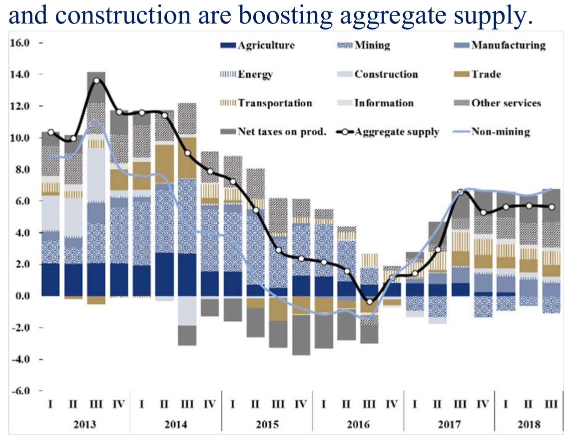
Aggregate demand is mainly driven by gross capital formation, while foreign trade deficit is weighing down on economic growth.[3]



Source: NSO

Figure II.2

Majority of production sectors excluding, mining and construction are boosting aggregate supply.



Source: NSO

[3] Growth calculated from sum of 4 consecutive quarters

equipment and non-residential buildings as well as increased accumulation of inventories such as equipment, parts and precious metals.

Mirroring the expansion in investments, investment driven imports namely, machineries, equipment and parts, and construction materials are growing rapidly. Moreover, after a stagnation of 3 years, credit to business sector, a domestic source for financing investments, has begun to recover within the last 2 quarters (Figure II.3). Intermediation services provided by banks and financial institutions including loan issuance and deposit collection activities exceeded expectations and thus made the greatest contribution to services sector, which boosted growth of aggregate supply by 1.8 percentage point.

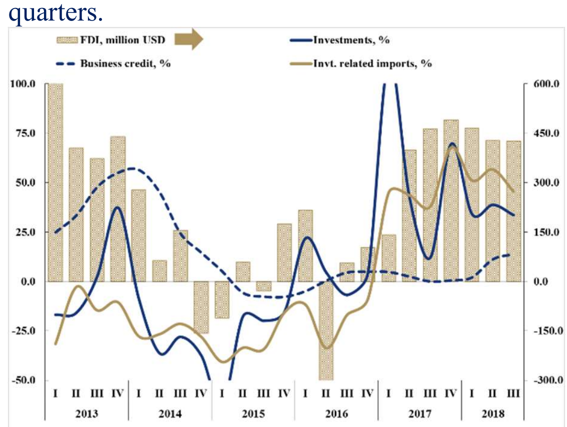
Household income generated through wage, salary, pension, allowances, and revenues from personal business has been growing consequently for the past 7 quarters. Supported by increased household income, household expenditure has been growing as well. Private consumption grew by 1.8 percent year-over-year in the reporting quarter and its contribution to aggregate demand stood at 0.9 percentage point. In correlation with growing private consumption, consumption imports began to recover since the latter half of 2016 and its growth has been gradually speeding up in the past 4 quarters (Figure II.4).

Both household income and expenditures are growing continuously. However, household income remains short of household expenditures. Consequently, household's power to purchase residential properties remains subdued. Thus, construction sector shrunk in the reporting quarter and had contractionary impact on aggregate supply. Such gap between household income and expenditures is leading to increased demand for consumer loans.

Although capacity of coal exports at the border was cut in mid-November, it rebounded soon enough. In addition, relatively high prices of mineral products and recovery in the metallic content of copper concentrate from Oyu Tolgoi open pit mines were the key factors of greater export revenues. Thus, in the thirds quarter exports revenue grew by 11.2 percent year-over-year. On the other hand, in conjunction with the above-mentioned expansion of investment and consumption, import expenditure grew at a much faster pace, specifically 18.4 percent year-over-year. Consequently, foreign trade deficit widened and thus cut 5.2 percentage out of aggregate demand growth in the reporting quarter.

Figure II.3

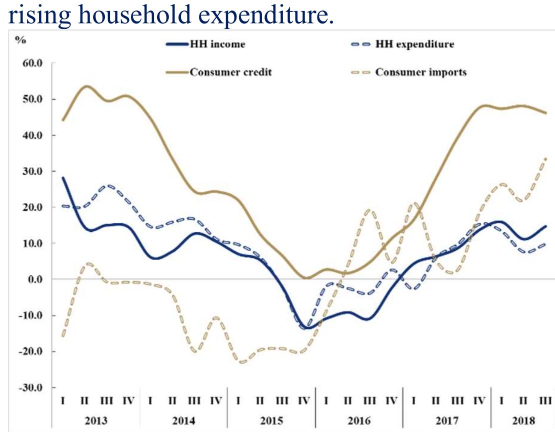
Following increased capital inflow investment related imports has surged. At the same time credit for business has been recovering in the last 2 quarters.



Source: NSO, Bank of Mongolia

Figure II.4

In addition to rising household income, consumer lending is growing rapidly thus, thus supported rising household expenditure.



Source: NSO, Bank of Mongolia

Notwithstanding the slight improvements in export prices from previous quarter, mining sector had a contractionary impact on aggregate supply. In the reporting quarter, mining production excluding Oyu Tolgoi fell short of expectations and thus, weighed down the economic growth (Figure II.5).

Prices of iron ore exceeded expectations, leading to higher exports and thus, a positive spillover impact on transportation sector. Furthermore, in relation to increased household income and expenditures, domestic transportation picked up and supported aggregate supply by 1.3 percentage point.

In line with the policy to ensure government debt-sustainability in the medium to longer run, budget expenditure on goods and services shrank significantly last year. However, it has begun to recover in the reporting year. In the third quarter government expenditure decreased by 1.1 percent year-over-year and accounted for a 0.1 percentage point reduction in aggregate demand.

Potential output: While potential output growth was kept over 10 percent during 2011-2013, it has been decelerating since 2014. Since the fourth quarter of 2016, activities in the non-mining sector intensified owing to indirect impact of large-scale developments in the mining sector, and led to expansion of potential output. Hence it accelerated from 2 percent to 4.5 percent within the past 2 years (Figure II.7).

Output gap: On the back of non-mining sectors, aggregate output exceeded its potential during 2011-2013, and thus, rendering positive output gap. Due to shrinking production in majority of non-mining sectors, output gap turned negative during 2014-2016. However, aggregate output has since picked up to stabilize around its potential level in the past quarters.

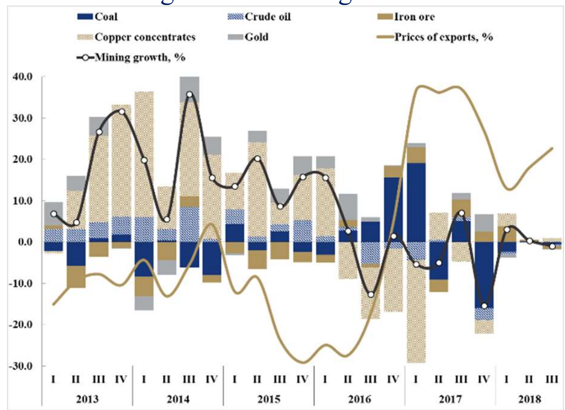
Although the mining sector had been growing faster than its potential level since the end of 2013 mainly owing to increased production of copper and gold, it has fallen below its potential level mostly due to reduction in the metal content of copper concentrates since mid-2016.

As for the non-mining sector, output gap had been negative from 2014 to mid-2017 due to weaker domestic and external economic environment. However, it turned positive starting late 2017, as production of mining except copper concentrates and investment recovered, creating positive spillover effect for the non-mining sectors.

Economic outlook: Compared to the previous report, economic growth projection is revised downwards for

Figure II.5

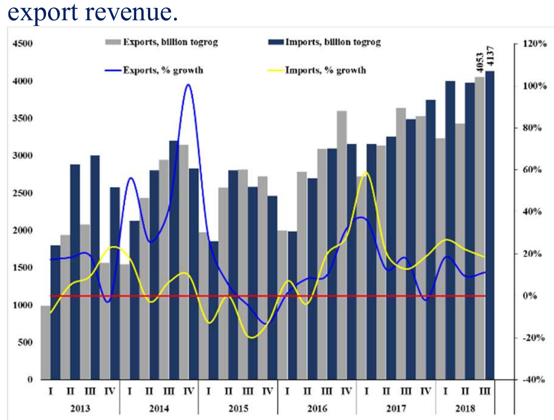
Major commodities except copper concentrates slowed down growth in mining sector.



Source: NSO, Bank of Mongolia

Figure II.6

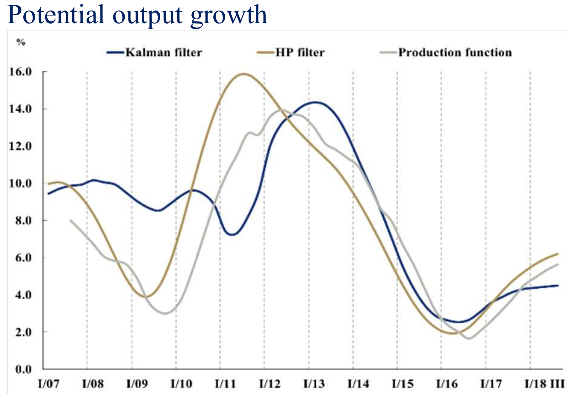
Foreign trade balance has been in deficit for the past 4 quarters, as growth of imports exceeded that of export revenue.



Source: NSO

Figure II.7

Potential output growth



Source: Expert's estimation

2018, kept unchanged for 2019 and revised upwards for 2020. The downward revision for 2018 is mainly attributed to disruption of coal transportation and reduction of crude oil exports, implying weaker growth in mining sector. In addition, expectations of lower iron ore exports led to lower projection of growth in the mining sector, from previous quarter.

On the other hand, growth projection for 2019 is slightly improved, as greater fiscal investment and current expenditures are expected to support growth in non-mining sectors including construction, energy, manufacturing and trade.

Economic growth is expected to be sustained in 2019 supported by both mining and non-mining sectors. Yet, it is projected to slow down in 2020 mainly due to weaker production outlook in non-mining sector.

Although metal contents in copper concentrates are recovering, coal production is expected to contract by the end of 2018 due to bottleneck issues at the border, leading to contraction in mining sector production. Mainly supported by improved outlook for prices of mining commodities and increased production of coal and gold, mining sector growth is expected to recover in 2019 and further pick up its pace in 2020.

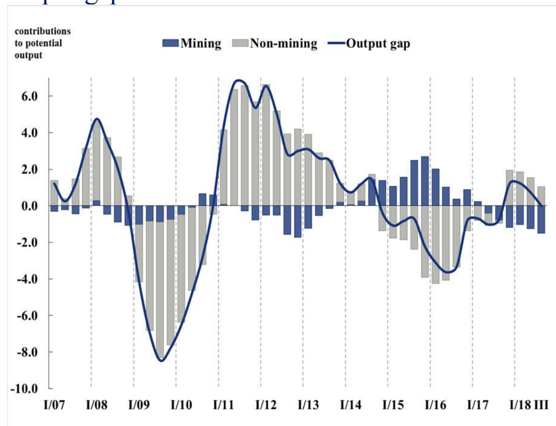
Growth of non-mining sector in 2019 is likely to be supported by ongoing large-scale developments in the mining sector and fiscal policy stance. For instance, activities in construction, manufacturing, trade and services' sectors are projected to accelerate, and tax revenues on goods and services are to be boosted by increasing imports of investment related goods. Production in non-mining sector is expected to slow down slightly in 2020, as spillover impact from large-scale developments in the mining sector wears off and fiscal investment expenditure declines. Within the forecasting horizon, no unexpected changes are expected in the weather conditions and it is assumed to be consistent with its long-term pattern, thus growth in agriculture sector is projected to be stable.

Uncertainties that may potentially affect the economic outlook:

In case the current disruption and limitation applied to the export transportation of coal and other mining products through the border persists for longer or recurs, coal mines may reduce their production beyond their production capacity. Such event may lead to lower potential of exports and create negative spillover effect on non-mining sectors such as freight transportation.

Figure II.8

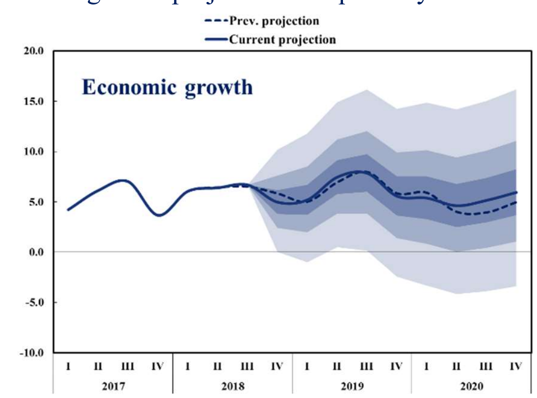
Output gap



Source: Expert's estimation

Figure II.9

Annual growth projections of quarterly GDP



Source: Bank of Mongolia

Table II.1.1

Economic growth projections [†]

	2017	2018*	2019*
	actual	*projection*	
GDP growth, %	5.3	4.8 – 7.3	4.6 – 8.8
Mining, %	-5.5	-2.6 – 0.9	-0.5 – 4.0
Non-mining, %	8.8	7.0 – 9.1	6.0 – 9.9

[†]Confidence intervals of 30 percent

Source: Bank of Mongolia

Trade conflict between the USA and China and Chinese authority's internal policy are expected to affect the outlook of key export commodity prices at international markets and prospects of commodity-exporting small open economies. However, the magnitude of such potential impact remains uncertain.

In case the Erdenes-Tavan Tolgoi JSC successfully launches its IPO at the international market in 2019 and commences its mining and infrastructure developments, it would have significant positive implications on economic growth. Moreover, construction of crude oil processing plant would not only expand production, but also ease pressure on exchange rate and foreign reserves through the substitution of fuel imports.

Implementation plan of other large-scale projects within the scope of "Economic recovery program", its financing sources and impact on foreign direct investments remain uncertain.

Table II.1.2

Change in economic growth outlook

Previous projection (2019)	Current projection (2019)
AGGREGATE DEMAND	**Revised upwards**
Consumption	**Expectation improved.**
	• Increases in household income and wages would support private consumption growth.
	• Government expenditure on goods and services to grow by 21 percent y-o-y according to the approved budget for 2019.
Investment	**Expectation remained unchanged.**
	• FDI inflows to remain at relatively high levels.
	• Expectations of business owners and managers to be positive, growth in business loans has been gradually picking up, leading to higher domestic private investment.
	• Upcoming exports of monetary gold that has been acculumated in recent quarters would drive changes in inventories down.
	• Government investment to expand by 1 trillion togrog y-o-y, according to the approved budget for 2019.
Foreign trade	**Expectation lowered.**
	• Though exports of gold is likely to pick up, outlook for external demand and main commodity prices as well as capacity to cross through border points have deteriorated.
	• Imports to slightly pick up from 2018 levels, in line with growths in consumption and government investment.
AGGREGATE SUPPLY	**Revised upwards**
Mining	**Expectation slightly lowered.**
	• Outlook for production of iron ore and crude oil has been lowered.
Non-mining	**Expectation improved.**
	• Confidence of market participants to remain positive, FDI inflows to remain at high levels, developments in the mining sector to continue.
	• Construction sector growth, especially construction works of schools and hospitals to be boosted through increased government current spending and investments.
	• Growth of tax revenues on products to be supported by increased outlook for imports.

Source: Expert's judgment

III. DOMESTIC ECONOMIC CONDITIONS

III.1. Labor market

In the third quarter of 2018, working age population expanded by 1.3 percent year-over-year reaching 2,172 thousand. Specifically, number of economically inactive population stood at 840 thousand and economically active population at 1,331 thousand. Of which labor force and unemployed population amount to 1,239 and 92 thousand respectively (Figure III.1.1).

Labor market indicators continued to demonstrate a comparatively stronger performance in the reporting quarter. As economically active population increased, labor force participation rate[4] rose by 0.2 percentage point year-over-year, reaching 61.3 percent. Since expansion of labor force exceeded that of working-age population, employment rate[5] grew by 1.5 percentage point year-over-year, reaching 57.0 percent. Furthermore, due to declining number of unemployed population, unemployment rate[6] decreased by 2.2 percentage point year-over-year reaching 6.9 percent in the reporting quarter (Figure III.1.2).

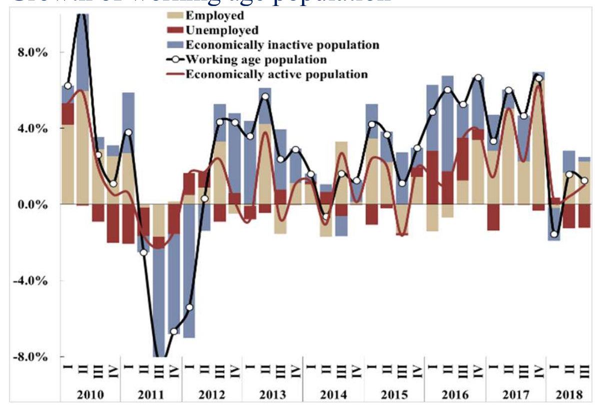
Total employment increased by 4.0 percent year-over-year as of third quarter in 2018 reaching 1,239 thousand. This can be attributed to increased employment in sectors such as mining, manufacturing, trade and transportation, as well as public administration, education, and health sectors, where production is recovering. However, number of workers in agriculture sector has declined (Figure III.1.3). Looking at the decomposition of total employment by status, number of self-employed people and paid workers has been growing in recent quarters.

While number of people who are not ready for employment or are studying declined, due to rising number of pensioners and people on childcare leave, economically inactive population expanded by 0.6 percent year-over-year and stood at 840 thousand in the reporting period.

In case of key income indicators, national average wage[7] rose by 7.9 percent year-over-year reaching 1,031.8 thousand MNT and national median wage increased by 6.1 percent year-over-year reaching

Figure III.1.1

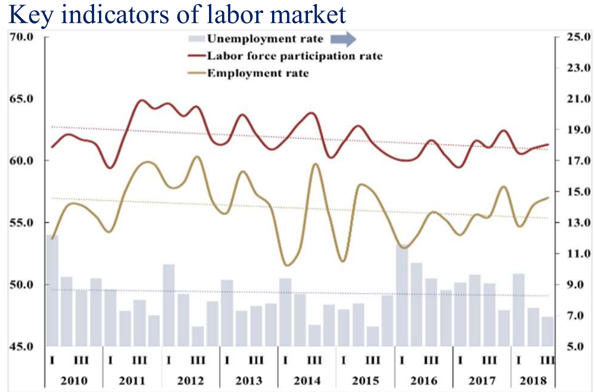
Growth of working age population



Source: NSO

Figure III.1.2

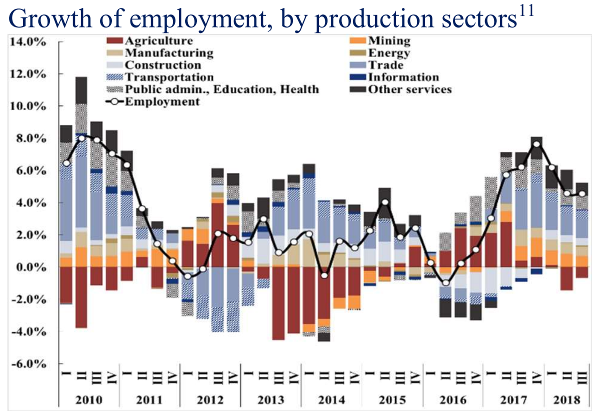
Key indicators of labor market



Source: NSO

Figure III.1.3

Growth of employment, by production sectors[11]



Source: NSO

732.7 thousand MNT as of third quarter in 2018. Moreover, real wage, which is adjusted by consumer price index and reflects people's purchasing power, improved by 2 percent year-over-year. Average monetary income of households[8] grew by 14.7 percent year-over-year to 1,169 thousand MNT; of which average salary income expanded by 12.1 percent year-over-year reaching 589 thousand MNT (Figure III.1.4).

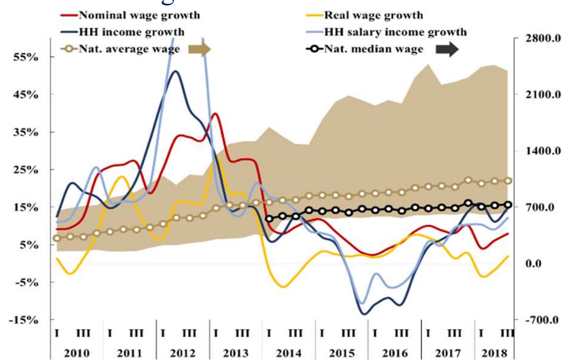
With regards to the main economic sectors, average wage is between 632 and 2,394 thousand MNT. While average wages are rising rapidly in sectors where economic activities have been recovering in recent quarters, namely mining, manufacturing, trade, public administration, education, and health sectors, average wages in agriculture sector are on a declining trend.

Although average labor productivity[9] had been on a downward trend in recent years, it is showing signs of recovery in the reporting quarter. Labor productivity improved by 2.6 percent year-over-year in the third quarter of 2018. When decomposed by key economic sectors, labor productivity is weakened considerably in mining sector, remained weak in trade sector and relatively unchanged in agriculture sector, while it has been on a rising trend in transportation, construction and manufacturing sectors (Figure III.1.5).

Unit labor cost[10] rose by 5.2 percent year-over-year in the reporting period. Among key economic sectors, unit labor cost has surged in mining sector and has been gradually increasing in manufacturing, construction, other services, agriculture and trade sectors. In the transportation sector however, it continued to decline. (Figure III.1.6).

Figure III.1.4

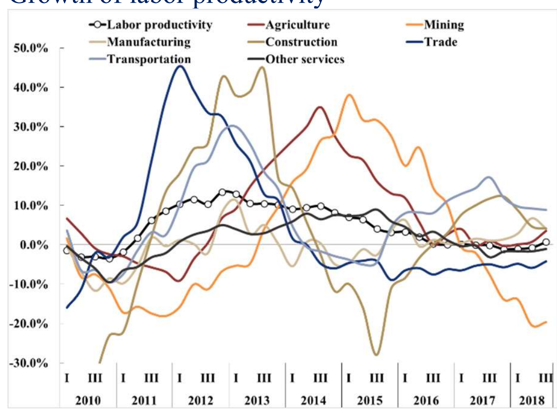
Growth of wage and household income



Source: NSO, experts' estimation

Figure III.1.5

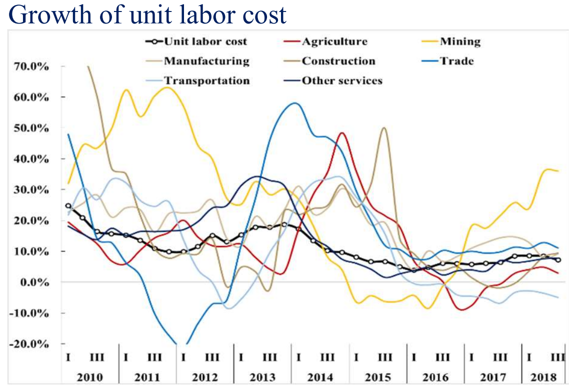
Growth of labor productivity[12]



Source: NSO, experts' estimation

Figure III.1.6

Growth of unit labor cost



Source: NSO, experts' estimation

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4 Share of economically active population in working age population

5 Share of employed people in working age population

6 Share of unemployed people in economically active population

7 Source: Social security payments' report by the General Office for Labor and Welfare Services

11 Growth of employment calculated by moving averages of 4 consecutive quarters

8 Source: Household Socio-Economic Survey by the NSO

9 Average of GDP per worker

10 Average labor cost or wage cost per unit of GDP

12 Growth of labor productivity and unit labor cost are calculated by moving averages of 8 consecutive quarters

III.2 Monetary and financial markets

III.2.1 Monetary and credit indicators

Growth of money supply picked up from last quarter, while outstanding level of credit issued by banks is growing steadily for the past 5 quarters. Growth of net foreign reserves, consumer loans[13] and corporate loans mainly form the growth of money supply. As of October 2018, M2 money grew by 26.5 percent year-over-year, while credit growth reached 19.6 percent[14].

Net foreign reserves expanded by close to 1.6 billion USD year-over-year, thus contributing 26 percentage points to growth of money supply. Such expansion in reserves was supported by foreign direct investments to underground project of Oyu Tolgoi mining, donor financing under the IMF's Extended Fund Facility program, and surplus in foreign trade balance. In addition, 500 billion USD was raised through bonds at the international market by the Development Bank of Mongolia, thus further enhanced net foreign reserves. On the other hand, rapid growth of imports on the back of economic recovery, is adding to current account deficit.

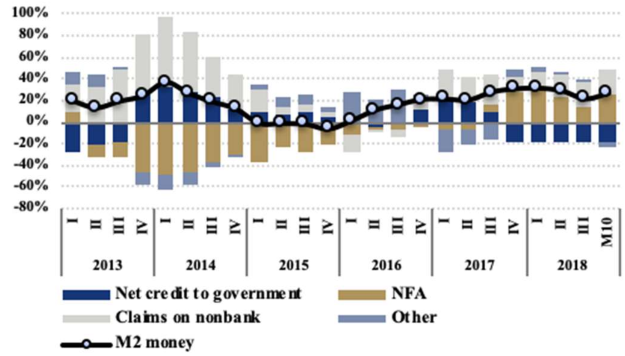
Loans issued by depository institutions are one of the main contributors of money supply growth. The need to finance fiscal deficit through domestic funding has receded, since the fiscal balance is in surplus of close to 100 billion MNT in first 10 months of the year and external funding is increasing. Hence, there is less crowding out effect on domestic funds, which are issued as loans to the private sector and households.

From the liability side, growth of money supply is supported by deposits in MNT and current account in foreign currency. Motivated by increased fluctuation of exchange rate in recent months, dollarization of liability is likely to increase. In October, growing balance of deposits and current accounts in foreign currency made up 8.5 percentage points of money supply growth, which is a 5.4 percentage points higher level from previous month.

Outstanding loans issued by depository institutions[15] including mortgage backed securities (MBS[16]) expanded by 19.6 percent, year-over-year. Of which 11 percentage point is made up of consumer loans, which continues to expand. Corporate lending on the other hand is increasing gradually, recovering from shallow growth in

Figure III.2.1.1

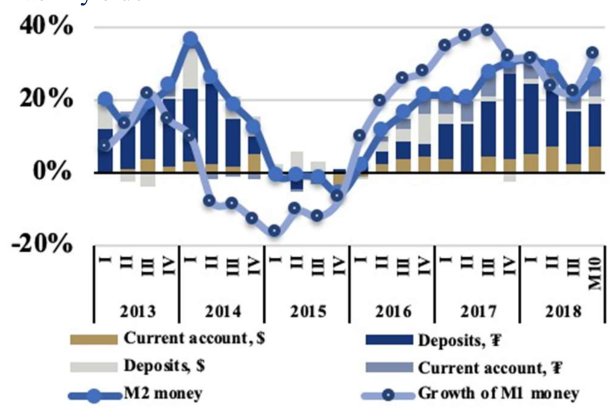
Annual growth of M2 money and its contributions, asset side



Source: Bank of Mongolia

Figure III.2.1.2

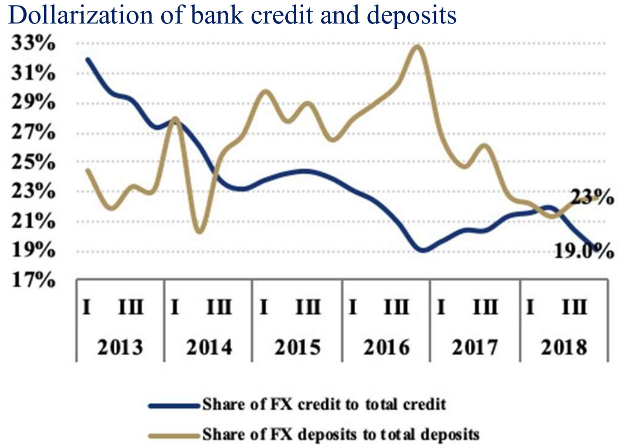
Annual growth of M2 money and its contributions, liability side



Source: Bank of Mongolia

Figure III.2.1.3

Dollarization of bank credit and deposits



Source: Bank of Mongolia

recent years. In particular, corporate loans are issued mostly for trade, mining and construction sectors, following recovery in real economy and expanding economic activities. Such trend can be explained by rapid improvement in quality of credit issued to these sectors. For instance, in the reporting quarter loans that were paid increased by 81 percent year-over-year, of which 44 percentage points can be attributed to the abovementioned sectors.

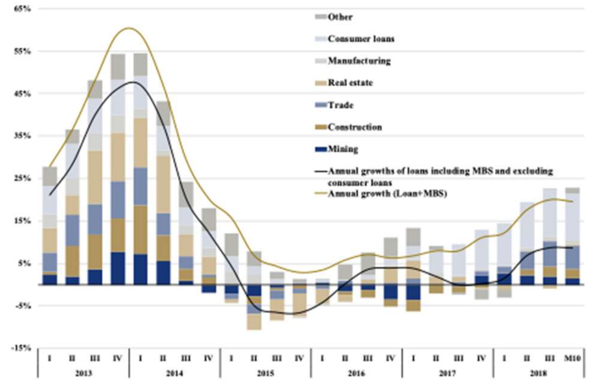
As consumer and corporate loans increase, structure of the banks' loan portfolio is changing rapidly towards consumer loans and loans issued for trade sector. Consumer loans make up 26 percent of total loans outstanding, which is a 4-percentage point higher level from a year earlier. Similarly, share of loans issued to trade sector increased in recent quarters reaching 13 percent. In total, as of October share of loans for consumption and trade sector increased from 33 percent to 40 percent within a year.

Although growth of corporate lending is recovering and overall credit dollarization has been declining, dollarization of credit issued to trade, construction and manufacturing sectors are not declining. Credit issued to such sectors make up a significant portion of loans issued to corporate sector. Credit dollarization declined by 2-percentage point year-to-date, reaching 19 percent. Such reduction is only observed in credits issued to mining, information and communication, and education sectors. As for the other business sectors, credit dollarization has not declined.

Despite recovery in economic activities and gradual pick up in credit growth, quality of loans issued by banks continues to deteriorate. In part, such trend can be attributed to recent adjustments in banks' balance sheet following the Asset Quality Review conducted in 2017, under the framework of Extended Fund Facility program. In the reporting month, 18 percent of total loans outstanding is classified as either past due or non-performing, which is a 3-percentage point expansion year to date. In particular, such adjustment mainly affected credit issued to construction, manufacturing and real estate sectors. Of which, quality of credit issued to

Figure III.2.1.4

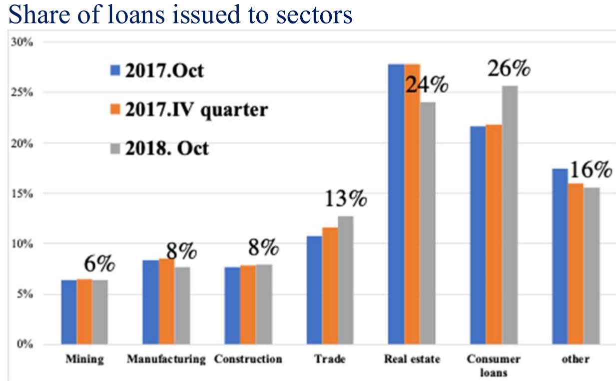
Break down of annual credit growth issued by depository institutions



Source: Bank of Mongolia

Figure III.2.1.5

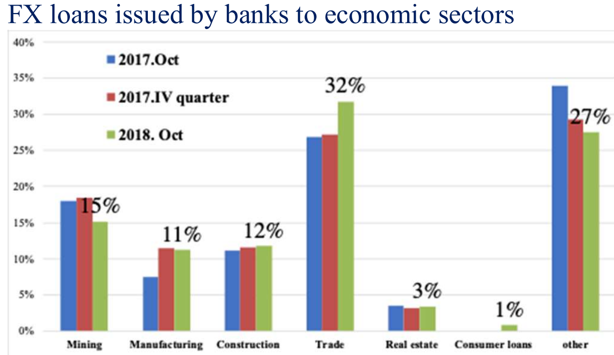
Share of loans issued to sectors



Source: Bank of Mongolia

Figure III.2.1.6

FX loans issued by banks to economic sectors



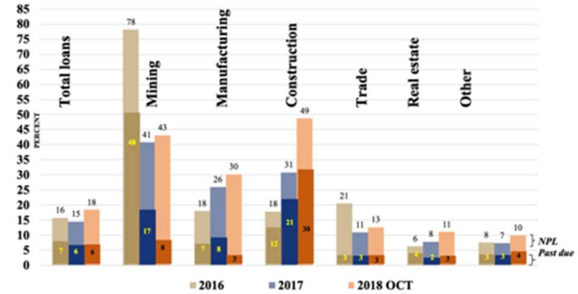
Source: Bank of Mongolia

13 Consumer loan consists of wage and pension loans, credit card, deposit backed loans and other consumer loans.
14 Adjusted by mortgage loans that were securitized through mortgage backed securities and thus removed from the banks' balance sheet.
15 Depository corporations consist of banks and deposits and loans cooperatives.
16 Banks securitize mortgages by selling mortgage portfolios to the Mongolian Mortgage Corporation, and growth of these securities are considered to be part of credit growth.

construction sector is the weakest, where 49 percent of total credit is classified as non-performing or past due. In the reporting quarter total outstanding level of past due or non-performing loans increased by 655 billion MNT from previous month, of which 49 percent can be attributed to construction sector.

Figure III.2.1.7

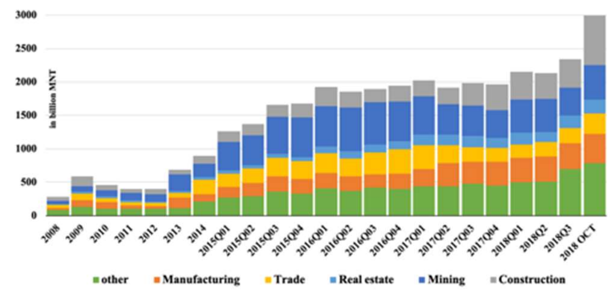
Past due and non-performing loans, as share of loans issued to each economic sector



Source: Bank of Mongolia

Figure III.2.1.8

Outstanding level of past due and non-performing loans, by economic sectors



Source: Bank of Mongolia

Box 2: Corporate/business loan

Business credit, a source of domestic financing for private sector, is one of the key financial supporters of economic growth in a country. Stable growth of business credit fuels production in private sector, employment and thus long-term sustainable growth. As such, it is of utmost importance to reduce procyclicality in growth of business credit and keep it stable to support sustainable economic growth.

However, in case of Mongolia growth of business credit fluctuates significantly and often follows the real economic cycle, depending on external economic environment, mega projects in mining sector and other uncertainties. As an economy dependent on mining sector, improvements in prices of exporting commodities at the global market and increasing production in mining sector often result in greater inflow of foreign direct investments and improvement in market sentiment. Due to spillover effect from the mining sector, sales and production in non-mining sectors surge, leading to surge of demand for business loans in a short period of time and thus resulting in rapid growth of bank credits. However, when external environment weakens risk builds up, domestic economic condition cools off, demand for business credit shrinks and thus fails to support economic growth. Such pattern was observed during 2015-2017 period and banks redirected their credit funds towards consumer loans, thus growth of business loans declined sharply. Starting mid-2017 however, inflow of foreign capital started to increase and real sector began to recover, leading to improvements in market sentiment. At the same time, the Monetary Policy Committee decided to reduce the policy rate step-by-step, while setting a ceiling on the debt-service-to-income ratio and an upper limit on its tenure effective January 1, 2019. In line with such decisions, growth of business credit is starting to pick up from the second quarter of 2018 and has reached 16.1 percent by October 2018. Majority of such growth can be observed in trade, mining, construction and manufacturing sectors. Following increased domestic funding, production in manufacturing, trades and mining sectors has been increasing in the past quarters.

Figure III.2.1.9 Bank credit growth, by purpose

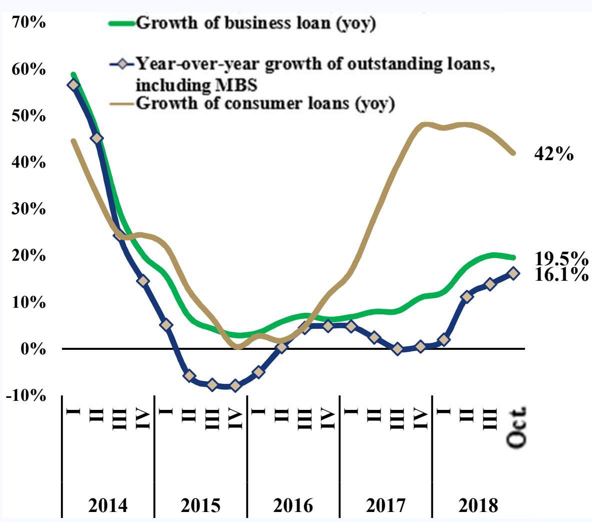
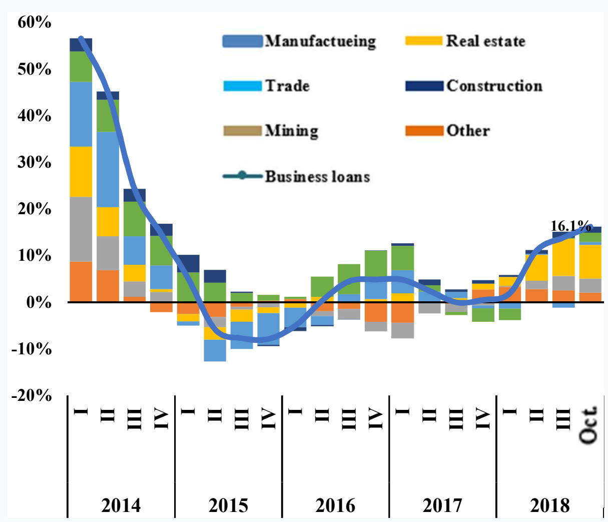


Figure III.2.1.10 Growth of business loans, by economic sectors



III.2.2 Interest rate

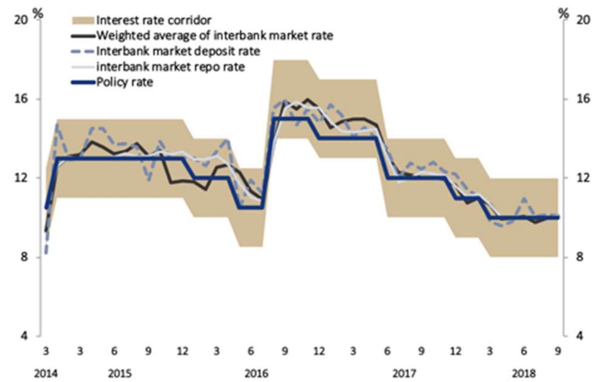
Considering risks to medium-term macroeconomic stability and uncertainties in the external sector, the Monetary Policy Committee of the Bank of Mongolia decided to raise the policy rate by 100 basis points to 11 percent during its unscheduled meeting in November, 2018. During its recurrent meeting in December however, the Committee decided to keep the policy rate unchanged. In November direct trading rate of central bank bills at the interbank market increased by 0.1 percentage point to 10.1 percent from previous month. Similarly, interest rate on overnight loans increased by 0.23 percentage point to 10.2 percent, rate on repo deals that collateralize central bank bill increased by 0.1 percentage point to 10.1 percent, overnight deposit rate increased by 0.3 percentage point to 10.3 percent and interbank deposit rate increased by 0.3 percentage point to 10.8 percent. Overall, weighted average of interbank market rate increased by 0.14 percentage point to 10.2 percent from previous month. Following the policy rate hike at the end of November, weighted average of interbank market rate further increased to 10.8 percent in December.

In November 2018, interest rate on credit issued in MNT declined by 2.42 percentage points to 17 percent year-over-year, while rate on MNT deposits declined by 0.8 percentage point to12.2 percent. Mainly due to declining credit rate, interest margin narrowed to 4.8 percent.

During the reporting period, relative yield on MNT declined by 1.13 percentage point year-over-year, reaching -0.12 percent, mainly due to exchange rate depreciation of MNT to USD.

Figure III.2.2.1

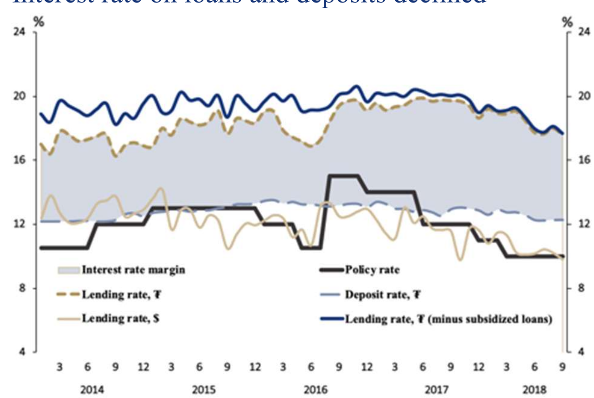
Policy rate is increased



Source: Banк of Mongolia

Figure III.2.2.2

Interest rate on loans and deposits declined



Source: Banк of Mongolia

III.2.3 Exchange rate

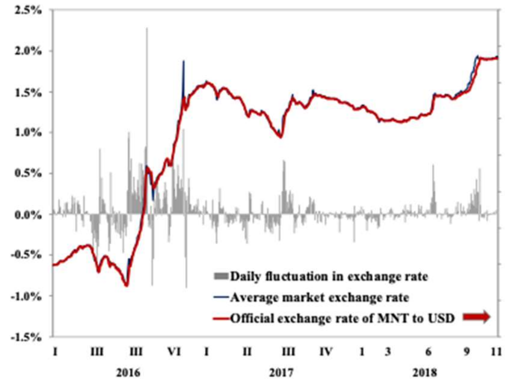
As of November 2018, exchange rate of MNT depreciated against USD by 6.3 percent or 152.9 MNT year-to-date, reaching 2581.1 MNT, which is a 5.4 percent or 132.2 MNT depreciation year-over-year. /Figure III.2.3.1/

The US Federal Reserve has raised its short-term rate 4 times year-to-date, setting it at 2.5 percent as of December 2018. Such actions pushed the yield on USD up and investors' appetite for USD increased, leading to stronger USD against other currencies, including MNT. On the other hand, lower inflow of foreign capital inflow and greater outflow pushed MNT to depreciate against USD. For instance, in the third quarter of 2018 foreign exchange inflow shrunk by 1.3 percent from previous quarter, while due to greater imports outflow of foreign exchange expanded by 14.2 percent, leading to a net outflow of 98.5 million USD.

Although cross rate of MNT depreciated against USD, nominal effective exchange rate of MNT (NEER), which is weighted by trade turnover, appreciated by 1.7 percent from previous quarter. It was mainly supported by appreciation of MNT against RMB and RUB by 2.9 and 4.2 percent, respectively. /Figure III.2.3.3/[17]. During the same period real effective exchange rate (REER) appreciated by 0.4 percent, as domestic prices declined and foreign relative price increased by 1.3 percent. /Figure III.2.3.2/.

Figure III.2.3.1

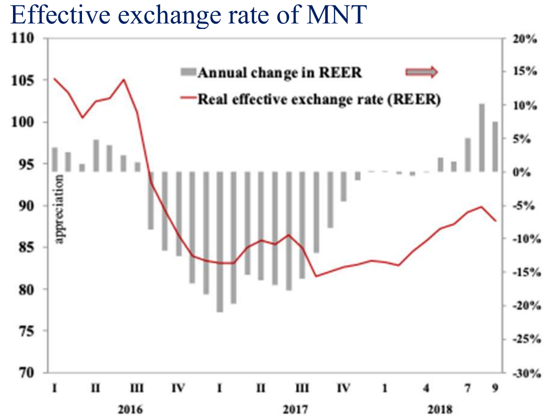
Cross rate of MNT to USD



Source:Банк of Mongolia

Figure III.2.3.2

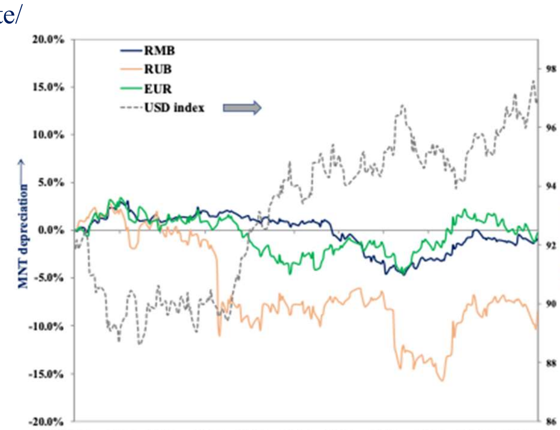
Effective exchange rate of MNT



Source: Банк of Mongolia

Figure III.2.3.3

Change in cross rate of MNT to major currencies /year-to-date/



Source: Банк of Mongolia

[17] Cross rates of RMB, RUB and EUR depreciated against USD by 6.7, 16.3, 5.9 percent year to date, respectively.

III.2.4 Capital market

Rental price improved in the reporting quarter, after it had been declining over the past year. Price of housing on the other hand remained relatively stable. Rising rental price was supported by increased demand, as schools started in the reporting quarter and thus price-to-rent ratio declined. Household average income increased as well, leading to a lower ratio of price-to-income from previous quarter. Main indicators of stock market weakened from previous quarter and its activities were subdued. However, a tendency of improvement is observed.

In the reporting quarter, rental price increased rapidly compared to housing price. (Figure III.2.4.1). Although housing price index reported by the NSO remained stable over the past year, a slight hint of improvement is observed in a similar index reported by Tenkhleg Zuuch. In particular, price of new housing increased by 11.4 percent year-over-year, while price of old housing improved by 3 percent, leading to an overall growth of 4.8 percent in housing prices. Rental price on the other hand increased by 7.1 percent year-over-year (Table III.2.4.1).

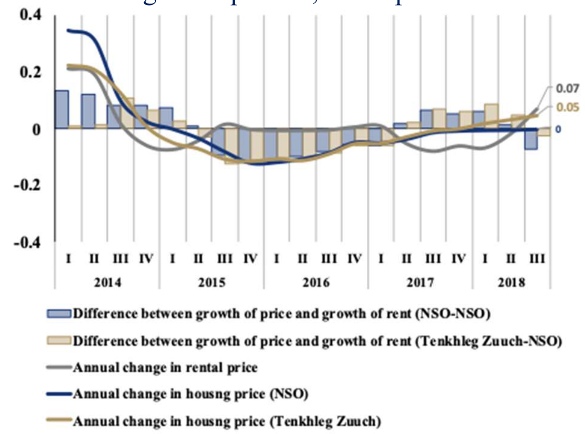
Household average income expanded by 14.7 percent year-over-year and by 1.9 percent from previous quarter, thus pushed price-to-income ratio down by 0.01 unit from previous quarter. Since growth of rental price exceeded change in housing price, price-to-rent ratio declined by 0.06 unit from previous quarter (Figure III.2.4.2).

Although the price-to-income ratio declined and some improvement is observed in purchasing power, number of new mortgage borrowers declined by 25.6 percent from previous quarter and by 7.7 percent year-over-year. Declining price-to-rent ratio suggests expanding demand for rental over purchasing.

Main indicators of stock market improved from a year earlier, yet weakened from previous quarter, hinting towards slowdown (Figure III.2.4.3). For instance, market capitalization reached 2.35 trillion MNT at the end of third quarter of 2018, which is a 28.3 percent expansion year-over-year, while a 5.5 percent shrink from previous quarter. MSE TOP 20 index on the other hand increased by 29.1 percent from previous year reaching 19645.6 unit. It is a 0.5 percent decline from previous quarter. Initial public offering of

Figure III.2.4.1

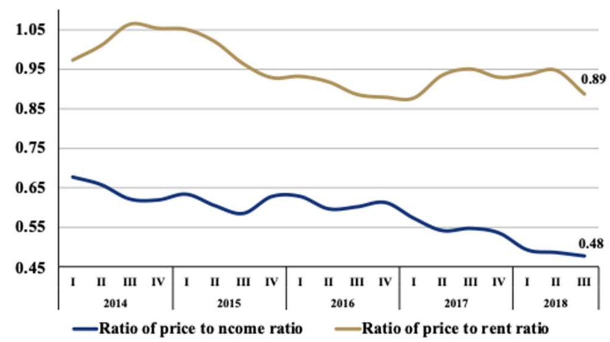
After declining for 5 quarters, rental price increased



Source: NSO, Tenkhkeg Suuch

Figure III.2.4.2

Ratios of price-to-income and price-to-rent weakened from previous quarter.



Source: NSO, Banк of Mongolia

Table III.2.4.1

Real estate sector indicators

		2018Q2	2018Q3
Change in price of housing, %			
NSO	*q-o-q* *year-over-year*	*0.0* *-0.3*	*0.0* *0.0*
Tenkhleg Zuuch	*q-o-q* *year-over-year*	*1.6* *3.3*	*1.9* *4.8*
Change in rental price, %	*q-o-q* *year-over-year*	*-1.1* *-1.6*	*6.7* *7.1*
Price to income ratio		*0.49*	*0.48*
Price to rent ratio		*0.95*	*0.89*

Source: NSO, Tenkhleg Zuuch, Banк of Mongolia

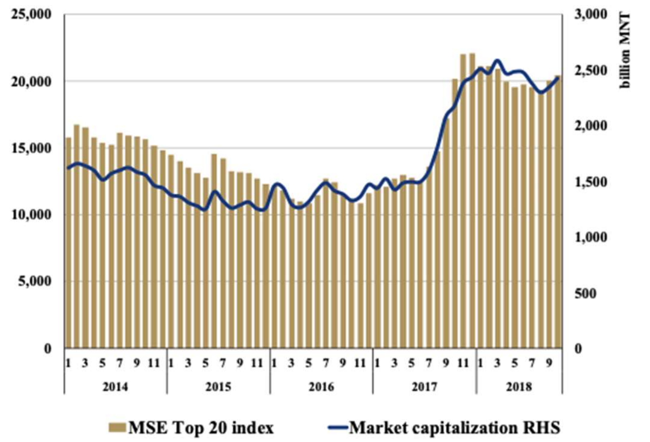
Mandal Insurance and Ard Insurance companies as well as rising prices of A-listed stocks at the MSE were main factors indicating a slight uptick in market indicators at the end of the reporting quarter.

Higher rate of market turnover indicates improved sentiment at the stock market and active participation of investors. In case of Mongolia, average rate of market turnover reached 24 percent in the reporting quarter, which is a 4-times lower or 75.9 percentage point weaker level compared to a year earlier. However, it is an improvement of 18.2 percentage point from previous quarter. Fluctuation in market turnover rate can be explained by fluctuation in volume of trade at the stock market. (Figure III.2.4.4).

Similar to the previous quarter portfolio investments worth 25.2 million USD were made to the Mongolian Stock Exchange by non-resident aliens, which is a 1.5 percent decline year-over-year (Figure III.2.4.5). While portfolio investment remained stable in the reporting quarter, foreign direct investments made by non-resident aliens doubled year-over-year.

Figure III.2.4.3

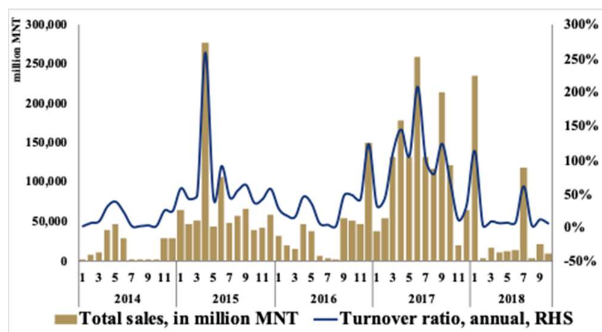
Market capitalization declined from previous quarter



Source: Mongolian Stock Exchange

Figure III.2.4.4

Activities at the stock market has weakened year-over-year



Source: NSO, Bank of Mongolia

Figure III.2.4.5

Portfolio investments remain stable

Source: Mongolian Central Securities Depository

III.3 Consolidated budget and sovereign debt

Consolidated budget: As of October 2018, consolidated budget balance is in surplus of 342 billion MNT, and the primary balance is in surplus of 1239 billion MNT. Since budget revenue has exceeded its approved level, the consolidated budget deficit is expected to be lower than its approved level for 2018. Consequently, the need to finance budget deficit through domestic fund is likely to decline and the government is expected to pay its domestic bonds, resulting in lower *debt-to-GDP* ratio.

Equilibrated revenue: Collection rate of equilibrated revenue in consolidated budget reached 123.5 percent as of October 2018. Of which, 89.3 percent is generated through tax revenue, while the remainder through non-tax revenue. By October 2018, equilibrated revenue reached 7519 billion MNT, supported by increased economic activities, change in certain tax rates and a cumulative growth of 38.2 percent in imports in the first 10 months relative to same period of previous year.

Total expenditure and net credit: In first 10 months, budget expenditure reached 7178 billion MNT, which is a 10.3 percent cumulative expansion from previous year. According to the approved budget, total expenditure is to expand by 7.5 percent or by 671 billion MNT. Majority of such expansion is allocated to capital spending and current transfers. In particular, spending on pension is planned to increase by 14 percent or 200 billion MNT, and spending on social welfare programs is planned to increase by 240 percent or 120 billion MNT.

Fiscal stance and fiscal impulse: As Mongolia's economic growth and budget revenue collection are highly dependent on change in commodity prices, overall equilibrated balance is adjusted by output gap to estimate the fiscal stance (cyclically adjusted fiscal stance).

Fiscal impulse is expected to be -4.2 percent in 2018, while 3.6 percent in 2019. It implies that although fiscal deficit in terms of GDP is expected to decline in 2018, starting 2019 it is likely to widen and thus fiscal stance loosens. (Figure III.3.3).

According to the historical trend, during parliamentary election years and years preceding elections fiscal impulse usually loosens. For

Table III.3.1

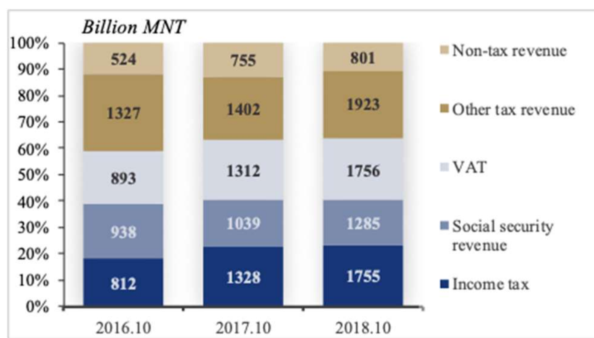
Fiscal Indicators

in billion MNT	2017	2018	3 year average*	2018.10	
	actual	approved		actual	%
Total revenue	**7922**	**7863**	**5159**	**8268**	**125.0**
Future heritage fund	358	509	306	559	133.1
Stabilization Fund	326	123	91	189	181.8
Equilibrated revenue	**7239**	**7231**	**4966**	**7519**	**123.5**
Tax revenue	6303	6269	4332	6719	129.2
Import ta revenue	1860	2114	1252	2136	123.0
VAT	1032	1095	628	1150	127.9
Customs duty	512	537	312	554	122.9
Excise tax	316	482	312	432	120.4
Income tax	1610	1408	979	1755	148.6
Social security collection	1314	1425	939	1285	111.2
Tax on domestic sales	986	823	590	842	125.0
VAT return	-147	-198	-74	-102	57.3
Other tax income	679	698	645	804	116.0
Non-tax income	936	962	634	801	90.4
Total expenditure	**8981**	**9652**	**6268**	**7178**	**82.4**
Primary expenditure	7825	8501	5612	6280	80.8
Current expenditure /-interest expenditu	5850	6305	4385	4945	88.3
Capital expenditure	1646	1929	995	1046	54.9
Net credit	329	267	232	290	88.8
Interest expenditure	1156	1151	656	897	92.4
Total equilibrated balance	**-1742**	**-2420**	**-1302**	**342**	
in percent of GDP	-6.5%	-8.0%	-4.3%	1.1%	
Primary balance	-586	-1269	-646	1239	
in percent of GDP	-2.2%	-4.2%	-2.1%	4.1%	

Source: Ministry of Finance, Bank of Mongolia

Figure III.3.1

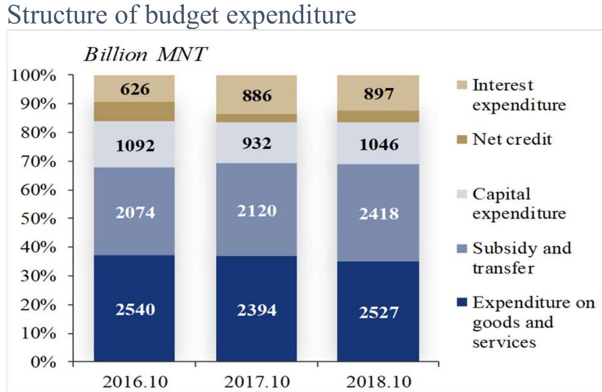
Structure of budget revenue



Source: Ministry of Finance

Figure III.3.2

Structure of budget expenditure



Source: Ministry of Finance

instance, during the election years of 2008, 2012 and 2016 budget capital expenditure increased by 79 percent on average, while during 2007, 2011 and 2015 it expanded by 42 percent on average.

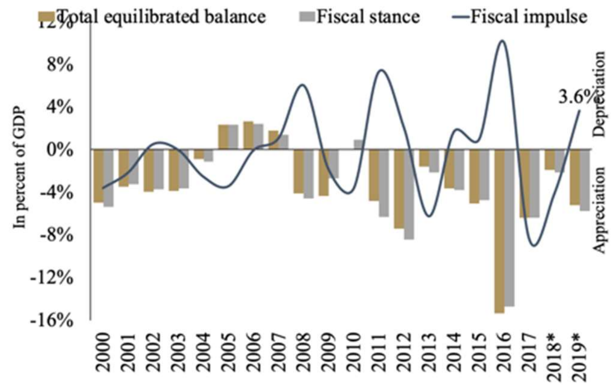
Ratio of newly issued debt-to-debt repayment: In recent years the *ratio of newly issued debt-to-debt repayment* constantly exceeded over 100 percent in recent years, a trend indicating build up of government debt in Mongolia. However, in 2018 this ratio could be reduced to 45 percent, as the government is set to pay 3716 billion MNT for its debt principle, loans and debt service, and to issue external debt and receive project loans worth 1684 billion MNT. (Figure III.3.4). The necessary gap is likely to be financed through surplus in primary balance and revenue of certain funds.

In 2019 on the other hand, the government is expected to issue new debts worth 2919 billion MNT through project loans, thus the *ratio of newly issued debt-to-debt repayment* is likely to pick up.

Present value of government debt: According to the budget proposal, present value of government debt is set to be within legal boundaries during 2019-2020 (Table III.3.2). In addition, if equilibrated revenue of consolidated budget and special funds exceeds its proposed level, the government debt may shrink by same amount.

Figure III.3.3

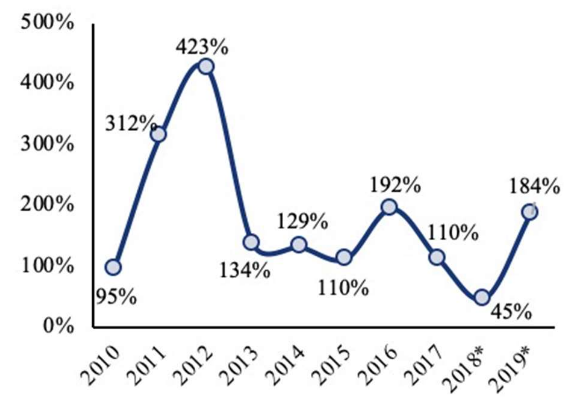
Fiscal stance and fiscal impulse



Source: Bank of Mongolia

Figure III.3.4

Ratio of newly issued debt-to-debt repayment



Source: Bank of Mongolia

Table III.3.2

Present value of government debt and debt services

	2016	2017	2018	2019	2020
billion MNT	actual	actual	approved	proj	proj
Government debt	18964	22752	24310	19552	19391
in percent of GDP	79	85	80	55	48
Debt limit/GDP	88	85	80	75	70
Debt service payments	988	1156	1128	915	
in percent of budget revenue	16.9	16.0	12.5	9.4	

Source: Ministry of Finance, Bank of Mongolia

IV. EXTERNAL CONDITIONS OF THE ECONOMY

IV.1 Assumptions regarding external conditions[18]

Growth forecasts of China, Russia and Euro area in 2019 have been revised down marginally. Prices of copper and coal are revised up from previous projections and price of crude oil is expected to remain stable.

External demand[19] outlook for 2018 and 2019 is revised down from the previous report, when conducting the macroeconomic analysis and forecasting in the third quarter of 2018. Within the forecasting horizon, slower growth in China, Russia, and the Euro area are expected to weaken external demand for Mongolia. As published in external sources, economic growth forecast of China in 2018 is now revised down from 6.5 percent to 6.4, that of Euro area is revised down from 1.8 to 1.7 and of Russia is revised down from 2.3 to 1.9 percent.

Chinese economic growth met expectations in the third quarter of 2018, mainly supported by 9.5 percent growth in retail trade, 8.7 percent growth in investment in manufacturing and 6.3 percent growth in private consumptions. Moreover, inflation remained stable and unemployment rate stood steady at 3.8 percent in the third quarter of 2018, which signal expansion of household consumption in the forecasting period.

Despite such strong economic performance, ongoing trade war with the US and mounting debts are the main factors to pull the Chinese growth forecast down for 2018-19. The Chinese authority is expected to loosen fiscal and monetary policies in response to lower demand potentially stemming from the trade conflict and lower growth in developing economies. The Shanghai Composite index has declined by 20 percent year-to-date, and Chinese RMB depreciated by 5.5 percent against USD. These could be premises for policy measures to support economic growth and to set up a favorable investment environment. The PBOC cut reserve requirements for banks 4 times in 2018 to improve banks' liquidity, and a further cut of 25 basis point is expected in 2019.

Table IV.1.1

Changes in Key Judgments of External Environment

Previous forecast of 2019	Current forecast of 2019
External demand	Revised down
GDP growth in China to slow down further due to the ongoing trade war, Moderate recovery in Russian economy	Growth forecast of China is revised down as China-US trade war prolongs, Recovery in Russian economy decelerated, Growth in Euro area is revised down
Terms of Trade	Revised up moderately
Copper and gold prices are to fall, Oil prices to increase, Coal and iron ore prices have downward trends, Import price growth will decline in line with depreciating RMB and RUB against MNT.	Downward trends in main export commodities remain. Price forecasts of copper and coal are revised up slightly in line with performance. We expect oil price to stabilize but import prices not to decline as USD appreciates.
Foreign interest rate	Revised down slightly
Fed rate is expected to increase 3 times, likely further appreciation in USD	Fed rate is expected to increase twice, USD is likely to appreciate
Global Inflation	Revised down slightly
The growth in trading partner countries surpassed the expectation, oil price forecast increased	The growth forecasts in trading partner countries are revised down, oil price outlook looks stable.

Source: Expert's judgment

Figure IV.1.1

Forecast of external demand, year-over-year percent

Sources: Bloomberg, Roubini, EIU

[18]Forecasts of economic growth and inflation in main trading partner countries and the relevant explanations were compiled from November 2018 edition of Roubini Global Economics, November 2018 edition of EIU Global Forecasting Report, the median of forecasts conducted by Bloomberg analysts. The external sector forecasts and their reasoning do not incorporate the views and analysis of Bank of Mongolia.

[19]External demand of Mongolia is calculated as the weighted average of main trading partner countries. (where China 0.90, Russia 0.02, and Euro Area 0.08)

The Chinese authority's decision to reduce its growth target for 2018-19 indicates its intention to limit risks in the financial sector. Such measures are expected to support economic stability and sustainable growth in the medium to long run.

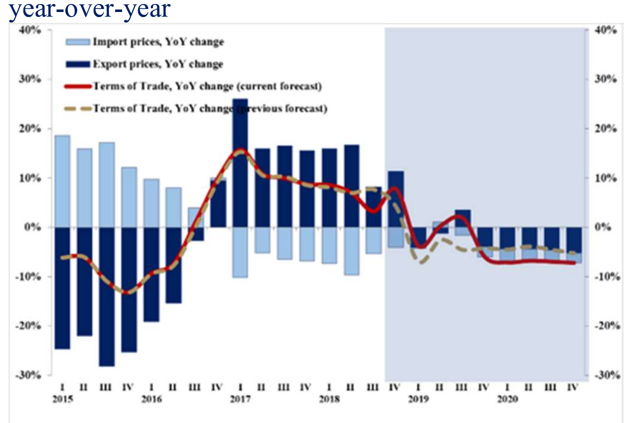
Growth of manufacturing, investment and consumption pushed economic growth up in Russia to 2.0 percent in the third quarter of 2018, which was consistent with previous expectations. Growth forecast for the Russian economy was revised down by 0.4 percentage point to 1.9 percent for 2018 and by 0.1 percentage point to 1.5 percent for 2019, as current factors supporting growth are predicted to dissipate in the medium term. Current projections reflect a combination of contractionary fiscal and expansionary monetary policy during 2018-19, tax reforms, decline in average price of oil, depreciation of RUB, and potential further tightening of U.S. sanctions on Russia. As for the Euro area, unconventional monetary policy of the ECB, and relatively loose fiscal stance have been supporting domestic demand and the regional economic growth. However, growth outlook was revised down by 0.1 percentage point to 1.7 percent for 2018 and by 0.1 percentage point to 1.8 percent for 2019, as the economic conditions weakened in some trading partner countries, growth in the labor market remains unstable and various foreign trade barriers persist.

Terms of Trade projection is improved for the upcoming five quarters, compared to the previous forecast, but it is expected to worsen in the medium term starting 2020. Export prices fell below expectations as copper and gold prices continued to decline in the third quarter of 2018. On the other hand, oil price declined to 79 USD per barrel, against previous expectations of 86 USD per barrel, thus pushed import prices down, and contributed to improvement in terms of trade, in the third quarter.

At the end of 2018, export prices are expected to rise slightly owing to an upturn in prices of copper and gold, while growth of import prices is expected to decline in line with weaker RMB and RUB against MNT. In 2019, the terms of trade is expected to deteriorate due to lower price of gold and downward trend in coal and copper prices. Yet, price forecasts slightly improved, and oil price is unlikely to surge.

Figure IV.1.2

Changes in terms of trade, export, and import prices, year-over-year

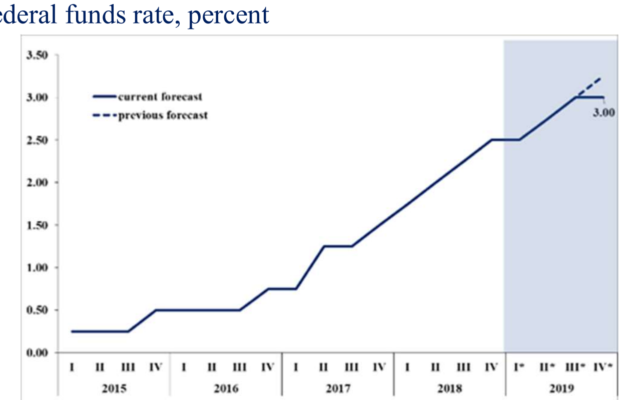


Source: Bank of Mongolia estimations

Foreign interest rate: The US Federal Reserve raised the federal funds rate by 25 basis point thrice in the first 3 quarters of 2018 to 2.25 percent, encouraged by a drop in unemployment to 3.7 percent, the lowest in past 49 years, improved labor market conditions, rising real income and expectations of stable private consumption. The Federal Reserve kept its rate unchanged in November and increased it by 25 basis point to 2.5 percent in December, 2018. Analysts expect the US Federal Reserve to hike interest rates twice instead of thrice in 2019, on the back of a weaker global economic outlook, China-US trade war, and the end of a 1.5 trillion USD tax cut.

Figure IV.1.3

Federal funds rate, percent



Source: Bloomberg

Moreover, a hike in the federal funds rate in December and the Federal Reserve's policy to squeeze its balance sheet are leading to lower yield on long-term assets. As of December 19, 2018, the yield on 10-year US treasury bond reached 2.8 percent, lowest in the past 7 months, the yield on 30-year US treasury bond reached 3.0 percent, lowest in the past 3 months, while the yield of 2-year US treasury bond is kept at 2.6 percent.

Global inflation projection is unchanged, as economic growth in main trading partner countries fell short of market expectations and price of oil declined at the international market. Growth of domestic demand is expected to accelerate to 1.5-1.7 percent in European developed countries and the depreciation pressure on euro looms as the ECB proceeds with its unconventional expansionary monetary policy. As a result, inflation in the Euro area is expected to reach 1.7-1.8 percent in 2018-19. Inflation in China was reported at 2.3 percent in the third quarter of 2018 and the People's Bank of China (PBOC) lowered its required reserve ratio. Moving forward, expansion of domestic demand is expected to be maintained throughout 2018. Inflation in China is expected to be 2.2 percent in 2018 and 2.3 percent in 2019, assuming growth of domestic demand does not accelerate and the impact of trade tension remains. Inflation projection for Russia is kept unchanged at 2.9 percent by the end of 2018, incorporating factors such as loose monetary policy, lower average price of oil, and buoyant economic growth. Inflation is projected to reach 4.9 percent in 2019 as the factors pushing inflation remains significant.

Compared to other advanced economies, the US economy outlook remains positive. However, appreciation of the USD and uncertainty regarding trade relations have pushed inflation above the 2 percent target. The US unemployment is anticipated to be kept at a low rate and private consumption growth is expected to recover. These factors are likely to spur economic growth, pushing inflation up around 2.3-2.5 percent for 2018-2019.

Uncertainties in the external conditions

The China-US trade conflict is likely to prolong and the import tariffs may come into effect starting 2019. The import tariffs could hit Chinese growth, thus have an adverse impact on commodity prices. In addition, effect of such tariffs on capital flows to emerging and developing economies remains uncertain.

- Oil price movements at the international market remains uncertain. Although the OPEC, its allies, and Russia reached a deal to cut production for the next 6 months starting 2019, a new installment of oil pipelines in the US is likely to increase supply of shale oil. On the supply side, upcoming expiration of exemptions granted to 8 countries from US sanctions on Iranian oil, and the interruptions on Venezuela's oil explorations are creating more uncertainties. On the demand side, track of global economic slowdown would shape the price outlook.
- If disruption of coal transportation at the Chinese border is extended, it could harm coal exports considerably, whereas the Government of Mongolia aims to boost coal exports to 42 million tons in the coming year.
- Regional geopolitical risks, populist movements and related chaos in some European countries, and the Brexit effect are the main risks that could slow down growth in the region.
- Potential FDI projects, which the Government of Mongolia aims to resolve soon, are not included in the current forecast. Initiation of projects such as Oil Processing Plant and the launch of Erdenes Tavan Tolgoi IPO could generate an additional positive impact on the economy.

IV.2 Global market prices of main exporting commodities of Mongolia

Gold and copper prices dropped in the reporting quarter due to appreciation of USD, a downward revision of China's growth projections, and uncertainty arising from the trade conflict between the US and China, whilst coal prices increased due to China's growing coal import and productions. On the other hand, oil prices exceeded previous predictions due to anticipation of the US sanction on Iranian oil and decreased inventories in the OPEC countries as well as the OPEC board of governors' decision to cut daily productions down to 1.2 million barrels.

Copper: Price of copper was 7,075 USD per ton on average in the first quarter of 2018, and 6,747 USD in the second quarter, but it declined to 6,151 USD in the third quarter. Underlying factors leading to lower price are improvement in supply projections for 2018 by some research agencies, trade conflict between the US and China, lower economic growth in China and 18 percent decline in demand for metal in energy and construction sectors early this year. In the coming quarters, copper demand will depend on China's economic growth, macroeconomic policy, and international geopolitics. Copper supply is expected to be shaped by several factors, including the conclusion of labor contract negotiations with mining workers in Chile, expectations of 18 new mines to come into operation in Peru by 2021, and anticipation of greater production of renewable energy and electric transportation vehicles in the next 2 years. World copper concentrate output is expected to increase from 21.5 million tons in 2018 to 23.5 million tons in 2019, thus pushed price projections down for the medium term. However, copper inventories in warehouses account to 120,000 tons as of December 18, 2018, which is the lowest level since 2008. As a result, the IMF and Bloomberg analysts revised copper price projections up to 6,341 USD per ton on average for 2018, and they are expecting the price to decrease in the medium term.

Gold: Price of an ounce of gold was at 1,311 USD on average in the first quarter of 2018, and 1,314 USD in the second, but declined to 1,210 USD in the third quarter. At the market, demand for gold declined and led to lower prices, as the federal funds rate was raised during the December meeting and consequently USD appreciated. Yield on USD is expected to rise mainly due to the fact that US unemployment is projected to be low, US Federal Reserve is expected to increase the federal funds rate again, and inflation rate in advanced economies is forecasted to remain at a moderate level. All of these factors are pushing gold prices down for 2018-2019. However, since demand for gold jewelry is projected to increase in 2019-2020, trade conflict between the US and China is likely to be prolonged, economic growth of developing countries is declining, and the stock prices are expected to be weaker at the global financial market, analysts of Bloomberg and the IMF revised gold price projections up to 1265 USD in 2018 and conversely down to 1238 USD in 2019.

Thermal coal: Price of thermal coal was 76 USD per ton on average in the first quarter of 2018, and 89 USD in the second, but increased to 98 USD in the third quarter. Thermal coal productions in China decreased by 3 percent in September year-over-year. Energy sector warehouses stocked up their inventories for winter months, creating demand for thermal coal and resulted in higher price. Although China's imports of thermal coal are projected to decrease and the US and European countries are planning to reduce their coal use, demand in developing countries is forecasted to increase as oil is becoming costlier to substitute coal. Thus, the IMF, World Bank, Australian Department of Industry, Innovation and Science and Bloomberg revised coal price projections up to 76 USD on average in 2018 and down to 69 USD in 2019.

Coking coal: According to the contract between Japan and Australia, the benchmark price of coking coal increased to 219 USD per ton in the first quarter of 2018, decreased to 199 USD in the second and consequently 197 USD in the third quarter. Furthermore, the IMF, World Bank, Australian Department of Industry, Innovation and Science and Bloomberg revised coking coal price projections down to 188 USD per ton on average as productions in Russia, Canada and Mozambique are expected to increase by 2.1, 2.4 and 1.9 million tons, during 2018-2020. In addition, Chinese productions are expected to account for up to 1.0 billion tons in 2018, and demand and production of steel is expected to be stable. As Chinese authorities are aiming to substitute coal usage with natural gas and utilize solar and wind power more extensively in the following 5 years, price of coking coal is expected to decline in the medium and long term.

Iron ore: In the first quarter of 2018 price of iron ore reached 69 USD per ton on average and 63 USD in the second, while slightly decreased to 62 USD in the third quarter. China's manufacturing PMI increased to 51.3 in November 2018 and steel production in China expanded by 6.6 percent year-over-year in the reporting quarter, leading to a steady price. Thus, the IMF, World Bank, Australian Department of Industry, Innovation and Science and Bloomberg revised average price projections up to 65 USD per ton in 2018. However, price projection is revised down to 60 USD per ton in 2019, due to increasing supply from main exporters such as Australia and Brazil as well as the slowing economic growth in developing countries.

Crude oil: A barrel of Brent oil was sold at 67 USD in the first quarter, 76 USD in the second quarter, and 79 USD in the third quarter. Although the US production of oil is likely to increase there as some risk of supply related shocks and thus price for crude oil remains higher, yet with significant degree of uncertainty. In particular, the US sanction on Iranian oil exports remains uncertain, the OPEC and non-OPEC countries came to a consensus to limit production, inventory in OPEC countries are low and production in Venezuela is declining. Nevertheless, the IMF, World Bank, Australian Department of Industry, Innovation and Science, and Bloomberg revised their price projections up to 74 USD per barrel in 2018 and down to 70 USD per barrel in 2019-2020, considering the 6-month-extension of the agreement among OPEC and non-OPEC countries to reduce their productions till the end of April 2019, cutting daily productions down to 1.2 million barrels. Predictions of increased productions in the US and negative impact of weaker global economic outlook are considered as well.

IV.3 Balance of Payments

In the third quarter of 2018, balance of payments was in a deficit of 303 million USD, which is a widening of 174 million USD quarter over quarter and 579 million USD year-over-year. Deficit of 489 million USD (3.9 percent of GDP) in current account was financed by surplus of 341 million USD (2.7 percent of GDP) in the capital and financial accounts. Overall balance was in a deficit of 303 million USD[20] or 2.4 percent of GDP[21] (Figure IV.3.1). Deficit in balance of payments can be attributed to shrink in trade balance as export revenues weakened while imports expenses remained elevated.

Export revenue grew by 15.2 percent year-over-year (Table IV.3.1) in the third quarter as a result of higher copper and coal prices, and increased volume of coal exports. However, the custom's activity at the border has been disrupted causing slowdown in coal export transportations since mid-November 2018. During the reporting quarter, Bank of Mongolia purchased non-monetized golds weighing 6.2-ton net, and kept it in the form of monetized gold abroad. The monetized gold added 222 million USD to the gross international reserves in the third quarter of 2018.

In mining and construction sectors, machinery, equipment, and technology upgrades were carried out following economic recovery and the development of the Oyu Tolgoi underground project. Consequently, imports of capital goods, construction materials, and diesel fuel expanded rapidly, pushing total imports to grow by 33 percent year-over-year. Of which, 14 percentage point is attributed to imports of capital goods while 7 percentage points is composed of fuel imports. Import of consumer goods grew rapidly (by 33 percent year-over-year), of which majority can be associated with substantial growth in imports of passenger car (Table IV.3.2). Specifically, imports of passenger cars increased by 63 million USD (80 percent year-over-year) in the third quarter of 2018. In the reporting quarter, rising cost of transportation in foreign trade and education expenses related to students studying abroad have widened the deficit in services account, while deficit in business services narrowed marginally. In the third quarter of 2018, deficit in services accounted for 1.9

Table IV.3.1

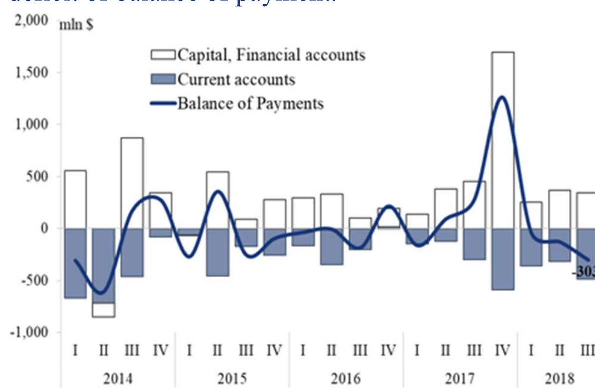
Key changes in assumptions of BOP projection

Previous projection in 2019	Current projection in 2019
Exports	Revised down
Custom's capacity for coal exports improved, We expect coal and crude oil price to increase slightly but copper and gold price to fall.	Potential fall in the customs' capacity for coal exports in early 2019, Forecast of crude oil export is revised down in line with its performance. Coal and copper prices are revised up slightly.
Imports	Revised up
Machinery and equipment imports will continue to increase (but acceleration will slow down) Fuel imports will increase.	Imports of capital goods and construction material will increase as the budget capital expenditure expands. Domestic demand is revised up.
FDI	Unchanged
FDI to increase: Investor's loan repayment is expected to decrease.	Assumptions are the same as in previous projection.
Portfolio investments	Broadly unchanged
	No new bond to issue, no principal payments of bonds are expected.

Source: Experts' judgment

Figure IV.3.1

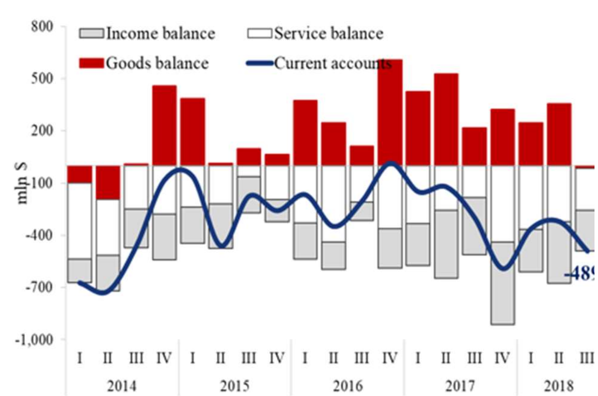
Greater current account deficit (year-over-year) and moderate financial account surplus resulted in a deficit of balance of payment.



Source: Bank of Mongolia

Figure IV.3.2

Trade surplus declined, resulting in a greater current account deficit from previous year.



Source: Bank of Mongolia

percent of GDP, which continues to drag the current account balance down.

Income account was in deficit of 330 million USD which is a reduction of 48.7 million USD year-over-year. This was due to lower dividends paid out to shareholders by banks and entities, and increased workers' remittances by 58.7 million USD from previous year. Despite slight narrowing in deficit, income account continues to impose substantial pressure on the overall balance. For instance, ratio of *deficit in the primary income to current account* was equivalent to 135 percent in 2017 and 67 percent in the reporting quarter (Figure IV.3.3).

Financial account was in a surplus of 320.8 million USD in the third quarter of 2018, which is a 26 percent or 110 million USD decline, year-over-year. The decline is mainly attributed to a contraction of 173 million USD in external loans and a net decline of 127 million USD in trade credit (Figure IV.3.4). Capital account was in surplus of 20.2 million USD in the reporting quarter.

In the third quarter of 2018, net inflow of 421.3 million USD was made through FDI, which is a 4 percent decline year-over-year. External loans registered net outflow of 147.0 million USD, which is 6 times lower level from previous year, and trade credits had registered net outflow of 29.0 million USD or 130 percent decline year-over-year. Although the disbursement of external loans issued by banks and entities was greater than in prevous year, loan repayments exceeded new disbursements, thus resulting in net outflow. Moreover, there were no disbursements under the Extended Fund Facility Program in the reporting quarter compared to a disbursement of 100 million USD by the ADB to the Government of Mongolia in the third quarter of 2017. As for FDI, it declined marginally due to lower reinvested earnings, despite increasing investments to the Oyu Tolgoi underground project.

Table IV.3.2

Growth in export revenue is mainly attributed to greater revenue from coal and copper concentrates.

	2017 III	2018 III	Year-over-year	Contribution %
Total Exports	**1,477**	**1,701**	**15.2%**	**15.2%**
Coal	446	718	61%	18%
Copper concentrates	391	474	21%	5.6%
Gold	222	-	-	-15%
Crude oil	90	104	15%	0.9%
Iron ore	70	84	21%	1.0%
Cashmere	53	77	45%	1.6%
Other	205	245	20%	2.8%

Table IV.3.3

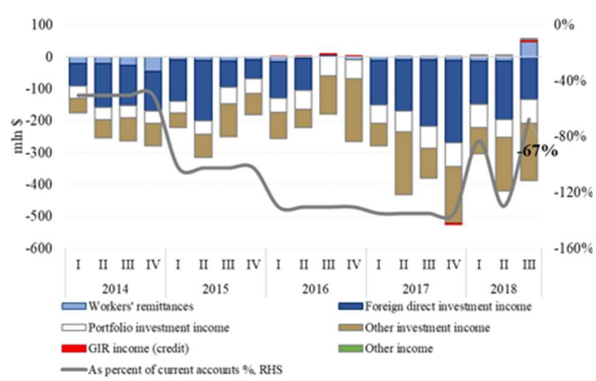
Imports of capital goods, consumer goods and fuel remain at high level...

	2017 III	2018 III	Year-over-year	Contribution %
Total imports	**1,200**	**1,592**	**33%**	**33%**
Capital goods	470	642	37%	14%
Consumer goods	327	436	33%	9%
Of which: Passenger cars	79	142	80%	5%
Fuels	240	327	36%	7%
Industrial inputs	158	186	18%	2.4%
Others	5	1	-79%	-0.3%

Source: Bank of Mongolia

Figure IV.3.3

Income account remains in deficit.



Source: Bank of Mongolia

[20] Errors and omissions of -155.3 million USD in the reporting quarter was reflected in the overall balance.
[21] Four quarter cumulation of nominal GDP

Gross international reserves (GIR) stands at 2,894.1 million USD at the end of September 2018. It is an adequate level to cover 5.8 months of imports, which is calculated as an average of the last three months' imports paid in hard currency (Figure IV.3.5). While deficit in balance of payments puts downward pressure on the GIR, increase in monetized gold of 223 million USD contributed positively for reserve accumulation. The import coverage of GIR has not improved much because of persistent growth in imports and relatively stable level of GIR in the last several months.

Net international reserves (NIR) decreased by 36 million USD, from previous quarter mainly due to decline in current accounts and deposits in foreign currency.

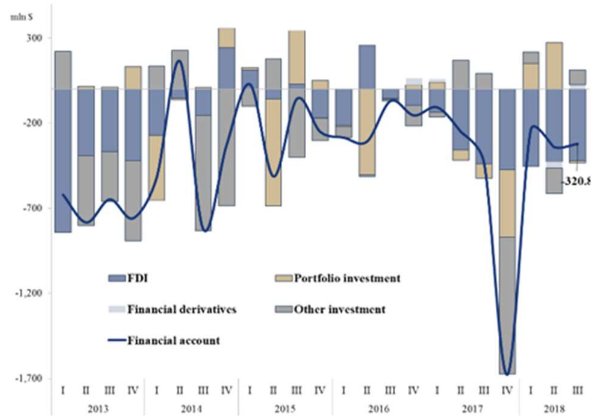
Terms of Trade improved by 16 percent year-over-year in the third quarter and by 15 percent year-over-year in October 2018. Price of exports increased rapidly compared to price of imports. (Figure IV.3.6).

Although metal prices at the international market started declining since the second half of 2018[22], prices are still higher than the previous year. As of October 2018, the customs price of coal, copper concentrates, crude oil, and cashmere increased by 13, 12, 33 and 51 percent year-over-year, respectively. These favorable changes contributed to a 20 percent growth in the overall price of exports. In contrast to a declining copper price in the global market, the customs price of copper concentrate is increasing because of higher gold contents in Oyu Tolgoi copper concentrate.

Price of imports increased by 3.8 percent year-over-year, mainly triggered by the increase in import price of consumer goods, capital goods, and fuel.

Figure IV.3.4

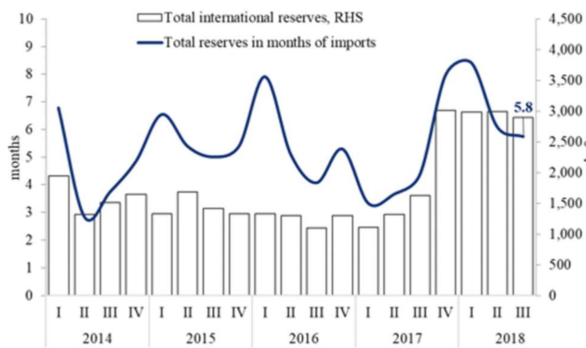
Financial account surplus narrowed year-over-year.



Source: Bank of Mongolia

Figure IV.3.5

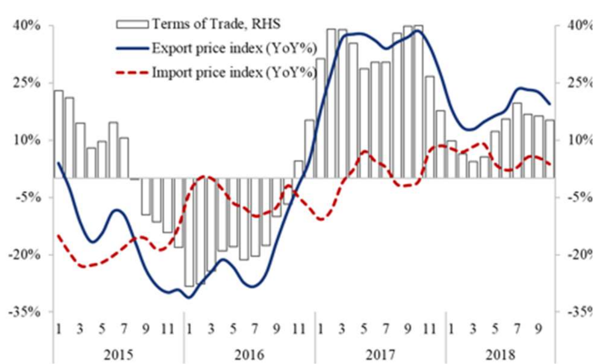
Gross international reserve is at a stable level.



Source: Bank of Mongolia

Figure IV.3.6

Terms of trade (TOT) improved.



Source: Bank of Mongolia, Customs Office

22 As of October 2018, prices of copper, gold and zinc declined by 8.6, 5.0, and 18 percent respectively.

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